KEY POINTS

- A defence of illegality usually raises a binary issue: is the contract enforceable or not?
- There may be scope for a more nuanced approach in some circumstances.
- The rights of innocent third parties will be a crucial consideration.

Feature

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Madison Pacific Trust v Shakoor Capital: a more nuanced approach to illegality?

In *Madison Pacific Trust Limited v (1) Shakoor Capital Company and (2) Joint-Stock Company Commercial Bank Privatbank* [2020] EWHC 610 (Ch), the court considered whether the trustee of securitised loan notes could pay only certain of the beneficiaries of the notes having regard to the *pari passu* distribution provisions in the relevant trust deed in circumstances where the underlying loans were tainted by illegality. Emily Saunderson considers the implications for findings of illegality in connection with loans and securitised notes.

The issue that arose in *Madison Pacific Trust Limited v Shakoor Capital Company*, was whether the trustee of loan notes (Notes), the proceeds of which had been loaned to the second defendant bank (Privatbank) by the note issuer, could legitimately distribute sums recovered from Privatbank to some but not all of the noteholders on the basis that the actions of some of the noteholders (those to whom it was proposed repayments would not be made) had resulted in the loans being tainted by illegality which also infected the Notes.

The Notes were issued by a UK orphan special purpose vehicle[1] further to two trust deeds (Trust Deeds), which were in materially similar terms. The claimant (Madison) was the trustee. The first series of Notes was issued in 2010 in the sum of US$200m, and the Notes were due for repayment in January 2018. The second series of Notes was issued in 2013 in the sum of US$175m; the Notes were due for repayment in February 2018.

The funds raised by the Notes were loaned by the issuer to Privatbank further to two loan agreements: one for US$200m in September 2010, and one for US$175m in February 2013 (Loan Agreements).

The issuer charged and assigned by way of security its interest pursuant to the Loan Agreements to Madison.

Payment under the Notes was dependent on the extent to which the Loans were repaid. The noteholders would only be repaid in full if Privatbank repaid the Loans.

The Loan Agreements provided that disputes arising out of or in connection with them were subject to arbitration in London in accordance with London Court of International Arbitration rules.

THE ARBITRATION

The Loans were not repaid, and Madison, enforcing its security, sought arbitration awards against Privatbank for repayment. In taking this action, Madison acted further to instructions and indemnification by specific holders of interests in the Notes (Instructing Group).

One of the bases upon which Privatbank defended the arbitral proceedings was that the Loan Agreements were unenforceable for illegality perpetrated by two former owners of Privatbank (Former Owners).

The Former Owners and/or entities controlled by them had bought interests in the Notes, but there were also noteholders, including the Instructing Group, who had no connection with the Former Owners.

The holding structure of the Notes was not straightforward. The Notes were deposited with a common depository, held on behalf of Euroclear and Clearstream, which allowed account holders or participants in each respective clearing system to trade interests in the Notes.

The clearing system participants held their interests in the Notes on behalf of investors. The ultimate owners of the interests in the Notes were referred to as the Ultimate Account Holders (UAHs). In the court proceedings, the UAHs represented by the Instructing Group and other innocent investors were referred to as the "Entitled UAHs" and the UAHs who were the Former Owners or who were controlled by them were referred to as the "Related UAHs".

The arbitral tribunal decided that Privatbank would be required only to pay certain amounts due under the Loan Agreements because, among other matters:

- the Loan Agreements were "tainted by illegality", and the illegality "infected" the Notes to the extent that interests in the Notes had been acquired by the Former Owners or entities controlled by them;
- the Instructing Group and others who had acquired interests in the Notes were innocent victims of the illegality; and
- the public policy considerations behind the illegality defence in English law required a tribunal to act to prevent recovery where allowing a claim would endorse a fraud and assist a fraudulent purpose.

The tribunal held that Privatbank had no liability to repay a sum equivalent to the value of the Notes held by the Related UAHs, but it had to pay Madison a sum equivalent to the value of the Notes held for the benefit of the Instructing Group. Madison was then required by para 5.2(3) of the awards to pay each member of the Instructing Group on a pro rata basis.

But the arbitration award provided that Madison was not obliged to make any payments until it had applied to the High Court seeking confirmation that it would have no further liability under the Trust Deeds or otherwise as a result of making those payments.

