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U.K. Supreme Court Considers the Correct Approach to the Three-Stage Test for the Application of the Illegality Defence Set Out in 'Patel v Mirza'

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On 30 October 2020, the Supreme Court handed down judgments in [Stoffel & Co v Grondona](#)¹ ("**Stoffel**") and [Henderson v Dorset Healthcare University NHS Foundation Trust](#)² ("**Henderson**"), both of which considered the three-stage test previously laid down in 2016 in the case of [Patel v Mirza](#)³ ("**Patel**") concerning the application of the illegality defence under English law (the "**Three-Stage Test**").

The Three-Stage Test represented a significant change in the law on illegality compared to the previous "**Reliance Test**" applied by the House of Lords more than 20 years earlier in [Tinsley v Milligan](#)⁴ (discussed further below). The Reliance Test determined that, if a claimant needed to rely on facts that disclosed an illegal act in order to prove their case, then the illegality defence would apply and the claim would be defeated.

The Three-Stage Test marked the move from a rule-based approach to a more pragmatic approach based on the balancing of public policy considerations.

However, as with all developments in the common law at appellate level, it has fallen to the lower courts to try and apply the new Three-Stage Test, while at the same time giving sufficient regard to the precedential value of numerous previous authorities in this area which, while not explicitly overruled by *Patel*, were decided by reference to the Reliance Test or much earlier. One of the most difficult questions for the lower courts has been whether to apply the Three-Stage Test in isolation, or whether to continue to take account of the factually analogous authorities that pre-date it.

Fortunately, the cases of *Stoffel* and *Henderson* have given the Supreme Court the opportunity to provide much needed guidance on both the application of the Three-Stage Test and the continuing precedential value of authorities that pre-date the *Patel* decision. The two judgments were given by similarly constituted courts (with the five Supreme Court justices who heard the case in *Stoffel* also forming part of the seven Supreme Court justices who heard *Henderson*) and the consistency in approach to the issues is evident. Both decisions were unanimous.

Bearing in mind an apparent increase in the use of the illegality defence in recent years and the likelihood of the defence being cited more frequently in future, not least owing to issues arising out of the current Covid-19 pandemic, these decisions bring some welcome clarity to what was a difficult area of the law to apply in practice.

Key takeaways:

1. The Three-Stage Test set out in *Patel* does *not* represent 'year zero' such that, in all future cases, it is only *Patel* that is to be applied. Prior decisions remain of precedential value unless it can be shown that they are not compatible with *Patel*.
2. It is neither necessary nor desirable for the relevant policy considerations considered under the Three-Stage Test to give rise to a mini-trial. They should usually be capable of being addressed as a matter of argument and at a level of generality that does not make adducing evidence on the point necessary. The court should not normally admit evidence on matters such as effectiveness of the criminal law or the likely social consequences of permitting a claim.
3. It will not be necessary in every case to complete an exhaustive examination of all stages of the test. If a clear conclusion emerges on examination of the relevant policy considerations at stages one and two that the defence should not be allowed, there will be no need to go on to consider proportionality under stage three.

Background

For many years, the leading authority in this area was the decision of the House of Lords in *Tinsley v Milligan* ("**Tinsley**"). In this case, the House of Lords found (by majority) that if a claimant needed to rely on facts which disclosed an illegal act in order to prove their case, then the illegality defence would apply and the claim would be defeated (the so-called Reliance Test). In establishing this principle, the court unanimously rejected any approach based on an "*affront to public conscience*" or any other test based on judicial discretion, noting that "*the real criticism of the present rules is not that they are unprincipled, but rather that they are indiscriminate in their effect, and are capable therefore of producing injustice*".

A number of later judgments of the lower courts were difficult to reconcile with the authority that *Tinsley* established. In addition, the decision was heavily criticised by the Law Commission in a report published in 2010⁵. Amongst other things, the Law Commission considered that *Tinsley*, and cases following it, exemplified the problems of arbitrariness, uncertainty and potential for injustice. In particular, the Reliance Test was deemed to be arbitrary, in that the question of whether the illegality defence applied depended not on the merits of the parties' respective cases, or the underlying policies for the illegality defence of maintaining coherence and public trust in the legal system, but on a procedural issue of whether a party needed to rely on an illegal act in order to advance its case. Moreover, the Law Commission felt that the effect of applying the Reliance Test gave rise to uncertainty because there was considerable confusion over what exactly amounted to "reliance". As a result, by the time the Supreme Court next came to consider the defence of illegality, it was already a topic that had fostered divergent views on the appropriate development of the law.

