

The Law Commission

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THE ILLEGALITY DEFENCE

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THE LAW COMMISSION

The Law Commission was set up by the Law Commissions Act 1965 for the purpose of promoting the reform of the law.

The Law Commissioners are:

The Right Honourable Lord Justice Munby, *Chairman*
Professor Elizabeth Cooke
Mr David Hertzell
Professor Jeremy Horder
Miss Frances Patterson QC

The Chief Executive of the Law Commission is Mr Mark Ormerod CB.

The Law Commission is located at Steel House, 11 Tothill Street, London SW1H 9LJ.

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THE LAW COMMISSION
THE ILLEGALITY DEFENCE
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SUMMARY

WHAT IS THE ILLEGALITY DEFENCE?

- 1.1 Where people are involved in illegal conduct, the State may prosecute, or confiscate or recover assets. This report is not concerned with issues of criminal law or with confiscating or recovering the proceeds of crime. It deals with an ancillary issue: where claimants are involved in some form of illegal conduct, how far should this prevent them from enforcing their normal legal rights?
- 1.2 The illegality defence arises when the defendant in a private law action argues that the claimant should not be entitled to their normal rights or remedies because they have been involved in illegal conduct which is linked to the claim. If the courts accept the illegality defence, it often involves granting an unjustified windfall to the defendant, who may be equally implicated in the illegality. However, if the courts refuse, they may be seen to be helping a claimant who has behaved illegally.
- 1.3 The courts have attempted to set out rules to govern this area. However, the rules are complex and confused. This is because of the breadth of circumstances in which the issue arises. It may arise in many different areas of law, including contract, tort, unjust enrichment, property rights or trusts law. It may involve a wide variety of illegal behaviour, from parking offences to serious crime. The conduct may be integrally linked to the claim (as where a contract is to carry out a crime); or it may be just one of many background facts (as where a speed limit is broken in the performance of a contract). The consequences may be borne by the wrongdoer personally, or by a third party (such as the wrongdoer's creditors).
- 1.4 We have reached the conclusion that it is not possible to lay down strict rules about when the illegality defence should apply. Instead, the courts should consider the policy rationales that underlie the defence and apply them to the facts of the case. On the one hand, the courts should attempt to do justice between the parties, enforcing the rights set down by law. On the other hand, the courts must not permit a claimant to profit from a wrong. They should deter illegal conduct and not allow the legal system to be abused by criminals.

OUR REVIEW

- 1.5 This final report concludes a long-running review of the illegality defence, which has considered how the defence applies to the law of contract, unjust enrichment, tort and trusts.¹

¹ See *Illegal Transactions: The Effect of Illegality on Contracts and Trusts Law* (1999) Consultation Paper No 154; and *The Illegality Defence in Tort* (2001) Law Commission Consultation Paper No 160.

- 1.6 In our 2009 consultative report we argued that in most areas of law, the courts could make the law clearer, more certain and less arbitrary simply by explaining the policy reasons that underlie their decisions.² In contract, tort and unjust enrichment cases, we thought that the courts were usually applying the illegality doctrine in a fair way to reach the right policy outcome. We said that it was open to the courts to develop the law by explaining their reasoning in policy terms.
- 1.7 In the area of trusts, however, we thought there was a need for legislative reform. We provisionally recommended that the courts should be given a statutory discretion to decide the effect of illegality on trusts in at least some cases.
- 1.8 Our final recommendations follow the provisional recommendations in our 2009 consultative report. The recent case law shows that the courts have become more open in explaining the policy reasons behind the illegality defence. Therefore, in most areas of law, we think that the illegality defence should be left to developments in the common law.
- 1.9 However, for trusts law we think that there is a need for a short, targeted Bill. This report therefore includes a draft Bill to be laid before Parliament.
- 1.10 Given the width of the subject, we have kept this final report fairly short. Those looking for a full account of the law should read our 2009 consultative report. Those interested in the social effects of our draft Bill should turn to the impact assessment at the back of this report.

DEVELOPMENTS IN CONTRACT AND TORT LAW

- 1.11 Since January 2009, the House of Lords has heard two cases involving the illegality defence. As we explain in Part 3, they show that the law is developing in the way we hoped.
- 1.12 The first, *Gray v Thames Trains*,³ looked at the illegality defence in tort. The judges rejected the mechanical use of a formal test, such as whether a party must “rely” on the illegality. As Lord Hoffmann explained, the illegality defence is based upon a group of policy reasons, which vary in different situations. In each case, the policy reasons must be considered against the facts of the case to reach a fair outcome.
- 1.13 The second case, *Stone & Rolls v Moore Stephens*,⁴ concerned the illegality defence in both tort and contract. Again, Lord Phillips stressed that it is necessary to look at the policy underlying the illegality defence.
- 1.14 Two subsequent High Court decisions, *Nayyar v Denton Wilde Sapte*⁵ and *K/S Lincoln v CB Richard Ellis Hotels Ltd*,⁶ have applied this reasoning. They seem to indicate that incremental change is taking place, as we hoped.

² The Illegality Defence (2009), Consultation Paper No 189.

³ [2008] EWCA Civ 713, [2009] 2 WLR 351.

⁴ [2008] EWCA Civ 644, [2008] 3 WLR 1146.

⁵ [2009] EWHC 3218.

⁶ [2009] EWHC 2344.

THE ILLEGALITY DEFENCE IN TRUSTS

Background

- 1.15 Calls for law reform arose out of the 1994 House of Lords' decision, *Tinsley v Milligan*.⁷ Here a lesbian couple bought a house together using joint money. However, they registered it in the name of only one of them so that the other could claim social security benefits to which she was not entitled.
- 1.16 When the couple fell out, the registered owner (Ms Tinsley) sought to evict her former partner (Ms Milligan) from the house. Ms Milligan counterclaimed, on the basis that she had contributed half of the purchase money, and was therefore entitled to half the house. In legal terms, she argued that she was entitled to a beneficial interest under a "resulting trust". Ms Tinsley countered that Ms Milligan was not entitled to ask the court to help her enforce the trust because she had behaved illegally.
- 1.17 The House of Lords held that the so-called "reliance principle" applied: Ms Milligan won, because she could prove her interest in the property without needing to "rely" on her illegal conduct. The outcome of the case depended on the legal starting point or "presumption" applied by trust law. In this case, once Ms Milligan had shown that she contributed towards the purchase price, the law "presumed" a resulting trust.
- 1.18 However, if the relationship had been different, the courts may have been forced to reach the opposite conclusion. For example, if a father had given money to a daughter, the "presumption of advancement" would apply. This archaic and discriminatory 19th century rule presumes that if a man gives money to his fiancée, wife or children, he intends to make a gift. The "reliance principle" means that a father could not rely on evidence of his true intention to keep ownership of the property where this was based on an illegal motive. However, a mother in the same circumstances would be given her property back.

Problems with the law

- 1.19 In *Tinsley v Milligan*, the court was clearly reluctant to deprive Ms Milligan of her interest. As Lord Goff pointed out, it seemed harsh to deprive her of her life savings for a relatively minor fraud. Equally, it seemed wrong to give an unjustified windfall to Ms Tinsley who was implicated in the same fraud. Thus in standard cases, the courts tend to ignore the effect of any illegality.
- 1.20 However, two criticisms are made of this:
- (1) In some cases the courts may be required to enforce the trusts, despite very serious illegality.
 - (2) In a few arbitrary cases, the claimant trying to enforce a beneficial interest will lose, even though the illegality is minor. The result depends not on the merits of the case, but on obscure legal presumptions, which are often outdated and may be discriminatory. Under human rights law, if people are to be deprived of valuable property rights, the law should be clear, proportionate, and justifiable.

- 1.21 There are other uncertainties. For example, in some cases, claimants are allowed their money back if they withdraw from the trust arrangement before the illegal purpose has been carried out. However, the scope of this is unclear.

Abolishing the presumption of advancement

- 1.22 In 2006, we considered whether the law could be made fairer simply by abolishing the presumption of advancement. However, we concluded that this would not solve all the problems.
- 1.23 In 2007 a House of Lords decision, *Stack v Dowden*,⁸ introduced further uncertainty into the law. The case appears to overturn the presumption that property is held on trust in the proportions to which the parties contributed towards the purchase money. Instead, in cases involving a family home, the starting point is that the property is owned by the registered owner. The non-owner is therefore required to produce evidence that the parties intended this to be different, so as to prove a “constructive trust”.
- 1.24 It is difficult to tell what effect this will have where cohabitants have placed the property in one of their names for an illegal purpose. It seems that the claimant may lead some evidence of a common intention to own property jointly, but not the most direct evidence, if this is associated with the illegality. As a result, the law is uncertain and complex, and is likely to lead to arbitrary results. Some claimants will win and some will lose, depending on how far any given conversation or action reveals the illegal intention of the parties.

The social context of trust disputes

- 1.25 In *Tinsley v Milligan* the issue arose in the context of the breakdown of a cohabiting relationship. Cohabitants are the group most likely to be affected by our recommendations.
- 1.26 In the case of married couples or civil partners, the court has a general discretion to transfer property as it thinks is fair. It does not have this discretion for cohabitants. Instead, unmarried couples are forced to rely on the complexities of trust law. In our impact assessment, we estimate that around 450,000 couples in England and Wales buy property together but place the property into the sole name of one partner. In the event of the dispute, it is then up to the party who is not the registered owner to argue that they have a beneficial interest. This may be on the basis of their contribution to the purchase price (a resulting trust) or a common intention to own the property together (a constructive trust).
- 1.27 However, disputes over trusts of this sort also arise in other contexts, whenever family members, friends or business partners own property together.

⁷ [1994] 1 AC 340.

⁸ [2007] UKHL 17, [2007] 2 AC 432.

- 1.28 There is wide potential for constructive or resulting trusts to raise issues of illegality, although the actual number of cases taken to court each year is low. The parties may attempt to hide assets from creditors, or potential creditors, or from an ex-spouse. People may also use trust arrangements to evade tax or to claim state benefits to which they are not entitled.

Our recommendations

- 1.29 This report includes a seven-clause draft Bill to reform the law on illegality in trusts. This is a limited, targeted reform. The Bill would apply where a trust has been created or continued to conceal the beneficiary's interest for a criminal purpose. These are the circumstances in which it is easiest to abuse the trust mechanism.
- 1.30 We recommend that in most cases a beneficiary would be able to rely on their normal legal rights. However, in "exceptional circumstances" the court would have a discretion to deny the beneficiary their normal right to enforce the trust.
- 1.31 The draft Bill sets out a list of factors that the courts may take into account, including the conduct of the parties; the value of the interest at stake; whether refusing the claim would act as a deterrent; and the interests of third parties.
- 1.32 Where the court decides that the beneficiary should not receive the property, the court will then have to decide to whom the interest belongs. In a simple case, involving a claimant beneficial owner and a defendant legal owner, we recommend that the beneficial interest should be transferred to the legal owner. In more complex cases we recommend that the court should be given a power to decide whether the property should belong to the trustee, the settlor or another beneficiary under the trust.
- 1.33 It is important that the draft Bill should not prejudice the powers of the State to confiscate the proceeds of crime. The draft Bill therefore includes a small amendment to the Proceeds of Crime Act 2002. This is designed to ensure that even if the court exercises its discretion to allow a trustee or other party to keep the property, the property can still be recovered by the State.

THE LAW COMMISSION

THE ILLEGALITY DEFENCE

To the Right Honourable Jack Straw MP, Lord Chancellor and Secretary of State for Justice

PART 1 INTRODUCTION

WHAT IS THE ILLEGALITY DEFENCE?

- 1.1 In this report we consider what happens when the claimant in a civil action has been involved in criminal activity that is in some way connected to the claim. In such cases the defendant may argue that the claim should not succeed because of the claimant's criminal conduct or intentions. This argument, known as "the illegality defence", can be raised in relation to a wide variety of cases. One example is where an employee seeks compensation for unfair dismissal and the employer argues that the claim should not be allowed because the employee has accepted wages "cash in hand" rather than through the PAYE system.¹ Another example is where a claimant seeks damages for personal injury inflicted by the defendant and the defendant argues that the claim should be denied because the claimant was committing an offence at the time the injury occurred.²

THE MAIN PROBLEMS WITH THE PRESENT LAW

- 1.2 This area of law purports to be governed by strict rules, which often appear arbitrary. Very early on, the case law established that the illegality doctrine is not there to find a just resolution to the dispute between the claimant and the defendant; rather it is based on "general principles of policy" that might arbitrarily apply to the advantage of the defendant.³ As the Chancery Bar Association noted in its response to our 2009 consultative report, "the result is a forensic lottery depending on the accidents of litigation or the manoeuvrings of the parties".
- 1.3 Yet illegality may affect a civil claim in numerous ways. The illegality may be deliberate and serious, or it may be accidental and technical in nature. It may be inextricably linked to the circumstances that give rise to the claim, or it may be fairly incidental. The parties may be equally guilty, or one may be more responsible than the other. To date, the common law rules have found it difficult to cope with such a variety of circumstances.

¹ In *Hall v Woolston Hall Leisure* [2001] 1 WLR 225 the Court of Appeal reviewed the case law on the unlawful performance of employment contracts.

² For example, *Cross v Kirkby* *The Times*, 5 April 2000. The claimant, a hunt saboteur, attacked the defendant with a baseball bat. The defendant wrestled the bat from him and, in the ensuing fracas, hit him with considerable force.

³ Many cases refer back to a defining statement made by Lord Mansfield in *Holman v Johnson* (1775) 1 Cowp 341, 343; 98 ER 1120, 1121: "The objection, that a contract is immoral or illegal as between plaintiff and defendant, sounds at all times very ill in the mouth of the defendant. It is not for his sake, however, that the objection is ever allowed; but it is founded in general principles of policy, which the defendant has the advantage of, contrary to the real justice, as between him and the plaintiff".

- 1.4 In several areas of the law, such as the protection of legal and equitable property rights, the illegality doctrine has been interpreted as essentially a question of procedure. The issue is governed by the so-called “reliance principle”. If the claimant needs to “rely on” or bring evidence relating to the illegality in order to prove his or her claim, then the claim will fail. However, if the claimant can make out the case without relying on such evidence, then regardless of the substantive involvement of any serious illegality, the claim can succeed.
- 1.5 In order to avoid reaching unjust results, the courts have developed various exceptions to the basic principle. We described these in detail in our 2009 consultative report. The result is a body of case law that is complicated and uncertain and which lacks transparency.
- 1.6 We think that, in most areas of law, legislative intervention is not required to solve these problems. It is open to the courts to make the law more transparent and less apparently arbitrary by doing more to articulate the policy rationales that underlie their decisions.
- 1.7 However, in the area of trusts, we have concluded that legislation is required. Here the reliance principle is deeply embedded. It produces complex and arbitrary results, depending on the detailed intricacies of trust law.

PREVIOUS CONSULTATION PAPERS

- 1.8 We have already published three papers in relation to the illegality defence. In 1999 we published our first consultation paper, *Illegal Transactions: The Effect of Illegality on Contracts and Trusts*⁴ (“CP 154”). In 2001 we published our second consultation paper, *The Illegality Defence in Tort*⁵ (“CP 160”).
- 1.9 In all areas we provisionally proposed legislative reform to give the courts a statutory discretion to decide whether the illegality defence should succeed. The discretion would have been structured to point the court towards the factors that it should take into account. These included the seriousness of the illegality involved, the deterrent effect of any decision, and whether allowing the claim would further or hinder the illegal purpose involved. Our provisional proposals were generally well received by those who responded to the papers.⁶ However, a minority gave us detailed critical and persuasive comments that ultimately led us to revise our views as to the best method of reform in relation to claims outside the trusts area.

⁴ Law Commission Consultation Paper No 154.

⁵ Law Commission Consultation Paper No 160.

⁶ We received nearly 100 responses in total from academics, solicitors, barristers and judges, and from various institutions and organisations.

- 1.10 In January 2009 we published a consultative report, *The Illegality Defence*⁷ (“CP 189”). In this paper we outlined our new provisional recommendations in relation to the illegality defence as it applies in contract, tort and unjust enrichment. It is unusual for the Law Commission to publish a further consultation paper before reaching its final recommendations. However, this project has proved to be difficult and we felt that we should consult further, given the length of time since the publication of our original consultation papers and the new non-statutory approach that we were considering.
- 1.11 In our 2009 consultative report we provisionally recommended that the illegality defence did not need legislative reform as it applied to claims for breach of contract, unjust enrichment, tort or legal property rights. In all these areas we recommended that any improvements which were needed would be better made through case law developments. We explained that there were two main reasons for our change in thinking. First, we found that it was difficult to draft a broad statutory scheme without introducing new uncertainties into the law. These problems could probably have been resolved. However, secondly and more importantly, developments in the case law and the critical responses that we received to the two consultation papers led us to conclude that it was open to the courts to develop the law in ways that would render it considerably clearer, more certain and less arbitrary.⁸
- 1.12 We also published the consultative report in the knowledge that the House of Lords would imminently have the opportunity to consider the illegality defence in two cases that were due for hearing in early 2009, *Stone & Rolls v Moore Stephens*⁹ and *Gray v Thames Trains*.¹⁰ These two cases provided their Lordships with an opportunity to consider the illegality defence in tort and contract for the first time in many years. We hoped that they might find the research and consultation that we had undertaken useful in their deliberations.
- 1.13 We consider the judgments of the House of Lords in more detail in Part 3. In deciding whether the illegality defence should succeed, their Lordships looked at the policy reasons that lay behind the existence of the defence in order to determine whether those policies applied to the facts. This is exactly the approach we suggested would be most helpful.

⁷ Law Commission Consultation Paper No 189.

⁸ CP 189, paras 1.12 to 1.15.

⁹ The Court of Appeal judgment is at [2008] EWCA Civ 644, [2008] 3 WLR 1146.

¹⁰ The Court of Appeal judgment is at [2008] EWCA Civ 73, [2009] 2 WLR 351.

- 1.14 However, there was one area where the consultative report did provisionally recommend legislative reform. This was in relation to the illegality defence as it applies to trusts. Here, there is a House of Lords' decision, *Tinsley v Milligan*,¹¹ which lays down the exact way in which the illegality defence should operate where the claimant is seeking to enforce an equitable interest under a trust. The ramifications of this decision have been much criticised, but lower courts are of course bound by it. We therefore provisionally recommended legislative reform in the area of trusts to give the courts a discretion to determine whether the illegality defence should succeed in such cases.

RESPONSES TO THE CONSULTATIVE REPORT

- 1.15 We received 21 responses to our 2009 consultative report. Nearly everyone who commented in relation to trusts agreed that legislative reform of the illegality defence was necessary for the reasons that we identified. The majority agreed that such reform should be by way of a statutory discretion, although a number pointed out that it would be difficult to draft and could lead to unwelcome uncertainty. As discussed in Part 2, our draft Bill is limited in its scope. It would only apply where a trust has been created or continued to conceal the beneficiary's interest for a criminal purpose. Furthermore, the court would only have a power to prevent enforcement in exceptional circumstances, bearing in mind the factors set out in the Bill. These limitations are designed to address the concerns raised.
- 1.16 There was less consensus in other areas. Opinion was divided over whether developments outside the trusts area were best left to the common law or whether statutory reform was preferable. While a majority supported our recommendation that the common law should be left to develop in these areas, a few respondents thought that this approach would not go far enough. In particular, they argued for the introduction of a partial illegality defence with proportionate remedies, rather than the "all or nothing" present approach. This was an approach which we considered, but did not favour, in our 1999 consultation paper. It was not supported by many consultees, who agreed with us that it would result in too much uncertainty and "palm tree" justice.

SUMMARY OF OUR FINAL RECOMMENDATIONS

- 1.17 We recommend that legislative reform is needed to provide the courts with a discretion to decide the effect of illegality on a limited class of trust. The statutory discretion should apply when the trust arrangement is created in order to conceal the beneficiary's interest in the trust property in connection with a criminal purpose.
- 1.18 We recommend that no legislative reform is needed in relation to the illegality defence as it applies to claims other than those arising under a trust.

¹¹ [1994] 1 AC 340.

THE NEED FOR LEGISLATION ON ILLEGALITY IN TRUSTS

- 1.19 This report includes a short, targeted seven-clause draft Bill to reform the law on illegality in trusts. We hope this will make the law clearer, fairer and more transparent, and discourage the use of trusts to commit fraud or other crimes. If the law is to deprive a claimant of valuable property because of illegal conduct, it is particularly important that the law is clear from the outset, proportionate, and justifiable. The deprivation must be shown to be for relevant and sufficient reasons.

The social significance of trust disputes

- 1.20 The issue of illegal trusts typically arises between cohabiting couples who own a home. As we explain in the accompanying impact assessment, it is common for cohabitants to buy a home together but place the property into the sole name of one partner. We estimate that there are over 450,000 couples in England and Wales in that position.
- 1.21 If the relationship breaks down, the court has no general discretion to transfer property, as it does on divorce or on the breakup of a civil partnership. Instead, any property disputes are treated as matters of trust law. Where the property is in the name of only one partner, the other party may claim a beneficial interest in the home on the grounds that there was a common intention to own the home jointly, or that he or she made a contribution towards the purchase price or mortgage payments. Even where the house is jointly owned, it is possible for the parties to use the mechanism of a resulting trust to argue that the shares in the home should not be divided equally.
- 1.22 However, disputes over constructive or resulting trusts are not confined to cohabitants. Research shows that they may arise in the context of any family relationship, or where business partners or friends own property together.¹²
- 1.23 There is wide potential for constructive or resulting trusts to be used for a criminal purpose. The parties may attempt to hide assets from creditors or potential creditors, or from an ex-spouse. For example, one partner may put property in the other partner's name because they are engaged in a risky business venture and are concerned about possible bankruptcy. People may also attempt to evade tax or claim state benefits to which they are not entitled. A parent, for example, may put property in the name of their child to evade inheritance tax, even though the parent intends that the child should give the property back if the parent needs it.¹³

¹² T Goriely and P Das Gupta, *Breaking the Code: the impact of legal aid reforms on general civil litigation* (2001), Institute of Advanced Legal Studies.

¹³ At one stage, there was some doubt about whether all these purposes amounted to crimes. However, the law has been strengthened and simplified by the Fraud Act 2006, and we think all these examples would amount to a criminal offence. Under section 3, for example, it is an offence to dishonestly fail to disclose information which you are under a legal duty to disclose, if you intend to cause a gain for yourself or loss to another. This would cover a case in which a man dishonestly concealed assets from an ex-wife.

1.24 In the impact assessment we explain that the number of trust disputes taken to court is low. Research shows that cohabitants are often ignorant of the law, confused by legal terminology and fearful of legal costs.¹⁴ Despite the potential significance of illegality in trusts, only a few cases are brought to court each year.

Problems with the law

1.25 In 1994, the House of Lords established that a claimant could enforce an illegal trust, provided that the claimant was not required to rely on their own illegal behaviour.¹⁵ In most cases the law presumed that the property was held on trust in the proportions to which the parties had contributed towards the purchase money. Thus a claimant only needed to show a contribution towards the purchase price. At this point, the law would presume that the claimant had an enforceable interest, and the claimant would not need to rely on an illegal motive. This meant that in most cases the courts would effectively ignore illegal behaviour, though there were a few arbitrary exceptions to this rule.

1.26 The law was subject to two criticisms:

(1) In some cases the courts were required to enforce the trusts, despite serious criminality. In 1994, Lord Goff highlighted that the protection given to minor fraudsters would also protect terrorists or armed robbers. He therefore called for the Law Commission to review the law.¹⁶

(2) In a few arbitrary cases, the trust was not enforced and the claimant lost, even though the illegality was minor. The most obvious example was when a man gave property to his son or daughter. Here the courts applied the archaic and discriminatory “presumption of advancement”. The law did not allow him to lead evidence of his true (but illegal) intention, namely that the money should be handed back once the creditors had been defeated.

1.27 In 2006, we considered whether this second problem would be solved simply by abolishing the presumption of advancement.¹⁷ However, in 2007, the House of Lords introduced further uncertainty into the law. The case of *Stack v Dowden* appears to overturn the presumption that property is held on trust in the proportions to which the parties contributed towards the purchase money.¹⁸ Instead, in cases involving a family home, the starting point appears to be that the property is owned by the registered owner. The non-owner is therefore required to produce evidence that the parties intended this to be different.

¹⁴ G Douglas, J Pearce and H Woodward, “A Failure of Trust: Resolving Property Disputes on Cohabitation Breakdown” (2007); study conducted jointly by Cardiff University and the University of Bristol.

