In Pari Delicto and *Ex Turpi Causa*: The Defence of Illegality – Approaches Taken in England and Wales, Canada and the US

Lincoln Caylor and Martin S Kenney*

The defence of illegality is grounded on the principle that a plaintiff should not be permitted to recover damages that arise from his or her own illegal or immoral conduct. This article considers the historical development of the illegality defence and its modern day application across three jurisdictions: Canada, the United States, and England and Wales. The application of the illegality defence in the context of facilitator liability is considered in order to highlight the similarities and inconsistencies across these jurisdictions. Despite having similar motivations for invoking the defence, courts in the US generally employ a more rigid approach to the defence of illegality, focusing almost exclusively on whether a wrongdoer will benefit from their wrongful conduct if the defence is not successfully invoked. In contrast, courts in Canada, and England and Wales are more flexible in their approach, which ultimately seeks to preserve the integrity of the justice system and often takes into account the impact that a successful application of the illegality defence will have on the 'true victim' of the wrongdoing.

* Martin Kenney is Managing Partner of Martin Kenney & Co, Solicitors. Lincoln Caylor is a Partner at Bennett Jones.

The defence of illegality finds its origin in the Latin maxim *ex turpi causa non oritur actio*, meaning 'no cause of action may be founded on an immoral or illegal act'.[1] Although often referred to as a singular doctrine, there are in fact two distinct lenses through which the illegality defence is interpreted and applied. The first, *ex turpi causa non oritur actio* ('from a dishonourable cause an action does not arise'), focuses on the illegality of the underlying act and holds that if one is engaged in illegal activity, one cannot sue another for damages that arose out of that doubtful activity. The second, *in pari delicto est conditio defendtis* ('of equal guilt or fault'), focuses on the allocation of fault between the parties and provides that in the case of mutual fault, the position of the defendant is the stronger one. These two perspectives serve as the starting point for the divergence in judicial application of this defence across jurisdictions, with Canada, and England and Wales approaching the analysis through the lens of *ex turpi causa*, and the US relying instead on *in pari delicto*.

Despite the different lens through which US courts consider the illegality defence, the basic motivation for applying the defence appears to be consistent across these three jurisdictions: a plaintiff should not be permitted to recover damages that arise from his or her own illegal or immoral conduct. However, when the illegality defence is applied in the context of liability claims against auditors, lawyers, banks or other third-party facilitators of fraud, the US clearly differs by emphasising, above all else, preventing a 'wrongdoer' from benefiting from its wrongful conduct despite the adverse consequences that such a view can yield for genuine underlying victims of fraud. By contrast, although courts in Canada, and England and Wales acknowledge this core premise underlying the illegality defence, these jurisdictions are much more open to taking into account the effect their decision will have on the real parties in interest who they deem to be the true victims of wrongdoing.

Early beginnings: English law

The earliest reported discussion of the concept of a defence or bar to recovery on the basis of the illegality of the claim appears in the English decision of *Everet v Williams*, also known as the *Highwayman's Case*.[2] In *Everet*, the plaintiff sued his partner, alleging that he had not received his share of the partnership's proceeds. The complaint referred only to the parties 'dealing for commodities with good success on Hounslow Heath,

1 *Revill v Newbery* [1996] QB 567 at 576, [1995] EWCA Civ 10 (Neill LJ).

2 *Williams v Everett* (1725) 104 ER 725 (*sub nom The Highwayman's Case* (1898) 9 LQR 197).

where they dealt with a gentleman for a gold watch'. Despite being vague on its face, the more sinister subtext of the complaint was apparent to the Court of Exchequer: the business in question was robbery and the claim amounted to a dispute between two highwaymen. The claim was dismissed and the lawyers were held in contempt of court. The parties themselves were arrested and later hanged. The court's abhorrence with the dispute was reflected in what is the first articulation of the public policy rationale underlying the illegality defence that continues to permeate judicial discussion of this principle today: wrongdoers do not deserve the protection of the court.

