Part III

Policing the Contract

12 A Duty to Disclose Material Facts?

In this part of the book we shall consider various ways in which the law of contract regulates the agreement concluded by the parties and allocates the risk of unforeseen events between the parties. In Chapters 12 and 13 we shall discuss the obligations which are imposed upon contracting parties during the process of contractual negotiation. In Chapter 14 we shall analyse the methods by which the courts allocate the risk between contracting parties when they enter into a contract under a common fundamental mistake or an unforeseen event occurs after they have entered into the contract which destroys the basis on which they entered into the contract. In Chapters 15 and 16 we shall consider the limitations which are placed upon the enforceability of contracts by the doctrine of illegality and by the rules relating to capacity to enter into contracts. Finally, in Chapter 17 we shall discuss the Unfair Terms in Consumer Contracts Regulations 1999 (SI 1999, No. 2083), together with the doctrines of duress, undue influence and inequality of bargaining power and then conclude this part by discussing the extent to which the law of contract is concerned with the fairness of the bargain concluded by the parties.

12.1 Introduction

In terms of disclosing information during the process of contractual negotiation, there are essentially two types of obligation which could be imposed by the courts upon contracting parties. The first is a duty to disclose all known material facts to the other contracting party. The second is a duty to refrain from making active misrepresentations: that is to say, a contracting party is not compelled to disclose information, but once he does disclose, he must do so truthfully. English law has adopted the latter approach and does not recognise the existence of a general duty to disclose material facts known to one contracting party but not to the other (*Keates* v. *Cadogan* (1851) 10 CB 591).

A number of reasons can be identified for this refusal to countenance the existence of a general duty of disclosure. An instructive example

provided by Professor Fried (1981, p.79) will help us to appreciate these reasons:

> 'An oil company has made extensive geological surveys seeking to identify possible oil and gas reserves. These surveys are extremely expensive. Having identified one promising site, the oil company (acting through a broker) buys a large tract of land from its prosperous farmer owner, revealing nothing about its survey, its purposes or even its identity. The price paid is the going price for farmland of that quality in that region.'

An English court would undoubtedly uphold the validity of such a contract and would not require the buyer to disclose his information to the seller prior to the making of the contract. A number of justifications can be provided for such a rule. The first is the simple proposition that the information acquired by the buyer has a financial value and to expect him to disclose it to the seller without compensation is to deprive him unfairly of his valuable information, to provide a disincentive to the acquisition of such information and to unjustly enrich the seller. The second is that contractual obligations are generally voluntarily assumed by parties who deal 'at arm's length', seeking to make the best bargain they can. In such a context contracting parties are not expected to share information with each other. The third justification is that, if such a duty were to be recognised, then questions would have to be resolved as to when it would arise and what would be its content. This justification may be called the floodgates argument. These are compelling justifications for the refusal of the law to recognise the existence of a *general* duty of disclosure.

But strong arguments can be adduced to support the recognition of a duty of disclosure in certain *particular* cases. For example, few would support a rule which enabled a car dealer to sell a car which he knew to be dangerous without revealing that fact to the purchaser. Thus we find that, in certain exceptional cases, a particular duty of disclosure is held to exist. We shall now consider these exceptions and conclude by considering whether they have any coherent rationale.

12.2 Snatching at a Bargain

The first example of a limited duty of disclosure arises from the rule, which we have already noted (see *Hartog* v. *Colin and Shields* [1939] 3 All ER 566, discussed at 2.2), that a claimant will be prevented from snatching at a bargain which he knew was not intended by the defendant.

Thus, in *Smith* v. *Hughes* (1871) LR 6 QB 597, the principle was established that a seller who knows that the buyer has misunderstood the terms of his offer is under an obligation to inform the buyer of the true nature of his offer. In other words, he is under a duty to disclose the existence of the mistake. But, where the buyer makes a mistake and that mistake does not relate to the terms of the seller's offer, then the seller, even if he is aware of the buyer's mistake, is not under an obligation to disclose the mistake to the buyer. It is the responsibility of the buyer to discover his mistake and he cannot escape from his bad bargain by arguing that it was the responsibility of the seller to inform him of his mistake (see further, Kronman, 1978a and Brownsword, 1987).

12.3 Representation by Conduct

The second group of exceptions all concern liability for misrepresentation (12.3–12.5). A misrepresentation consists of a false statement of fact (see 13.3) but the courts have, in limited circumstances, been flexible in their identification of a 'statement' of fact so that, in effect, they have imposed a limited duty of disclosure by the back door. For example, a contracting party does not have to open his mouth to make a statement; he can make it by his conduct. In *Walters* v. *Morgan* (1861) 3 D F & J 718, Campbell LC said that, while simple reticence does not amount to a legal fraud, 'a nod or a wink, or a shake of the head, or a smile from the purchaser intended to induce the vendor to believe the existence of a non-existing fact, which might influence the price of the subject to be sold' would be a sufficient ground for refusing to enforce a contract.