¹⁵ *Tinsley v Milligan* [1994] 1 AC 340.

¹⁶ Above, at 362.

¹⁷ See short paper, The Presumption of Advancement: does it have any effect in practice? December 2006, available at <http://www.lawcom.gov.uk/illegal.htm>.

¹⁸ [2007] UKHL 17, [2007] 2 AC 432.

- 1.28 The implications of *Stack v Dowden* for the illegality defence are unclear. In our 2009 consultative report we considered its effect where cohabitants intend to own property jointly, but have placed it in one person's name for an illegal purpose, for example to conceal it from an ex-spouse. It seems that the claimant may lead some evidence of a common intention, but not the most direct evidence, which reveals the true reason behind the parties' actions. The law is uncertain and complex, and may lead to arbitrary results.

The new statutory discretion

- 1.29 In a trust, the person who does not appear to be the legal owner of property may claim the benefits of ownership. The trust mechanism therefore provides a vehicle for fraudulent behaviour because it offers a unique opportunity to conceal the true ownership of the property for criminal purposes. It is therefore important that the law should be seen to deter those who may take advantage of this opportunity.
- 1.30 Our draft Bill would apply where a trust has been created or continued to conceal the beneficiary's interest for a criminal purpose. We recommend that in most cases a beneficiary would be able to rely on their normal legal rights. However, in "exceptional circumstances" the court would have discretion to deny the beneficiary their normal right to enforce the trust, bearing in mind the factors set out in the Bill.

OUTLINE OF THIS REPORT

- 1.31 The report is divided into a further three parts:
- (1) Part 2 contains our recommendations in relation to the illegality defence as it applies to claims arising under a trust.
 - (2) Part 3 contains our recommendations in relation to the illegality defence as it applies to claims other than those arising under a trust.
 - (3) Part 4 contains a summary of our recommendations.
- 1.32 Appendix A contains a draft Bill which would implement our recommendations. Explanatory notes on the draft Bill are provided at Appendix B.
- 1.33 Appendix C contains an impact assessment, showing the costs and benefits of our draft Bill.
- 1.34 Finally, Appendix D lists those who responded to the 2009 consultative report. We are very grateful to those who took the time and trouble to give us their comments. We have found these very helpful in formulating our final policy.

PART 2

ILLEGALITY AND TRUSTS

A BRIEF SUMMARY OF THE PRESENT LAW

- 2.1 In our 2009 consultative report, we set out a detailed account of the present law on illegality and trusts.¹ There have been a few relevant cases reported since then,² but the legal principles remain the same. To avoid unnecessary repetition, here we give only a brief outline of the legal rules and then explain the problems that they cause.

1. The reliance principle

- 2.2 In *Tinsley v Milligan*,³ the House of Lords held that for the purposes of determining the effect of any illegality, equitable interests were to be treated in the same way as legal interests.⁴ This means that the so-called “reliance principle” applies. Under this principle, the claimant is able to enforce his or her equitable interest notwithstanding any illegality in the arrangement, provided that the claimant does not need to plead or lead evidence of the illegality to prove the interest. How this principle works in practice can be shown by two straightforward examples.

Example 1: Mr A transfers some business assets to a friend, Mr B. Mr B agrees to hold the assets for Mr A and return them to him when requested. The purpose of the arrangement is to hide the assets from Mr A’s creditors. Once the creditors have left empty-handed Mr A asks for the assets back. Mr B refuses to return them, arguing that because of the illegal purpose of the arrangement, the trust in Mr A’s favour is unenforceable. However, the law presumes that when Mr A transferred the assets to Mr B for no consideration, a resulting trust arose in Mr A’s favour. Mr A can therefore establish this trust by relying on the presumption without any need to plead or lead evidence of the illegality involved. Under the reliance principle Mr A will succeed and the illegality has no effect.

¹ CP 189, Part 6.

² For example, *Bales v Porritt* [2008] EWHC 2188.

³ [1994] 1 AC 340.

⁴ “If the law is that a party is entitled to enforce a property right acquired under an illegal transaction, in my judgment the same rule ought to apply to any property right so acquired, whether such right is legal or equitable”: Lord Browne-Wilkinson in his leading judgment in *Tinsley v Milligan* [1994] 1 AC 340, 371.

Example 2: Now suppose that Mr A transferred the assets not to a friend but to his wife, Mrs A. Because the transfer is from husband to wife, the law presumes that Mr A intended to make a gift. Generally Mr A would be able to lead evidence of the arrangement which he and Mrs A entered into, in order to rebut this presumption of advancement and show that his intention was to create a trust in his favour. However, this would involve leading evidence of the illegal purpose of his scheme. Under the reliance principle Mr A is not permitted to do this and his claim against his wife will fail.

- 2.3 Many of the cases concerning the reliance principle involve resulting trusts. However, it is clear that the reliance principle is used to determine the effect of illegality whatever type of trust is in issue. For example, in *Collier v Collier*,⁵ the claimant was not able to rely on any presumption of resulting trust in his favour because his daughter to whom he had transferred two business properties had, at least ostensibly, provided consideration.⁶ He therefore argued that his daughter held the properties on express trust for him, pursuant to their agreement that they had been transferred into her name only to hide them from potential creditors and that she was to hold them on his behalf. The Court of Appeal used the reliance principle to hold that the claimant could not prove the express trust in his favour.⁷ In order to prove the express trust he would have to lead evidence of their illegal scheme and this was not permitted.
- 2.4 The reliance principle has also been used in cases involving constructive trusts.⁸ Following the House of Lords' decision in *Stack v Dowden*,⁹ it is clear that the common intention constructive trust will in future play a greater role in determining disputes over equitable interests in the home. What is less clear is how the reliance principle will operate in this context. The House of Lords held that where a couple were joint legal owners of their home, the presumptions of resulting trust and advancement should not be used. Rather, the starting point should be that equity follows the law. A claimant attempting to prove otherwise must do so by establishing a common intention constructive trust, discerned from "the parties' shared intentions, actual, inferred or imputed, with respect to the property in the light of their whole course of conduct in relation to it."¹⁰ Whether the court's examination of the "whole course of conduct" will allow a party to lead evidence of illegal behaviour has not yet been determined.

⁵ [2002] EWCA Civ 1095, [2002] BPIR 1057.

⁶ This was the view taken by Aldous and Chadwick LJJ. By contrast, Mance LJ was of the view that since the consideration was a sham, the presumption of advancement would apply.

⁷ The judgments of the Court of Appeal refer to the alleged trust as an "express trust", although given that there was no writing evidencing the trust as required by section 53(1)(b) of the Law of Property Act 1925, the trust could only be enforceable under the equitable doctrine which prevents a statute from being used as an instrument of fraud. Such a trust may alternatively be described as a "constructive trust".

⁸ For example, *Barrett v Barrett* [2008] EWHC 1061 (Ch), [2008] 2 P & CR 17.

⁹ [2007] UKHL 17, [2007] 2 AC 432.

¹⁰ [2007] UKHL 17, [2007] 2 AC 432 at [60].

2. The withdrawal exception

- 2.5 There is one general exception to the application of the reliance principle. In *Tribe v Tribe*,¹¹ the Court of Appeal held that where the claimant was seeking to withdraw from the arrangement before the illegal purpose had been wholly or partly accomplished, then reliance on the illegality was allowed.
- 2.6 So, in Example 2 (in paragraph 2.2 above), the outcome would be different if Mr A had not yet actually deceived anyone as to his available assets. In that case, Mr A would be able to rebut the presumption that he had given the assets to his wife by pleading their illegal scheme to defraud the creditors.
- 2.7 There is some uncertainty as to the exact scope of the withdrawal exception. The case law makes it clear that true repentance of the illegal scheme is not required, and it is sufficient that the scheme was simply not needed. However, judicial statements suggest that forced withdrawal as a result of the discovery of the illegal scheme is not sufficient.¹² It is unclear how far it is possible to go before withdrawal is no longer allowed. Non-binding commentary in *Q v Q*¹³ suggests that the illegal purpose should be broadly defined and that as soon as any steps have been taken towards its accomplishment over and beyond the creation of authentic-looking documents kept within the family, then withdrawal is no longer allowed.

3. Consequences that follow from the application of the reliance principle

- 2.8 Where a claimant is unable to enforce his or her equitable interest because of the application of the reliance principle, it is not clear whether this results in a substantive or merely procedural bar. The case law suggests that the trust still notionally exists, but the beneficiary is under some sort of personal disentitlement and therefore unable to enforce it.¹⁴
- 2.9 This leaves open two important questions. First, is it possible for an innocent party, often the victim of the arrangement, to claim through the barred beneficiary? In one case,¹⁵ the Court of Appeal assumed that an executor could be in no better position than the deceased beneficiary. However, in a subsequent case,¹⁶ one Court of Appeal judge suggested that a creditor might be able to enforce its interest in the trust property even though the debtor/beneficiary could not.

¹¹ [1996] Ch 107.

¹² *Tribe v Tribe* [1996] Ch 107, 135, by Millett LJ.

¹³ [2008] EWHC 1874 (Fam), [2009] 1 FLR 935.

¹⁴ See, in particular, the comments of Lord Browne-Wilkinson in *Tinsley v Milligan* [1994] 1 AC 340, 374: "The effect of illegality is not to prevent a proprietary interest in equity from arising or to produce a forfeiture of such a right: the effect is to render the equitable interest unenforceable in certain circumstances. The effect of illegality is not substantive but procedural."

¹⁵ *Silverwood v Silverwood* (1997) 74 P & CR 453.

¹⁶ *Collier v Collier* [2002] EWCA Civ 1095, at [111].

- 2.10 The House of Lords recently considered this issue in *Stone & Rolls v Moore Stephens*,¹⁷ though not in relation to a trust. In this case, the claimant company which had been used as a vehicle to commit fraud was insolvent, meaning that any damages recovered would in fact go to the innocent creditors. It was argued that even if the claim would ordinarily be barred by illegality, it should succeed on this basis. Their Lordships rejected this argument on the ground that the duty the defendants owed to the claimant company did not extend to creditors. Allowing the claim to succeed would be the equivalent of extending the duty, which the majority of judges thought would be wrong.¹⁸
- 2.11 It would seem therefore that in tort (and in concurrent contract) claims creditors are unlikely to be in a better position than a claimant unless a defendant owes a duty to them directly. However in the area of trusts where the existence of the claim does not depend on a duty of care, the outcome could still be different, notwithstanding the reasoning in *Stone & Rolls*.
- 2.12 Further, if the intended beneficiary is not entitled to enforce the trust, what is the position of the trustee? There has been little discussion of this point, but several cases assume that the trustee effectively holds the trust property for him or herself beneficially.¹⁹

PROBLEMS WITH THE PRESENT LAW

1. Arbitrariness

- 2.13 A major problem with the reliance principle is its arbitrariness. Whether or not the illegality has any effect on the recognition or enforcement of the trust does not depend on the merits of the parties or the policies that underlie the illegality defence. The outcome of the case will turn solely on the procedural issue of whether any legal presumption is in play and how closely the illegality is tied up with any evidence that the parties may wish to rely on. The effect of applying the reliance principle to cases involving the presumption of advancement has been to give that presumption an overriding importance that it was never intended to have. For many years the presumption has been regarded as anachronistic and, apart from cases involving illegality, little notice has been paid to it.²⁰

2. Uncertainty

- 2.14 We have already highlighted several areas in which the application of the reliance principle and withdrawal exception is unclear. In addition, there is much confusion over exactly what amounts to “reliance”, particularly when the claimant is seeking to establish an equitable interest under a constructive trust. How closely connected to his or her evidence can any illegality be, before the reliance principle makes it inadmissible?

¹⁷ [2009] UKHL 39, [2009] 1 AC 1391.

¹⁸ See for example Lord Phillips, *Stone & Rolls v Moore Stephens* [2009] UKHL 39 at [85].

¹⁹ For example, *Barrett v Barrett* [2008] EWHC 1061, [2008] 2 P & CR 17 at [28] and *Q v Q* [2008] EWHC 1874 (Fam), [2009] 1 FLR 935 at [139].

²⁰ See, for example, the comments of Lord Diplock in *Pettitt v Pettit* [1970] AC 777, 824.

3. Potential injustice

- 2.15 Because of its arbitrary operation, the reliance principle has the potential to force the courts into unjust decisions. We consider that whether or not illegality has any effect on a case should be determined by reference to the policies that justify the existence of the defence. This will allow the court to take into account such matters as the conduct of the parties, the seriousness of the illegality involved and the value of the interest at stake. By focusing solely on procedural matters, the reliance principle does not permit these issues any relevance.

REJECTED REFORM OPTIONS

- 2.16 In our 2009 consultative report²¹ we explained that we had considered, but subsequently rejected, various options for reform. These included:

- (1) Abolishing the illegality defence in relation to trusts.
- (2) Abolishing the presumption of advancement.
- (3) Introducing a broad statutory discretion that would apply to determine the effect of illegality on all trusts.

Although we accept that strong arguments can be put forward for abolishing the illegality defence in relation to the recognition of equitable interests, this is not ultimately a view which we endorse. We think that the policy issues that underlie the illegality defence may come into play in relation to trusts as much as they do in any other area, and should not be completely ignored. There was little support from respondents to either our 1999 or 2009 consultations for the complete abolition of the illegality defence.

- 2.17 We were at one stage attracted to the argument that many of the problems in this area could be solved by the abolition of the presumption of advancement. It is the interaction of the reliance principle with the presumption of advancement that causes much of the arbitrariness of the present rules and which has attracted much of the criticism. The Government is already committed to its abolition because of its discriminatory treatment of husbands and wives.²² We understand that legislation is likely in this area.²³

²¹ CP 189 at paras 6.89 to 6.101.

²² The Government accepts that legislation is needed to amend or abolish the presumption of advancement before the Government can carry out its stated commitment to ratify Article 5 of Protocol 7 of the European Convention of Human Rights: Written Answer, Hansard (HL) 21 April 1988, vol 588, col 197W.

²³ An amendment to the Equality Bill 2009 to abolish the presumption of advancement has been tabled for debate at the Committee stage in the House of Lords.

- 2.18 However, following *Stack v Dowden*, we no longer consider that this is the best approach. It is now clear that, where a family home is jointly owned at law, the courts will presume that it is jointly owned in equity too.²⁴ A party who wishes to prove otherwise must establish a constructive trust in his or her favour. In such cases, neither party may rely on a resulting trust and abolishing the presumption of advancement will not have any impact.
- 2.19 In our 1999 consultation paper we provisionally proposed that the reliance principle should be abolished and replaced with a broad statutory discretion that would apply to all trusts tainted by illegality. Although most respondents supported replacing the reliance principle with a statutory discretion, several commented that our proposals would introduce a larger degree of uncertainty than was acceptable in relation to property rights. Many trusts may involve some connection with illegality in their formation, performance or purpose, which under the present law would not affect the trust's validity or enforcement.
- 2.20 Under our 1999 proposals, for example, the discretion would not be confined to criminal conduct. It would apply to any trust created to facilitate any legal wrong, or which was otherwise contrary to public policy. We considered what should happen where, for example, a testator left money under a will subject to a condition that was unlawful or contrary to public policy.²⁵ In these cases, the courts ask whether the unlawful condition can be severed. In 1999, we proposed to reform the law in this area. However, although the law on severance is somewhat complex, it usually reaches the right result. As we explore below,²⁶ we now think that law in this area is neither so complex nor so significant that it requires statutory intervention.
- 2.21 In our 2009 consultative report we therefore provisionally recommended the introduction of a statutory discretion that would apply only to a limited category of trusts, where the illegality currently has the most impact. This provisional recommendation was very well supported by respondents to that paper.²⁷
- 2.22 **We recommend that legislative reform is needed to provide the courts with a discretion to determine the effect of illegality on a limited class of trust.**
- 2.23 In Appendix A we provide a draft Bill to give this recommendation effect. It is limited in scope, and only covers cases where a trust is used to conceal the true ownership of property for a criminal purpose. Explanatory notes are provided in Appendix B. In the paragraphs below we set out our recommendations in more detail and explain our reasoning.

²⁴ Although the position in relation to a case involving illegality is made more complicated by the suggestion in one Court of Appeal decision that a claimant who was the joint legal owner of a house might not be able to rely on any presumption of joint beneficial ownership where there was an issue of illegality involved: see *Gibson v Revenue & Customs Prosecution Office* [2008] EWCA Civ 645, [2008] All ER 157 at [24].

²⁵ An example is *Re Beard* [1908] 1 Ch 393, where a nephew was left property provided he did not "enter military service". The judge declared that few provisions could be "more against the public good and the welfare of the state". The condition was severed from the trust.

²⁶ Paras 2.110 to 2.114.

²⁷ For a critical appraisal see P Davies, "The illegality defence – two steps forward, one step back?" [2009] *Conveyancer and Property Lawyer* 182.

OUR RECOMMENDED SOLUTION – A STATUTORY DISCRETION TO APPLY TO A LIMITED CLASS OF TRUSTS

1. To which trusts should the discretion apply?

(1) Trusts created in order to conceal beneficial ownership for a criminal purpose

2.24 As we explained above, we no longer advocate the broad approach which we put forward in 1999. We agree with those respondents who told us that our provisional proposals were too broad in scope and would have created too much uncertainty. We therefore want to target the discretion at those cases where the use of the reliance principle is causing most difficulty. Much of the recent case law concerning the effect of illegality on trusts has involved arrangements whereby the claimant has transferred or bought assets in the name of an initially friendly defendant while intending to retain the beneficial ownership but hide it from others for a criminal purpose.²⁸ In these cases, the very purpose of the creation of the trust is to conceal the true beneficial ownership. Here the case law has bound itself up with rigid rules which are arbitrary and can cause injustice. We therefore recommend that it is to this type of “concealment” case only that the statutory discretion should apply.

For example, Mr A wants to protect his estate from any future liability to inheritance tax. He therefore transfers his assets into the name of his daughter, Miss B, on the understanding she should hold them on his behalf. He retains control over them, but they agree to hide this arrangement from the tax authorities. Should Mr A and Miss B later disagree over the ownership of the assets, the case would fall within the scope of our recommended discretion.

2.25 We considered whether the Bill should only apply to purposes which are criminal, or whether the Bill should apply to any case involving a legal wrong. At one stage, there was some doubt about whether certain frauds (such as concealing assets from an ex-spouse) were necessarily criminal.²⁹ However, the Fraud Act 2006 has clarified the law in this area, and all the examples we considered in which property had been concealed from creditors, ex-spouses or the tax authorities, are either specific offences or fall within sections 2 or 3 of the Fraud Act 2006. It is true that not all concealment is necessarily criminal: a public figure may, for example, conceal wealth to prevent media intrusion. However, in such cases the law currently permits the trust to be enforced, and we think this is correct. The discretion to refuse enforcement should be confined to cases revealing a criminal intention.

²⁸ For example, *Tinsley v Milligan* [1994] 1 AC 340; *Tribe v Tribe* [1996] Ch 107; *Silverwood v Silverwood* (1997) 74 P & CR 453; *Lowson v Coombes* [1999] Ch 373; *Collier v Collier* [2002] EWCA Civ 1095, [2002] BPIR 1057; *Anzal v Ellahi* (2001) 82 P & CR DG21; *Slater v Simm* [2007] EWHC 951, [2007] WTLR 1043; *Knowlden v Tehrani* [2008] EWHC 54; *Barrett v Barrett* [2008] EWHC 1061, [2008] 2 P & CR 17; *Q v Q* [2008] EWHC 1874 (Fam), [2009] 1 FLR 935 and *Bales v Porritt* [2008] EWHC 2188.

²⁹ For discussion of the law in this area prior to the Fraud Act 2006, see the Law Commission report on Fraud (2002; Law Com No 276).

2.26 We also considered limiting the scope of the recommended discretion to cases where the claimant's purpose in concealing the ownership was to commit a fraud, rather than any type of crime. However, this may not be wide enough. In *Tinsley v Milligan*, Lord Goff was concerned about how the reliance principle supported by the majority would apply in cases where the claimant had been involved in serious, although not necessarily fraudulent, illegality. He said:

There may be cases in which a group of terrorists, or armed robbers, secure a base for their criminal activities by buying a house in the name of a third party not directly implicated in those activities ... Is it really to be said that criminals such as these, or their personal representatives, are entitled to invoke the assistance of a court of equity in order to establish an equitable interest in the property?³⁰

2.27 If, as Lord Goff appeared to be suggesting, the house is bought in the name of a third party because the terrorist or armed robber wants to hide his or her interest, then there seems to be no reason why these cases should not also fall within the proposed discretion. We therefore recommend that the discretion should apply when the trust has been created to conceal the true beneficial ownership in connection with any criminal purpose.

2.28 We did consider whether we should limit the scope of the discretion to cases where the purpose was a "serious" crime in order to ensure that we did not capture minor technical infringements of the criminal law. However, we found it difficult to ring-fence particular "serious" crimes that might be included here. Short of trawling through all crimes that exist and listing those that appear in some sense worse than others, there is no obvious method of selecting particularly serious ones.³¹ Any such demarcation would be controversial. We consider that, by limiting the application of the recommended discretion to cases where the purpose was to "conceal" the interest, we have already narrowed it sufficiently.

2.29 We recommend that the discretion should apply whether or not the criminal purpose has been acted upon. This means that it will apply to those cases that are currently dealt with under the withdrawal exception to the reliance principle. Of course, the fact that the intention has not been acted upon will be a very relevant factor in deciding what the outcome of the exercise of the discretion should be.³²

³⁰ [1994] 1 AC 340, 362.

³¹ We have considered definitions by reference to method of trial, potential or likely punishment, and other legislation such as the Proceeds of Crime Act 2002 and the Serious Crime Act 2007. None of these has provided a workable solution.

³² For details of the factors that the court should take into account, see paras 2.62 to 2.80 below.

2.30 We recommend that the discretion should apply whether it is the trustee or the beneficiary that is using the trust arrangement to conceal the true ownership. In most of the cases that we have discussed, it is the beneficiary who is attempting to conceal his or her own interest in order to hide it from those who may have claims over it – such as creditors, tax authorities or social security administrators. However, there are also cases where it is the trustee who has concealed the trust arrangement, in order to give the false impression that he or she has greater wealth than is really the case.³³

For example, Ms C wants to set up in business and is seeking backers to meet her start up costs. Ms C has few assets herself. To appear more creditworthy, she asks her friend, Ms D, to transfer funds into her bank account, both agreeing that Ms C holds the funds for Ms D and will return them when asked. Although it is the trustee who is attempting to conceal the real ownership of the trust property, this example still falls within the recommended discretion.

2.31 We recommend that the discretion should also apply where the trust was not only entered into to conceal the true ownership of the property but for other purposes as well. For example, in *Tinsley v Milligan* the parties had contributed to the purchase of a home together, but transferred the legal title into the name of Miss Tinsley only. They believed that this would assist Miss Milligan to claim social security benefits on a fraudulent basis. However, as well as having this illegal purpose, the trust was also created to provide a home for them.

2.32 **We recommend that the statutory discretion should apply when the trust arrangement is created in order to conceal the beneficiary's interest in the trust property in connection with a criminal purpose.**³⁴

2.33 **We recommend that the statutory discretion should apply whether or not the criminal purpose has been acted upon.**³⁵

2.34 **We recommend that the statutory discretion should apply whether it is the beneficiary or the trustee who intends to use the trust arrangement in order to conceal the real ownership of the trust property.**³⁶

2.35 **We recommend that the statutory discretion should apply when the trust arrangement is created for other purposes in addition to the concealment of the real ownership.**³⁷

³³ One example is *Re Great Berlin Steamboat Co* (1884) LR 26 Ch D.

³⁴ See clause 2(2) of the draft Bill.

³⁵ See clause 2(2) of the draft Bill.

³⁶ See clause 2(3)(a) of the draft Bill.

³⁷ See clause 2(3)(b) of the draft Bill.