Later, in *Holman v Johnson*, Lord Mansfield articulated the illegality defence as being grounded in public policy[3] and stated that '[n]o court will lend its aid to a man who founds his cause of action upon an immoral or an illegal act'.[4] With these words, Lord Mansfield ushered in two centuries of case law grappling with the extent and effect of this maxim.

Modern evolution: England and Wales

The illegality defence began to receive renewed judicial scrutiny in the latter parts of the 20th century, beginning with the English Court of Appeal's decision in *Euro-Diam v Bathurst*.[5] In *Euro-Diam*, the Court of Appeal concluded that the defence of illegality should apply in circumstances where granting the requested relief would be viewed by the public as tacit approval of the underlying illegal conduct and therefore amount to 'an affront to the public conscience'.[6]

This position elicited a swift reaction from the House of Lords who unanimously rejected the idea of a public conscience test in *Tinsley v Milligan*.[7] Despite unanimity in rejecting the Court of Appeal's position, the House of Lords was split on the appropriate understanding of the illegality defence. The majority favoured a 'reliance test' whereby a party to an illegal act could recover a legal or equitable proprietary interest so long as the

3 *Holman v Johnson* (1775) 98 All ER 1120.

4 *Ibid* 1121.

5 *Euro-Diam v Bathurst* [1990] 1 QB 1, [1988] 1 Lloyd's Rep 228 (*Euro-Diam*).

6 *Ibid.*

7 *Tinsley v Milligan* [1993] UKHL 3, [1994] 1 AC 340. In this case, a woman, Tinsley, owned a house that she had shared with her companion, Milligan. The couple split up and Tinsley sought an order granting her sole possession of the home. Milligan had contributed to the purchase price of the home. When it was purchased, the title to the home was placed into Tinsley's name in furtherance of a scheme to claim social security benefits unlawfully. Milligan pleaded that it was the common intention that the property should belong to both of them such that she did not need to rely on any illegality to advance her claim. Her claim was not struck out for illegality as a result.

interest could be established without relying on his or her own illegality.[8] By contrast, the minority favoured a strict rule, which would have defeated any claim 'tainted' by the claimant's illegal purpose.

The reliance test was later interpreted, and somewhat tempered, by the Court of Appeal in *Cross v Kirby*.[9] In *Cross*, a protester was injured while attacking a man in an attempt to sabotage a hunt in England. The claimant argued that illegality would only preclude his claim if he was forced to plead, give evidence of, or rely on his own illegality. The Court of Appeal rejected such a strict interpretation of the reliance test and instead held that the correct question was whether the claimant's claim is so closely connected or inextricably linked with his own criminal or illegal conduct that the court could not permit him to recover without appearing to condone that conduct.[10]

In 2016, the Supreme Court of the United Kingdom had the opportunity to revisit the illegality defence in *Patel v Mirza*.[11] Patel had transferred sums totalling £620,000 to Mirza for the purpose of betting on the price of certain shares with the benefit of insider information. This insider information was never in fact obtained by Mirza and so the intended betting did not take place. Patel sought the return of his funds. Mirza refused. The agreement between Patel and Mirza amounted to a conspiracy to commit an offence of insider dealing under the Criminal Justice Act 1993. In order for Patel to establish his claim for the return of his money, it was necessary for him to explain the nature of the agreement. Therefore, an application of the reliance test would see Patel's claim fail. Nevertheless, the court concluded that Patel's claim was not barred by illegality since the insider trading never occurred and he was therefore not seeking to profit from the illegal activity.

In analysing the illegality defence, the Supreme Court noted two underlying policy rationales. First, the illegality defence prevents a person from profiting from his or her own wrongdoing. Second, the law must be coherent, not condoning illegality by giving with the left hand what it takes with the right. In determining the type of conduct that would produce such damage or inconsistency in the law, the court noted three considerations:

> 'In assessing whether the public interest would be harmed in that way, it is necessary a) to consider the underlying purpose of the prohibition which has been transgressed and whether that purpose will be enhanced by denial of the claim, b) to consider any other relevant public policy on which the denial of the claim may have an impact and c) to consider

8 *Ibid* 375.