The refusal to draw a rigid distinction between statements and conduct seems eminently sensible in the examples given by Campbell LC in *Walters*. Conduct can be as misleading as words. An apparently straightforward example of the imposition of liability on the basis of the conduct of the defendant is provided by *Gordon* v. *Selico* (1986) 11 HLR 219 (see Gleeson and McKendrick, 1987). An independent contractor, employed by the defendants, was asked to bring a flat which was infected with dry rot up to a very good standard for the purpose of selling it. The independent contractor simply covered up the dry rot and made no attempt to eradicate it. The claimants purchased the flat and later discovered the presence of the dry rot. It was held that, in concealing the dry rot, the independent contractor had knowingly made a false representation to the claimants that the flat did not suffer from dry rot and that he and the vendors were therefore liable to the claimants in damages.

But, once it is recognised that a representation may be made by

conduct, difficulties arise in identifying the meaning to be ascribed to the conduct and in ascertaining the situations in which the defendant is under an obligation to correct the meaning conveyed by his conduct. For example, in a case such as *Gordon* v. *Selico*, what would have been the position if the independent contractor had papered the dining-room prior to selling the house, partly because it needed redecorating anyway and partly to hide the defective state of the plaster? What is the meaning to be attributed to such conduct and is such a vendor under a duty to disclose the reasons why he has papered the room? In the High Court in *Gordon* v. *Selico* (1985) 275 EG 899, 903, Goulding J said that

> 'the law must be careful not to run ahead of popular morality by stigmatising as fraudulent every trivial act designed to make buildings or goods more readily saleable even if a highly scrupulous person might consider it dishonest.'

The vagueness of this principle highlights the fact that, in the absence of a general duty of disclosure, it is extremely difficult to mark out the limits of any particular duty of disclosure.

12.4 Representation Falsified by Later Events

A person may also be guilty of misrepresentation where he fails to correct a representation which, when made was true, but which subsequently, to his knowledge, has become false or which, at the time of making it he believed to be true, but which he has subsequently discovered to be false. In *With* v. *O'Flanagan* [1936] Ch 575, negotiations for the sale of a medical practice began at a time when the practice was valued at £2000. But when the contract of sale was concluded, the practice had become worthless because of the ill-health of the vendor in the intervening period. It was held that the vendor was under an obligation to disclose the change of circumstances to the buyer. The justification for this rule appears to be that a representation, once made, is deemed to be a continuing representation so that, once it becomes false to the knowledge of the representor and he fails to correct it, it becomes a misrepresentation (*Shankland & Co* v. *Robinson and Co* 1920 SC (HL) 103, per Lord Dunedin). However, where the representation relates to a statement of intention and the contracting party changes his intention before the conclusion of the contract, then there is no obligation to communicate that change of intention (*Wales* v. *Wadham* [1977] 1 WLR 199).

12.5 Statement Literally True but Misleading

A further situation in which a court may conclude that a misrepresentation has been made is where the statement is literally true but is nevertheless misleading because the maker of the statement has failed to disclose all the relevant information. In *Notts Patent Brick and Tile Co* v. *Butler* (1866) 16 QBD 778, a purchaser of land asked the vendor's solicitors whether the land was subject to restrictive covenants. The solicitor replied that he was not aware of any, but he did not say that the reason for his ignorance was that he had not bothered to check. It was held that, although the solicitor's statement was literally true, it nevertheless amounted to a misrepresentation.

12.6 Contracts *Uberrimae Fidei*

There are a group of contracts which are known as contracts '*uberrimae fidei*' or contracts of the utmost good faith. Insurance contracts are contracts '*uberrimae fidei*'; in such contracts the insured is under a duty to disclose all facts which a reasonable or prudent insurer would regard as material. The insured is in the best position to know the relevant facts and therefore a duty of disclosure is placed upon him.

12.7 Fiduciary Relationships

There is also a limited class of fiduciary relationships in which the party in whom the trust is reposed is placed under an obligation to disclose information to the person who has placed his trust in him (a good example is provided by the cases in which the presumption of undue influence is held to arise, see 17.3). Where such a fiduciary relationship exists, the parties do not bargain 'at arm's length' and the objection to the imposition of a duty of disclosure disappears.