(2) Trusts already created but subsequently used to conceal beneficial ownership for a criminal purpose

- 2.36 We have considered whether the statutory discretion should cover cases where a trust is already in existence and the criminal motive is formed at a later date. It is possible that one person may transfer property to another, without intending to make a gift to the other, but without at that time having any illicit motive. What if the transferor should at a later time decide to conceal his or her beneficial interest for a criminal purpose? Say, for example, that in *Tinsley v Milligan*, Miss Milligan had decided to defraud the Department of Social Security regarding the ownership of the house only after the conveyance to Miss Tinsley had been made. In some cases, particularly those involving a constructive trust, it may be difficult to pinpoint the exact time that the trust came into existence.
- 2.37 Under the present law such a trust would be valid and enforceable, because the beneficiary does not need to rely on the subsequent criminal purpose in order to establish the claim. In *Slater v Simm*,³⁸ the claimant was the administratrix of Miss Nashida's estate. Miss Nashida was the former partner of the defendant, with whom she had bought an investment property. For reasons that are not made clear, the title to the property had been registered solely in Miss Nashida's name. The defendant claimed an interest in the property on a resulting trust basis, equivalent to the contribution that he had made towards the purchase price. The claimant argued that the defendant was unable to enforce this interest because five years after the purchase he had concealed the interest in a financial statement made under oath relating to his divorce proceedings. The Court upheld the defendant's claim. It found that the decision to conceal his interest only arose after the purchase had been made. The parties' intentions had to be assessed at the time of the purchase. The defendant could rely on the presumption of resulting trust, and under the reliance principle he had no need to explain why the property was put into Miss Nashida's name only.³⁹

³⁸ [2007] EWHC 951 (Ch), [2007] WTLR 1043.

³⁹ However, in *Collier v Collier* the Court of Appeal took an arguably broad view of the father's illegal purpose, without which his claim would have succeeded. His subsequent fraudulent intention to defraud the mortgagees was caught, because the Court defined his original intention at the time of the transfer as deceiving "creditors generally" and not simply those in sight at the moment: see, in particular, the reasoning of Mance LJ, [2002] EWCA Civ 1095, [2002] BPIR 1057 at [108] to [109].

- 2.38 In our 1999 consultation paper, we were unsure whether these cases of subsequent unlawful motive should be included within the broad discretion that we then proposed. We excluded from our definition of an “illegal trust” cases where the beneficiary decided to use the trust property for illegal purposes only after the trust had been created. We suggested that this was but one illustration of a much more general fact pattern: that is, where a person to whom property is given, independently chooses at some later date to use the property to accomplish an illegal end.⁴⁰ The court is not generally able to invalidate property rights in all such cases. That would produce an unacceptable degree of uncertainty.
- 2.39 Now that our recommended discretion is limited to cases where the beneficial ownership is being concealed in connection with a criminal purpose, there seems less reason not to include these cases. Their inclusion would not result in an unacceptably wide discretion. In the contract context, we have criticised the present position under the common law rules whereby the contract’s validity depends on whether the intention to perform illegally was formed before or after the contract was made.⁴¹ We have suggested that the timing of the intention should not be the determining factor in deciding its validity. The same arguments apply here.
- 2.40 However, we do not want to include those cases where the trust arrangement is merely incidental to the crime that is committed. A person who simply happens to hold an interest under a trust arrangement (such as shares) may fail to declare that interest when under a duty to do so, for example by failing to disclose a shareholding in his or her tax return. The fact that the shares are held under a trust is not part and parcel of the fraud – it is simply the mechanism in which the vast majority of shares happen to be held. To include all these cases would cover a much wider remit than our policy requires. We are concerned here only with those cases where the trust institution itself has been used for criminal purposes. Where the trust was not created with the criminal purpose in mind, we therefore propose to include only those cases where the beneficiary has deliberately continued the trust arrangement in order to take advantage of the opportunity for criminal behaviour which it offers.
- 2.41 In addition, in these cases we consider that there should be two limiting factors to the application of the discretion. First, it should only apply where the arrangement has already been exploited. Secondly, the discretion should only apply where the concealment is either by the beneficiary or with the consent or connivance of the beneficiary. Otherwise he or she would risk having the beneficial interest in the property taken away despite being wholly innocent of the unlawful scheme.

⁴⁰ See CP 154, paras 8.38 to 8.39. However, we expressed doubts about whether this argument remained valid where a party decided to use the trust institution itself for a fraudulent purpose after the date that the trust was created. Here we thought that it might be more sensible to subject such a case to the proposed discretion rather than draw a hard and fast line depending on the date on which the criminal intention was created.

⁴¹ CP 189, para 3.59.

For example, suppose that F, a young child, is the beneficiary of a trust fund set up by a wealthy benefactor. On reaching majority, F is asked whether she would like the trust to terminate and have the funds transferred into her name directly. F decides not to take up this option. She wants to claim a student grant to continue her studies and believes that she is more likely to be able to hide her true wealth if the funds are not in her bank account. She completes the application form without revealing her equitable interest. Should a dispute arise at a later date over the ownership of the trust, the case would fall within our recommended discretion.

2.42 We recommend that the discretion should apply where the intention to use the trust arrangement to conceal the beneficial ownership for a criminal purpose is formed after the trust was created. However, it should be limited to cases where:

- (1) the beneficiary has taken steps to ensure that the trust arrangement continues in place so that the concealment can be made; and**
- (2) the criminal purpose has been carried out either by the beneficiary or by somebody with the beneficiary's consent.⁴²**

(3) Trusts involving some element of illegality but not within the scope of our recommended discretion

2.43 The new narrow scope that we have recommended for the statutory discretion means that it will not apply to every case in which the reliance principle is presently used. For example, the discretion will not apply where the only illegality involved is the technical breach of a statutory prohibition relating to the proper formation of the trust. There has not been any attempt at concealment here. The correct approach to determining the effect of the illegality on the validity or enforcement of such a trust will depend on the interpretation of the statute and the reliance principle.

2.44 Nor will the discretion apply to cases such as *Macdonald v Myerson*⁴³ or *Mortgage Express v McDonnell*,⁴⁴ where the only illegal element in the case is the source of the trust property. Here the reliance principle will still be used to determine the case, but the effect is that the illegality is simply ignored. We think that, in these cases, the statutory provisions for forfeiture and civil recovery contained in the Proceeds of Crime Act 2002 are likely to apply. There is therefore less need for any civil doctrine of illegality.

⁴² Clause 2(4) of the draft Bill.

⁴³ [2001] EWCA Civ 66, [2001] EGCS 15.

⁴⁴ [2001] EWCA Civ 887, (2001) 82 P & CR DG21.

For example, say that Mr G had benefited from a lifestyle of crime. He used his ill-gotten gains to set up a trust fund for the benefit of himself and his family. The trust arrangement was used for quite legitimate tax purposes and there was no attempt to conceal the ownership. Should a dispute later arise in relation to the trust property, the case would not fall within our recommended discretion. Any illegality issues would be resolved using the reliance principle and the Proceeds of Crime Act 2002.

2. The scope of the discretion

(1) Cases that will be included within the ambit of the discretion

- 2.45 We consider that the discretion should apply even where the parties did not realise that the concealment would be criminal and where nobody has been prosecuted. Of course the court will need to be satisfied to the civil standard of proof, that is “on the balance of probabilities”, that the purpose of the trust arrangement was to conceal the beneficial ownership for a criminal purpose before the Bill will apply, and these are factors that may be relevant when the discretion is exercised.
- 2.46 In many cases the concealment of the beneficial interest will in itself constitute the criminal purpose. For example, a party may falsely declare that he or she does not have any interest in a property in order to continue receiving state benefits. We consider that the definition of a criminal purpose within the draft Bill should make clear that such cases are included.
- 2.47 Our recommended discretion would apply whatever type of trust was in issue: oral, written, express, resulting or constructive. The same considerations apply in each case. The advantage of this approach is that we are not seeking to isolate in statutory language the various different types of trust when the boundaries between each of them are ever shifting.
- 2.48 **We recommend that the statutory discretion should apply even where the parties did not realise that the concealment would be criminal and where there has not been any prosecution.**⁴⁵
- 2.49 **We recommend that the statutory discretion should apply when the concealment of the beneficial ownership would itself constitute a criminal offence.**⁴⁶
- 2.50 **We recommend that the statutory discretion should apply whichever type of trust is in issue.**⁴⁷

⁴⁵ See clause 2(5)(a) and (c) of the draft Bill.

⁴⁶ See clause 2(6) of the draft Bill.

⁴⁷ See clause 1(4)(b) of the draft Bill.

(2) The application of the discretion to trusts where the person creating the trust is not also the intended beneficiary

2.51 So far, we have only looked at examples of cases where the settlor, that is the person creating the trust, and the beneficiary of the trust are the same person. The settlor has devised the scheme so that he or she can remain the real hidden owner of the trust property, but another person, the trustee, is to hold the bare legal title to the property. It is this type of arrangement that has given rise to litigation in the past. However, it is possible to envisage that a similar type of scheme might be set up involving three or more parties. Here, for example, the settlor may wish to give property to another who, for fraudulent reasons, plans to hide the fact that he or she is the true beneficiary of the gift.

For example, a father wants to give property to his son. However, his son is presently going through an acrimonious divorce and does not want his wife to benefit from the gift. The father therefore agrees that the property should be transferred to a third party to be held on trust for the son, thereby making it easier for his son to conceal his interest in it. The son fails to disclose his interest in the divorce proceedings.

2.52 In the situation outlined above, the type of behaviour involved – the use of the trust institution for an unlawful purpose – is exactly the same as that which occurs where the settlor and beneficiary are the same person. We therefore consider that these cases should also be included within the scope of the proposed discretion. Indeed if they were not included, it would be all too easy for a settlor to avoid the application of the proposed discretion simply by inserting a friendly third party into the arrangement. Where several people are involved in the trust arrangement, there is greater scope for the trust to be used for unlawful purposes. We intend that the discretion should apply in all these circumstances.

2.53 **We recommend that the statutory discretion should apply to cases both where the settlor and beneficiary are the same person and to cases where the settlor and beneficiary are different.**⁴⁸

⁴⁸ See clause 2 of the draft Bill.

(3) The different treatment that would be given to equitable and legal interests as a result of our recommendations

- 2.54 If our recommendations are implemented, it would mean that the illegality doctrine applies differently to legal interests and (most) equitable interests. In relation to legal interests, the reliance principle will continue to apply. This discrepancy has caused us concern. The main driving force behind the House of Lords' decision in *Tinsley v Milligan* was its determination that legal and equitable interests should be treated in the same way.⁴⁹ However, we believe that we can justify our recommendation for different treatment in relation to the equitable interest here. In the cases that fall within the proposed discretion, the trust institution is being used to conceal the equitable interest in a way that is simply not possible with the legal interest. We are recommending the different treatment of the two estates because the claimant has treated them differently. It is the intention to conceal the beneficial ownership by splitting the two estates that sets this type of case apart.

HOW IS THE DISCRETION TO OPERATE?

1. A declaration of entitlement

- 2.55 We recommend that once the court has determined that the trust falls within the scope of the proposed discretion, the court must first declare that the intended beneficiary *is* entitled to the equitable interest. It must do this before it goes on to exercise its discretion.
- 2.56 At first sight such an approach seems unnecessary and counter-intuitive, so why do we recommend it? The reason is that this step is needed to cure an inconsistency that might otherwise arise between the interaction of the criminal and civil law. If the civil courts were simply to declare that the beneficiary was not entitled to the equitable interest in question, then the beneficiary could not have committed an offence by failing to declare it when asked, or by claiming benefits on the basis that it was not owned. Such a declaration would jeopardise any criminal prosecution that had been brought or was to be brought against the beneficiary. Likewise it might prevent the State from being able to bring any successful confiscation proceedings under the Proceeds of Crime Act 2002. The case law shows that the courts are already struggling to deal with the interaction between the illegality rules and the rules for the confiscation of the proceeds of crime.⁵⁰ We do not intend that the recommended discretion should be used in order to legitimise retrospectively the criminal behaviour of any of the parties.
- 2.57 **We recommend that the first step that the court should take in relation to a trust to which the discretion applies is to declare that the intended beneficiary is entitled to the equitable interest.**⁵¹

⁴⁹ See, in particular, the comments of Lord Browne-Wilkinson in [1994] 1 AC 340, 371.

⁵⁰ See, for example, *R v David Edward Dale* [2006] EWCA Crim 1889.

⁵¹ See clause 3(1) of the draft Bill.

2. The need for exceptional circumstances

- 2.58 The second step for the court to take will be to determine whether it should exercise its discretion not to allow the beneficiary to enforce the trust. That is, the court will have a discretion to determine that, even though the beneficiary is entitled to the equitable interest, the beneficiary ought not to be allowed to enforce that interest.
- 2.59 However, even within the limited scope of our recommended discretion we consider that illegality should only affect the beneficial entitlement of a trust where there are “exceptional circumstances”. To succeed, a beneficiary must establish an equitable entitlement to the property. We consider that there will need to be strong public policy reasons for the court to decide that the beneficiary’s usual equitable rights should be denied. We raised this issue in our 1999 consultation paper when we asked whether there was a need for a “starting point” for our proposed discretion. There was strong support for a starting point that, notwithstanding the illegality, the trust should be valid.
- 2.60 Because of the many varied circumstances in which the discretion may come into play, we do not think that it is sensible to attempt to set out in legislation what might constitute “exceptional circumstances”. We think that this matter can be safely left to the courts. However, we anticipate that the court might consider that the circumstances were exceptional where, for example, the claimant’s conduct has been particularly blameworthy and the State’s powers of confiscation and recovery do not apply. What the need for exceptional circumstances does indicate is that in the general “run of the mill” type of case we do not expect the illegality to have any effect on the beneficiary’s entitlement.
- 2.61 **We recommend that the illegality should only have an effect on the beneficial entitlement under the trust when the court considers that there are exceptional circumstances.**⁵²

3. The factors the court may take into account when exercising its discretion

- 2.62 Where the court concludes that there are exceptional circumstances, we recommend that it should have a discretion to determine that the beneficiary ought not to be allowed to enforce the equitable interest.
- 2.63 In order to provide some guidance to the court on how to exercise its discretion, we recommend that the draft Bill sets out a list of factors guiding the court towards the relevant points to take into account. As we have seen, some respondents were reluctant to endorse the introduction of a statutory discretion because of the uncertainty that they believed that it would create. We consider that any such uncertainty can be reduced by structuring the discretion in this way.

⁵² See clause 4(1) of the draft Bill.

2.64 The purpose of the statutory discretion is to ensure that the courts' decisions reflect the policy issues that underpin the illegality doctrine. We examined these in some detail in our 2009 consultative report.⁵³ The relevant factors set out in the draft Bill are designed to ensure that these policies are properly reflected in the outcome of the particular case. Some factors look at the comparative "guilt" or "innocence" of the parties to the dispute and might be regarded as ensuring that justice is done between the parties. Others focus on the wider public policy issues that come into play when illegality is involved. These may, in certain cases, conflict with what would otherwise be the fair resolution of the case. We propose that the court should balance all these factors against each other in order to reach its decision.

2.65 The list that we recommend here is similar to that which we proposed in both our 1999 and 2001 consultation papers, when we suggested a more general statutory discretion. All respondents who commented on this issue thought that the provision of a list of factors would be helpful, and largely agreed with those that we had suggested. The main point of difference here is the inclusion of two new factors: (1) the conduct of all the parties involved; and (2) the possibility that the intended "victim" of the concealment may have an interest in the value of the assets of the beneficiary. We look at these issues below.

(1) The conduct and intention of all the relevant parties

2.66 We recommend that the court may consider the conduct and intention of the intended beneficiary. It may look at such issues as whether a crime has actually been committed; whether the beneficiary instigated the arrangement; whether he or she was aware that the purpose was illegal; and whether the crime involved was serious.

2.67 We consider that the conduct and intention of the beneficiary should have a prominent impact on the decision whether the various policies which justify the illegality doctrine would be effectively advanced by determining that the beneficiary ought not to be allowed to enforce the trust. For example, if the beneficiary was unaware that the purpose of the arrangement was illegal, or had already repented and withdrawn from the crime, then allowing the claim would be less likely to abuse the integrity of the legal system. On the other hand, if the beneficiary instigated the criminal purpose of the arrangement, then not allowing the claim may act as a strong deterrent to others from entering into similar schemes.

⁵³ CP 189, Part 2.

- 2.68 We also recommend that the court may consider the conduct and intention of the trustee and the settlor (where they are not the same person as the beneficiary). This is largely because these are the people who are likely to benefit if the beneficiary is not allowed to enforce the trust. In the 1999 consultation paper we did not include this in our provisional list of factors. However, we did point out that, if the trustee were ever to be allowed to benefit from the failure of the trust for illegality, it may be necessary to add as a factor whether invalidity would “unjustly enrich the trustee”.⁵⁴ Few respondents commented on this point. One did not find the terminology of “unjust enrichment” helpful here; and another thought that the point was so obvious that it did not require separate mention.
- 2.69 We have now reconsidered our position, and believe that the court should take into account each relevant person’s conduct when exercising its discretion. There are a limited number of people to whom the beneficial interest can belong, if the trust is not enforced in favour of the beneficiary. The trustee, the settlor and any other beneficiaries are prime candidates. We discuss this point further (at paragraphs 2.87 to 2.99) when we consider what the ramifications might be if the court decides not to allow the beneficiary to enforce the trust. We do not suggest that the courts should simply compare, for example, the guilt of the beneficiary and the trustee and find in favour of whoever is “less” guilty. Yet it seems to us to be artificial to look at the claimant’s conduct in isolation and ignore the behaviour of the other party to the transaction, who may well benefit if the trust is not enforced. Therefore, we recommend that the court may consider the conduct of all the relevant parties. In particular, were they involved in the illegal purpose, were they the instigator of it, or have they even profited from it?

(2) *The value of the equitable interest at stake*

- 2.70 We recommend that the court may consider the value of the interest which the beneficiary is trying to enforce, particularly in relation to the seriousness of the offence which was committed or intended. A beneficiary who is not allowed to enforce the trust will lose the interest to which he or she was otherwise entitled. While we have said that the illegality defence should not be used as a means of punishing the claimant, the beneficiary might quite understandably regard such an outcome as punitive. We therefore believe that the value of the interest is relevant to the decision.

⁵⁴ See CP 154, paras 8.80 to 8.81.

- 2.71 This factor may be particularly important if the person claiming the equitable interest is also the settlor (or, in the case of a resulting trust, the transferor). In such cases, the court's decision not to enforce the trust would result in the expropriation of the trust property. Unless the illegality involved was particularly serious, the loss caused could vastly exceed any potential gain to be made from the illegality or the maximum penalty which could be imposed in criminal proceedings. For example, in *Tinsley v Milligan*,⁵⁵ Miss Milligan had carried out social security fraud for a few years. She had subsequently admitted it and "made her peace with the DSS", presumably by the repayment of the amount overclaimed and any fines due. Yet she stood to lose her half share in her home. While not wanting to detract from the seriousness of the fraud or imply that this should be the only relevant factor to take into consideration, we believe that it is important for the court to bear in mind the value that the beneficiary stands to lose, compared with the seriousness of the conduct involved.
- 2.72 This factor may be less relevant when the beneficiary is not also the settlor/transferor. The beneficiary in this case is the recipient of a gift, and the fact that his or her expectations may be defeated by the illegality doctrine would seem to bear less weight in reaching the appropriate result. In such a case it would be possible for the court to decline to enforce the illegally tainted trust, but return the property to the settlor so that he or she has the opportunity of giving it to the beneficiary again, but this time in a legitimate manner.

(3) *The effect of allowing the claim on the criminal purpose*

- 2.73 In some cases, allowing the claimant to enforce his or her usual rights would defeat the criminal purpose. So, for example, if the claimant had been attempting to put assets out of reach of creditors, to return the assets to the claimant might make them available to creditors, thereby defeating the purpose of the scheme. In other cases, returning the assets might further the criminal purpose. For example, if the claimant had "parked" assets in the name of the defendant to deceive investors into believing that the defendant was more creditworthy than was really the case, and such investments had been made, then returning the assets to the claimant would further the fraud. We think that the effect of any determination under the Bill on the unlawful act or purpose is a highly relevant factor.
- 2.74 However, the court should also bear in mind the principle that like cases should be treated alike. It is possible that allowing the claimant to enforce the trust might actually open the door to others to set up similar schemes in the knowledge that their assets would not be at risk. This proliferation of schemes might ultimately undermine the rule which has been infringed.

⁵⁵ [1994] 1 AC 340.

2.75 Where the intended crime involves the breach of a legislative provision, the court will need to consider the policy behind the relevant statutory provision to determine whether enforcing the trust would further that policy. We can draw analogies from the common law approach to the enforcement of illegal contracts, where the policy of any legislation infringed plays a central role. In *Nelson v Nelson*,⁵⁶ the High Court of Australia adopted this approach as its primary test for determining the validity of the trust, in place of the reliance principle. Of course, if the statute actually provides that the trust is void or ineffective because of a breach of its provisions, then the case will not fall within the proposed discretion at all.

(4) Whether refusing the claim would act as a deterrent

2.76 We recommend that the court should consider whether there would be any deterrence value in determining that the beneficiary ought not to be allowed to enforce the trust. That is, if the court were to deprive the claimant of a valuable asset, would that deter others from entering into similar arrangements? Of course, this will be difficult for the courts to assess with any degree of precision. However, we consider that deterrence is one of the policies that underpins the illegality doctrine, and the potential deterrent effect of the decision is another factor that the courts may take into account.

(5) The possibility that the person from whom the equitable interest was being concealed may have an interest in the value of the assets of the beneficiary

2.77 In some cases the intended victim of the fraudulent scheme may have an interest in the value of the assets of the beneficiary. The victim may have a right to bring a claim against the beneficiary. In these cases, we recommend that the court may consider whether that interest would be unduly prejudiced if the court were to determine that the beneficiary could not enforce the trust. For example, a husband may transfer the legal title to assets to his mistress in an attempt to hide them from his wife. If a dispute were to arise between the husband and mistress over the beneficial ownership of those assets, in exercising the discretion proposed by our recommendations the court could take into account the possibility that the wife might at some point in the future bring a claim for financial relief against her husband under the Matrimonial Causes Act 1973. The value of that claim might be reduced if the court were to decide that the trust ought not to be enforced in the husband's favour.

⁵⁶ (1995) 184 CLR 538.

(6) Other factors

- 2.78 In most cases we would expect these factors to be the most relevant ones. We therefore recommend that they are listed in the draft Bill in order to point the court towards the type of matter which may help it to reach a decision. However, we also recognise that cases in this area tend to vary significantly in terms of their facts and in terms of the type of trust arrangement that can be devised by the parties. We do not intend therefore that this list of factors should be exhaustive. We do not want to preclude the court from considering any other factors that may be relevant to a specific case.⁵⁷
- 2.79 **We recommend that the legislation should provide a non-exhaustive list of the factors that might be relevant for the court to take into account when exercising its discretion to determine that the beneficiary ought not to be allowed to enforce the equitable interest.**⁵⁸
- 2.80 **We recommend that those factors should be:**
- (1) **the conduct and intention of all of the relevant parties;**
 - (2) **the value of the equitable interest at stake;**
 - (3) **the effect of allowing the claim on the criminal purpose;**
 - (4) **whether refusing the claim would act as a deterrent; and**
 - (5) **the possibility that the person from whom the equitable interest was being concealed may have an interest in the value of the assets of the beneficiary.**

WHAT SHOULD BE THE CONSEQUENCES OF THE COURT'S DECISION?

1. Where the court does not exercise its discretion, and the beneficiary may enforce the trust

- 2.81 As we have explained, under the draft Bill it is only in exceptional circumstances that the court may determine that the beneficiary ought not to be allowed to enforce the trust. The court will have already declared that the beneficiary is entitled to the equitable interest and the result is that the illegality has no effect on the civil claim. There is at present a whole range of equitable remedies that the claimant may ask for in order to protect that interest. For example, the claimant may ask for a declaration that the trust property is held on trust for him or her. The claimant may ask for an order for sale or an order that the property be transferred to him or her. We do not intend to create any new remedies for the claimant under our proposals. Instead, the claimant will have the usual remedies available to enforce an equitable interest.⁵⁹

⁵⁷ See clause 5(1) of the draft Bill.

⁵⁸ See clause 5(1) of the draft Bill.

⁵⁹ See clause 5(2) of the draft Bill.