9 *Cross v Kirkby* [2000] EWCA Civ 426 (*Cross*).

10 *Ibid.*

11 *Patel v Mirza* [2016] UKSC 42, [2016] 3 WLR 399.

> whether denial of the claim would be a proportionate response to the illegality, bearing in mind that punishment is a matter for the criminal courts. Within that framework, various factors may be relevant, but it would be a mistake to suggest that the court is free to decide a case in an undisciplined way.'

The Supreme Court noted that a 'range of factors' may be relevant when carrying out this assessment but that courts are not free to decide cases in an undisciplined way. Rather, a principled and transparent assessment of the relevant considerations in each case is required.

Canada: *ex turpi causa*

The application of the *ex turpi causa* doctrine has been strictly limited in Canada and will only apply where allowing a plaintiff's claim would introduce inconsistency into the fabric of the law. In *Hall v Herbert*,[12] the plaintiff was injured when, while under the influence of alcohol, he lost control of his friend's car and crashed. The plaintiff sued his friend for giving him permission to drive the car while drunk. The defendant car owner raised the defence of illegality, arguing that the plaintiff's illegal act of driving while under the influence of alcohol should bar his claim.

The Supreme Court ultimately held that the defence of illegality should be invoked sparingly, holding that '[i]ts use is justified where allowing the plaintiff's claim would introduce inconsistency into the fabric of the law, either by permitting the plaintiff to profit from an illegal act or wrongful act, or to evade a penalty prescribed by criminal law'.[13] Applying this principle to the facts of the case, the Supreme Court held that the plaintiff driver was not barred by the illegality defence since he was not seeking to recover illegal profit or gain but rather compensation for his personal injuries.

Following *Hall*, the Supreme Court of Canada had occasion to revisit the doctrine of illegality in the case of *British Columbia v Zastowny*.[14] In *Zastowny*, the Supreme Court confirmed that there is only one justification for the application of the illegality defence: the preservation of the integrity of the legal system. This justification comprises two complementary components. First, the court will not permit a person to profit from his or her wrongful conduct. Second, the court will not allow a person to evade a penalty prescribed by law. *Zastowny* dealt with the latter. The plaintiff, who was incarcerated, was sexually assaulted by a prison guard. In addition to seeking and being awarded general and aggravated damages, the plaintiff

12 *Hall v Hebert* [1993] 2 SCR 159.

13 *Ibid* para 25.

14 *British Columbia v Zastowny*, 2008 SCC 4 (*Zastowny*).

was awarded compensation for past and future lost wages. On appeal to the Supreme Court, recovery for past and future lost wages was denied. The Supreme Court held that to permit recovery on this ground would allow the plaintiff to be indemnified for the consequences of committing the illegal acts for which he was originally imprisoned. The Supreme Court reasoned that this was a situation where the integrity of the justice system would be compromised since the court would, in essence, be rewarding the plaintiff for conduct that it had previously punished.

In both England and Canada, there has been a great deal of inconsistency over the years in terms of the interpretation and application of the illegality doctrine. In both jurisdictions, courts have expressed dismay with the over-reliance on a simple maxim when faced with complex and variable facts. As stated by McLachlin J (as she then was) in *Hall*, and adopted by the UK Supreme Court in *Patel*, the statement that a plaintiff will not be allowed to profit from his or her own wrongdoing may have the undesirable effect of tempting judges to focus on whether the plaintiff is 'getting something' out of the wrongdoing, rather than considering whether allowing recovery would produce inconsistency in the law and cause damage to the integrity of the legal system.[15]

US*: in pari delicto*

In the US, the illegality defence has been considered through the lens of *in pari delicto*. The defence of *in pari delicto* operates in cases of mutual fault and provides that in such cases, the position of the defendant is the stronger one.[16] The doctrine prohibits one party from suing another where the plaintiff was 'an active, voluntary participant in the unlawful activity that is the subject of the suit'.[17] It has been further described as 'an affirmative defence that bars a wrongdoer from recovering against his alleged co-conspirators'.[18] The defence of *in pari delicto* thus applies where the defendant is also at fault and requires the court to engage in a balancing exercise.