12.8 A Duty of Disclosure in Tort?

Rather than seek a remedy in contract, a claimant may argue that the defendant committed the tort of negligence in failing to disclose the information to the claimant. But the law of tort does not impose a general duty of disclosure; indeed, Lord Keith has reaffirmed that a person who sees 'another about to walk over a cliff with his head in the air, and forbears

to shout a warning' incurs no liability in the tort of negligence (*Yuen Kun-yeu* v. *Attorney General of Hong Kong* [1988] AC 175). On the other hand, a failure to speak may give rise to liability in the tort of negligence where the defendant has voluntarily assumed a responsibility to disclose information to the claimant and the claimant has relied upon that assumption of responsibility (*Banque Keyser Ullmann SA* v. *Skandia (UK) Insurance Co Ltd* [1990] 1 QB 665, 794). A duty of disclosure may also be imposed by the law of tort in certain other exceptional cases. Thus a doctor who fails to disclose to a patient the risks involved in a course of treatment may be liable in the tort of negligence if he fails to act in accordance with a standard accepted as proper by a responsible body of medical men (*Sidaway* v. *Bethlem Royal Hospital Governors* [1985] AC 871). But these remain exceptions to the general rule and the law of tort has not taken, and is unlikely to take, the step of imposing a duty on contracting parties to bargain in good faith.

12.9 The Role of the Sale of Goods Act 1979

We have already noted (see 9.8) that the Sale of Goods Act 1979 implies certain terms into contracts for the sale of goods. Two of these terms are of particular significance here. First, where a seller sells goods in the course of a business, there is an implied condition that the goods supplied under the contract are of satisfactory quality, except in relation to defects drawn to the buyer's attention before the contract was concluded or, in the case where the buyer examines the goods, as regards defects which that examination ought to reveal (s.14(2) and (2C)). Secondly, where the seller sells goods in the course of a business and the buyer makes known to the seller any particular purpose for which the goods are being bought, there is an implied condition that the goods supplied under the contract are reasonably fit for that purpose (s.14(3)). In many ways the rights conferred by these provisions are greater than any protection afforded by any duty of disclosure because the seller may be liable even where he was unaware of the existence of the defect; it suffices that the goods were not of satisfactory quality or were not reasonably fit for their purpose. The Supply of Goods and Services Act 1982 and, to a lesser extent, Part I of the Consumer Protection Act 1987 (which imposes strict liability for defective products) further extend the scope of such regulatory legislation and lessen the need for the creation of the general duty of disclosure because they protect the 'consumer' irrespective of whether the supplier of the goods, the provider of the services or the manufacturer of the product, knew of the relevant defect.

12.10 Conclusion

In *Interfoto Picture Library Ltd* v. *Stiletto Visual Programmes Ltd* [1989] QB 433, 439, Bingham LJ noted that in many legal systems in the world 'the law of obligations recognises and enforces an overriding principle that in making and carrying out contracts parties should act in good faith'. A duty of good faith is, of course, wider in scope than a duty of disclosure because it is not confined to pre-contractual behaviour but can extend to the way in which the parties behave during performance of the contract and even to its termination. A case which might have been caught by a duty of good faith is *Arcos Ltd* v. *E A Ronaasen & Co* [1933] AC 470 (discussed in more detail at 10.3), where the buyers under a contract of sale rejected goods ostensibly on the ground that they did not conform with description but in reality because the market price for the goods had fallen. As Professor Brownsword has noted (1992), the real objection is that the buyers 'acted in bad faith'. But English law recognises no general principle that a party must exercise his contractual rights 'reasonably' or 'in good faith' and so there was no way in which an English court could at that time challenge the buyers' actions on this ground (the buyers' action could now possibly be challenged under s.15A of the Sale of Goods Act 1979, on which see 10.4). The traditional hostility towards the recognition of a doctrine of good faith can be seen in the decision of the House of Lords in *Walford* v. *Miles* [1992] 2 AC 128 (discussed in more detail at 4.1), where Lord Ackner refused to imply a term that the parties would continue to negotiate in good faith on the ground that a 'concept of a duty to carry on negotiations in good faith is inherently repugnant to the adversarial position of the parties when involved in negotiations'. He maintained that each party 'is entitled to pursue his (or her) own interests, so long as he avoids making misrepresentations'. But there are signs that the traditional English hostility towards good faith might be abating. The courts have adopted a more sympathetic stance on a number of occasions recently (see *Timeload Ltd* v. *British Telecommunications Ltd* [1995] EMLR 459; *Philips Electronique Grand Publique SA* v. *British Sky Broadcasting Ltd* [1995] EMLR 472; *Balfour Beatty Civil Engineering Ltd* v. *Docklands Light Railway Ltd* (1996) 78 Build LR 42, 58; and *Re Debtors (Nos 4449 and 4450 of 1998)* [1999] 1 All ER (Comm) 149, 157–158), and the express references to 'good faith' in the Unfair Terms in Consumer Contracts Regulations 1999 and the Commercial Agents (Council Directive) Regulations 1993 (SI 1993, No 3053) will require English judges to use the language of good faith. Thus in *Director General of Fair Trading* v. *First National Bank plc* [2000] 1 WLR 98, 109 Evans-Lombe J stated that the words 'good faith' in the Unfair Terms in Consumer Contracts

Regulations were not to be construed 'in the English law sense of absence of dishonesty but rather in the continental civil law sense' which he understood to be a reference to a principle of fair and open dealing (to similar effect see the judgment of Peter Gibson LJ in the Court of Appeal, [2000] 2 All ER 759). These Regulations might serve to nudge English law further towards the recognition of a duty of good faith and fair dealing in that, once good faith is admitted into the language of the courts, it might be difficult to ring-fence it.