The Supreme Court was first given the opportunity to consider the application of the defence in the 2014 case of *Hounga v Allen*⁶ ("**Hounga**"), in which it considered whether public policy considerations merited applying the doctrine of illegality to the facts of the case. Mere months later, in *Les Laboratoires Servier and another v Apotex Inc*⁷ ("**Les Laboratoires Servier**"), a differently constituted Supreme Court affirmed the Reliance Test, overruling the Court of Appeal decision that had relied on an approach based on policy considerations similar to that set out in *Hounga*. *Les Laboratoires Servier* exposed a division in the highest court between those who considered Lord Sumption's reasoning in support of the Reliance Test to be correct, and those who agreed with Lord Toulson's opinion advocating a move to a policy based approach. The issue came before the Supreme

Court again in 2015, albeit only peripherally, in *Bilta (U.K.) Ltd (in liquidation) and others v Nazir and others (No 2)*⁸ where both Lord Toulson and Lord Sumption set out their respective positions on the development of the illegality defence in detail. Although the issue of illegality was not ultimately determinative of the case, the president of the Supreme Court at the time, Lord Neuberger, noted that “*the proper approach to the defence of illegality needs to be addressed by this court... as soon as appropriately possible*”⁹.

That opportunity came in *Patel*, where the majority of the Supreme Court favoured the adoption of a policy-based approach and departed from the Reliance Test espoused in *Tinsley*. Lord Toulson (for the majority) concluded that there were two main policy reasons for the defence of illegality: “[o]ne is that a person should not be allowed to profit from his own wrongdoing. The other, linked consideration is that the law should be coherent and not self-defeating, condoning illegality by giving with the left hand what it takes with the right hand.”¹⁰ He held that the court should consider whether allowing a claim to succeed that was in some way tainted by illegality would be contrary to the public interest, because it would be harmful to the integrity of the legal system. This question should be determined by the following “*trio of necessary considerations*”, which make up the Three-Stage Test:

1. first, considering the underlying purpose of the prohibition which has been transgressed and whether that purpose will be enhanced by denial of the claim;
2. second and conversely, considering any other relevant public policies which may be rendered ineffective, or less effective, by denial of the claim; and
3. third, keeping in mind the possibility of overkill if the law is not applied with a due sense of proportionality, such that it should be considered whether denial of the claim would be a proportionate response to the illegality.¹¹

For the purposes of this article, we shall refer to the three stages of this test as the First Limb, the Second Limb and the Third Limb respectively.

The adoption of the Three-Stage Test in *Patel* represented a significant shift in the law and it was not long before questions were raised at first instance as to the proper application of the new test and the relevance of case law decided before *Patel* but not expressly overruled by it. Four years later, two such cases have now made their way to the Supreme Court for consideration.

The decisions in *Stoffel and Henderson*

Stoffel

Facts and Issues for Determination

In 2002, Ms. Grondona obtained mortgage finance from Birmingham Midshires in the amount of £76,475 to purchase a leasehold from a business associate, Mr. Mitchell. The mortgage advance was procured by fraud, in that Ms. Grondona dishonestly misrepresented to Birmingham Midshires that the sale by Mr. Mitchell was not a sale between connected persons, the deposit moneys were from her own resources and that she was independently managing the property. The purpose of the fraud was to obtain finance for Mr. Mitchell that he would not otherwise have been able to raise. A firm of solicitors, Stoffel & Co, acted for Ms. Grondona, Mr. Mitchell, and for Birmingham Midshires in the transaction. They failed to register the sale at the Land Registry and failed to discharge the former charge on the property or register the new charge in favour of Birmingham Midshires.