In the US, the *in pari delicto* defence is governed by state law and is accordingly the subject of significant jurisdictional variation. One notable

15 *Hall*, 175–176; *Patel*, para 100.

16 Although the defence is the 'legal corollary of the equitable unclean hands doctrine', it differs from the unclean hands doctrine in that it applies only when 'the degrees of fault are essentially indistinguishable or the plaintiff's responsibility is clearly greater' see *McAdam v Dean Witter Reynolds Inc*, 896 F (2d) 750, 757 (3d Cir 1990).

17 *Pinter v Dahl*, 486 US 622 at 636 (1988).

18 *In re Michael Bogdan*, 414 F (3d) 507 at 514 (4th Cir 2005).

example of this variation between states is that some courts treat the defence as an affirmative defence and others treat it as a matter of standing.[19]

The *in pari delicto* defence has been said to serve two public policy purposes: (1) it deters illegality by denying judicial relief to an admitted wrongdoer; and (2) it avoids entangling courts in disputes between wrongdoers.[20] Although these policy goals are quite similar to those discussed in Canada and the UK, when the illegality defence is invoked in the context of third-party facilitator liability, the more fundamental differences in policy rationale among these jurisdictions become apparent.

Illegality defence in the context of third-party facilitator liability

The defence of illegality raises interesting issues when it is advanced by bankruptcy trustees or receivers on behalf of creditors or shareholders of a corporation whose management engaged in financial fraud that was allegedly either assisted or not detected by the corporation's outside professional advisers, such as auditors, investment bankers, financial advisers and lawyers. Both England and Canada appear to be converging on a principled approach, focused on identifying and compensating the 'true victim' of the wrongdoing. In these jurisdictions, the illegality defence has limited application in the context of third-party facilitator liability since courts view the defence as impeding the ability of the true victims of the wrongdoing from recovering their losses. By contrast, the US applies the illegality defence much more broadly in the context of facilitator liability, based on a strict interpretation of the concept of imputation of fault to a body corporate coupled with a strong focus on preventing a 'wrongdoer' from benefiting from their wrongful conduct.

The UK Supreme Court most recently considered the defence of *ex turpi causa* within the context of a directors' liability claim in *Jetivia SA v Bilta (UK)*.[21] Bilta was an English company that was compulsorily wound up in November 2009. Upon its winding up, Bilta had an outstanding value added tax (VAT) liability of approximately £38m. Bilta ultimately entered liquidation and its liquidators brought proceedings against the directors alleging a conspiracy to defraud Bilta and breach of fiduciary duties.

---

19 A detailed analysis of the issue of standing as applied to the illegality defence is beyond the scope of this article. The US perspective on the illegality defence will therefore only be considered in cases where US courts have approached it as an affirmative defence.

20 *Kirschner v KPMG LLP*, 938 NE 2d 941 at 464 (*Kirschner*).

21 *Jetivia SA and Another v Bilta (UK) Limited (in Liquidation) and Others* [2015] UKSC 23, [2016] AC 1 (*Jetivia*).

The liquidators alleged that the directors caused Bilta to engage in the fraudulent trading of carbon credits with various third parties, including Jetivia SA, a Swiss company. It was alleged that Bilta purchased carbon credits from Jetivia, free of VAT and then sold them back to UK companies registered for VAT at a slightly lower price, so that the UK company could make a profit through resale. The proceeds of sale (including VAT) received by Bilta were subsequently paid to other parties, including Jetivia, leaving Bilta insolvent and unable to meet its VAT liability. Jetivia and its chief executive officer were alleged to have dishonestly assisted in this fraud.