At present, English law appears to stand out from the many other jurisdictions which recognise the existence of a doctrine of good faith. In America, the Uniform Commercial Code states in s.1–203 that 'every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement' and, for this purpose, s.1–201 defines good faith as 'honesty in fact in the conduct or transaction concerned' (see also the definition in s.2–103). Further, the recognition of a duty of good faith and fair dealing in the performance and enforcement of contracts in section 205 of the Restatement (Second) of Contracts (note that it does not extend to the negotiation of contracts) has been hailed by Professor Summers (1982) as a reflection of 'one of the truly major advances in American contract law during the past fifty years'. Article 242 of the German BGB states that 'the debtor is bound to effect performance according to the requirements of good faith, giving consideration to common usage'. Article 1134 al.3 of the French Civil Code states that contracts must be executed or performed in good faith. Article 7(1) of the Vienna Convention on Contracts for the International Sale of Goods states that in the interpretation of the Convention regard is to be had, *inter alia*, to the 'observance of good faith in international trade'. Article 1.7 of the Statement of Principles for Commercial Contracts prepared by Unidroit (see 1.7) states that 'each party must act in accordance with good faith and fair dealing in international trade' and further that 'the parties may not exclude or limit this duty'. The comment to the article states that 'good faith and fair dealing may be considered to be one of the fundamental ideas underlying the Principles'. Article 1.106(1) of the Principles of European Contract Law states that 'These Principles should be interpreted and developed in accordance with their purposes. In particular, regard should be had to the need to promote good faith and fair dealing, certainty in contractual relationships and uniformity of application'. Further, Article 1.201 states that 'each party must act in accordance with good faith and fair dealing' and that the 'parties may not exclude or limit this duty'.

Yet this contrast between English law and other jurisdictions can be over-stated. In the first place, while English law does not presently recognise a duty of good faith, it can be very firm (possibly even harsh) in its

treatment of those who act in bad faith. Specific examples of bad faith, such as telling lies (see Chapter 13), using illegitimate pressure (see 17.2), exploiting the weakness of others and abusing positions of confidence (see 17.3 and 17.4), all constitute grounds upon which a contract can be set aside. Those who make false statements, even innocently, will find little to cheer them in English law (see 13.8). However it may be that it is when we turn from the negative (not telling lies) to the positive (requiring disclosure of the whole truth) that English law may be found wanting. Secondly, many if not most of the rules of English contract law do in fact conform with notions of good faith. The individual bricks which could be used to create a general principle of good faith and fair dealing can already be identified. The existence of contracts *uberrimae fidei* and the limited duty of disclosure which English law recognises (see 12.2–12.6), the operation of the doctrines of promissory estoppel (5.25) and estoppel by convention (5.26), the law applicable to fiduciaries (12.7), the rules which the courts apply when seeking to interpret contracts (see 9.6) and the willingness of the courts to imply terms into a contract in particular situations (9.8 and 12.9) could all be rationalised in terms of good faith. As Dr Clarke has acknowledged (1993), the 'foundations of a general rule of good faith can be discerned in the common law dust' but the courts have not been prepared to use these particular rules 'as the piles for the building of a principle of good faith'. Finally, civilian lawyers may well use the doctrine of good faith to reach results which English law would reach by a more narrowly defined doctrine. For example, English law has developed a distinct doctrine of frustration to deal with impossibility and impracticability in performance (see 14.8–14.17) rather than use a broad notion of good faith. The difference may be more one of technique than result.

Why then does English law not recognise a doctrine of good faith or a general duty of disclosure? A number of reasons can be identified. The first is that English law starts from a premiss of rugged individualism, in which the parties are expected to look after their own interests and to bargain to obtain the best terms which they can for themselves. But, as we have noted, this is not the complete picture: the commitment to individualism is not an absolute one. The piecemeal exceptions which we have noted represent a limited attempt by the courts and Parliament to protect the expectations of consumers and to impose a limited duty of co-operation in an effort to avoid the unfairness and the excesses which would arise from an absolute refusal to recognise the existence of any duty of disclosure or a duty to bargain in good faith (for an alternative explanation of these exceptions in terms of a liberal theory of contract, see Fried, 1981, pp.77–85). The second reason is that English law is