- 2.82 In 1999, we raised the possibility that the court should be given a discretionary power to allow the beneficiary's claim only if the beneficiary made a payment or transferred property to a third person (such as the State) who was not a party to the action.⁶⁰ Such a condition might be imposed to strip away any gains that have been made at the expense of the third party. So, for example, in *Tinsley v Milligan*,⁶¹ had Miss Milligan not already made reparation with the Department of Social Security, the recognition of her equitable interest could have been made conditional on her repaying all the benefits which she had fraudulently claimed. We did not express a preferred view on this issue.
- 2.83 Responses on this point were fairly evenly divided. Just under half thought that such a power would be useful. It was felt that the third party was unlikely, often through ignorance or lack of resources, to take any action itself in most cases.
- 2.84 On the other hand, just over half of those who commented thought that such a power should not be given to the courts. It was felt that where a gain had been made at the expense of a third party, that third party would generally have a right to recover it. It was argued that it should be left to the third party to decide whether to do so. Respondents suggested that it would defeat the point of the exercise of the discretion if, after deciding in favour of the beneficiary, this condition were imposed at the end. Others suggested that it would involve giving the courts an inappropriate "quasi-criminal" jurisdiction.
- 2.85 We have found this issue to be a difficult one, as the arguments on each side are finely balanced. However, we have come to the conclusion that no such power should be included in the draft legislation. The fact that in exercising its discretion the court will take into account whether the proceeds of fraud have been returned will provide an incentive for the beneficiary to make any reparation due. Otherwise, we are persuaded by those who argued that it should be a matter for the third party to decide whether and, if so, how to bring a claim for relief. In many cases, particularly where the fraud has involved the overpayment of a benefit or subsidy from the State, the third party will have some discretion in how best to handle the matter. Such issues should therefore be left for it to deal with.
- 2.86 **We do not recommend that the court should be given a discretionary power to determine that the beneficiary ought to be allowed to enforce the equitable interest only on terms that require the beneficiary to make a payment or transfer property to a third party.**

2. Where the court exercises its discretion to determine that the beneficiary should not be allowed to enforce the equitable interest

- 2.87 What should be the position where there are exceptional circumstances and the court determines that the beneficiary ought not to be allowed to enforce the equitable interest? Again, we looked at this issue in 1999. However it is sometimes difficult to make direct comparisons, because our 1999 provisional proposals covered a much wider range of trusts than the present recommendations.

⁶⁰ See CP 154, paras 8.86 to 8.88.

⁶¹ [1994] 1 AC 340.

2.88 As we have seen,⁶² under the present law, where the claimant fails because of the illegality doctrine, it is not entirely clear to whom the interest then belongs. In looking at this question, it is helpful to deal separately with two party trusts where the beneficiary and settlor are the same person (or in the case of resulting trusts and some constructive trusts, the beneficiary and contributor/transferor) and three or more party situations, where the beneficiary and settlor are different.

(1) Where the intended beneficiary is the settlor (or transferor/contributor)

2.89 In a two party trust, most cases work on the assumption that, if the claimant cannot enforce the trust, then the “trustee” will be effectively entitled to the property absolutely. However, there are judicial statements to suggest that the illegality is merely a personal disentitlement on the part of the claimant beneficiary, and that, for example, his creditors may be able to claim rights over it.⁶³ The interest appears to be in some sort of limbo. There is no suggestion in the case law that the trust property is forfeited to the State.

2.90 We believe that this confusion is unsatisfactory and unnecessary. We therefore propose that the court must declare, in those cases where it determines that the beneficiary ought not to be allowed to enforce the equitable interest, who ought to become entitled to it instead. The court can then determine in whom the interest is now vested and make such consequential orders as it sees fit.

2.91 In a two party situation, if the beneficiary is not to be allowed to enforce the trust, there are in most cases only two possible alternative owners. Either the legal owner may take beneficially, or the trust property, being effectively “ownerless”, should be forfeited to the State. In 1999 we asked respondents for their preferred option. Very few (seven) made any comments. Of these, four argued that the trust property would be ownerless and should belong to the State. Otherwise, it was argued, the trustee would be inevitably unjustly enriched by the decision. No one argued in favour of trustee ownership only. A few suggested that the preferable solution may vary from case to case and the courts should be given a choice about which option to pursue.

⁶² See paras 2.8 to 2.12 above.

⁶³ *Collier v Collier* [2002] EWCA Civ 1095, [2002] BPIR 1057.

2.92 We have found this a difficult matter to decide. In a different context,⁶⁴ several respondents expressed their reservations about giving the court a power to declare that trust property should belong to the State. It was suggested that this would amount to an order for the forfeiture of assets, which properly belongs to the criminal law. We tend to agree with this view. The only other option in most cases, therefore, is that the purported “trustee” should be allowed to keep the trust property. While such a solution will inevitably result in a windfall gain to the legal owner, there are safety checks to ensure that such a result is reached only in appropriate cases. In exercising its discretion not to enforce the trust, the court will have taken into account the conduct of the trustee. Furthermore, it will only be in exceptional cases that the court will have exercised its discretion not to allow the beneficiary to enforce the trust.

2.93 We therefore recommend that the court may determine that the legal owner of the property ought also to become the beneficial owner. This would appear to require a new statutory power to be given to the court. For example, even where the alleged “trustee” has not counterclaimed for any declaratory relief in his favour, we propose that the court should have the power to determine that the trustee ought to become entitled to the equitable interest in order to avoid uncertainty of ownership.

2.94 **In cases where the intended beneficiary and settlor are the same, we recommend that, if the court determines that the beneficiary ought not to be allowed to enforce the equitable interest, then it must make a declaration to that effect and declare in whom the equitable interest is now to be vested.**⁶⁵

(2) Where there is more than one beneficiary or the intended beneficiary and settlor are different people

2.95 In cases where there is more than one beneficiary or the intended beneficiary and settlor are not the same person, the situation is more complex because here there are a greater number of people competing over the same interest. Generally, when a primary trust fails, under the present law the trust property is held by the trustee on a “default” resulting trust in favour of the settlor. There is no question that the trustee might benefit personally. It is not clear, however, whether or how the reliance principle operates here. Could it ever prevent the settlor from being able to prove the resulting trust if the primary trust has failed because of illegality? It could be argued that the settlor has to “rely” on the illegality, in order to prove that the primary trust has failed. Certainly there are illegality cases where the courts have enforced resulting trusts in favour of the testator’s estate,⁶⁶ but there does not appear to have been a case where the claimant has been the settlor him or herself.

⁶⁴ This was in answer to the question whether a person who has declared him or herself trustee of an illegal trust should be required to transfer the trust property to the State: CP 154, para 8.71.

⁶⁵ See clause 4 of the draft Bill.

⁶⁶ For example, *Thrupp v Collett (No 1)* (1858) 26 Beav 125; 53 ER 844.

- 2.96 We raised this point in 1999 and asked whether consultees thought that the court should have a discretion to invalidate the “default” resulting trust. We did not receive many responses on this controversial issue. The majority of those who expressed a view thought that such a discretion should be available. It was felt that the courts would only use such a power in appropriate cases. It was also thought inconsistent to give the court a power to invalidate a fraudulent resulting trust in favour of the transferor in two party cases, but not to provide it with a similar power to invalidate a default resulting trust in favour of the settlor in three (or more) party cases. The minority argued that such a power would constitute unnecessary punishment of the settlor. It would be sufficient sanction that the primary trust is not enforceable. The settlor should not be in any worse position than he or she would have been had the illegal trust not been attempted at all.
- 2.97 Again, we have found this a difficult issue to resolve. In most cases, where the court exercises its discretion not to enforce the trust in favour of the intended beneficiary, the appropriate response would be to return the trust property to the settlor (as generally occurs when a trust fails). The failure of the primary trust would seem to be sufficient sanction to protect the policies that underlie the illegality doctrine. In most cases, the invalidity of this trust would prevent the integrity of the court system from being abused, would protect any rule which enforcing the trust would have infringed, and would deter others from attempting to set up similar trusts.⁶⁷
- 2.98 However, there may be cases where the court considers that the settlor’s illegal motivation has been so grave that simply unwinding the transaction is not sufficient to protect these policies. In these cases we consider that the court should determine that one of the other relevant parties to the arrangement ought to become entitled to the equitable interest. This may be the legal owner or any other beneficiary. We therefore recommend that the court should be given a power to determine that the settlor, trustee or any other beneficiary ought to become entitled to the equitable interest and make such consequential orders as it sees fit.
- 2.99 **In cases where there is more than one beneficiary or the intended beneficiary and settlor are different people, we recommend that, if the court determines that the intended beneficiary ought not to be allowed to enforce the equitable interest, then it must determine who ought to become entitled to the interest instead. This may be either the legal owner, the settlor or any other beneficiary.**⁶⁸

⁶⁷ For support for the view that it is sufficient to invalidate the trust in favour of the beneficiary and return the trust property to the settlor, see N Enonchong, “Illegal Transactions: The Future?” [2002] *Restitution Law Review* 82.

⁶⁸ See clause 4 of the draft Bill.

3. What should be the position where the original intended beneficiary has already dealt with the equitable interest in some way?

2.100 So far, we have been assuming that the claimant is the original intended beneficiary under the trust. However, in some cases, the claimant will be a person who alleges that he or she has acquired the interest from the original beneficiary in some way. For example, the original beneficiary may have purported to transfer the equitable interest to the claimant, or the claimant may be the heir of a deceased beneficiary. The outcome of the dispute will then depend on whether the original beneficiary was entitled to the equitable interest under the trust arrangement at some time in the past. We recommend that this should be dealt with in the same way as the general scheme, as outlined above.

2.101 The first step, therefore, will be for the court to make a declaration that the originally intended beneficiary was at the relevant time – that is, at the time that the claimant purports to have acquired the interest – entitled to enforce the trust. However, where the court considers that the circumstances are exceptional, the discretion will apply so that the court may determine that that beneficiary ought not, at that time, to have been allowed to enforce it, and that another person ought to have become entitled to it. The court can then determine in whom the interest should now be vested. This will allow the court to look at what has happened in relation to the equitable interest in the time since the claimant purports to have acquired it. For example, if the claimant has acted in good faith and spent money in relation to the interest, these are factors that the court can take into account in exercising its discretion.

For example, Mr G transfers money to the bank account of his friend Mr H so that Mr G can falsely claim state benefits. Both parties intend that the money should still belong to Mr G. Mr G dies and his son inherits his whole estate. When the son asks Mr H to transfer the funds to him, Mr H refuses. This case would fall within the recommended discretion. The court would declare that Mr G was entitled to the money at the time of his death, but will need to consider whether the circumstances were exceptional so that it should exercise its discretion to determine that Mr G ought not to have been entitled to enforce the trust in his favour. If the court were to make such a determination, the court would also have to determine who ought to have become entitled to the money instead.

2.102 **We recommend that in those cases where the claimant purports to have acquired the equitable interest from the original intended beneficiary of a trust to which the discretion applies, the court should declare that that beneficiary was entitled to the equitable interest, but that if the circumstances are exceptional, the discretion will apply to determine whether the beneficiary ought to have been allowed to enforce that interest.**⁶⁹

⁶⁹ See clauses 1(2), 3(2) and 4(1) of the draft Bill.

HOW WOULD THE DISCRETION INTERACT WITH OTHER LEGAL RULES?

- 2.103 The illegality defence clearly does not operate in a vacuum. We therefore need to consider how the recommended statutory discretion will interact with other legal rules which may be relevant to the recognition and enforcement of the trust. First, the purported beneficiary must establish that, illegality apart, he or she would be entitled to the equitable interest in dispute. For example, the usual trust rules relating to formalities, certainty and purpose will all apply.
- 2.104 More difficult to discern is how the discretion should interact with other rules relating to the illegality. We consider this issue below.

1. The discretion does not apply where a statute provides that the illegality prevents the beneficiary from enforcing the trust

- 2.105 We recommend that the discretion should not apply where a statute provides that the beneficiary may not enforce the trust created under an arrangement or transaction which involves a breach of one of its provisions.⁷⁰ The statute might say, for example, that the transaction is void or ineffective. Alternatively, the statute may make no express provision for the consequences. Instead, they may be implied from the express words. In either case, we do not intend that the discretion should apply to determine the equitable ownership. The court should instead defer to the Parliamentary intention set out in the statute.
- 2.106 **We recommend that the discretion should not apply where a statute provides that the trust is void or otherwise ineffective as a consequence of the illegality arising from a breach of one of its provisions.**

2. Where the discretion does apply, then the effect of the illegality on the equitable interest should be determined only by using the discretion and not by any other rule of common law or equity relating to the illegality

- 2.107 Once the court has determined that the case before it falls within the scope of the discretion, we recommend that no other rules relating to illegality should apply. In particular, the reliance principle, the withdrawal exception and the “clean hands” rule should not be used to determine the outcome of the case.

⁷⁰ There are numerous examples of legislative provisions which declare defined transactions to be void or ineffective. They are relevant to a much wider range of scenarios than those which we are considering. However, where they do apply to a case that would otherwise fall within the scope of the discretion, we consider that they should govern the position, and not the recommended discretion. For example, the Insolvency Act 1986 prescribes situations in which a transfer of shares or disposition is void, see sections 88 and 284.

2.108 The reliance principle and withdrawal exception have already been explained.⁷¹ Loosely related to, and potentially overlapping with, these rules is the equitable maxim of “clean hands”. Under this maxim, a claimant whose conduct has been improper will be denied equitable relief. Their Lordships representing the minority in *Tinsley v Milligan* argued that relief should be denied to Miss Milligan under the clean hands doctrine, but the majority rejected this approach. The maxim survives in other instances. It applies, for example, where the claimant seeks some form of discretionary equitable relief, such as specific performance or an injunction, or where the claimant asserts an equitable proprietary estoppel.⁷² We do not intend that it should have any role to play where the case falls within the statutory discretion. The conduct of the beneficiary will be taken into account as one of the factors that the court considers in exercising its discretion. All respondents who considered this matter agreed that this was the correct approach to take.

2.109 **We recommend that, where the discretion applies, it should be the sole determinant of the effect of the illegality.**

3. Severance

2.110 The severance rules are general trust rules that are used to determine which, if any, objectionable terms of a trust may simply be struck out and ignored. The term may be objectionable either because it is unlawful or for other reasons, for example, that it is impossible or contrary to public policy. If the objectionable term can be “deleted”, so that no illegal element remains, clearly the discretion would not apply.

2.111 The courts have developed technical rules for determining which terms can be “severed”. Broadly, if the trust property is land, the court must decide whether the term is a “condition precedent” or a “condition subsequent”. A condition precedent is one which must be satisfied before the gift can vest, whereas a condition subsequent operates to defeat an already vested gift by forfeiture.⁷³ Where the latter is objectionable, it may be struck out entirely and the rest of the trust is then enforced free of the condition. However, an invalid “condition precedent” will cause the whole trust to fail. The rules are similar in the case of personal property, but with an extra complication. Even where the condition is considered to be a condition precedent, the trust will not necessarily fail if the illegality is only “*malum prohibitum*” (not offensive in itself but made unlawful by statute). The trust will only fail where the illegality is “*malum in se*” (wrong in itself). This allows the court to strike out minor forms of illegality (even where expressed as a condition precedent), so as to enable the beneficiary to take the property clear of them.

⁷¹ The reliance principle was explained above at paras 2.2 to 2.4 and the withdrawal exception at paras 2.5 to 2.7.

⁷² *Gonthier v Orange Contract Scaffolding Limited* [2003] EWCA Civ 873, WL 21353340.

⁷³ An interest subject to a condition subsequent must be distinguished from a determinable interest. Where the determining event is unlawful, then the whole interest will fail: *Re Moore* (1888) 39 Ch D 116.

2.112 The rules of severance will not generally be relevant to the typical cases that fall within the proposed discretion. However, it is possible to imagine a scenario where they could be applied, and then we would want them to be. Only if the illegal condition could not be severed, would the discretion then be relevant. An example may help to explain the point:

A father wants to give money to his son but dislikes his daughter-in-law and does not want her to receive any benefit from his gift. He therefore transfers the money to a trustee to hold on trust for his son on the condition that the son does not declare the fund's existence should the son ever divorce.

2.113 If, under the general trust rules on severance, the condition could be struck out, then this will be a straightforward trust for the son. The discretion would not be relevant. In 1999 we provisionally proposed that the rules relating to when a term may be severed should be reformed.⁷⁴ However, there was not much support from consultees for our proposals. Given that we have now limited our recommendations for legislative reform to one narrowly defined area, we no longer propose to reform the severance rules as part of this project.

2.114 **We recommend that the statutory discretion should not apply to cases where it is possible under general trust principles to sever the terms tainted by illegality from the trust.**

4. The Proceeds of Crime Act 2002

2.115 In addition to the private law of illegality, the law contains extensive provisions on forfeiture, confiscation and civil recovery of the proceeds of crime. These provisions were increased by the Proceeds of Crime Act 2002. Earlier in our consultation we considered whether the concealment of trust property for illegal purposes could be dealt with solely by such legislation. However, we concluded that reform of the law on illegality and trusts was still needed for three main reasons:

- (1) In many cases a crime is contemplated but not actually committed;
- (2) Even if a crime is committed, it will often not be prosecuted;
- (3) Even if prosecuted, the subject matter of the trust will not necessarily be the proceeds of crime and therefore would not be caught by the confiscation provisions. For example, assets may be hidden to defraud creditors, but the concealment may be discovered before the creditors were actually defrauded.

2.116 Thus, in many cases the concealment of trust property for an illegal purpose will not be caught by the Proceeds of Crime Act 2002. We are therefore of the view that reform of the private law of illegality is needed, in order to provide remedies in addition to those under the Proceeds of Crime Act.

⁷⁴ See CP 154, paras 8.116 to 8.125.

2.117 However, we do not want our proposals to prejudice the powers which the State has under the Proceeds of Crime Act 2002 to recover the proceeds of crime.⁷⁵ We therefore think that it will be necessary to make small amendments to that legislation in order to clarify how it should interact with our proposed discretion.

2.118 Under the provisions for criminal confiscation contained in Part 2 of the Proceeds of Crime Act 2002, the court is required to determine the worth of the criminal – his or her “available amount”.⁷⁶ Any confiscation order imposed by the court on the criminal cannot be for more than this available amount. We want to prevent a criminal claimant from arguing that, because the court has determined that the criminal ought not to be allowed to enforce a beneficial interest under a trust, the available amount is thereby reduced by the value of that interest. When this argument has been raised in the past,⁷⁷ it has been peremptorily rejected. As Mr Justice Mitting said:

It cannot have been the intention of Parliament to allow a sound principle of civil law to prevent the enforcement by the state of the very provisions by which it is seeking to deprive criminals of the benefits of their crimes.⁷⁸

2.119 To ensure that a criminal is not able to benefit from our proposals in this way, we have included within the draft Bill provisions which will allow the value of the equitable interest to be included in the criminal’s available amount. The Proceeds of Crime Act 2002 already requires the court to include the value of any “tainted gifts” in its determination. The effect of our recommended amendments is to treat the beneficiary as having made a gift of any equitable interest that the court determines he or she ought not to be allowed to enforce.

2.120 The position is slightly different in relation to Part 5 of the Proceeds of Crime Act 2002 which deals with the civil recovery of property obtained through unlawful conduct. Here any recovery order is directed against the property, and not at the criminality of any particular individual. The order entitles the enforcing authority to recover the relevant property from whomever is now holding it. Generally property only ceases to be “recoverable property” when it is obtained by a person in good faith, for value and without notice that it was recoverable property.⁷⁹ Again we do not want the provisions in our Bill to interfere with the possible recovery of assets from the claimant (or any other relevant party) using civil confiscation proceedings. The draft Bill therefore contains a provision which makes it clear that any determination made under the discretion will not affect the operation of any civil confiscation proceedings.

⁷⁵ We looked at the relevant provisions in some detail in Appendix A to CP 189.

⁷⁶ Proceeds of Crime Act 2002, section 9.

⁷⁷ *R v David Edward Dale* [2006] EWCA Crim 1889.

⁷⁸ Above at [12].

⁷⁹ Special provision is needed in the draft Bill to prevent the legal owner from taking advantage of section 308(3) of the Proceeds of Crime Act 2002 which provides that property ceases to be recoverable property for the purposes of the civil recovery provisions if it is obtained in civil proceedings by a claimant whose claim is based on the unlawful conduct.

2.121 **We recommend that amendments should be made to the Proceeds of Crime Act 2002 to ensure that where the court exercises its discretion to determine that the beneficiary may not enforce the trust, there should be no adverse impact on the right of the State to recover the proceeds of crime.**⁸⁰

5. Where the purpose of the concealment of the equitable interest is in connection with an offence under foreign law

2.122 Our recommendations for reform are aimed at trusts that are created to conceal the equitable interest for a criminal purpose. The type of offence that the use of a trust arrangement most frequently facilitates is one associated with fraudulent behaviour. This type of offence is by its very nature not restricted by national boundaries. It would, for example, be quite easy for a transferor in one country to create a trust over property situated in a second country with the intention of committing a fraud within a third country. We need to consider whether, and if so how, our reform proposals should apply to such an international scenario.

2.123 Initially we were attracted to the idea that our reform proposals should only apply where the purpose of the trust arrangement would constitute a crime under the law of England and Wales. We considered that it could substantially increase the complexity of the proceedings if courts were required to take into account foreign criminal laws. However, this would leave the existing common law rules and the reliance principle to apply to any cases where the purpose of the arrangement was an offence in another country. It is not at all clear how those rules would be applied. Would the courts allow a claimant to rely on evidence that constituted an offence under the law of a foreign state? If not, the court would be required to take into account the foreign law in any event. In this case we felt that it would be better to do so in the context of our proposed discretion, rather than the reliance principle. There is very little authority at all on the correct choice of law rules for resulting or constructive trusts – the trusts most commonly found where the arrangement has been used to conceal an interest.⁸¹

2.124 We looked at the conflict of law rules which apply in other areas to see whether these might provide any guidance. The most closely analogous situation seemed to be the rules governing the enforcement of contractual obligations.⁸² Under the common law rules, a contract was not enforceable (whether lawful under its governing law or not) where its performance was unlawful in the country where the contract was to be performed.⁸³

⁸⁰ See clause 6 of the draft Bill.

⁸¹ The governing law of a trust is generally determined by the Recognition of Trusts Act 1987 which implements the Hague Convention on the law applicable to trusts. However, the extent to which this Act applies to resulting and constructive trusts has not yet been tested. Helpful discussion on this subject can be found in A Chong, "The Common Law Choice of Law Rules for Resulting and Constructive Trusts" (2005) 54 *International and Comparative Law Quarterly* 855 and Underhill and Hayton, *Law of Trusts and Trustees* (17th ed 2006) ch 25.

⁸² For a detailed account, see Dicey, Morris and Collins, *The Conflict of Laws* (14th ed 2006) ch 32.

⁸³ *Foster v Driscoll* [1929] 1 KB 470.

2.125 We therefore concluded that, by analogy, our discretion should apply not only where the concealment of the equitable interest is in connection with the commission of an offence under the law of England and Wales, but also where it is in connection with an offence under the law of the country where it was, or was intended to be, carried out. In the latter case, we do not consider that it is necessary that the conduct should also constitute an offence if it had taken place within England and Wales. Such an approach seemed unduly parochial⁸⁴ and would leave cases outside its remit within the scope of the unsatisfactory common law. Any concerns that we had that behaviour regarded as innocent by our criminal law, although penalised abroad, should not disproportionately affect a claimant's property rights were allayed by our confidence that the court would exercise its discretion with sensitivity.

2.126 **We recommend that the proposed discretion should apply where the concealment of the equitable interest was for the purpose of:**

- (1) **an offence under the law of England and Wales; or**
- (2) **an offence under the law of the country where the conduct element of the offence was, or was intended to be, carried out (whether or not it would also constitute an offence under the law of England and Wales).**⁸⁵

COMMENCEMENT AND EXTENT

1. Territorial extent

2.127 The draft Bill in Appendix A extends only to England and Wales. This is because the Law Commission cannot make recommendations for Northern Ireland and Scotland. However, the Proceeds of Crime Act 2002 extends to Northern Ireland and Scotland, and consideration should be given to introducing provisions implementing our recommendations in relation to this Act in these jurisdictions, in order to achieve a consistent approach.

2. Application of the discretion to existing trusts

2.128 We initially considered that our recommendations should only apply in relation to trusts that were created after the date of enactment of our draft Bill. This is consistent with the idea that legislative proposals should not retrospectively alter property rights. However, the effect of such a recommendation would be that the present unsatisfactory state of the law would continue for many years in relation to existing trusts, running alongside the statutory discretion which would apply to new trusts. Such an arrangement could certainly complicate an already complex area of the law. All the unsatisfactory features of the present law would continue for a long time into the future.

⁸⁴ The common law "double actionability" test for determining the applicable governing law adopted in tort law was regarded as unsatisfactory and has been replaced by the Private International Law (Miscellaneous Provisions) Act 1995. The applicable law is now generally the law of the country in which the events constituting the tort occur.

⁸⁵ See clause 2(7) of the draft Bill.