The issue was that the Trust Deeds provided that payment of any sums recovered as a result of Madison enforcing its security had to be made on a pro rata basis in respect

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of all sums due under the Notes irrespective of the ultimate beneficiaries of such payments. The concern was therefore that if Madison paid only the Instructing Group from the proceeds of the sums recovered further to the arbitration awards, it may be susceptible to potential claims from other innocent ultimate noteholders, as well as the Related UAHs.

The court proceedings

Madison duly applied to court for an order that it was at liberty to make the payments provided for in the arbitral award, alternatively that it would not be liable to any noteholder or UAH by reason of making or withholding any payment in accordance with the arbitral award.

The Instructing Group was represented by the first defendant (Shakoor).

In determining the application, Zacaroli J said that the starting point in considering whether distributing any payments from Privatbank further to the arbitral awards would put Madison in breach of its duties as trustee was to consider what would happen if the court refused the relief sought. He said the matter would be referred back to the arbitral tribunal who would conclude either that Madison's action against Privatbank failed because the Loans were unenforceable for illegality, or an alternative solution might be found to ensure the Related UAHs recovered nothing, but this would involve delay and expense given the locations, resources and conduct of those who might be targeted for relief (presumably including the Former Owners).

Further, if Madison refrained from taking action, the noteholders had a right to enforce the Trust Deed themselves. Although the way in which this may happen was not straightforward, in such an event, privity could be established between Privatbank and the Noteholders.

If any Related UAH sought to pursue an action against Privatbank, the bank argued and Zacaroli J accepted that such an action would be prevented by virtue of issue estoppel because there was a binding arbitral decision against the trustee that recovery could not be made on behalf of the Related UAHs, and decisions adverse to a trustee which had sought to claim trust property from a third party are binding on all the beneficiaries of a trust, see *Gleeson v Wipple & Co Ltd* [1977] 1 WLR 510 at 515.

Zacaroli J found that there was a sufficient degree of identification between the interests of the trustee (Madison) and all the UAHs such that the Related UAHs would be prevented from making any direct recovery against Privatbank, but that there would be no bar to the Entitled UAHs recovering in full.

There were therefore no circumstances in which Madison could make a recovery for the Related UAHs, and it could only recover anything at all if it accepted that what it did recover had to be paid to the Entitled UAHs.

Zacaroli J also noted that although Madison's actions would only benefit some of the UAHs, it would not be at the expense of the other UAHs because Madison was incapable of benefitting them by a legal impediment in the form of the arbitral decision. The judge therefore allowed Madison's application.

ANALYSIS

Recovery of sums paid under an illegal, and therefore unenforceable, transaction would usually be by way of restitution. Illegality is usually a binary issue: a contract is enforceable, or it is not. In *Madison*, it appears that there was no finding that either the Loan or the Notes were unenforceable, but it remains unclear what "tainted by illegality" in the context of the Loans and "infected by illegality" in the context of the Notes actually meant.

When faced with a claim based on a contract which involves illegal activity, the Supreme Court said in *Patel v Mirza* [2016] 3 WLR 399 that in deciding how to account for the impact of the illegality on the claim, the court should bear in mind the need for integrity and consistency in the justice system and particularly:

- the policy behind the illegality;
- any public policy that may be rendered less effective by denial of the claim; and
- the need for proportionality.

The effect of a finding of illegality in the context of a loan or securitised note will therefore depend, among other matters, on what the illegality is, who the claimant is, whether allowing the claim would be consistent with policy, and what the proportionate response should be.

There are some standard clauses in finance documents that provide for illegality, for example, under the standard form Loan Market Association loan agreements, illegality in terms of the performance of a borrower's obligations triggers an event of default. The standard clause provides that an event of default occurs "if it is or becomes unlawful for the Borrower to perform any of its obligations under any Finance Document to which it is a party". This clause would usually be relevant in the context of, for example, sanctions coming into effect that made it unlawful for a borrower to make repayment.

The decision in *Madison v Shakoor* perhaps suggests that a tribunal faced with illegality somehow connected to a loan or loan note may be amenable to taking a more nuanced approach than simply ruling the agreement unenforceable or subject to an event of default, particularly where innocent third parties are involved and may lose out if such a finding was made. ■

1 The equity in an orphan special purpose vehicle is held by a third party, typically a trust, which has no connection to the primary parties involved in the securitisation.

Further Reading:

- The new approach to illegality (2016) 10 JIBFL 575.
- The effect of foreign illegality on English law contracts (2010) 9 JIBFL 531.
- LexisPSL: News analysis: What next for transactions tainted by illegality?