reluctant to embrace broad general principles, such as a duty of good faith. It prefers to develop incrementally and by analogy to existing precedents rather than by reference to broad statements of general principle. As Bingham LJ noted in *Interfoto*, while English law recognises no 'overriding principle' that parties must act in good faith, it has 'developed piecemeal solutions in response to demonstrated problems of unfairness'. It could be said that English law prefers to mark out on an incremental basis what constitutes 'bad faith' but that it refuses to lay down a broad principle that parties must act in good faith. The third reason, closely related to the second, is that a broad general principle would generate too much uncertainty. When would a duty of good faith arise and what would be its content? Is good faith a subjective standard or an objective one? Should it apply to all contracts, or only in a non-commercial context where the need for certainty is less pressing? These are difficult questions which the proponents of a doctrine of good faith must answer.

But the arguments are not all one way, particularly in relation to the adoption of a doctrine of good faith and fair dealing. In so far as the House of Lords in *Walford* v. *Miles* (above) refused to recognise the validity of an obligation to negotiate in good faith, even where such an obligation has been expressly assumed by the parties, the decision can be criticised on the ground that it has undermined both freedom of contact and sanctity of contract. If negotiating parties or contracting parties wish to use the language of good faith, why should the law deny validity to their agreement? It is one thing for a legal system to refuse to imply into a contract or to impose on the parties a duty of good faith and fair dealing. It is quite another for a legal system to refuse to give effect to such an obligation when it has been expressly assumed by the parties. Secondly, as we have seen, good faith is an important feature of International Conventions on contract law, such as the Vienna Convention, the Unidroit Principles and the Principles of European Contract Law. To give one example, relevant to the obligations of negotiating parties, Article 2.301 of the Principles of European Contract Law states that

> '(1) A party is free to negotiate and is not liable for failure to reach agreement.
> (2) However, a party which has negotiated or broken off negotiations contrary to good faith and fair dealing is liable for the losses caused to the other party.
> (3) It is contrary to good faith and fair dealing, in particular for a party to enter into or continue negotiations with no real intention of reaching an agreement with the other party.'

Although examples can be found of English cases in which liability has been imposed on a negotiating party who has prematurely broken off negotiations (see, for example, *William Lacey (Hounslow) Ltd* v. *Davis* [1957] 1 WLR 932, where the defendant was held to be under a restitutionary obligation to pay the claimant the reasonable value of the work done by the claimant in anticipation of a contract which never materialised), it knows of no such general principle (witness, for example, the uncertainty over whether or not an English court would follow the decision of the High Court of Australia in *Walton Stores (Interstate) Ltd* v. *Maher* (1988) 164 CLR 387 (see 5.28), a case which would surely fall within Article 2.301). Yet if English law is to embrace international conventions or to play a role in the development of the Principles of European Contract Law, it must begin to get to grips with the language of good faith. And, in what is now a global economy (see 1.7), it may not be possible for English contract law to resist the commercial and economic pressure in favour of an increasingly unified law of contract and that unified law of contract will almost certainly contain a significant role for good faith and fair dealing.

The final argument in favour of the recognition of a doctrine of good faith and fair dealing or a general duty of disclosure is that the present rules can create hardship in individual cases. While English law is currently *influenced* or *shaped* by notions of good faith it does not recognise the existence of a *doctrine* of good faith. The point was well-made by Steyn LJ (as he then was) in *First Energy (UK) Ltd* v. *Hungarian International Bank Ltd* [1993] 2 Lloyd's Rep 194, 196, when he said:

> 'a theme that runs through our law of contract is that the reasonable expectations of honest men must be protected. It is not a rule or a principle of law. It is the objective which has been and still is the principal moulding force of our law of contract. It affords no licence to a Judge to depart from binding precedent. On the other hand, if the prima facie solution to a problem runs counter to the reasonable expectations of honest men, this criterion sometimes requires a rigorous re-examination of the problem to ascertain whether the law does indeed compel demonstrable unfairness.'

In this way, notions of good faith may be said to inform our law of contract. One of the aims of the law of contract is to produce fair and workable rules, which conform to the standards of fair and reasonable people (see Steyn, 1997). To the extent that a rule appears to encourage bad faith, it will be the subject of 'rigorous re-examination' by the courts. But those who advocate the introduction of a doctrine of good faith argue that this

is not sufficient because, as Steyn LJ acknowledges, it does not enable judges to depart from 'binding precedent'. Thus good faith could not be used to overrule a case such as *Arcos* v. *Ronaasen* (above), nor to give effect to the agreement of the parties in *Walford v. Miles* (above). It can therefore be argued that the influence of good faith is at times rather muted and that judges require stronger weapons to combat bad faith, which can only be done by elevating good faith to the status of a legal doctrine or a principle of law. Yet, as we have noted, such a step would give rise to a number of problems, most notably the uncertainty which would thereby be caused and the difficulties involved in defining the scope of good faith. Further, it is not at all clear that English law presently countenances many examples of bad faith. On the other hand, the express recognition of a duty of good faith and fair dealing would require more searching re-examination of rules which are alleged to be incompatible with such a standard, it would bring English law into line with many other jurisdictions and it would make it easier for English law to accede to international conventions. The arguments are finely balanced.