- 2.129 We therefore looked for an alternative approach which would result in less overlap, but at the same time would not risk undermining any person's property rights. We now recommend that the discretion should apply both to trusts created before and after the enactment of the Bill. However, beneficiaries should be given ample time between the enactment of the legislation and the date on which the discretion comes into force to consider whether they wish to rearrange their affairs. For example, a beneficiary who is concerned that he or she might lose the equitable interest under the exercise of the court's discretion could ask the trustee to transfer the property to him or herself thereby putting an end to the trust and to any possibility of concealment.
- 2.130 We have considered whether a recommendation that the scheme should apply to trusts existing at the date that the legislation is enacted would be compatible with the European Convention on Human Rights, and in particular with Article 1 of Protocol 1.⁸⁶ We consider that it would be. Article 1 of Protocol 1 protects a person's right to the peaceful enjoyment of his possessions, but this right is subject to the public interest. In our view, any potential deprivation of property pursuant to a court order relating to a trust that was created before enactment would be justifiable on the basis that the exercise of the discretion strikes a fair balance between the parties' interests and the public interest.
- 2.131 **We recommend that the statutory discretion should apply to all trusts within its scope whenever created, but that there should be a substantial period of time (say, one year) between the date of enactment of the provisions of the Bill and their coming into force.**⁸⁷

⁸⁶ This states that: "Every natural and legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law."

⁸⁷ See clause 7 of the draft Bill.

PART 3

ILLEGALITY AND OTHER CLAIMS

INTRODUCTION

- 3.1 In this Part we consider how the illegality defence applies in relation to claims other than those brought to enforce a beneficial interest under a trust. We start by considering claims for breach of contract, claims in relation to a tort, and claims for restitution to prevent unjust enrichment. These are dealt with in paragraphs 3.2 to 3.41. Different rules apply in relation to claims to protect proprietary interests transferred or retained under executed contracts. These are considered in paragraphs 3.42 to 3.47.

THE ILLEGALITY DEFENCE IN CONTRACT, TORT AND UNJUST ENRICHMENT

- 3.2 In our 2009 consultative report, we examined the present law in these areas in some depth.¹ We explained that, outside the context of proprietary claims, the reliance principle is by no means the universal rule that is used to determine whether illegality should have any effect on the civil claim. The case law in these other areas does occasionally refer to the reliance principle, but rarely to give it decisive effect.²
- 3.3 Where the claim is for breach of contract, the relevant illegality often involves the breach of a statutory regulation. If the regulation does not expressly specify what the effect of its breach should be on any contractual claim, then the court is left with the difficult task of interpreting the legislation to determine whether it impliedly provides for the issue.³ In addition, overlying this question of “statutory illegality”, there are common law illegality rules which may prevent the claim from succeeding. These are difficult to establish with any degree of certainty. Where the terms of the contract require the commission of an offence,⁴ or committing the offence was a purpose of entering into the contract,⁵ it is often stated that the contract will be unenforceable. However, there are exceptions to these rules – for example where the illegality involved is of a minor or trivial nature or one of the contracting parties was unaware of the other’s illegal intent.

¹ CP 189, Parts 3, 4, 5 and 7.

² For example, *Archbalds (Freightage) Ltd v S Spanglett Ltd* [1961] 1 QB 374, 388; *Colen v Cebrian (UK) Limited* [2003] EWCA Civ 1676, [2004] ICR 568 at [23].

³ The current purposive approach to take to an allegation of statutory illegality is set out by the Court of Appeal in *Hughes v Asset Managers plc* [1995] 3 All ER 669.

⁴ *J M Allan (Merchandising) Ltd v Cloke* [1963] 2 QB 340.

⁵ The relevant case law is reviewed in *Anglo Petroleum Limited v TFB (Mortgages) Limited* [2007] EWCA Civ 456, (2007) BCC 407.

- 3.4 In the consultative report we explained that there were problems with the present law. Of particular concern is its uncertainty. For example, the law on when a party can claim damages for breach of a contract that has been performed in an illegal way is not clear. Sometimes the illegality is ignored.⁶ In other cases the court has held that illegal performance prevents a party from being able to sue on the contract.⁷ It is not always clear how one case is distinguished from another. The judges have tended to focus on the point in time at which the parties decided on their illegal performance, but this is not always decisive.⁸
- 3.5 The result is a body of case law made up of an intricate web of tangled rules that are difficult to ascertain and distinguish. Neither litigants nor their advisers are able to predict with confidence which particular line of authority the court may follow. There is seldom any discussion in the judgments of what considerations the court has taken into account in deciding whether the illegality defence applies.
- 3.6 Similar criticisms might be made of the illegality rules as they apply to claims for unjust enrichment. The traditional approach adopted by the courts is to apply the Latin maxim “in pari delicto, potior est conditio defendentis” (where the parties are equally blameworthy, the defendant has the stronger position). The illegality defence will succeed unless the claimant is the “less blameworthy” party. To date this maxim has been inflexibly applied, so that the illegality defence fails in cases based on the duress,⁹ mistake¹⁰ or vulnerability of the claimant, but succeeds where the claim is based on a total failure of consideration.¹¹ There is little or no discussion of the relative merits of the parties, the proportionality of applying the defence or the policy considerations that justify its existence.
- 3.7 Until recently, there was equal confusion in relation to the illegality defence and claims in tort. The Court of Appeal decision in *Moore Stephens v Stone & Rolls*¹² held that the illegality defence depended on the indiscriminate application of the reliance principle and that no discretionary element was permitted. However, in its subsequent decision in *Gray v Thames Trains*,¹³ a differently constituted Court of Appeal adopted a broader proximity-based approach. Both cases have now been the subject of House of Lords’ decisions.¹⁴ In paragraphs 3.25 to 3.33 below, we look at the ramifications of these House of Lords’ decisions.

⁶ A ship owner who takes on more than the legally permitted weight of cargo is still able to sue for his fee: *St John Shipping Corporation v Joseph Rank Ltd* [1957] 1 QB 267.

⁷ An employee who participates in his or her employer’s PAYE fraud cannot claim unfair dismissal: *Hall v Woolston Hall Leisure* [2001] 1 WLR 225.

⁸ For a more detailed discussion see CP 189, paras 3.27 to 3.46.

⁹ *Davies v London and Provincial Marine Insurance Co* (1878) 8 Ch D 469.

¹⁰ *Kiriri Cotton Co Ltd v Dewani* [1960] AC 192.

¹¹ *Parkinson v College of Ambulance Ltd and Harrison* [1925] 2 KB 1.

¹² [2008] EWCA Civ 644, [2008] 3 WLR 1146.

¹³ [2008] EWCA Civ 713, [2009] 2 WLR 351.

¹⁴ See *Gray v Thames Trains* [2009] UKHL 33, [2009] 1 AC 1339 and *Stone & Rolls Limited v Moore Stephens* [2009] UKHL 39, [2009] 1 AC 1391.

- 3.8 Despite the criticisms that we made of the law in our consultative report, we noted that it was rare for the courts to reach what might be regarded as an “unjust” result. For the most part, the courts applied the illegality defence in a fair fashion, to achieve the right policy outcome. We examined the possible policy rationales for the illegality defence. We concluded that in the vast majority of cases the illegality defence only succeeded where one or more of those policies justified its use. We therefore provisionally recommended that since the common law was already reaching the right result, legislative intervention was neither necessary nor helpful.
- 3.9 The problem was that the courts were less good at articulating the policy reasons behind their reasoning. This meant that the law was not as transparent and clear as it might be. We noted that it was rare for the court to refer explicitly to any of the policy reasons that justified the application of the defence. Indeed in many cases the courts referred to the illegality doctrine as operating indiscriminately. Yet despite outwardly applying a set of rules, the courts do take into account a wide range of considerations to ensure the defence only applies where it is a just and proportionate response to the illegality involved. We argued that the courts should base their decisions directly on the policies that underlie the illegality defence and explain their reasoning accordingly. We considered that the common law could develop incrementally to reach this outcome.
- 3.10 In our 2009 consultative report we provisionally recommended that in each individual case the courts should consider whether the illegality defence can be justified on the basis of the policies that underlie that defence.¹⁵ The law would be clearer, more transparent and easier to understand if judges discussed these policy considerations openly in relation to the facts of the case before them. Following the recent House of Lords’ decisions in *Gray v Thames Trains*¹⁶ and *Stone & Rolls v Moore Stephens*,¹⁷ this does seem to be the direction in which the courts are moving, at least in relation to tortious claims.

The House of Lords’ decision in *Gray v Thames Trains*

- 3.11 The House of Lords handed down its judgment in *Gray v Thames Trains*¹⁸ some five months after we published the 2009 consultative report. In some very helpful judgments their Lordships looked at some of the policy reasons which justified the application of the illegality defence and explained why those policies applied to the facts of the case.

¹⁵ See Part 8, recommendations 8.3, 8.6 and 8.11.

¹⁶ [2009] UKHL 33, [2009] 1 AC 1339.

¹⁷ [2009] UKHL 39, [2009] 1 AC 1391.

¹⁸ [2009] UKHL 33. See, P Davies, “The Illegality Defence and Public Policy” (2009) 125 *Law Quarterly Review* 556.

- 3.12 The claimant, “a decent and law-abiding citizen”, sustained minor physical injuries in the Ladbroke Grove rail crash. He also suffered a psychiatric injury in the form of post traumatic stress disorder, which led to a significant change in his personality. He became unable to hold down a job. About two years after the crash, he stabbed a complete stranger to death. The claimant was convicted of manslaughter on the grounds of diminished responsibility and sentenced to be detained in hospital. He claimed damages for his loss of earnings from the date of the crash. He also claimed general damages for his detention, conviction, feelings of guilt and an indemnity against any claims which might be brought against him by the dependants of his victim.
- 3.13 The defendants accepted liability for the rail crash and loss of earnings up to the date of the killing. However, relying on the illegality defence, they argued that they were not liable for any loss of earnings after that date or for the general damages claims. The defendants did not dispute that but for the psychiatric injury that the claimant suffered in the rail crash, he would not have killed anybody.
- 3.14 The House of Lords held that the illegality defence applied both to the claim for lost earnings after the date of the manslaughter and to the general claims based directly on the killing and conviction.
- 3.15 Lord Hoffmann (in a judgment with which Lords Phillips and Lord Scott agreed) said that there was both a narrow and a wide form of the illegality defence. The narrow form is that:

You cannot recover for damage which flows directly from loss of liberty, a fine or other punishment lawfully imposed upon you in consequence of your unlawful act.¹⁹

- 3.16 This is justified on the basis of consistency. Where the law, as a matter of penal policy, has caused the damage, it would be inconsistent for the law to require you to be compensated for that damage. This narrow version of the illegality defence meant that neither damages for the loss of earnings after the date of the killing were recoverable nor general damages for the conviction and detention.²⁰
- 3.17 The wide form of the illegality defence is that:

You cannot recover compensation for loss which you have suffered in consequence of your own criminal act.²¹

¹⁹ [2009] UKHL 33 at [29].

²⁰ [2009] UKHL 33 at [33] to [50].

²¹ [2009] UKHL 33 at [29].

- 3.18 This wide version is justified on the basis that it is offensive to public notions of the fair distribution of resources that a claimant should be compensated (usually out of public funds) for the consequences of his own criminal conduct. The wide version of the rule might lead to difficult issues of causation. Lord Hoffmann said he did not find it helpful to apply a Latin tag such as whether the claim arose “*ex turpi causa*” (that is, “from a dishonourable cause”).²² Nor was it useful to apply a test based on whether there was “an inextricable link”²³ between the claim and the illegality.²⁴ Rather, a distinction had to be drawn between cases where, although the damage would not have happened but for the tortious conduct of the defendant, it was caused by the criminal act of the claimant; and cases where, although the damage would not have happened without the criminal act of the claimant, it was caused by the tortious act of the defendant. On the facts of this case, the wide version of the defence ruled out the claim for general damages for feelings of guilt and the claim for an indemnity against claims by dependants of the victim.²⁵
- 3.19 Lord Hoffmann explained that the illegality defence is “not so much a principle as a policy”.²⁶ It is a policy based on not one but several justifications, which would vary in different circumstances. Therefore a rule which might be applicable in one area of the law would not necessarily be applicable in another. In particular, he had not found any discussion of *Tinsley v Milligan* and the reliance principle helpful in the context of the case before him.

The House of Lords’ decision in *Stone & Rolls*

- 3.20 The House of Lords handed down its judgment in *Stone & Rolls v Moore Stephens* in late July 2009.²⁷ The case involved several issues, including the illegality defence.

²² [2009] UKHL 33 at [30]. This test was suggested by Bingham LJ in *Saunders v Edwards* [1987] 1 WLR 116, 1134.

²³ The need for an “inextricable link” between the claim and the illegality was suggested by Judge LJ in *Cross v Kirkby*, *The Times* 5 April 2000 and adopted in subsequent cases, for example, *Vellino v Chief Constable of the Greater Manchester Police* [2002] 1 WLR 218.

²⁴ [2009] UKHL 33 at [48].

²⁵ Above at [51] to [55].

²⁶ Above at [30] to [31].

²⁷ [2009] UKHL 39.

- 3.21 The appellant company, Stone & Rolls, was managed and effectively controlled by Mr Stojevic. Moore Stephens, the defendants, acted as the auditors of Stone & Rolls. Unknown to Moore Stephens, Mr Stojevic used Stone & Rolls as a vehicle to defraud several banks. The most substantial fraud was committed against a Czech bank which eventually brought proceedings against Mr Stojevic and Stone & Rolls for deceit.²⁸ In these proceedings both of the defendants were found liable. The effect of this judgment was that Stone & Rolls went into provisional liquidation. Stone & Rolls subsequently brought a concurrent action in contract and tort against Moore Stephens for their negligence in failing to detect Mr Stojevic's fraudulent activities at an earlier date.
- 3.22 Moore Stephens accepted that they owed Stone & Rolls a duty to exercise reasonable care and skill in carrying out their duties as auditors, and that they breached this duty by failing to detect the fraud. However Moore Stephens argued that the claim by Stone & Rolls could not succeed as it was founded on the fraud committed by Stone & Rolls. The first main issue was whether the fraudulent acts of Mr Stojevic could be attributed to Stone & Rolls as a company. The next issue was whether the illegality defence should bar the claim on the basis that Stone & Rolls would need to rely on Mr Stojevic's illegal acts to prove their claim.
- 3.23 The House of Lords held by a majority of three to two that the acts of Mr Stojevic should be attributed to Stone & Rolls and that illegality should bar the claim. However, the reasoning of the majority differed. Both Lord Walker and Lord Brown proceeded on the basis that, providing the acts of Mr Stojevic could be attributed to Stone & Rolls, the reliance principle should operate so as to bar the claim. Lord Phillips rejected the argument that the reliance principle should be applied automatically. However, he held that in this case the illegality did bar the claim. This was because Moore Stephens' duty did not extend to creditors. It extended only to protecting the company and its shareholders, and in this case these parties could not take advantage of that protection as they had acted fraudulently.
- 3.24 Of the minority, Lord Scott rejected the idea that the illegality defence had any application to the case. He argued that if Stone & Rolls were to succeed, the only parties to benefit would be the creditors who had been defrauded. Lord Mance did not consider the application of the reliance principle or the illegality defence at great length and decided the case on the other issues that were involved.

²⁸ *Komerčni Banka As v Stone & Rolls Ltd* [2002] EWHC 2263 (comm), [2003] 1 Lloyd's Rep 383.

Consequence of the House of Lords' decisions

Gray v Thames Trains

- 3.25 The House of Lords' decision in *Gray v Thames Trains* makes it clear that in tort cases the illegality defence must be justified in terms of public policy. The judges rejected the mechanical use of a formal test based on which party must "rely on" or plead the illegality. We anticipate that the reasoning adopted by courts in deciding whether the illegality defence succeeds will therefore become more transparent. One clear ground on which the illegality defence may be applied is consistency. Lord Hoffmann and Lord Rodger drew support for this rationale from decisions of the Canadian Supreme Court, where the illegality defence has been strictly confined and limited to cases where "allowing the plaintiff's claim would introduce inconsistency into the fabric of the law".²⁹ They also referred to an earlier decision of the New South Wales Court of Appeal which similarly used consistency as a reason to allow the defence.³⁰
- 3.26 However, their Lordships made it clear that unlike the Canadian Supreme Court they did not consider consistency to be the only underlying rationale for the illegality defence. This would have resulted in a very narrow doctrine. Instead, Lord Hoffmann explained that the illegality defence is based upon a group of reasons, which vary in different situations.³¹ It seems that the courts are to look at a range of factors in deciding whether these policy issues apply. Certainly the moral culpability of the claimant is one of them. Lord Phillips reserved his position in a case where the claimant, although detained under the Mental Health Act 1983, had not shown any significant responsibility for his offence.³² Another relevant factor is the seriousness of the illegality involved. For example, Lord Rodger suggested that the decision might have been different if the offence for which the claimant was convicted was trivial.³³

Stone & Rolls

- 3.27 Unlike *Gray v Thames Trains*, *Stone & Rolls v Moore Stephens* involved the consideration of issues other than illegality.³⁴ This, coupled with the different reasoning used by each of their Lordships, makes this a harder case from which to extract general principles regarding the application of the illegality defence.

²⁹ *Hall v Hebert* [1993] 2 SCR 159, 180 by McLachlin J. This was followed in *British Columbia v Zastowny* [2008] 1 SCR 27.

³⁰ "If the law of negligence were to say, in effect, that the offender was not responsible for his actions and should be compensated by the tortfeasor, it would set the determination of the criminal court at naught. It would generate the sort of clash between civil and criminal law that is apt to bring the law into disrepute": *State Rail Authority of New South Wales v Wiegold* (1991) 25 NSWLR 500, 514 by Samuels JA.

³¹ [2009] UKHL 33 at [30].

³² Above at [15]. Lord Rodger and Lord Brown agreed with these reservations: [2009] UKHL 33 at [83] and [103].

³³ Above at [83].

³⁴ [2009] UKHL 39.

THE APPLICATION OF THE ILLEGALITY DEFENCE

- 3.28 Again, the House of Lords appeared to reject the idea that the reliance principle should operate in a mechanical fashion. Lord Phillips made this point explicitly:

I do not believe that it is right to proceed on the basis that the reliance test can automatically be applied as a rule of thumb. It is necessary to give consideration to the policy underlying the *ex turpi causa* in order to decide whether this defence is bound to defeat [Stone & Rolls'] claim.³⁵

- 3.29 Lord Phillips identified the critical policy issue as whether the auditors had a duty to protect the creditors, for whose benefit the claim was brought.³⁶ He concluded that they did not. The auditor's duty was only owed to the shareholders. In this case, the duty was only owed to Mr Stojevic, who was the sole will and mind and beneficial owner. Clearly, Mr Stojevic could not recover for his own fraud. It therefore followed that the illegality defence barred the claim.³⁷

- 3.30 Lord Phillips observed that the central policy question ("whom did the auditor's duty protect?") also appeared to underlie the reasoning of the other judges. Lord Walker and Lord Brown thought that the duty was owed for the benefit of shareholders but not creditors. On the other hand, Lord Mance considered that auditors should also protect the interests of creditors.³⁸

- 3.31 Although Lord Brown and Lord Walker appeared to apply the illegality defence in a more mechanistic way, both conceded that this should not be done where different facts led to different policy considerations being relevant. For example Lord Brown said:

I recognise, of course, that confining the *ex turpi causa* defence, as I would, to one man company frauds means that, where any innocent shareholders are involved, a claim against the auditors may well lie (through the company) at their suit.... A claim of that nature would seem to me to accord altogether more readily with the policies and principles generally understood to apply in this context.³⁹

³⁵ [2009] UKHL 39 at [25].

³⁶ Above at [67].

³⁷ Above at [86].

³⁸ Above at [68].

³⁹ Above at [203].

- 3.32 It is difficult to anticipate what precedent, if any, *Stone & Rolls* will set regarding the illegality defence. Though there was a majority verdict, there was no majority reasoning, with all their Lordships reaching different conclusions on how the defence should be applied. However there was no general endorsement of the view that the illegality defence should always be applied so as to defeat a claim founded on an illegal act. The majority judges all confined their reasoning to cases of fraud committed by “one man companies”, in which the beneficial owners were all implicit in the fraud. Furthermore, we are encouraged by the references made by their Lordships to the importance of considering the policies that underlie the application of the illegality defence.

THE “VERY THING” PRINCIPLE

- 3.33 Following the reasoning of Lord Justice Buxton in *Reeves v Commissioner of the Police of the Metropolis*, it had been argued that where a party is under a duty to prevent a claimant from committing an illegal act and the claimant goes on to commit the very same illegal act, the claimant should always have remedy for the breach of duty notwithstanding the claimant’s illegality.⁴⁰ To do otherwise would render the duty nugatory. This has become known as the “very thing” principle. In *Stone & Rolls* it was argued that the “very thing” which the auditors were under a duty to do was to prevent the commission of fraud. They could not therefore rely on the very fraud which they were supposed to prevent to avoid liability for their breach of duty. All of their Lordships rejected this argument, save for Lord Scott. Lord Walker, Lord Brown and Lord Mance agreed that the “very thing” principle was no more than a principle of causation which was not in itself capable of preventing the application of the illegality defence. Thus, in the future, it is unlikely that the “very thing” principle will influence the use of the illegality defence in tort cases.

Subsequent cases

- 3.34 Since *Stone & Rolls v Moore Stephens* and *Gray v Thames Trains*, two subsequent High Court decisions have applied the House of Lords’ reasoning on illegality. In *Nayyar v Denton Wilde Sapte*⁴¹ the claimants sued solicitors for breach of contract and negligence. They sought damages for their failure to recover a deposit paid to a third party. The defendants argued that the deposit money amounted to a bribe and so the claim was barred by the illegality defence. Mr Justice Hamblen did not apply the reliance principle automatically but instead looked at the underlying policy, citing Lord Phillips’ two policy principles from *Stone & Rolls*; that the court will not enforce a contract forbidden by statute or entered into with the intention of committing an illegal act, nor will it assist a claimant to recover a benefit from his own wrongdoing. He then proceeded to look at the degree of connection between the wrongful conduct, along with the seriousness of the offence. He concluded that bribery involves “serious moral turpitude” which was sufficient to bring the defence into play.⁴²

⁴⁰ [1999] QB 169.

⁴¹ [2009] EWHC 3218.

⁴² Above at [92].

- 3.35 The second case, *K/S Lincoln v CB Richard Ellis Hotels Ltd*,⁴³ was an application to strike out a paragraph of the defence which contained an allegation of unlawful tax evasion. Mr Justice Coulson again considered the policy basis of the illegality defence. He cited Lord Hoffmann's statement in *Gray v Thames Trains* that the maxim "*ex turpi causa*" expressed not so much a principle as a policy, based on a group of reasons which varied in different situations. He also cited Lord Phillips' explanation of the underlying policy from *Stone & Rolls*. He derived a number of general principles from recent authorities, and concluded that the underlying policy rationale for the illegality defence was one of deterrence:

Although the test is no longer to ask if the public conscience is affronted by the allowance of such a claim (*Tinsley v Milligan*), it seems clear that the underlying principle or policy is one of deterrence; that the courts will not encourage illegal acts by allowing claims based upon them.⁴⁴

- 3.36 These two cases are encouraging developments which indicate a willingness to move away from a mechanical application of the reliance principle and instead explore the relevant policy reasons which are at the heart of the defence. When deciding whether the illegal behaviour should bar the claim, the courts recognised the importance of the connection between the illegality and the claim, and the seriousness of the offence. The cases appear to confirm that incremental change is already taking place.

Conclusion

- 3.37 In our 2009 consultative report, we argued that it was open to the courts to develop the law in ways that would render it considerably clearer, more certain and less arbitrary. Instead of purporting to apply rigid rules, the courts should consider each case to see whether the application of the illegality defence can be justified on the basis of the policies that underlie that defence. We did not think this would require a major alteration. The policy rationales were already found within the case law and the courts already apply them to do justice. All that was required was an incremental change, as courts became more prepared to articulate the policy reasons behind their decisions.
- 3.38 The decision in *Gray v Thames Trains* shows that this incremental change is already taking place. As Lord Hoffmann explained, the illegality defence is based upon a group of reasons, which vary in different situations. In each case, the policy reasons must be considered against the facts of the case. *Stone & Rolls* is a more difficult decision, but we do not think it is inconsistent with this approach.

⁴³ [2009] EWHC 2344.

⁴⁴ Above at [22].