Ms. Grondona ultimately defaulted on payments and Birmingham Midshires brought proceedings against her in 2006 for a money judgment. It was at this point that the errors by Stoffel & Co were discovered, and Ms. Grondona sought an indemnity or contribution equivalent to the amount remaining under the mortgage based on Stoffel & Co's negligence or breach of contract. Stoffel & Co admitted negligence but argued that damages were not recoverable by Ms. Grondona as the mortgage fraud entitled them to rely on the defence of illegality.

At first instance, the judge applied the Reliance Test as set out in *Tinsley*, as *Patel* had not yet been decided. The judge found that the illegality defence did not apply and Stoffel & Co appealed the decision.

By the time the case was heard in the Court of Appeal, the Supreme Court had handed down judgment in *Patel*, and so the court applied the new Three-Stage Test in accordance with that decision. The Court of Appeal rejected Stoffel & Co's appeal and concluded that, although mortgage fraud was a societal problem, barring the claim against the negligent solicitors would not enhance the fight against mortgage fraud and there was a countervailing public policy of ensuring that civil redress was available to clients of negligent solicitors. Further, to deny the claim would be disproportionate to the wrong involved.

Stoffel & Co sought permission to appeal to the Supreme Court on four grounds, one of which was granted: that the Court of Appeal erred fundamentally in its application of the Three-Stage Test to Stoffel & Co's illegality defence.

Judgment

The Supreme Court began by providing some general guidance for the application of the Three-Stage Test, noting that in the application of the First and Second Limbs, a court will be concerned to identify the relevant policy considerations at a high level of generality, before considering their application to the facts at hand. The court should not normally admit evidence on matters such as the effectiveness of the applicable criminal law or the likely societal consequences of permitting a claim. The essential question is whether allowing the claim would damage the integrity of the legal system, the answer to which depends on whether it would be inconsistent with the identified policies to which the legal system gives effect. In contrast, when considering the Third Limb, the court will need to closely scrutinise the case at hand to assess proportionality.

The Supreme Court went on to note that it will not be necessary in every case to complete an exhaustive examination of all three limbs of the test. If a clear conclusion emerges that the defence should not be allowed on examination of the relevant policy considerations under the First and Second Limbs, there will be no need to go on to consider the Third Limb (proportionality), as there will be no risk of disproportionate harm because the claimant's entitlement to the relief sought will not be barred by the defence.

On the facts of the *Stoffel* case, the Supreme Court found as follows:

1. For the purposes of the First Limb, there were two relevant public policies which pointed in favour of refusing relief to Ms. Grondona: (i) condemnation of mortgage fraud as a serious criminal offence; and (ii) the protection of the public (and in particular mortgagees) from loss. However, in this case, protection of the mortgagee (Birmingham Midshires) would actually necessitate allowing Ms. Grondona's claim against Stoffel & Co to proceed as this would afford them the opportunity to recover the sums that had been lent.

2. When considering the Second Limb, the Supreme Court identified the countervailing public policy that conveyancing solicitors should perform their duties diligently and without negligence and those who use their services should be entitled to civil remedies for loss arising out of a breach of those duties. In addition, given that it is now recognised that property can pass under an illegal contract, it would give rise to an inconsistency in the law if, on the one hand, the law recognised Ms. Grondona as equitable owner of the property but, on the other hand, denied her a remedy against the solicitors who failed to properly protect her interests in that property by filing the requisite forms at the Land Registry.
3. The court considered that the public policy considerations in permitting Ms. Grondona's claim against Stoffel & Co outweighed the public policy considerations in favour of denying the claim. Accordingly, there was no need to consider proportionality under the Third Limb of the test. However, the court nevertheless did go on to do so. The court considered that the lack of centrality of the mortgage fraud to Ms. Grondona's case against Stoffel & Co meant that it would be disproportionate to deny her a remedy: Stoffel & Co's negligence was conceptually entirely separate from the mortgage fraud committed against Birmingham Midshires.
4. Finally, the Supreme Court considered whether allowing Ms. Grondona's claim would be allowing her to profit from her own wrongdoing. The court noted that, although profiting from one's own wrong remained a relevant consideration, it is no longer the true focus of the enquiry. In any event, the court was not helping Ms. Grondona profit from the fraud, but to obtain relief for property rights lost by negligent solicitors.