Summary

1 English law does not recognise the existence of a general duty to disclose material facts known to one contracting party but not to the other.
2 A defendant who knows that the claimant has misunderstood the terms of his offer is under an obligation to inform the claimant of the true nature of his offer.
3 A representation may be made by conduct.
4 A person is under a duty to disclose material facts which come to his notice before the conclusion of a contract if they falsify a representation previously made by him.
5 A person may be guilty of misrepresentation if his statement is literally true but is in fact misleading.
6 A duty to disclose material facts is imposed in the case of contracts *uberrimae fidei* (of the utmost good faith) and in the case of certain fiduciary relations.
7 Exceptionally a duty of disclosure may be imposed by the law of tort.
8 The existence of the 'satisfactory quality' and 'fitness for purpose' provisions in the Sale of Goods Act 1979 mitigate the hardships which would otherwise be caused by the refusal of English contract law to recognise the existence of a general duty of disclosure. Similar obligations are now contained in the Supply of Goods and Services Act 1982.

Exercises

1 Why does English law not recognise the existence of a general duty of disclosure? Do you think it should recognise the existence of such a duty?
2 List the exceptional situations in which English law does recognise the existence of a particular duty of disclosure. Do these exceptions have any coherent rationale?

3 In Professor Fried's illustration concerning the oil company and the farmer (see 12.1), should the oil company be required to disclose its information to the farmer? Give reasons for your answer. Can you distinguish this illustration from the case of *Gordon* v. *Selico*?

4 Joe papered his dining-room prior to selling the house, partly because it needed redecorating anyway and partly to hide the defective state of the plaster. Emma bought the house and later discovered that the defective state of the plaster was in fact caused by a serious structural fault in the dining-room wall. Has she a cause of action against Joe?

5 It is a noticeable feature of the duty of disclosure cases which have arisen this century that they concern contracts which fall outside the scope of regulatory legislation, such as the Sale of Goods Act 1979. Can we learn any lessons from this fact?

13 Misrepresentation

13.1 Introduction

Although English law does not recognise the existence of a general duty to disclose information during the process of contractual negotiation, the process of contractual negotiation is not left unregulated. Rather, a duty is imposed not to make any false statements of fact to the other contracting party and thereby to induce him to enter into the contract. As we shall see, the law relating to misrepresentation does have a crucial role to play in the policing of contractual negotiations (see 13.3).

At the outset a fundamental distinction must be drawn between a promise and a representation. A promise may be defined as a statement by which the maker of the statement accepts or appears to accept an obligation to do or not to do something. A representation, on the other hand, is a statement which simply asserts the truth of a given state of facts. The distinction can be illustrated by reference to the case of *Kleinwort Benson Ltd* v. *Malaysia Mining Corporation Berhad* [1989] 1 WLR 379. The claimants agreed to make available to a subsidiary company of the defendants a £10 million credit facility. The defendants refused to act as guarantors but they gave to the claimants a letter of comfort which stated that 'it is our policy to ensure that the business of [the subsidiary company] is at all times in a position to meet its liabilities to you under the above arrangements'. The subsidiary company ceased to trade after the collapse of the tin market at a time when its indebtedness to the claimants was £10 million. The defendants refused to honour their undertaking in the letter of comfort and so the claimants took proceedings against them, arguing that the defendants were in breach of contract in failing to pay. But the Court of Appeal held that the letter of comfort did not amount to a contractual promise by the defendants. Therefore they were not liable to the claimants. It was held that the letter of comfort was simply a representation of fact as to the defendants' policy at the time when the statement was made. The defendants did not promise that they would not change their policy for the future; they did not state that 'it is *and will at all times continue to be* our policy to ensure that the subsidiary will at all times be in a position to meet its liabilities to you'.