- 3.39 *Gray v Thames Trains* was a claim in tort and *Stone & Rolls* involved a concurrent claim in both contract and tort. However, there appears to be no reason why a similar approach might not be adopted in relation to claims for the reversal of unjust enrichment or indeed any other claims falling outside the strict remit of *Tinsley v Milligan*.⁴⁵
- 3.40 In view of these trends within the case law, we do not think that legislative reform is needed outside the area of trust law.
- 3.41 **We do not recommend legislative reform in relation to the illegality defence as it applies to claims for breach of contract, tort or unjust enrichment.**

CLAIMS TO RECOGNISE LEGAL PROPERTY RIGHTS

- 3.42 Where a legal interest in property is transferred under a contract that involves some element of illegality, ownership of the interest passes. The legal rights created by the contract will be recognised and enforced by the courts. This is the position despite the fact that, if the contract had not been executed, the illegality defence would have defeated any claim to enforce the contract.⁴⁶ Once the contract has been completed, the illegality has no effect.
- 3.43 The same rule applies where the contract is for the transfer of a limited legal interest only – for example, a lease. The court will recognise that the limited interest has passed to the transferee.⁴⁷ The position is slightly more difficult in relation to the transferor who is seeking to protect his or her reversionary interest on the termination of the limited interest. This looks much more like an attempt to enforce a contract. However, the courts will still protect such an interest, provided that the claimant can prove it without having to plead or “rely on” the illegality.
- 3.44 This rule, the same “reliance principle” which we have already discussed in relation to equitable interests, stems from a decision of the Court of Appeal in *Bowmakers Ltd v Barnet Instruments Ltd*.⁴⁸ The defendants had hired tools from the claimant finance company under three separate hire purchase agreements. The agreements were part of an arrangement that contravened statutory pricing regulations and were assumed to be “illegal”. After making some of the payments due under the agreements, the defendants refused to pay anything further. They sold the tools hired under two of the agreements and refused to return the tools hired under the third. The Court of Appeal found the defendants liable to the claimant for conversion in respect of all the tools, on the basis that the claimant could prove its reversionary interest without founding its claim on the illegal contract or pleading its illegality. This case shows that the way in which the courts have interpreted the reliance principle means that the illegal contract, once executed, is “past history” which can be ignored.

⁴⁵ [1994] 1 AC 340.

⁴⁶ *Singh v Ali* [1960] AC 167.

⁴⁷ *Feret v Hill* (1845) 15 CB 207, 139 ER 4000.

⁴⁸ [1945] KB 65.

- 3.45 This reliance principle is heavily enshrined in the law. Indeed in the House of Lords' decision in *Tinsley v Milligan*,⁴⁹ their Lordships held that it was the only rule applicable when deciding the effect of illegality on the recognition and enforcement of all property rights generally, whether legal or equitable. In Part 2 we have considered this rule in the trusts context in more detail, and indeed recommended its abolition in the trusts context.
- 3.46 In our 2009 consultative report we recognised that the possibility for common law development was limited in this area of the law. However, we also reported that it was clear from the responses that we received to our earlier 1999 consultation paper that generally the law was felt to be satisfactory here. Respondents told us that if the illegality defence had a greater role to play in relation to the recognition and enforcement of legal property rights this would cause unacceptable uncertainty and would be detrimental to the interests of third parties.
- 3.47 **We do not recommend legislative reform of the illegality defence as it applies to claims to enforce legal interests created, transferred or retained under contracts involving some element of illegality.**

⁴⁹ [1994] 1 AC 340.

PART 4

LIST OF RECOMMENDATIONS

- 4.1 We make the following recommendations:

ILLEGALITY IN TRUSTS

- 4.2 Legislative reform is needed to provide the courts with a discretion to determine the effect of illegality on a limited class of trust. (Paragraph 2.22)

WHEN SHOULD THE DISCRETION APPLY?

Trusts created to conceal ownership for a criminal purpose

- 4.3 The statutory discretion should apply when the trust arrangement is created in order to conceal the beneficiary's interest in the trust property in connection with a criminal purpose.¹ (Paragraph 2.32)
- 4.4 The statutory discretion should apply whether or not the criminal purpose has been acted upon.² (Paragraph 2.33)
- 4.5 The statutory discretion should apply whether it is the beneficiary or the trustee who intends to use the trust arrangement in order to conceal the real ownership of the trust property.³ (Paragraph 2.34)
- 4.6 The statutory discretion should apply when the trust arrangement is created for other purposes in addition to the concealment of the real ownership.⁴ (Paragraph 2.35)

Trusts subsequently used to conceal ownership for a criminal purpose

- 4.7 The discretion should apply where the intention to use the trust arrangement to conceal the beneficial ownership for a criminal purpose is formed after the trust was created. However, it should be limited to cases where:
- (1) the beneficiary has taken steps to ensure that the trust arrangement continues in place so that the concealment can be made; and
 - (2) the criminal purpose has been carried out either by the beneficiary or by somebody with the beneficiary's consent.⁵ (Paragraph 2.42)

Other recommendations on when the discretion should apply

- 4.8 The statutory discretion should apply even where the parties did not realise that the concealment would be criminal and where there has not been any prosecution.⁶ (Paragraph 2.48)

¹ See clause 2(2) of the draft Bill.

² See clause 2(2) of the draft Bill.

³ See clause 2(3)(a) of the draft Bill.

⁴ See clause 2(3)(b) of the draft Bill.

⁵ See clause 2(4) of the draft Bill.

- 4.9 The statutory discretion should apply when the concealment of the beneficial ownership would itself constitute a criminal offence.⁷ (Paragraph 2.49)
- 4.10 The statutory discretion should apply whichever type of trust is in issue.⁸ (Paragraph 2.50)
- 4.11 The statutory discretion should apply to cases both where the settlor and beneficiary are the same person and to cases where the settlor and beneficiary are different.⁹ (Paragraph 2.53)

HOW THE DISCRETION SHOULD OPERATE

A declaration of entitlement

- 4.12 The first step that the court should take in relation to a trust to which the discretion applies is to declare that the intended beneficiary is entitled to the equitable interest.¹⁰ (Paragraph 2.57)

The need for exceptional circumstances

- 4.13 The illegality should only have an effect on the beneficial entitlement under the trust when the court considers that there are exceptional circumstances.¹¹ (Paragraph 2.61)

The factors the court may take into account when exercising its discretion

- 4.14 The legislation should provide a non-exhaustive list of the factors that might be relevant for the court to take into account when exercising its discretion to determine that the beneficiary ought not to be allowed to enforce the equitable interest.¹² (Paragraph 2.79)
- 4.15 We recommend that those factors should be:
- (1) the conduct and intention of all of the relevant parties;
 - (2) the value of the equitable interest at stake;
 - (3) the effect of allowing the claim on the criminal purpose;
 - (4) whether refusing the claim would act as a deterrent; and
 - (5) the possibility that the person from whom the equitable interest was being concealed may have an interest in the value of the assets of the beneficiary. (Paragraph 2.80)

⁶ See clause 2(5)(a) and (c) of the draft Bill.

⁷ See clause 2(6) of the draft Bill.

⁸ See clause 1(4)(b) of the draft Bill.

⁹ See clause 2 of the draft Bill.

¹⁰ See clause 3(1) of the draft Bill.

¹¹ See clause 4(1) of the draft Bill.

¹² See clause 5(1) of the draft Bill.

THE CONSEQUENCES OF THE COURT'S DECISION

No power to allow the beneficiary to enforce on special terms

- 4.16 We do not recommend that the court should be given a discretionary power to determine that the beneficiary ought to be allowed to enforce the equitable interest only on terms that require the beneficiary to make a payment or transfer property to a third party. (Paragraph 2.86)

Where the court determines that the beneficiary may not enforce the trust

- 4.17 In cases where the intended beneficiary and settlor are the same, we recommend that, if the court determines that the beneficiary ought not to be allowed to enforce the equitable interest, then it must make a declaration to that effect and declare in whom the equitable interest is now to be vested.¹³ (Paragraph 2.94)
- 4.18 In cases where there is more than one beneficiary or the intended beneficiary and settlor are different people, we recommend that, if the court determines that the intended beneficiary ought not to be allowed to enforce the equitable interest, then it must determine who ought to become entitled to the interest instead. This may be either the legal owner, the settlor or any other beneficiary.¹⁴ (Paragraph 2.99)

Where the original beneficiary has disposed of the equitable interest

- 4.19 In those cases where the claimant purports to have acquired the equitable interest from the original intended beneficiary of a trust to which the discretion applies, the court should declare that that beneficiary was entitled to the equitable interest, but that if the circumstances are exceptional, the discretion will apply to determine whether the beneficiary ought to have been allowed to enforce that interest.¹⁵ (Paragraph 2.102)

INTERACTION WITH OTHER LEGAL RULES

Statutory provisions

- 4.20 The discretion should not apply where a statute provides that the trust is void or otherwise ineffective as a consequence of the illegality arising from a breach of one of its provisions. (Paragraph 2.106)

Rules of common law or equity

- 4.21 Where the discretion applies, it should be the sole determinant of the effect of the illegality. (Paragraph 2.109)

Severance

- 4.22 The statutory discretion should not apply to cases where it is possible under general trust principles to sever the terms tainted by illegality from the trust. (Paragraph 2.114)

¹³ See clause 4 of the draft Bill.

¹⁴ See clause 4 of the draft Bill.

¹⁵ See clauses 1(2), 3(2) and 4(1) of the draft Bill.

Proceeds of Crime Act 2002

- 4.23 Amendments should be made to the Proceeds of Crime Act 2002 to ensure that where the court exercises its discretion to determine that the beneficiary may not enforce the trust, there should be no adverse impact on the right of the State to recover the proceeds of crime.¹⁶ (Paragraph 2.121)

Offences under foreign law

- 4.24 The proposed discretion should apply where the concealment of the equitable interest was for the purpose of:
- (1) an offence under the law of England and Wales; or
 - (2) an offence under the law of the country where the conduct element of the offence was, or was intended to be, carried out (whether or not it would also constitute an offence under the law of England and Wales).¹⁷ (Paragraph 2.126)

COMMENCEMENT AND EXTENT

Application of the discretion to existing trusts

- 4.25 The statutory discretion should apply to all trusts within its scope whenever created, but that there should be a substantial period of time (say, one year) between the date of enactment of the provisions of the Bill and their coming into force.¹⁸ (Paragraph 2.131)

ILLEGALITY AND OTHER CLAIMS

- 4.26 We do not recommend legislative reform in relation to the illegality defence as it applies to claims for breach of contract, tort or unjust enrichment. (Paragraph 3.41)
- 4.27 We do not recommend legislative reform of the illegality defence as it applies to claims to enforce legal interests created, transferred or retained under contracts involving some element of illegality. (Paragraph 3.47)

(Signed) JAMES MUNBY, *Chairman*
ELIZABETH COOKE
DAVID HERTZELL
JEREMY HORDER
FRANCES PATTERSON

MARK ORMEROD, *Chief Executive*
10 February 2010

¹⁶ See clause 6 of the draft Bill.

¹⁷ See clause 2(7) of the draft Bill.

¹⁸ See clause 7 of the draft Bill.

**APPENDIX A
DRAFT TRUSTS (CONCEALMENT OF
INTERESTS) BILL**

DRAFT
OF A
B I L L
TO

Make provision about cases where arrangements in respect of property have been made, or continued, so as to enable an equitable interest in the property to be concealed in connection with the commission of an offence.

BE IT ENACTED by the Queen’s most Excellent Majesty, by and with the advice and consent of the Lords Spiritual and Temporal, and Commons, in this present Parliament assembled, and by the authority of the same, as follows:—

1 Application of this Act

- (1) Sections 3 to 5 of this Act apply if in any proceedings—
- (a) there is a dispute about the entitlement of a person (in this Act referred to as “B”) to an equitable interest under a trust of any property,
 - (b) the court is satisfied that the arrangements made in respect of the property are such that B is entitled to an equitable interest in it, or would be so entitled if reliance on an unlawful act or purpose were allowed, and 5
 - (c) the court is also satisfied that either of the concealment conditions set out in section 2 is satisfied in relation to the arrangements, or that both of them are. 10
- (2) The dispute may be about a past entitlement (for example, where B has died), and in that case the references in paragraphs (b) and (c) of subsection (1) to the arrangements and the concealment conditions are to be read as if they referred not to the present but to the relevant time in the past. 15
- (3) For the purposes of this Act it does not matter—
- (a) whether or not it appears to the court that there are, or were, or would be or would have been, any other equitable interests in the property;
 - (b) whether or not anyone knew that a trust would be or had been established, or established at any particular time. 20
- (4) In this Act—

- (a) references to arrangements, in relation to property in which there is an equitable interest, include setting up a trust expressly;
- (b) “trust” means any description of trust;
- (c) “property” includes anything capable of being held on trust.

2 Concealment conditions

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- (1) The concealment conditions are as follows.
- (2) The first condition is that the arrangements mentioned in section 1(1)(b) were made in order to enable B’s interest in the property to be concealed in connection with the commission of an offence (whether or not an offence has in fact been committed). 10
- (3) For the purposes of the first condition, the following do not matter –
 - (a) whether or not the purpose mentioned in subsection (2) was shared by all the relevant parties;
 - (b) whether or not the arrangements were also made for another purpose.
- (4) The second condition is that since the arrangements mentioned in section 1(1)(b) were made – 15
 - (a) B has taken steps to secure that the arrangements continue in being, with the intention of enabling them to be exploited in order to conceal B’s interest in the property in connection with the commission of an offence, and 20
 - (b) B, or another person with B’s consent or connivance, has so exploited them.
- (5) For the purposes of this section it does not matter –
 - (a) whether or not anyone knew that an act (or intended act) of concealment involved (or would involve) committing an offence; 25
 - (b) whether or not it was B who would have committed an offence;
 - (c) whether or not anyone has been or is to be prosecuted for an offence.
- (6) In this section –
 - (a) concealment in connection with the commission of an offence includes the case where the concealment would itself involve committing an offence; 30
 - (b) concealment includes failure to disclose in circumstances where there is a duty to disclose.
- (7) In this section, references to an “offence” are to –
 - (a) an offence under the law of England and Wales, and 35
 - (b) an offence under the law of any other part of the United Kingdom, or the law of any other country or territory, where all or any part of the conduct element of the offence was to occur, or would have occurred.

3 Declaration of entitlement

- (1) Where this section applies (see section 1(1)), the court must declare that (notwithstanding an unlawful act or purpose, if any) – 40
 - (a) B is entitled to the relevant equitable interest, or
 - (b) in the case mentioned in section 1(2), B was at the relevant time entitled to it.

- (2) In this section (and in sections 4 and 5), “the relevant equitable interest” means the interest which by virtue of section 1(1)(b) the court has satisfied itself that B is (or was) entitled to (or would be, or would have been, entitled to, if reliance on an unlawful act or purpose were allowed).

4 Court’s further powers

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- (1) If in the court’s opinion the circumstances are exceptional, the court may (in addition to making a declaration under section 3) also determine in the light of the exceptional circumstances –
- (a) that B ought not to be allowed to enforce the relevant equitable interest, or in the case mentioned in section 1(2) ought not at the relevant time to have been allowed to enforce it, and 10
 - (b) that, instead of B, a person mentioned in subsection (4) ought to become entitled to the relevant equitable interest, or in the case mentioned in section 1(2) ought at the relevant time to have become entitled to it.
- (2) If the court makes a determination under subsection (1), it must determine in whom the relevant equitable interest is accordingly now to be vested. 15
- (3) A determination under subsection (1)(b) –
- (a) may not include a person from more than one paragraph of subsection (4), but
 - (b) includes all the persons of the relevant description, in such shares as the court determines, if there is more than one such person. 20
- (4) The persons are the following, not including any of them who is also B, or in the case mentioned in section 1(2) was also B at the relevant time –
- (a) the trustee;
 - (b) the settlor; 25
 - (c) any beneficiary under the same trust.
- (5) In this section “the relevant equitable interest” has the meaning given by section 3(2).

5 Sections 3 and 4: supplementary

- (1) In making any determinations under section 4, the court may take anything which it thinks relevant into account, including (for example) –
- (a) the conduct of all the relevant persons;
 - (b) the effect which the declaration or determination would have on any relevant unlawful act or purpose;
 - (c) the fact that an offence has, or has not, been committed; 35
 - (d) the value of the relevant equitable interest;
 - (e) any deterrent effect on others;
 - (f) the possibility that a person from whom the relevant equitable interest was to be concealed might have an interest in the value of B’s assets (for example, as a creditor of B or because of proceedings under the Matrimonial Causes Act 1973 or the Civil Partnership Act 2004). 40
- (2) The court may make any order which it thinks appropriate –
- (a) to give effect to a declaration under section 3 or a determination under section 4, and

(b) to deal with any ancillary matters which the court thinks should be dealt with.

(3) In this section “the relevant equitable interest” has the meaning given by section 3(2).

6 Amendments of Proceeds of Crime Act 2002

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(1) The Proceeds of Crime Act 2002 is amended as follows.

(2) After section 78 insert—

“78A Determinations under Trusts (Concealment of Interests) Act 2010

(1) This section applies to proceedings under this Part if it has been determined under section 4(1)(b) of the Trusts (Concealment of Interests) Act 2010 that, instead of the defendant, another person—

10

(a) ought to become entitled to an equitable interest in any property, or

(b) ought at some previous time to have become entitled to such an interest.

15

(2) The defendant is to be treated as having made a gift of the equitable interest, and the other person is to be treated as the recipient of that gift.

(3) The gift is to be treated as having been made—

(a) in a case within paragraph (a) of subsection (1), at the time at which the equitable interest becomes vested in the other person pursuant to the determination, and

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(b) in a case within paragraph (b) of that subsection, at the time mentioned in that paragraph.”

(3) In section 308 (cases in which property is not recoverable for the purposes of Part 5 of that Act), at the end add—

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“(11) Nothing in this section is to be read as providing for any property to cease to be recoverable as a result of anything done in pursuance of the Trusts (Concealment of Interests) Act 2010.”

(4) In section 314(3) (disposing of property), after “law,” insert “or in pursuance of the Trusts (Concealment of Interests) Act 2010,”.

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7 Short title, application, commencement and extent

(1) This Act may be cited as the Trusts (Concealment of Interests) Act 2010.

(2) This Act applies whether the trust referred to in section 1 came into existence before or after the coming into force of the Act.

(3) This Act comes into force at the end of the period of 12 months beginning with the day on which it is passed.

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(4) This Act extends to England and Wales only.

APPENDIX B

EXPLANATORY NOTES ON THE DRAFT BILL

BACKGROUND

- B.1 A person who wishes to hide the fact that he or she is the owner of property may use a trust arrangement in order to do so. For example, he or she may transfer the legal title to property into the name of another, or purchase property in another's name, but with the intention that the recipient should (secretly) hold the property on trust for him or herself. This separation of the legal and equitable interests permits the true ownership to be concealed. The concealment may be for perfectly legitimate reasons. However, it can also be for criminal reasons. Examples can be found in case law of parties entering into this type of arrangement in order to evade tax,¹ make false benefits claims² and hide assets from creditors.³ This Bill determines whether such criminal purpose or conduct should have any effect on the beneficiary's entitlement to the trust property.

THE BILL

- B.2 The purpose of this Bill is to abolish, in defined circumstances, the rule laid down by the House of Lords in *Tinsley v Milligan*⁴ that a claimant may not lead or rely on evidence of any illegality in order to establish an equitable interest under a trust. This rule, frequently referred to as the "reliance principle", is generally regarded as arbitrary and unjust. The operation of this rule does not always prevent the beneficiary from being entitled to an equitable interest, even where he has behaved unlawfully, but exceptionally it may do so, in circumstances which have nothing to do with the justice of the case.
- B.3 Where the Bill abolishes the operation of the reliance principle it replaces it with a discretion on the part of the court to determine that the beneficiary ought not to be allowed to enforce the equitable interest. The Bill does not apply to all trusts that are in some way tainted by illegality. It only applies where the trust was created, or subsequently continued, in order to conceal the true beneficial ownership of the trust property in connection with the commission of an offence.

COMMENTARY ON THE CLAUSES

Clause 1

- B.4 This clause sets out the precise circumstances in which the discretion applies.

¹ *SMQ v RFQ and MJQ* [2008] EWHC 1874 (Fam), [2009] 1 FLR 935.

² *Tinsley v Milligan* [1994] 1 AC 340.

³ *Tribe v Tribe* [1996] Ch 107, 128.

⁴ [1994] 1 AC 340.

Subsection (1) paragraphs (a) and (b)

- B.5 The discretion applies where there is a dispute in relation to a beneficiary's interest in trust property but the court is satisfied that the beneficiary is entitled to the interest, or would be entitled to it if he or she could rely on an unlawful act or purpose in order to prove the claim.
- B.6 Under the present law laid down by the House of Lords in *Tinsley v Milligan*,⁵ a claimant is not allowed to rely on any unlawful conduct or purpose in order to prove his or her equitable interest under a trust. This rule is known as the "reliance principle". It means that where the beneficiary is able to take advantage of a legal presumption in order to establish his or her interest (such as the presumption of a resulting trust) the court will enforce the trust. However, where the beneficiary does not benefit from such a presumption the trust will not be enforced if the beneficiary needs to lead evidence of any illegality in order to prove its existence. This will depend on the precise nature of the evidence and how closely any illegality is tied up with it. This rule is widely perceived as arbitrary and unfair. Its operation is effectively removed for trusts that come within the scope of the Bill.
- B.7 Under this subsection, the court is required to consider first whether the beneficiary is entitled to the interest under general trust rules, but ignoring the reliance principle. The court can therefore consider all the available evidence, regardless of its connection to any illegality.

For example, Mr A (who is still married to Mrs A) and Ms B want to buy a home together. They contribute equally to its purchase price and intend to own it jointly. However, before completing the documents necessary for the registration of its legal title, Mr A says to Ms B: "Although we both intend to have an equal share in the house, let's keep my name off the registered title. That way, if my wife brings proceedings for ancillary relief against me, I can conceal my interest in the house from her". Ms B agrees. The relationship crumbles. Ms B seeks to eject Mr A from the house relying on her legal title. Mr A claims that he is entitled to a half share of the beneficial interest under a common intention constructive trust.⁶

Under the reliance principle, it is unlikely that Mr A would be entitled to rely on his conversation with Ms B in order to prove their common intention to share the equitable interest in the house because it would involve relying on his unlawful purpose of defrauding his wife. Under clause 1(1)(b) the court must consider if it is satisfied that he would be entitled to the equitable interest if he could rely on that evidence.

⁵ [1994] 1 AC 340.

⁶ For a case based on similar facts see *Lowson v Coombes* [1999] Ch 373.

Subsection (1) paragraph (c)

- B.8 Once the court has determined (without the reliance principle) that the beneficiary is entitled to the interest under general trust rules, it must look at the purpose of the arrangements which created the trust, or the purpose behind continuing those arrangements. The Bill only applies where the trust was created or continued in being in order to conceal the equitable interest in connection with the commission of an offence. These are referred to as the “concealment conditions” and are set out in more detail in clause 2.
- B.9 The Bill abolishes the application of the reliance principle for cases that fall within its scope. However, the Bill is not intended to abolish the application of the reliance principle in all trust cases. In most instances, particularly where any illegality involved is merely incidental and quite possibly inadvertent, the reliance principle has no substantive effect. It was felt that its abolition and replacement with a discretion in all trust cases that involve any element of illegality could result in widespread uncertainty. Should any sanction for the unlawful behaviour be necessary, this can be left to the criminal law to deal with. The Bill therefore only applies where the illegality is central to the purpose of the trust.

Subsection (2)

- B.10 Subsection (2) caters for circumstances where a person claims an interest in the trust property through the original beneficiary of the trust referred to in subsection (1). The claimant might be, for example, the heir or assignee of the original beneficiary. The discretion will apply in relation to that claimant’s claim.

For example, Mrs S transfers the bulk of her savings into a bank account in the name of her grandchildren. She does not intend to give the money to them, but to retain it for her own use. She claims state benefits on the false basis that she has no capital of her own. When Mrs S dies, her personal representatives seek to recover the funds in the bank account on behalf of the estate on the basis that the grandchildren held them on a resulting trust for Mrs S.⁷

The dispute between the personal representatives and the grandchildren is about the past entitlement of Mrs S to an equitable interest in the funds in the bank account and so falls within subsection (2). The court must therefore determine whether it is satisfied that, ignoring the reliance principle, Mrs S was entitled to the equitable interest and whether the concealment conditions are satisfied. If so, the discretion will apply to determine whether the grandchildren can now claim the funds held in their name.

⁷ For a case based on similar facts see *Silverwood v Silverwood* (1997) 74 P & CR 453.