Accordingly, the Supreme Court agreed with the Court of Appeal's application of the Three-Stage Test and held it was correct in its conclusion that the illegality should not bar Ms. Grondona's claim.

Henderson

Facts and Issues for Determination

Ms. Henderson stabbed her mother to death in 2010 whilst experiencing a severe psychotic episode. In view of the psychiatric evidence, a plea of manslaughter by reason of diminished responsibility was accepted by the court and Ms. Henderson was sentenced to a hospital order and unlimited restriction order under the Mental Health Act 1983. Dorset Healthcare University NHS Foundation Trust ("**Dorset NHS Trust**") admitted liability in negligence for failing to return Ms. Henderson to hospital on the basis of her psychotic state, acknowledging that the tragic killing of her mother would not have occurred had this been done. Ms. Henderson sought damages from Dorset NHS Trust and Dorset NHS Trust sought to rely on the doctrine of illegality to bar her claim.

Both the High Court and the Court of Appeal considered themselves bound by the House of Lords decision in *Gray v Thames Trains Ltd*¹², given that the facts were essentially identical. In that case, the claimant (Mr. Gray) was a passenger on a train involved in a major rail disaster, as a result of which he suffered from PTSD. Whilst suffering from that disorder, he killed a man and subsequently pleaded guilty to manslaughter on the grounds of diminished responsibility and was detained under the Mental Health Act 1983. Mr. Gray brought a claim in negligence against the train operator and company responsible for the rail infrastructure, who both admitted negligence, but argued that the illegality doctrine applied and precluded Mr. Gray's recovery. The House of Lords found against Mr. Gray.

As such, the question for the Supreme Court in *Henderson* was twofold: first, whether the decision in *Gray* could be distinguished and, second, if it could not be distinguished, whether it should be departed from in light of the decision in *Patel*.

In respect of the second issue, Ms. Henderson contended that *Gray* should be departed from on a number of grounds and, in particular, on the basis that: (i) the reasoning in *Gray* could no longer stand with the approach to illegality adopted in *Patel*; (ii) *Gray* should not apply where the claimant has no significant personal responsibility for the relevant criminal act and/or there is no penal element in the sentence imposed; and (iii) the application of the Three-Stage Test in *Patel* led to a different outcome to that in *Gray*.

Judgment

In relation to the first issue, the Supreme Court held that the reasoning in *Gray* could not be distinguished: it involved the same offence, the same sentence, and the reasoning of the majority in *Gray* applied regardless of personal responsibility for the offending.

In relation to the second issue, as to whether *Gray* should nevertheless be departed from, the Supreme Court held as follows:

- Sub-Issue (i): that the reasoning in *Gray* cannot stand with the approach to illegality adopted in *Patel*
 - The essential reasoning in *Gray* was consistent with the approach adopted in *Patel* and was not an example of the now discredited Reliance Test. The House of Lords in *Gray* considered the policy reasons for the rules and concluded they were justified as a matter of public policy. Moreover, in *Patel* itself, Lord Toulson observed that the decision in *Gray* was an example of a decision on illegality based on policy considerations rather than reliance. In addition, the fundamental policy consideration relied upon in *Gray* was the need for consistency so as to maintain the integrity of the legal system, which was considered in *Patel* to be the fundamental underlying question behind the illegality doctrine. As such, the reasoning given by the House of Lords in *Gray* was consistent with the approach adopted by the Supreme Court in *Patel* and there was no reason why it should be departed from.
- Sub-Issue (ii): *Gray* should not apply where the claimant has no significant personal responsibility for the criminal act and/or there is no penal element in the sentence imposed
 - Ms. Henderson’s case that there was no inconsistency between the civil and the criminal law in a case which the claimant had no significant personal responsibility for the criminal act was rejected. Although Ms. Henderson’s punishment contained no penal element and the judge at her criminal trial expressed that he considered her to bear no significant responsibility for the crime, it would nevertheless turn the criminal under criminal law into a victim under tort law if there was a civil right to reimbursement in cases such as this. To allow recovery would be to attribute responsibility for the criminal act not the convicted criminal but to the tortious defendant.