The defendants applied to strike out the claims on the grounds that *ex turpi causa* barred the action. The Supreme Court unanimously dismissed the defendant's application holding that where a company has been the victim of wrongdoing by its directors, the wrongdoing cannot be attributed to the company as a defence to a claim brought against the directors in the company's name by its liquidators.[22]

Canada: Livent

In Canada, the most recent case concerning the *ex turpi causa* defence is the Ontario Court of Appeal's decision in *Livent Inc v Deloitte & Touche* in January 2016.[23] Building on previous case law, the Court of Appeal's decision emphasises the continued although limited role of the *ex turpi causa* doctrine in Canada, holding that the doctrine's application ought to be limited to circumstances requiring the maintenance of the integrity of the Canadian justice system.

Livent arose as a result of the failure of Canadian-based entertainment business, Livent Inc ('Livent'). While Livent outwardly appeared to be a healthy and successful business, behind the scenes its finances were in disarray. The principals of Livent – Garth Drabinsky and Myron Gottlieb – had been fraudulently manipulating the company's books in order to inflate earnings and profitability. Doing so allowed Drabinsky and Gottlieb to attract significant funding through capital markets. The scam was revealed when new management was appointed. Soon after, Livent filed for insolvency protection in Canada and the US and was placed into receivership. Drabinsky and Gottlieb were ultimately criminally convicted of fraud and forgery, and imprisoned.

Deloitte & Touche ('Deloitte') was Livent's auditor. Notwithstanding the ongoing fraud being committed by Drabinsky and Gottlieb, Deloitte issued clean audited financial statements for nearly a decade. As a result,

22 *Ibid* para 7.

23 *Livent Inc (Receiver of) v Deloitte & Touche*, 2016 ONCA 11, 128 OR (3d) 225 (*Livent*).

following its collapse, Livent – through its receiver – commenced an action in Ontario against Deloitte. The action alleged that Deloitte was liable under the operative contract and in negligence as a result of Deloitte's failure to follow generally accepted auditing standards and discover the material misstatements in Livent's books.

In its defence, Deloitte argued that it should not be held responsible for the fraud committed by Livent. Its position was that knowledge of the misconduct of Drabinsky and Gottlieb must be attributed to Livent. On this basis, Deloitte argued that the doctrine of *ex turpi causa* applied, barring Livent from succeeding in its action. Following a 68-day trial, the Ontario Superior Court of Justice rejected Deloitte's arguments and found Deloitte liable. Deloitte subsequently appealed, setting the stage for the Ontario Court of Appeal to canvass, among other things, the doctrine of *ex turpi causa* and its application to insolvent companies in Canada.

When the illegality defence is invoked, courts must first consider whether the underlying immoral or illegal conduct is in fact attributable to the corporation. As the Court of Appeal in *Livent* explained, this is done by applying the corporate identification doctrine.

The leading Canadian case on corporate identification is *Canadian Dredge and Dock Company et al v R*.[24] In *Canadian Dredge*, the Supreme Court held that the doctrine of corporate identification is only engaged when the action taken by the directing mind:

1. was within the field of operation assigned to him;
2. was not totally in fraud of the corporation; and
3. was by design or result partly for the benefit of the company.[25]

In *Livent*, Deloitte argued that the identification doctrine was engaged such as to allow it to raise the defence of *ex turpi causa*. The Court of Appeal disagreed and concluded that the corporate identification doctrine must be 'tailored to the terms of the particular substantive rule it serves'.[26] In cases of third-party facilitator liability, this means that corporate identification must be assessed bearing in mind the broader goal of preserving the integrity of the justice system.

The Court of Appeal in *Livent* concluded that the *ex turpi causa defence* does not give the court discretion to withhold a civil remedy for damages merely because the plaintiff has engaged in misconduct. Rather, the corporate identification and *ex turpi causa* doctrines may only be applied where allowing a plaintiff's claim would introduce an inconsistency in the fabric of the law and compromise the integrity of the justice system. No such inconsistency

24 *Canadian Dredge and Dock Company et al v R* [1985] 1 SCR 662 (*Canadian Dredge*).