Subsection (3)

- B.11 This subsection provides for two circumstances in which the Bill will apply. Paragraph (a) provides that the Bill applies whether or not the beneficiary is claiming the whole equitable interest in the trust property. In many instances this will not be the case. For example, the person holding the legal title may also be beneficially interested in the trust property.
- B.12 Paragraph (b) provides that the Bill applies whether or not the parties realised that their arrangements constituted a trust. This is important particularly in the case of constructive trusts where it may be difficult to determine whether, and if so, when, a trust has come into existence.

Clause 2

Subsection (1)

- B.13 As we have seen, the Bill does not apply to all trusts that are currently affected by the reliance principle. Clause 2 sets out the “concealment conditions” referred to in clause 1. Generally the Bill only applies where the trust was created, or has been continued, in order to conceal the ownership of the equitable interest in connection with the commission of an offence.
- B.14 There are two concealment conditions and the Bill applies where either (or both) conditions are satisfied.

Subsection (2)

- B.15 The first concealment condition, set out in subsection (2), applies where the trust was created in order to conceal the beneficiary’s interest for the purpose of committing an offence.

For example, a father is concerned that his business is doing badly and that his creditors may seek recovery against his assets. He therefore transfers these assets into the name of his son, but on the understanding that the son is to hold them on trust for the father and return them to him when asked.⁸ The first concealment condition is satisfied. The trust was created in connection with the father’s intention to defraud his creditors.

- B.16 The Bill applies whether or not the offence was in fact committed.

Subsection (3)

- B.17 Subsection (3) provides that the first concealment condition may apply whether or not all the parties were aware of the criminal purpose of one of them. For example, in some cases the trustee may be complicit in the beneficiary’s fraudulent scheme, but in others the trustee will be an unwitting party.

⁸ For a case based on similar facts see *Tribe v Tribe* [1996] Ch 107.

- B.18 The first concealment condition may also be satisfied when the arrangements have another purpose besides the concealment. For example, a home may have been purchased in the name of one person in order to allow the other more easily to make fraudulent benefits claims, but another purpose of the purchase may have been to provide a home for the parties.

Subsection (4)

- B.19 The second concealment condition, set out in subsection (4), is relevant when the trust was not initially created for the purposes of committing the offence, but the arrangements have subsequently been deliberately continued to conceal the equitable interest for such a purpose. The second concealment condition is narrow in scope. The beneficiary must have carried out some deliberate act to continue the trust arrangement for the purpose of concealing his or her equitable interest for the commission of an offence. It is not sufficient that the beneficiary has simply taken advantage of the pre-existing trust arrangement in order to commit an offence. He or she must have taken steps to continue the arrangement for this purpose.

For example, a taxpayer may hold shares under a trust arrangement. This is a common method of shareholding, the legal title being registered in the name of a nominee. Believing that his dishonesty is less likely to be discovered because he does not hold the registered title, a taxpayer may conceal his interest on a tax return and thereby fraudulently avoid tax. This would not bring the trust within the scope of the Bill because neither concealment condition is satisfied. The second concealment condition is only met where the beneficiary has deliberately taken steps to continue the arrangement, in circumstances when it would otherwise have been ended, in order to commit the offence.

- B.20 In addition, the relevant concealment in connection with the offence must actually have been made either by the beneficiary, or by another person with the beneficiary's consent or connivance.

Subsection (5)

- B.21 This subsection lists a number of factors that are not taken into account when determining whether the concealment conditions are satisfied. It is not relevant whether or not the parties were aware that concealing the ownership of the equitable interest in the relevant circumstances would be a criminal offence.
- B.22 It is not relevant whether or not it was the beneficiary who was to commit an offence. The relevant case law shows that it is usually the beneficiary who intends to conceal his or her interest in order to commit the offence. However, this will not always be the case. A trust may also be used to inflate artificially the wealth of the trustee for fraudulent purposes.

For example, at the request of the directors of a company, Mr A transfers funds into the bank account of the company, intending that the company should hold the money on trust for him. However, the intention is to enable the company to give a false impression of its creditworthiness and so attract investors on a fraudulent basis.⁹

- B.23 It is not relevant whether or not there has been, or will be, any criminal prosecution.

Subsection (6)

- B.24 The purpose of paragraph (a) is to make clear that the concealment itself may constitute the offence. This would be the case where a party was under a legal duty to disclose the ownership of the equitable interest and failed to do so. For example, when completing a tax return or benefits claim form, a person is under a legal duty to disclose all his or her relevant assets. In other cases, the concealment itself will not constitute the offence. However, the parties may want to hide the real ownership for other criminal purposes. In *Tinsley v Milligan*, Lord Goff gave by way of example cases in which a group of terrorists, or armed robbers, secure a base for their criminal activities by buying a house in the name of a third party not directly implicated in those activities.¹⁰ Both these scenarios are included within the Bill.

Subsection (7)

- B.25 This subsection provides for what is to count as an “offence” for the purposes of the Bill. The Bill applies where the relevant conduct constitutes an offence under the law of England and Wales, wherever that conduct takes, or is intended to take, place. The Bill also applies where an offence would be committed under the law of any country where all or any part of the conduct element of the offence occurred or was to occur, whether or not it would also constitute an offence under the law of England and Wales.

Clause 3

- B.26 Clauses 3, 4 and 5 set out the obligations and powers of the court when the Bill applies.

Subsection (1)

- B.27 Where the Bill applies, the court must declare that the beneficiary is entitled to the equitable interest in the trust property. At this stage the illegality is therefore ignored.
- B.28 Where the present claimant is a person claiming through the original beneficiary, the court must declare that the original beneficiary was entitled to the equitable interest in the trust property at the relevant time. Again, at this stage the illegality is ignored.

⁹ For a case based on similar facts see *Re Great Berlin Steamboat Company* (1884) 26 Ch D 616.

¹⁰ [1994] 1 AC 340, 362.

- B.29 Such a declaration is required in order to cure a circularity that would otherwise arise between the interaction of the criminal and civil law. If the court were simply to determine that the beneficiary was not entitled to the relevant equitable interest, then the beneficiary would not have committed any offence by concealing it. Therefore no prosecution could be brought against him and criminal confiscation proceedings for the recovery of any benefits gained would be unsuccessful. The purpose of the Bill is not to legitimise retrospectively any criminal behaviour.

Clause 4

Subsection (1)

- B.30 However, where the court is of the opinion that the circumstances are exceptional, the court may also exercise its discretion to determine (a) that the beneficiary ought not to be allowed to enforce the relevant equitable interest and (b) who ought to become entitled to it instead. Where the claimant is claiming through the original beneficiary of a trust which falls within the Bill, the court may exercise its discretion to determine that that original beneficiary ought not to have been allowed to enforce the equitable interest and who ought to have become entitled to it instead. In determining who ought to (or ought to have) become entitled to the interest the court must select a person from the list set out in subsection (4).
- B.31 Although the Bill sets out (in clause 5) some of the factors that the court may take into account in making its determination, it does not specify what the exceptional circumstances might be that might lead it to make a determination under subsection (1). However, we anticipate that the circumstances might be exceptional where, for example, the claimant's behaviour has been particularly reprehensible, and he or she has benefited from it and has not been deprived of those gains as a result of the application of any other legal principle.

Subsection (2)

- B.32 Where the court makes a determination under subsection (1) that the beneficiary ought not to be allowed to enforce the relevant equitable interest and that another person ought to become entitled to it, it is required by subsection (2) to determine in whom the interest is now to be vested. This avoids the uncertainty that exists under the present law where the reliance principle operates to prevent the beneficiary from succeeding in his or her claim. There are some judicial comments which suggest that the reliance principle creates merely a procedural personal disentitlement affecting the beneficiary, but does not operate to alter the substantive interests in the trust.¹¹ However, in other cases it has been assumed that where the beneficiary cannot enforce the trust, the trustee is entitled to the beneficial as well as legal ownership in the trust property.¹²

¹¹ See, for example, *Tinsley v Milligan* [1994] 1 AC 340, 374, by Lord Browne-Wilkinson.

¹² See, for example, *SMQ v RFQ and MJQ* [2008] EWHC 1874 (Fam), [2009] 1 FLR 935 at [139], by Black J.

Subsections (3) and (4)

- B.33 The court may not determine that any person whosoever is entitled to the equitable interest. It may only select from those on the list set out in subsection (4). These are the trustee, the settlor, and any beneficiary under the same trust. Where more than one person falls into any one of these categories, the interest is to be split between them as the court thinks fit.
- B.34 In many of the reported cases which involve the application of the reliance principle, there are only two parties involved in the trust. This is because the settlor and beneficiary are the same person (or, in the case of resulting and some constructive trusts, the contributor/transferor and beneficiary). Where the court declares that the beneficiary ought not to be allowed to enforce the equitable interest, the only option for the court is to determine that the trustee ought to become the beneficial owner instead.
- B.35 However, there may be more parties involved in the trust, and therefore more persons whom the court might potentially determine ought to become entitled to the equitable interest. Where the settlor and beneficiary are different persons, the court may feel that it is sufficient to undo the effects of the illegal conduct or purpose if the trust is effectively unwound and the trust property returned to the settlor. In other cases, there may be a number of other beneficiaries, and, for example, where these beneficiaries are not tainted by the illegal purpose, the court may declare that any or all of them ought to become entitled to the interest.

Clause 5

Subsection (1)

- B.36 This subsection provides that the court may take anything which it thinks relevant into account in making a determination under clause 4, but also sets out a list of factors as examples of what might be relevant in any particular case.
- B.37 Paragraph (f) guides the court towards taking into consideration the position of the person from whom the equitable interest was being concealed – that is the intended “victim” of the trust arrangement. This person may have an interest in the value of the assets of the beneficiary. Indeed it may be because of a potential claim by this person that the beneficiary set up the trust arrangement in the first place. In making its determination under the discretion, the court may therefore want to consider whether that interest would be unduly prejudiced if the beneficiary were not allowed to enforce the trust.

For example, a brother (T) goes bankrupt. T enters into an arrangement with his brother (J) for J to buy T's home from T's trustee in bankruptcy. T continues to live in the home, carries out repairs and renovations, and pays all the contributions towards the mortgage that J takes out in order to purchase the home. The purpose of the arrangement is for T to conceal his interest in the home from his trustee in bankruptcy. J sells the home and disputes T's claim to be entitled to the proceeds. In deciding whether or not to allow T to enforce the equitable interest, the court can take into account the fact that if T were to succeed it would be open to the trustee in bankruptcy to claim the interest for the benefit of the estate.¹³

Subsection (2)

- B.38 The purpose of this subsection is to provide the court with the necessary powers to make such orders as are appropriate to give effect to its declarations and determinations. What orders the court makes will depend on exactly what remedy or relief the claimant is seeking.

Clause 6

- B.39 This clause makes amendments to the Proceeds of Crime Act 2002 in order to ensure that anything done in pursuance of this Bill does not prejudice the State's ability to confiscate or recover property under the provisions of that legislation.

Subsection (2)

- B.40 Under Part 2 of the Proceeds of Crime Act 2002 where the defendant is convicted of an offence, the Crown Court may make a confiscation order, designed to deprive the criminal of the benefits of his or her crime. The order may not be for more than "the available amount".¹⁴ In assessing the available amount, the court must include the total value of all property held by the defendant and all "tainted gifts" made by the defendant.¹⁵ The effect of subsection (2) is to treat as a gift made by the defendant, the value of any equitable interest that the court has determined a person other than the defendant ought to become entitled to. Where the necessary conditions set out in Part 2 of the Proceeds of Crime Act 2002 are met, this gift may be a "tainted gift" and so the value of the interest can then be included as part of the defendant's available assets for the purposes of any confiscation order.

¹³ For a case on similar facts see *Barrett v Barrett* [2008] EWHC 1061 (Ch), [2008] All ER 233.

¹⁴ Proceeds of Crime Act 2002, section 9.

¹⁵ Proceeds of Crime Act 2002, sections 77 to 78.

For example, a thief is concerned that the police might catch up with him. He therefore transfers the legal title to his property into the name of his wife, intending secretly to retain the beneficial interest for himself, but hoping to prevent the property from being confiscated by the authorities. His wife later claims the property for herself and the thief brings an action against her claiming that it is held on trust for him. The court considers that the case is exceptional and determines that the thief ought not to be allowed to enforce his interest and that the wife ought to become entitled to the equitable interest in the property. The court orders that the equitable interest in the property is now to be vested in the wife.

The thief is subsequently convicted of his crimes and a confiscation order is to be made under Part 2 of the Proceeds of Crime Act 2002. In assessing the thief's available assets, the thief is treated as having made a gift to his wife of the equitable interest in the property. If made within the necessary time limits, it will therefore be a tainted gift and the value of the property can be included within his available assets.

Subsections (3) and (4)

- B.41 Part 5 of the Proceeds of Crime Act 2002 provides broad powers for the recovery of property by the State which is, or which represents, "property obtained through unlawful conduct".¹⁶ Where the property has been disposed of and passed to someone else, it can generally be followed into the hands of that person and recovered from them.¹⁷ Part 5 of the 2002 Act does not contain any general definition of "disposal", although section 314(3) provides that property is to be treated as disposed of when it passes to another under a will or intestacy or by operation of the law. Subsection (4) of clause 6 amends subsection 314(3) by adding a provision that property is also to be treated as disposed of when it passes in pursuance of this Bill. This makes clear that whenever property passes from one person to another under this Bill it will count as a disposal for the purposes of Part 5 of the 2002 Act.
- B.42 In certain circumstances property which has been disposed of ceases to be recoverable. These circumstances are set out in section 308 of the Proceeds of Crime Act 2002. They include the case where the claimant obtains property from the defendant in civil proceedings which are based on the defendant's unlawful conduct (section 303(3) of the 2002 Act). Subsection (3) of clause 6 introduces a new subsection into section 308 to clarify that property does not cease to be recoverable as a result of anything done under the Bill.

¹⁶ Proceeds of Crime Act 2002, section 240.

¹⁷ Proceeds of Crime Act 2002, section 304(2) and (3).

In the example above, say that the thief was not convicted of his crimes because he died before the criminal court hearing took place. Without a conviction, it is not possible for the court to impose a confiscation order. However, proceedings may still be brought for civil recovery. If the relevant property was obtained through unlawful conduct, it will be recoverable in the hands of his wife unless it falls within one of the specified exceptions. The wife may argue that it has ceased to be recoverable property because section 308(3) of the Proceeds of Crime Act 2002 provides that property ceases to be recoverable if it is obtained in civil proceedings by a claimant (the wife) whose claim is based on the unlawful conduct. Clause 6(3) prevents this argument from succeeding.

Clause 7

Subsection (2)

- B.43 The Bill applies to all trusts that fall within its scope whether created before or after the Bill comes into force.
- B.44 Although it is unusual for legislation to permit the alteration of property rights that came into existence before the legislation was enacted, it was felt to be necessary here in order to avoid the possibility of the reliance principle continuing to have effect for many years into the future.

Subsection (3)

- B.45 The provisions of the Bill do not come into effect until one year after the Bill is enacted. Therefore a beneficiary who believes that he might lose his equitable interest under the exercise of the court's discretion could put his affairs into order by, for example, declaring his interest or asking the trustee to transfer the legal title to him.

Subsection (4)

- B.46 This provides the extent of the Bill. It provides that the Bill only extends to England and Wales because the Law Commission cannot make recommendations for Northern Ireland and Scotland.

**APPENDIX C
IMPACT ASSESSMENT FOR REFORMING THE
LAW OF ILLEGALITY IN TRUSTS**

Summary: Intervention & Options

Department /Agency: Law Commission	Title: Impact Assessment for Reforming the Law of Illegality in Trusts	
Stage: Draft Bill	Version: Final	Date: February 2010
Related Publications: The Effect of Illegality on Contract and Trusts (1999) (Consultation Paper No 154); The Illegality Defence (2009) (Consultative Report No 189)		

Available to view or download at:

<http://www.lawcom.gov.uk>

Contact for enquiries: Tamara Goriely

Telephone: 020-3334-0281

What is the problem under consideration? Why is government intervention necessary?

A person may use trust law to conceal their ownership of property for a criminal purpose, typically by “parking” property with a partner or relative to evade tax or creditors. In serious cases, the property may be confiscated under the Proceeds of Crime Act 2002, but in other cases, the issue is left to private law. The courts are faced with a choice between ignoring the illegality (and applying normal property law rules) or granting a windfall to the holder of the property, who may be equally guilty.

The law in this area is confused. It depends on the intricacies of trust law, which few people understand, and which have arbitrary consequences, unrelated to the merits of the case.

What are the policy objectives and the intended effects?

The policy objectives and intended effects are to:

1. Make the law clear and proportionate, so that outcomes are related to the merits of the case, rather than obscure legal “presumptions”. At present, the outcome of the case may depend on the “presumption of advancement” (an outdated and discriminatory 19th century rule by which a man who transfers money to his wife or children is presumed to have intended it as a gift).
2. Deter people from concealing their property for a criminal purpose.

What policy options have been considered? Please justify any preferred option.

1. Do nothing
2. Abolish the “presumption of advancement”.
3. Allow the courts to decide, at their discretion, whether to enforce trusts created or used to conceal the true ownership of property for a criminal purpose. The courts would only refuse to enforce property rights in exceptional circumstances, bearing in mind a list of relevant factors. This is the preferred option: the rules would be clearly set out, and decisions would be directly related to the merits of the case.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

Ministerial Sign-off For SELECT STAGE Impact Assessments:

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister:

.....Date:

Summary: Analysis & Evidence

Policy Option: 2	Description: Abolish the presumption of advancement (not recommended)
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COSTS	ANNUAL COSTS	Description and scale of key monetised costs by 'main affected groups': In 2005, the MOJ commented that this would have no significant impact on businesses, charities or the public sector. If there were any financial effects at all they would be minimal.				
	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 70%; padding: 2px;">One-off (Transition)</td> <td style="width: 30%; text-align: center; padding: 2px;">Yrs</td> </tr> <tr> <td style="padding: 2px;">£</td> <td></td> </tr> </table>		One-off (Transition)	Yrs	£	
	One-off (Transition)		Yrs			
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Average Annual Cost (excluding one-off)						
£						
Total Cost (PV)	£ negligible					
Other key non-monetised costs by 'main affected groups' We support abolition which would remove an incident of clear gender bias in family law (see below). However, it would not solve many of the problems with the law of illegality in trusts.						

BENEFITS	ANNUAL BENEFITS	Description and scale of key monetised benefits by 'main affected groups': None have been identified.				
	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 70%; padding: 2px;">One-off</td> <td style="width: 30%; text-align: center; padding: 2px;">Yrs</td> </tr> <tr> <td style="padding: 2px;">£</td> <td></td> </tr> </table>		One-off	Yrs	£	
	One-off		Yrs			
	£					
<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 70%; padding: 2px;">Average Annual Benefit (excluding one-off)</td> <td></td> </tr> <tr> <td style="padding: 2px;">£</td> <td></td> </tr> </table>	Average Annual Benefit (excluding one-off)		£			
Average Annual Benefit (excluding one-off)						
£						
Total Benefit (PV)	£ negligible					
Other key non-monetised benefits by 'main affected groups': Abolition would remove a discriminatory provision, and permit the UK to ratify Article 5 of Protocol 7 of the European Convention on Human Rights.						

Key Assumptions/Sensitivities/Risks:

Price Base Year	Time Period Years	Net Benefit Range (NPV) £	NET BENEFIT (NPV Best estimate)
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What is the geographic coverage of the policy/option?	England & Wales				
On what date will the policy be implemented?					
Which organisation(s) will enforce the policy?	Civil courts				
What is the total annual cost of enforcement for these organisations?	£ negligible				
Does enforcement comply with Hampton principles?	Yes				
Will implementation go beyond minimum EU requirements?	Yes				
What is the value of the proposed offsetting measure per year?	£ none				
What is the value of changes in greenhouse gas emissions?	£ none				
Will the proposal have a significant impact on competition?	No				
Annual cost (£-£) per organisation (excluding one-off)	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 25%; text-align: center;">Micro</td> <td style="width: 25%; text-align: center;">Small</td> <td style="width: 25%; text-align: center;">Medium</td> <td style="width: 25%; text-align: center;">Large</td> </tr> </table>	Micro	Small	Medium	Large
Micro	Small	Medium	Large		
Are any of these organisations exempt?	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 25%; text-align: center;">No</td> <td style="width: 25%; text-align: center;">No</td> <td style="width: 25%; text-align: center;">N/A</td> <td style="width: 25%; text-align: center;">N/A</td> </tr> </table>	No	No	N/A	N/A
No	No	N/A	N/A		

Impact on Admin Burdens Baseline (2005 Prices)				(Increase -
Increase	£	Decrease	£	Net
				£

Key: Annual costs and benefits: (Net) Present

Summary: Analysis & Evidence

Policy Option: 3	Description: Give the courts discretion whether to enforce trusts created or used to conceal ownership for a criminal purpose (recommended option)
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COSTS	ANNUAL COSTS	Description and scale of key monetised costs by 'main affected groups': Lawyers and judges would need to become familiar with the new law. Initially, a few cases may be taken to a hearing to test the limits of the legislation. In the first 5 years, we anticipate up to five first instance cases.				
	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 70%; padding: 5px;">One-off (Transition)</td> <td style="width: 30%; text-align: center; padding: 5px;">Yrs</td> </tr> <tr> <td style="padding: 5px;">£</td> <td style="padding: 5px;"></td> </tr> </table>		One-off (Transition)	Yrs	£	
	One-off (Transition)		Yrs			
	£					
Average Annual Cost (excluding one-off)						
£						
Total Cost (PV)		£ minor				
Other key non-monetised costs by 'main affected groups'						

BENEFITS	ANNUAL BENEFITS	Description and scale of key monetised benefits by 'main affected groups': The Bill will introduce greater clarity into the law, removing the need for potentially expensive litigation. There will be less risk of expensive litigation before the Court of Appeal, Supreme Court and European Court of Human Rights.				
	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 70%; padding: 5px;">One-off</td> <td style="width: 30%; text-align: center; padding: 5px;">Yrs</td> </tr> <tr> <td style="padding: 5px;">£</td> <td style="padding: 5px;"></td> </tr> </table>		One-off	Yrs	£	
	One-off		Yrs			
	£					
Average Annual Benefit (excluding one-off)						
£						
Total Benefit (PV)		£ minor				
Other key non-monetised benefits by 'main affected groups': The new law will be seen to be fair. It will also deter people from entering into fraudulent arrangements, leading to a possible reduction in tax and benefit fraud.						

Key Assumptions/Sensitivities/Risks: If the law is not clarified, there is a risk that the courts may be seen to deprive claimants of valuable property for disproportionate and arbitrary reasons. This would give the impression that the law is unfair and could contravene the UK's human rights obligations.

Price Base Year	Time Period Years	Net Benefit Range (NPV) £	NET BENEFIT (NPV Best estimate)
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What is the geographic coverage of the policy/option?	England & Wales			
On what date will the policy be implemented?				
Which organisation(s) will enforce the policy?	Civil courts			
What is the total annual cost of enforcement for these organisations?	£ negligible			
Does enforcement comply with Hampton principles?	Yes			
Will implementation go beyond minimum EU requirements?	Yes			
What is the value of the proposed offsetting measure per year?	£ none			
What is the value of changes in greenhouse gas emissions?	£ none			
Will the proposal have a significant impact on competition?	No			
Annual cost (£-£) per organisation (excluding one-off)	Micro	Small	Medium	Large
Are any of these organisations exempt?	No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices)					(Increase -
Increase	£	Decrease	£	Net	£

Key: Annual costs and benefits: (Net) Present

BACKGROUND

Calls for law reform arose out of the 1994 House of Lords' decision, *Tinsley v Milligan*.¹ Here a lesbian couple bought a house together using joint money. However, they registered it in the name of only one of them so that the other could claim social security benefits to which she was not entitled.

In arrangements of this sort, where the intended owner is not the registered owner, lawyers analyse the situation in terms of a trust. The registered owner is said to hold the "legal" title, while the other party is left to argue that they are entitled to a "beneficial interest". They may do this either on the basis of their contribution to the purchase price (a "resulting trust") or on the basis of a common intention to own the property jointly (a "constructive trust").

When the couple fell out, the registered owner (Ms Tinsley) sought to evict her former partner (Ms Milligan) from the house. Ms Milligan counterclaimed, on the basis that she had contributed half of the purchase money, and was therefore entitled to half the house. To use legal terminology, she argued that she was entitled to a beneficial interest under a "resulting trust". Ms Tinsley countered that Ms Milligan was not entitled to ask the court to help her enforce the trust because she had behaved illegally.