- Sub-Issue (iii): whether the application of the Three-Stage Test in *Patel* should lead to a different outcome
 - The Supreme Court began by considering a number of general issues that might arise in the proper understanding and application of the Three-Stage Test, namely:
 - a. It is neither necessary nor desirable for the relevant policy considerations to give rise to a mini-trial. They should usually be capable of being addressed as a matter of argument and at a level of generality that does not make adducing evidence on the point necessary.
 - b. The Three-Stage Test necessitates a balancing of considerations that arise under the First and Second Limbs, with the Third Limb relating to factors specific to the case, rather than general policy considerations.
 - c. Policies falling under the First Limb should not be limited to the specific purpose of the prohibition in issue, but will include general considerations, such as consistency of the law and integrity of the legal system. Similarly, relevant policy considerations would include someone profiting from his own wrong (linked to the need for consistency and coherence in the law), as well as the closeness of the connection between the claim and the illegal act (the closer the connection is, the greater and more obvious the inconsistency in the law would be if the claim was allowed). In this regard, Lord Toulson recognised in *Patel* the importance of the policy considerations that a person should not be allowed to profit from his own wrong and that the law should be coherent. Where either or both of these considerations are engaged, it would be appropriate to give them great weight.
 - d. Proportionality under the Third Limb does not always have to be considered. In some cases, it may be apparent that the balancing of policy considerations comes down firmly against denial of the claim and if so, it will not be necessary to go on to consider the issue of proportionality: "*In other words, they are a disproportionality check rather than a proportionality requirement*".¹³ Of the four factors Lord Toulson identified in *Patel* as likely to be of particular relevance in relation to proportionality (namely, the seriousness of the conduct, its centrality to the transaction, whether it was intentional, and whether there was marked disparity in the parties' respective culpability), the Supreme Court considered that centrality of the illegal conduct will often be a factor of particular importance.

The court then considered the application of the Three-Stage Test to the specific facts in Ms. Henderson's case.

The First Limb – relevant policy considerations

In relation to relevant policy considerations, the court held:

1. The consistency principle was engaged by the case and there was a need to avoid inconsistency so as to maintain the integrity of the legal system. In particular, there was a very close connection between Ms. Henderson's claim and the illegality, which emphasised the inconsistencies in the law that would be raised if her claim were to succeed.

2. Public confidence in the legal system was also engaged, and the gravity of the wrongdoing by Ms. Henderson heightened the significance of the public confidence considerations, as did the proper allocation of resources (i.e. NHS funding which is of significant public interest).
3. Specifically, there is an important purpose in deterring unlawful killing, as there is no more important right than the right to life, and a public interest in the condemnation of unlawful killing and the punishment of offenders. If there is some deterrent effect in a clear rule that unlawful killing never pays, any such effect is important.

The Second Limb – countervailing policy considerations

In relation to the countervailing policy considerations, the court held that:

1. While there is a policy of encouraging NHS bodies to care competently for the most vulnerable, and imposing a duty of care can enhance standards, it is unlikely that NHS staff or organisations need any encouragement to do their best to prevent their patients from killing people.
2. There is a policy of providing compensation to victims of torts where they are not responsible for their conduct and ensuring that public bodies pay compensation to those whom they have injured.
3. There is a policy of ensuring that defendants in criminal trials receive sentences proportionate to their offending (consistent with the purpose of avoiding giving back with one hand what has been taken away by the other).

The court recognised there was force in at least some of the policy considerations relied upon by Ms. Henderson but did not consider they outweighed those in support of the denial of the claim.

The Third Limb – proportionality

The court considered the four factors identified by Lord Toulson, as no additional factors were raised by the parties, as follows:

1. Seriousness of conduct – manslaughter is a very serious offence and Ms. Henderson knew what she was doing and that it was legally and morally wrong.
2. Centrality of the conduct – Ms. Henderson’s offence was central to the loss she was claiming and was the effective cause of such loss.
3. Whether the conduct was intentional – there was an intent on the part of Ms. Henderson to kill, even though there was no significant personal responsibility for it.
4. Disparity in the parties’ respective conduct – Ms. Henderson was convicted of manslaughter, whereas Dorset NHS Trust was negligent in Ms. Henderson’s treatment.