Thus promises and representations are functionally different and have different legal consequences. A representation is a statement of fact which

induces the other party to enter into a contract or otherwise act to his detriment. The representor does not promise anything; he simply asserts the truth of his statement and invites reliance upon that statement. If his statement of fact is false then it is a misrepresentation and the most appropriate remedy is to put the other party in the position which he would have been in had he not acted upon the misrepresentation to his detriment. Thus, on the facts of *Kleinwort Benson*, had the defendants' policy, at the time at which they made the statement, not been to ensure that the subsidiary would at all times be in a position to meet its liabilities, then their statement would have amounted to an actionable misrepresentation (see 13.3). A promise, on the other hand, creates an expectation that the promise will be fulfilled and the promisor accepts (or is deemed to accept) an obligation to carry out his promise. Having accepted such an obligation, the law will call upon the promisor to fulfil that obligation and will seek, by the remedy granted, to protect the expectation so created (see further 20.3). Although promises and representations are functionally different, it can be very difficult to tell whether a particular statement is a promise or a representation. For example, in *Kleinwort Benson* the trial judge, Hirst J, held that the letter of comfort was a contractual promise, whereas the Court of Appeal held that it was a representation of fact. But any difficulty experienced in drawing the line should not blind us to the fact that representations and promises are fundamentally different types of statement.

One final point must be made before we consider the substance of the law relating to misrepresentation. That point is that misrepresentation lies on the boundary of contract, tort and restitution. A party who has been induced to enter a contract by a misrepresentation may seek a remedy in contract, tort or restitution. Therefore at various points in the chapter we shall have to consider liability in all three branches of the law.

Our analysis will proceed in four stages. At the first stage we will define a misrepresentation; at the second stage we shall discuss the different types of misrepresentation; at the third stage we shall consider the remedies for misrepresentation and at the final stage we shall discuss the exclusion of liability for misrepresentation.

13.2 What is a Misrepresentation?

A misrepresentation may be defined as an unambiguous, false statement of fact (or possibly of law) which is addressed to the party misled, which is material (although this requirement is now debatable) and which induces the contract. This definition may be broken down into three dis-

tinct elements. The first is that the representation must be an unambiguous false statement of fact or possibly of law (13.3), the second is that it must be addressed to the party misled (13.4) and the third is that it must be an inducement to entry into the contract and possibly it must also be material (13.5).

13.3 A Statement of Existing Fact (or Law?)

Until recently, the rule was always stated in the form that a representation must be an unambiguous false statement of existing fact. A misrepresentation of law did not give rise to a right to rescind a contract or to claim damages at common law. But in *Kleinwort Benson Ltd.* v. *Lincoln City Council* [1999] 2 AC 349 the House of Lords held that money paid under a mistake of law could be recovered on essentially the same basis as money paid under a mistake of fact. While their Lordships in *Kleinwort Benson* did not comment on the rule that a misrepresentation of law does not give rise to a right of action at law, there does not seem to be any justification for retaining the fact/law distinction in this context but not in the context of a restitutionary claim to recover the value of a benefit conferred. This being the case, it is suggested that a misrepresentation of law should in future give a representee a cause of action on the same basis as if the misrepresentation had been of an existing fact.

Misrepresentations of law apart, the representation must be an unambiguous false statement of existing fact. The need for a statement underlines the point that a failure to disclose information will not generally constitute a representation, although, as we have noted, the courts have been flexible in their identification of a 'statement' so that, for example, a statement can be made by conduct as well as by words (see 12.3–12.5). The statement must also be one of *existing fact*. The following three categories of statement have been held *not* to constitute statements of existing fact and therefore cannot amount to actionable misrepresentations.

The first is a 'mere puff'. We have already noted (see 8.1) that a commendatory statement may be so vague as to be neither a promise which is incorporated into the contract as a term, nor a statement of fact. In *Dimmock* v. *Hallett* (1866) LR 2 Ch App 21, Turner LJ said that a representation that land was 'fertile and improveable' would not, except in an extreme case, be considered such a misrepresentation as to entitle the innocent party to rescind the contract. But there are limits to this principle. The more specific the statement, the less likely it is to be treated as a mere puff (*Carlill* v. *Carbolic Smoke Ball Co* [1893] 1 QB 256, discussed in more detail at 3.3).

Secondly, a statement of opinion or belief which proves to be unfounded is not a false statement of fact. In *Bisset* v. *Wilkinson* [1927] AC 177, a vendor of a farm in New Zealand, which had not been used for sheep farming before, represented to a prospective purchaser that, in his judgment, the land could carry 2000 sheep. In fact it could not carry 2000 sheep and the purchaser, when he discovered this, sought to set aside the contract on the ground of the vendor's misrepresentation. He was unable to do so because the vendor's statement was not a false statement of fact but a statement of opinion which he honestly held.