The House of Lords held that the so-called "reliance principle" applied: Ms Milligan won, because she could prove her interest in the property without needing to "rely" on her illegal conduct. The outcome of the case depended on the legal starting point or "presumption" applied by trust law. In this case, once Ms Milligan has shown that she contributed towards the purchase price, the law "presumed" a resulting trust. However, if the relationship had been slightly different, the courts may have been forced to reach the opposite conclusion. For example, if a father had given money to a daughter, the "presumption of advancement" would apply. This archaic and discriminatory 19th century rule presumes that if a man gives money to his fiancée, wife or children, he intends to make a gift. The "reliance principle" means that a father could not rely on evidence of his true intention to keep ownership of the property where this was based on an illegal motive. However, a mother in exactly the same circumstances would be given her property back.

Problems with the law

In *Tinsley v Milligan*, the court was clearly reluctant to deprive Ms Milligan of her interest. As Lord Goff pointed out, it seemed harsh to deprive her of her life savings for a relatively minor fraud, when she had confessed her wrongdoing to the Department of Social Security and had made her amends with them. Equally, it seemed wrong to give an unjustified windfall to Ms Tinsley who was implicated in the same fraud. Thus in standard cases, the courts tend to ignore the effect of any illegality.

However, two criticisms are made of this:

1. In some cases the courts may be required to enforce the trusts, despite very serious illegality. In 1994, Lord Goff highlighted that the protection given to minor fraudsters would also protect terrorists or armed robbers. He therefore called for the Law Commission to review the law.²

¹ [1994] 1 AC 340.

² Above, at 362.

2. In a few arbitrary cases, the claimant will lose, even though the illegality is minor. The result depends not on the merits of the case, but on obscure legal “presumptions”, which are often outdated and may be discriminatory. Under human rights law, if people are to be deprived of valuable property rights, the law should be clear, proportionate, and justifiable. The deprivation must be for relevant and sufficient reasons.

In 2006, we considered whether the second criticism would be solved simply by abolishing the presumption of advancement.³ However, we have concluded that this would not solve all the problems. This is because in 2007 the House of Lords introduced further uncertainty into the law. The case of *Stack v Dowden* appears to overturn the presumption that property is held on trust in the proportions to which the parties contributed the purchase money.⁴ Instead, in cases involving a family home, the starting point is that the property is owned by the registered owner. The non-owner is therefore required to produce evidence that the parties intended this to be different, so as to prove a “constructive trust”.

It is difficult to tell what effect this will have where, for example, cohabittees have placed the property in one name to conceal it from an ex-spouse. It seems that the claimant may lead some evidence of a common intention, but not the most direct evidence, which reveals the true reason behind the parties’ actions. As a result, the law is uncertain and complex, and is likely to lead to arbitrary results. Some claimants will win and some will lose, depending on the exact details of the evidence led.

There are other uncertainties. For example, in some cases, claimants are allowed their money back if they withdraw from the trust arrangement before the illegal purpose has been carried out. However, the scope of this is unclear. It seems that repentance is not required: it is possible to withdraw simply because the scheme is not needed.

Trust law and the breakdown of cohabiting relationships

In *Tinsley v Milligan*, the issue arose in the context of the breakdown of a cohabiting relationship. As we explain below, this is by far the most common circumstance where people bring claims on the basis of constructive or resulting trusts (though not the only circumstance). By contrast, these issues do not generally arise following divorce or the breakdown of a civil partnership. Here, the courts have wide powers to deal with property to ensure a broadly fair outcome between the parties.⁵ Spouses and civil partners do not need to worry about concepts of trust law.

In our 2007 report, *Cohabitation: The Financial Consequences of Relationship Breakdown*, we examined the patchwork of legal rules on which cohabitants are forced to rely, including constructive and resulting trusts.⁶ We concluded that these rules were complex, uncertain and expensive to rely on. They were not designed for family circumstances and often gave rise to outcomes that were unjust.⁷ We recommended a completely new scheme for financial relief for those who met the criteria set out in the report. If our recommendations for financial relief were implemented, the need for this Bill would reduce, though not disappear. As we explain below, people may also “park” property with relatives, friends or business partners.

³ See short paper, *The Presumption of Advancement: does it have any effect in practice?* December 2006, available at <http://www.lawcom.gov.uk/illegal.htm>.

⁴ [2007] UKHL 17, [2007] 2 AC 432.

⁵ Matrimonial Causes Act 1973, Part II and Civil Partnership Act 2004, sch 5.

⁶ Law Com No 307, July 2007.

⁷ Executive Summary, para 1.4.

This impact assessment is written on the assumption that trust law continues to be the main way in which cohabiting couples resolve disputes about ownership of their home. We are conscious that the rules on illegality in trusts are not the only problem with trust law in this context. They are simply a further twist to the tangle. However, if a policy decision is taken that trust rules should remain the main way to resolve issues of cohabitation, we think this particular twist is worth removing.

We are also conscious that the concepts described here (such as “constructive and resulting trusts” and “presumptions of advancement”) appear alien to non-lawyers. Research indicates that a majority of cohabitants believe in the “common law marriage myth”: the idea that unmarried couples who are living together are, after a certain length of time, treated as if they were married. Few have any notion of “trust law”. If they think of it at all, they see it as the preserve of the rich, with no relevance to ordinary people. In one research study, for example, one woman going through a messy relationship breakdown said she had become familiar with “constructive or relating [sic] trusts”. However she commented that friends “look at me like I’m talking Swahili”.⁸

This makes the Bill difficult to describe in simple terms, but no less necessary.

OBJECTIVES

Our first objective is to ensure that the law is clear and proportionate. Under the European Convention on Human Rights, if the law is to deprive people of their property rights because of a criminal intention, it is important that the law is clearly set out in advance, and is seen to be based on relevant and sufficient reasons. For example, Article 7 states that the law may not impose a heavier penalty than the one applicable at the time the offence was committed. Similarly, Article 1 of the First Protocol states that “no-one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law”. We therefore think the law should be clearly set out in advance, and should be seen to be based on reasons which are relevant to the public interest.

Our second objective is to deter people from using trust structures for serious wrongdoing. In a trust, the person who does not appear to be the legal owner of property may claim the benefits of ownership. Trust structures can be used for legitimate purposes, but they also offer a unique opportunity to conceal the true ownership of the property for illegitimate purposes – for example to defraud creditors, tax authorities, or social security administrators. It is therefore important that the law should be seen to be deterring those who may take advantage of this opportunity.

On the other hand, it is important to preserve a balance. Where the court refuses to enforce a trust, this may provide an unjustified windfall for the legal owner, who may be equally or more complicit in the fraud. It is important that litigants are not allowed to raise allegations of minor illegality to obtain a tactical advantage in what may already be fraught litigation following family breakdowns.

RATIONALE FOR GOVERNMENT INTERVENTION

Government intervention is necessary to remove the arbitrary and uncertain effect of the present law which can result in unjust decisions. Judicial reform is unlikely as the present law is laid down by a decision of the House of Lords. The decision is well-established and leaves little room for flexibility. We think that primary legislation offers the only real prospect of change.

⁸ Above, p 111.

CONSULTATION

Our recommendations on illegality in trusts are part of a lengthy review of the law of illegality. The first consultation paper was published in 1999: *The Effect of Illegality on Contract and Trusts* (CP 154). We received 43 responses. This was followed in 2001 by a further consultation paper, *The Illegality Defence in Tort* (CP 160). In 2006 we consulted on whether the problems could be solved by abolishing the presumption of advancement (Short Paper: *The Presumption of Advancement: Does it Have any Effect in Practice?*). In 2009, given the length of time, we consulted again, in *The Illegality Defence* (Consultative Report No 189). We received 21 responses.

We have also held seminars in the course of our review. In 2001 we held a seminar on the *Illegality Defence in Tort*, organised jointly with the Society for Advanced Legal Studies and the Tort Section of the Society for Public Teachers of Law. In 2002 we presented a paper to the SPTL Conference. In 2005 the Trade Union Congress legal officers group organised a seminar to discuss illegality in employment contracts.

SCALE OF THE PROBLEM

Below, we review the available data on the scale of the issue. Our conclusion is that the law on illegality in trusts has wide potential. It would appear that the issue may have relevance to several thousand cases a year. However, the actual use made of legal aid and the courts to deal with issues of trust law is very low: in 2004/5 (the last date for which data are available), the Legal Services Commission recorded only 118 cases.

The number of such cases which raise issues of illegality is very low indeed. As discussed below, we identified 19 reported cases in 9 years: roughly two cases a year. Although there will also be some unreported cases, we do not think that the numbers are large: probably no more than a dozen a year.

Below we summarise the available data, looking first at the effect of trust law on cohabittees and then in other contexts. We then look at how a trust may be used to conceal property for a criminal purpose.

The use of trust law on the breakdown of cohabiting relationships

Disputes over such trusts typically arise between cohabiting couples who own a home. The 2001 census revealed that there were just over two million cohabiting couples in England and Wales. Work by John Haskey shows that around 40% of cohabittees buy property on a mortgage, rather than rent. Yet, of those buying property on a mortgage only a minority (40%) put the property in joint names. In most cases (57%), the property was registered in the name of only one of the partners.⁹ If the relationship breaks down, the court has no general discretion, as it does when dealing with marriage cases, to transfer property. Instead, any property disputes are treated as matters of trust law.

Issues of constructive and resulting trusts are therefore relevant to the 456,000 couples in England and Wales who bought a home on a mortgage and put it into the name of only one partner. It is open to the other party to claim a beneficial interest in the home on the grounds that there was a common intention to own the home jointly, or that they made a contribution towards the purchase price or mortgage payments. Even where the house is jointly owned, it is possible for the parties to use the mechanism of a resulting trust to argue that the shares in the home should not be divided equally.

⁹ J Haskey, "Cohabiting couples in Great Britain: accommodation sharing, tenure and property ownership", *Population Trends* 103, Spring 2001.

Although there is the potential for many disputes in this area, relatively few cases are brought to court. A 2007 study by Douglas and others showed that most cohabittees were ignorant of the law, confused by legal terminology and fearful of legal costs.¹⁰ Thus people often settle disputes in the shadow of the law without issuing proceedings. Although trust law is the main legal mechanism for resolving property disputes, couples were particularly unlikely to report their disputes in these terms.

This means that the number of cases classified as involving issues of trust law is low. In 2005 the Legal Services Commission provided us with data on the number of trusts cases that received legal aid funding. The data indicated that for the financial year 2004-2005 the Legal Services Commission received 118 applications for General Family Help for cases involving trusts of land. Of these applications, 98 (83%) were made by ex-cohabittees.

Douglas and others also found a low number of court applications from cohabittees. Searching the 2004 case files at a large County Court for applications brought by cohabittees under the Trusts of Land and Appointment of Trustees Act 1996, they found only 15 cases that year. Their interviews with cohabitants and solicitors explored the reasons why cohabittees were particularly reluctant to resolve their property disputes through the court.

Constructive and resulting trusts in other contexts

The law in this area is not solely concerned with the breakdown of cohabiting relationships. Issues of resulting or constructive trusts can arise in a wide range of relationships, whenever people share property without coming to a formal written understanding of its ownership.

Research published by the Institute of Advanced Legal Studies in 2001 analysed 125 legal aid files about interests in land which involved issues of trust law.¹¹ Although most disputes were between former cohabittees, the study also found 10 disputes between parents and children (or step-parents and step-children); 6 disputes between siblings, and 2 disputes with in-laws.

There were also 31 disputes which arose outside a family context, between former friends or business partners.

The cost of disputes over constructive and resulting trusts

The IALS study of 125 legal aid files also recorded data on the cost of the cases. It found that in 1998, the median cost of a legal aid dispute over an interest in land was £2,323, but there was a wide variation in costs. A quarter of cases cost the legal fund less than £1,000 and a quarter cost over £4,000. Four cases cost over £25,000 and the most expensive case cost £45,000. This is an area where, once the parties start taking technical legal points, costs can escalate quickly.

¹⁰ G Douglas, J Pearce and H Woodward, "A Failure of Trust: Resolving Property Disputes on Cohabitation Breakdown" (2007); study conducted jointly by Cardiff University and the University of Bristol.

¹¹ T Goriely and P Das Gupta, *Breaking the Code: the impact of legal aid reforms on general civil litigation* (2001), Institute of Advanced Legal Studies. The research examined a sample of legal aid files closed in 1998/9, before the introduction of the 2000 reforms.

The effect of illegality in trusts

Although it is very difficult to quantify, there is also wide potential for constructive or resulting trusts to raise issues of illegality. Among the most common forms of illegality are attempts to hide assets from creditors or potential creditors, or from an ex-spouse. A possible scenario, for example, is where one partner contributes to the mortgage on a new home, but leaves the property in the other partner's name to prevent an ex-spouse from finding out about it. Alternatively, one partner may put property in the other partner's name because they are engaged in a risky business venture and are concerned about possible bankruptcy.

People may also attempt to evade tax. An elderly parent, for example, may put property in the name of their child to evade inheritance tax, even though the parent intends that the child should give the money back if the parent needs it. Others may hide their wealth in order to claim state benefits to which they are not entitled.

A search through Westlaw shows that between 2000 and 2008 there were 19 reported cases which raised issues of illegality in trusts. This underestimates the effect of the issue. Many cases are resolved without proceedings being issued, or settled before trial, or heard in the county court without being reported. However, the overall number of cases is likely to be low.

Our conclusion, therefore, is that the issue of illegality in trusts is raised in only a few cases (probably no more than a dozen a year). However, the law in this area has the potential to cast a long shadow over the property rights and relationships of several thousands of people, in a wide variety of circumstances.

OPTIONS

Option 1 – Do nothing

The courts would be left to interpret and apply the present law as best they can. There are two possible dangers.

The first danger is that the courts might deprive claimants of valuable property rights by refusing to enforce trusts where the claimant has committed a minor illegality. Following *Stack v Dowden*, it is difficult to tell how the courts would react to a case in which a cohabiting couple put a house bought with joint money (and intended to be owned jointly) into the name of only one of the parties to commit a minor offence. It appears that the starting point is now that the "equitable title follows the legal title". In other words, the registered owner, who appears to own the property, really does own the property, unless it is proved otherwise. The other party may not be permitted to lead evidence of the couple's true intention to own the property jointly, if this was bound up with an intention to defraud.

In some cases this could be harsh and disproportionate. It could deprive the non-registered owner of their life savings, while rewarding the registered owner with a windfall profit, even where they are equally complicit in the fraud. Under human rights law, if citizens are to be deprived of property, the law should be known in advance, proportionate and based on a clear policy rationale. It must not be seen to be arbitrary, or based on technicalities unrelated to the public interest.

The second danger is that the courts may interpret the law so that claimants are always permitted to enforce their property rights under a trust, however illegally they have acted. This might be seen to bring the law into disrepute as the courts are seen to lend aid to an illegal scheme. People could, for example, pretend to give money to a son or daughter to evade inheritance tax, in the certain knowledge that if they need the money back, the courts will always allow the claim. The law will not be seen to deter illegal behaviour.

Option 2 – Abolish the “presumption of advancement”

As we have seen, the interaction of the illegality rules with the presumption of advancement can result in discriminatory and unjust decisions.

The Government has already accepted that the discriminatory nature of the presumption of advancement means that legislation is needed to amend or abolish it. Only then can the Government carry out its stated commitment to ratify Article 5 of Protocol 7 of the European Convention on Human Rights.¹² In 2005, the Government drafted provisions to this effect for the Family Law Property and Maintenance Bill. The explanatory notes explain the impact of the reforms in the following terms.

No Regulatory Impact Assessment has been carried out. The Bill would have no significant impact on business, charity or the voluntary sector. It is not envisaged that the Bill will incur any additional public sector costs... Therefore, if there were any financial effect at all, it would be minimal.

The 2005 draft Bill was not introduced. However, we understand that in January 2010, amendments were tabled to the Equality Bill to introduce this policy.

Our consultation revealed no good reason to keep the presumption of advancement. We support its abolition. However, we do not think that this alone will cure all the problems. Following *Stack v Dowden*, the law on constructive trusts also has the potential to cause injustice.

Option 3 – Allow the courts to decide, at their discretion, whether to enforce trusts created or used to conceal the true ownership of property for a criminal purpose

Our preferred option is to pass legislation to give the courts a discretion to decide whether to enforce property interests in favour of those who have created or used the trust mechanism to conceal the true ownership of property for a criminal purpose. The courts would only refuse to enforce property rights in exceptional circumstances, bearing in mind a list of relevant factors.

This is the policy set out in our draft Bill on Trusts (Concealment of Interests). The scope of the discretion would be clearly set out in statute, allowing citizens to organise their affairs in the knowledge that the discretion exists. The courts would only deprive claimants of property in exceptional cases, such as where the illegality was serious. This means that litigants would not be able raise minor issues to gain a tactical advantage.

The legislation would ensure that where the courts do deprive claimants of property rights they do so for a good reason, acting in the public interest, and focusing explicitly on relevant policy factors. This would meet human rights obligations.

¹² Written Answer, Hansard (HL) 21 April 1998, vol 588, col 197W.

The effect of our preferred option on the Proceeds of Crime Act 2002

Where criminals attempt to conceal the proceeds of crime, the State has extensive powers to confiscate the property. The law in this area was strengthened by the Proceeds of Crime Act 2002, as amended by the Serious Crime Act 2007. These Acts provide for both confiscation orders in criminal proceedings and for civil recovery by the Serious Organised Crime Agency.¹³ At one stage, we considered whether these extensive powers had removed all need for a private law doctrine of illegality in trusts. In serious cases, where a criminal concealed property gained in the course of a crime, the State would confiscate it. Could it be argued that in other cases the courts should simply enforce normal property rights, and not worry about any possible illegality?

We have decided that the courts still need some discretion in private law to refuse to enforce trusts - and the matter cannot be left solely to confiscation orders and civil recovery. This is because:

- (1) in many cases a crime is contemplated but not actually committed;
- (2) even if a crime is committed, it will often not be prosecuted;
- (3) the subject matter of the trust will not necessarily be the proceeds of crime and therefore would not be caught by the confiscation provisions. For example, assets may be hidden to defraud creditors, but the concealment may be discovered before the creditors were actually defrauded. In this case, there would be no proceeds of crime.

However, we have made sure that the draft Bill does not prejudice the powers which the State has to confiscate the proceeds of crime. We therefore include a small amendment to the 2002 Act to ensure that even if the court exercises its discretion to allow the trustee to keep the property, the property can still be recovered by the State.¹⁴

COSTS AND BENEFITS OF THE PREFERRED OPTION

Monetised costs and benefits

As discussed above, each year only a handful of cases involving illegality and trusts receive legal aid or are brought before the courts. This suggests that both the direct costs and the direct benefits will be very low.

We think that the introduction of a statutory discretion will prevent difficult appeals on points of law. It will remove the costs of some cases before the Court of Appeal, Supreme Court and European Court of Human Rights. On the other hand, any new legislation may generate a few additional cases before the lower courts until the full scope of the legislation is understood.

By way of illustration, it is possible that over the next 5 years, leaving the law alone will generate a couple of Court of Appeal hearings, a case to the Supreme Court and an application to the European Court of Human Rights. On the other hand, statutory reform may generate an additional 3-5 lower court decisions: cases which might otherwise have settled may proceed to court as the parties seek to explore the effect of the new statute. Overall, the net effect on litigation costs is likely to be small.

¹³ We give details of these provisions in our 2009 consultative report, Appendix A.

¹⁴ Draft Bill, clause 6.

Non-monetised benefits

The law in this area casts a long shadow and has the potential to affect the property rights of several hundred thousand people. If the law is seen to be unfair, either because it condones serious illegality, or because it allows parties to raise minor tactical points, it brings the legal system into disrepute.

We have considered what effect legislative change will have on tax and benefit fraud. The problem is that if the current law is left unchanged, there may be a high profile case in which the courts are seen to ignore illegality. The public may be left with the impression that “the rich get away with it”: that is, those who can afford litigation and lawyers may commit fraud with impunity. When the law is shown to be unfair in this way, it weakens people’s respect for it. This makes it slightly more likely that people will commit tax and benefit fraud when given the opportunity.

A growing body of research demonstrates this link. For example, Tyler has shown a statistical correlation between how far individuals believe a law to be legitimate and how far they are willing to comply with it.¹⁵ Nadler has tested the thesis experimentally. Participants were shown newspaper articles: for one group, the articles described the law in a good light; for the other group, the articles were altered to make the outcome of the law appear unjust. The participants were then asked to indicate their willingness to undertake various forms of illegal behaviour. Those shown “unfair” reports were significantly more likely to say they would break the law in minor ways.¹⁶

It is not possible to quantify this effect. One cannot say that x column inches of negative press coverage converts to £y million in tax evasion. However, the relationship nevertheless exists. We think that our reform would produce some savings in the form of reduced tax and social security benefit fraud. The reform is designed to deter people from entering into such fraudulent arrangements because they will be at risk of losing their interest in the trust property.

Finally fairness is a benefit in its own right. The reform would provide fair decisions based on clear policies.

SPECIFIC IMPACT TESTS

We do not think this reform will have any measurable impact on competition, small firms, sustainable development, carbon assessment, the environment, health, race equality, disability equality or the rural environment.

Legal aid

As discussed above, the effect on legal aid will be minimal. Legal aid funds only a few disputes in this area. The latest data available show that in 2004-2005 the Legal Services Commission received 118 applications for General Family Help for cases involving trusts of land. Only a small minority of cases will raise issues of illegality.

Although new legislation may raise new issues to be litigated, the overall effect of the legislation will be to clarify the law and provide litigants with greater certainty. The Bill makes it clear that the issue of illegality should be raised only in exceptional circumstances. We think that overall the savings provided by clearer law will offset the initial cost of testing the legislation.

¹⁵ T Tyler, “Procedural Fairness and Compliance with the Law” [1997] *Swiss Journal of Economics and Statistics*.

¹⁶ J Nadler, “Flouting the Law” (2005) 83 *Texas Law Review* 1399. See also C R Sunstein, *Social Norms and Social Rules* (1995) *Law and Economics Working Paper No 36*.

Gender equality

A major problem with the current law is that it is overtly discriminatory. A man who parks property with a son or daughter is treated more harshly than a woman who carries out the same actions in identical circumstances. This is because in illegality cases, the outdated “presumption of advancement” is not simply a starting point for considering the evidence, but determines the outcome of the case.

The clearest way of resolving this problem is to abolish the presumption of advancement. The Government is already committed to this, in order to ratify Article 5 of Protocol 7 of the European Convention on Human Rights. However, the draft Bill on illegality in trusts will also remove the discriminatory nature of the law, by ensuring that the presumption of advancement does not affect the outcome of the case.

Human rights

If the law is to deprive a claimant of valuable property because of illegal conduct, it should do so in a way which is compatible with Article 1 of the First Protocol. This states that “no-one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law”. This does not prevent legal rules which deprive those who have behaved illegally of their possessions. However, it is important that the law on this subject is clearly set out, proportionate, and justifiable. The deprivation must be for relevant and sufficient reasons.

Unfortunately, the current law is confused, uncertain and arbitrary. There is a danger that the current law could reach a surprising result for no clear policy reason. In the case of a constructive trust, the reliance principle can deprive a claimant of extremely valuable property on account of a minor crime carrying only a small fine. If this result were impossible to foresee at the time the offence was committed, and if the result could not be justified in policy terms, then there is a danger that it would breach the UK’s human rights commitments.

The draft Bill would ensure that the law was clearly established. Decisions made under the Bill would be directly related to the policy rationales underlying the illegality defence, and therefore would be based on sufficient and relevant reasons. They can be justified as proportionate. We think the draft Bill will ensure that the law is compatible with the European Convention on Human Rights.

APPENDIX D

LIST OF CONSULTEES

List of those who responded to the 2009 consultative report, *The Illegality Defence* (2009) Law Commission Consultation Paper No 189.

Judiciary

Association of HM District Judges

Council of HM Circuit Judges

Sir Richard Buxton

Lord Justice Longmore

Barristers

Mr Michael Brindle QC

Mr Simon Levene

Academics

Professor Richard Buckley

Mr Peter Cane

Mr Derek Davies

Mr Paul Davies

Associate Professor Margaret Fordham

Mr Justice Hayton

Dr Hugo van Kooten

Associate Professor Mark Lunney

Dr Duncan Sheehan

Ms Janet Ulph

Organisations

Association of Personal Injury Lawyers

Chancery Bar Association

Law Reform Committee of the Bar Council

Metropolitan Police

Society of Trust and Estate Practitioners