25 *Ibid* 714.

26 *Livent* para 157.

was present in this case. In fact, if Deloitte was allowed to invoke the defence successfully, innocent shareholders would be unjustifiably denied a remedy, while the auditors would be allowed to escape liability for the very fraud they should have detected.

The Court of Appeal's decision in *Livent* may not, however, represent a definitive formulation of the *ex turpi causa* defence in the context of auditors' liability to a corporation. The Supreme Court of Canada granted Deloitte leave to appeal the judgment of the Ontario Court of Appeal and the appeal was heard on 15 February 2017. The judgment of the Supreme Court remains under reserve.

US versus Canada

The US position has led to a line of jurisprudence that has generally dismissed claims against third-party advisers or facilitators brought by trustees in bankruptcy, or other parties standing in the shoes of a corporation harmed by fraud. This is because the doctrine of *in pari delicto* has been interpreted as applying broadly, even in difficult cases and is not 'weakened by exceptions'.[27] When this is coupled with the strict interpretation of the concept of imputation of wrongdoing by a corporate officer to the corporation that is applied by many US courts, *in pari delicto* becomes a powerful defence to an action in which a corporate plaintiff, or a party standing in its shoes, is considered to be equally responsible for the wrongdoing on which the claim is based. Imputation of wrongdoing to a corporation is somewhat tempered – to varying degrees depending on the state – by the adverse interest exception, which applies when an agent is found to have abandoned his principal's interest and is acting solely for his own or another's purpose.

The decision of the New York Court of Appeals in *Kirschner v KPMG LLP*,[28] with respect to the illegality defence in the context of facilitator liability, stands in stark contrast to the Ontario Court of Appeal's decision in *Livent*. In *Kirschner*, a litigation trust established following the bankruptcy of leading brokerage firm Refco brought a claim against Refco's auditor for aiding and abetting the fraud and failing to discover it. The Court of Appeal concluded that the *in pari delicto* defence applied to protect Refco's auditor from liability.

The Court of Appeals in *Kirschner* emphasised an extremely broad application of corporate imputation – corporations are presumed responsible for the acts of their authorised agents even if particular acts were unauthorised.[29] Further, the adverse interest exception to imputation is extremely narrow and is limited

27 *Kirschner* at 464.
28 *Ibid.*
29 *Kirschner* at 465.

to rare cases where a corporate executive's misconduct benefits only himself or a third party. This can be contrasted with the Canadian approach, under which the issue of corporate identification is not fully divorced from the overall *ex turpi causa* analysis. In Canada, corporate identification must be considered in the context of the underlying goal of the *ex turpi causa* defence – preserving the integrity of the justice system. In *Livent*, the Court of Appeal concluded that shareholders or creditors would be unjustifiably denied a remedy if corporate identification allowed for the *ex turpi causa* defence to be successfully invoked.

With respect to the overall policy goal driving the illegality defence, the New York Court of Appeals in *Kirschner* rejected the need to protect the innocent shareholders of the corporation as a relevant consideration. Justice Read explained that doing so would create a double standard by allowing the interests of innocent stakeholders of corporate fraudsters to trump those of innocent stakeholders of the outside professionals who are the defendants in these cases.[30]

The Ontario Court of Appeal did not consider the US perspective in its reasons for decision in *Livent*. However, on appeal before the Supreme Court of Canada, Deloitte has made explicit reference to *Kirschner* in its submissions.[31] It remains to be seen what, if any, weight the Supreme Court will give to the US approach to the illegality defence or whether it will definitively confirm the divergence in policy perspectives between these two jurisdictions.

30 *Kirschner* at 475.

31 Factum of the Appellant, Deloitte LLP submitted to the Supreme Court of Canada at para 145.