Accordingly, in all the circumstances, the denial of Ms. Henderson’s claim was not found to be disproportionate.

Further, the application of the Three-Stage Test did not lead to a different outcome than the application of *Gray*. Accordingly, the Supreme Court concluded that the decision in *Gray* should be “affirmed as ‘Patel compliant’ – it is how *Patel* ‘plays out in that particular type of case’”.¹⁴

Comment

The decisions in *Stoffel* and *Henderson* provide much needed clarity to the lower courts on both the application of the Three-Stage Test and the continuing precedential value of authorities which pre-date the decision in *Patel*.

The guidance around the application of the Three-Stage Test is particularly helpful with regard to how to approach an assessment of the policy considerations under the First and Second Limbs of the test, and also when a full assessment under the Third Limb (relating to proportionality) is required. With regard to the First and Second Limbs, it has been usefully clarified that these factors are to be considered at a high level of generality, without the need for evidence to be adduced on the facts. As a result, only proportionality under the Third Limb requires a specific analysis of the facts of any given case, and this Limb only needs to be considered where there is no clear determination arising from a consideration of the opposing policy factors under the First and Second Limbs.

In addition to the specific application of the Three-Stage Test, the court explicitly recognised that the Three-Stage Test was "*intended to provide guidance as to the proper approach to the illegality defence across civil law more generally...*" and that "*the approach set out... is expressed in general and unqualified terms.*"¹⁵ This is a useful indication as there had been some debate as to whether the approach outlined in *Patel* should be confined to the specific facts of that case (which related to a claim for unjust enrichment) or whether it was intended to espouse more general principles applicable to all cases concerning the illegality doctrine. This debate has now surely been disposed of.

Finally, in relation to the precedential value of prior authority, the Supreme Court stated that:

*...this does not mean that Patel represents 'year zero' and that in all future illegality cases it is Patel and only Patel that is to be considered and applied. That would be to disregard the value of precedent built up in various areas of the law to address particular factual situations giving rise to the illegality defence. Those decisions remain of precedential value unless it can be shown that they are not compatible with the approach set out in Patel in the sense that they cannot stand with the reasoning in Patel or were wrongly decided in light of that reasoning.*¹⁶

This should not come as a surprise to practitioners, given that this is generally the way that the common law operates. However, the approach in *Patel* was a sufficiently radical departure from prior authority on the illegality defence that the continuing applicability of these authorities had been questioned by some. It is now clear that, unless prior decisions cannot be reconciled with the approach in *Patel*, they will remain of precedential value and applicable to any analogous factual scenario that may arise.

Owing to the apparent uptick in the use of the illegality defence in commercial cases as a result of behaviours connected to the financial crisis of 2008 and subsequent economic stress, and those which will no doubt flow from the current Covid-19 pandemic, the clarification provided by the Supreme Court is both welcome and timely. Battling opponents and their advisers will no doubt wish to give careful consideration as to when illegality can be used as a shield or when their limbs might be vulnerable to attack.

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¹ [2020] UKSC 42

² [2020] UKSC 43

³ [2016] UKSC 42

⁴ [1994] 1 AC 340

⁵ See: *The Illegality Defence: A Consultative Report* (LCCP 189) (2009) and *The Illegality Defence* (Law Com 320) (2010)

⁶ [2014] 1 WLR 2889

⁷ [2014] UKSC 55

⁸ [2015] UKSC 23

⁹ *Ibid* at 12 C-D

¹⁰ [2016] UKSC 42 at para 99 per Lord Toulson

¹¹ *Ibid.* at paras 101 and 120

¹² [2009] AC 1339

¹³ [2020] UKSC 43 at para 123

¹⁴ *Ibid.* at para 145

¹⁵ [2020] UKSC 43 at para 76

¹⁶ *Ibid* at para 77

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