Bisset was distinguished, however, in the important case of *Esso Petroleum Ltd* v. *Mardon* [1976] QB 801. Esso represented to the defendant, a prospective tenant of a petrol filling station which was in the process of construction, that the throughput of petrol at the station was likely to reach 200,000 gallons per year. However the local authority refused planning permission for the petrol pumps to front on to the main street. Instead, the station had to be built back to front with the forecourt at the back of the station and the only access to the petrol pumps being from a side street. Esso, through their experienced officials, assured the defendant that this change would not affect the projected throughput of petrol. In fact, as a result of the change, the throughput only reached 78,000 gallons per year. The defendant incurred considerable losses in operating the station and he eventually reached the position where he could no longer pay Esso for his petrol. Esso consequently sought to repossess the station and to recover the money owed to them by the defendant. The defendant counterclaimed for damages for breach of contract and for negligent misrepresentation. Esso argued that their statement as to the throughput of petrol was a statement of opinion and hence was not actionable. But the Court of Appeal held that the statement was one of fact. Lord Denning distinguished *Bisset* on the ground that there 'the land had never been used as a sheep farm and both parties were equally able to form an opinion as to its carrying capacity'. Esso, on the other hand, had special knowledge and skill in the forecasting of the throughput of petrol and they were held to represent that they had made the forecast with 'reasonable care and skill'. On the facts it was held that they had not exercised reasonable care and skill and they were therefore liable to the defendant in damages. A similar approach to that adopted in *Esso* was espoused by Bowen LJ in *Smith* v. *Land and House Property Corp* (1884) 28 Ch D 7, when he said that where

> 'the facts are equally known to both parties, what one says to the other is frequently nothing but an expression of opinion . . . But if the facts

are not equally well known to both sides, then a statement of opinion by one who knows the facts best involves very often a statement of material fact, for he impliedly states that he knows facts which justify his opinion.'

Combining the principles established in *Esso* and *Smith* we can deduce the following proposition: where the representor has greater knowledge than the representee, the courts will imply that the representation must be made with reasonable care and skill (*Esso*) and that the representor knows facts which justify his opinion (*Smith*). In effect, these cases impose upon negotiating parties who have special skill a duty to take reasonable care in the preparation of forecasts and opinions.

Finally, a statement of intention is not a statement of fact. Nor is a promise a statement of fact. A person who fails to carry out his stated intention does not thereby make a misrepresentation (*Wales* v. *Wadham* [1977] 1 WLR 199). But a person who misrepresents his present intention does make a false statement of fact because the state of his intention is a matter of fact. In *Edgington* v. *Fitzmaurice* (1885) 29 Ch D 459, directors of a company invited the public to subscribe for debentures on the basis that the money so raised would be used to expand the business. In fact, the real purpose in raising the money was to pay off company debts. It was held that the directors were guilty of misrepresentation because they had misrepresented their actual intention.

13.4 Addressed to the Party Misled

Secondly, it must be shown that the representation was addressed to the party misled. There are two ways in which a representation may be addressed to the party misled. The first and most obvious method is by the direct communication of the misrepresentation to the claimant by the representor. Alternatively, the misrepresentation may be addressed by the representor to a third party with the intention that it be passed on to the claimant. In *Commercial Banking Co of Sydney* v. *RH Brown and Co* [1972] 2 Lloyd's Rep 360, the defendant bank misrepresented to the claimants' bank the financial standing of one of the claimants' customers. The claimants' bank communicated the information to the claimants, who acted on it to their detriment. It was held that the defendants were liable to the claimants because they knew that the claimants' bank did not want the information for their own purposes and that it was to be passed on

to a customer who was proposing to deal with a client of the defendant bank.

13.5 Inducement

Finally, the representation must be an inducement to entry into the contract and possibly it must also be a material misrepresentation. The materiality requirement can be taken first because of the controversy which currently surrounds it. In the old cases, frequent references can be found to the requirement that the misrepresentation must be material (see, for example, *Mathias* v. *Yetts* (1882) 46 LT 497, 502 per Jessel MR). The precise meaning of materiality was not always clear but it seems to have meant that the misrepresentation must have been such as would affect the judgment of a reasonable man in deciding whether or not to enter into the contract on these terms. Today the requirement that the misrepresentation be material is commonly doubted. The reality would appear to be that the modern courts tend not to distinguish carefully between materiality and inducement. Rather an inference of inducement is often drawn from a finding of materiality, so that materiality ceases to be a distinct requirement and becomes a part of the inquiry into whether or not the misrepresentation induced the contract. The orthodox position today can be stated in the following propositions. If the misrepresentation would have induced a reasonable person to enter into the contract, then the court will presume that it did induce the representee to enter into the contract and the onus of proof is then placed on the representor to show that the representee did not in fact rely on the representation (see *Museprime Properties Ltd* v. *Adhill Properties Ltd* (1991) 61 P & C R 111, 124, per Scott J and *County NatWest* v. *Barton*, *The Times*, 29 July 1999). On the other hand, where the misrepresentation would not have induced a reasonable person to enter into the contract, then the onus of proof is upon the representee to show that the misrepresentation did in fact induce him to enter into the contract. These propositions may well strike a reasonable balance between the interests of the parties. The difficult case is where an innocent and immaterial misrepresentation does actually induce a representee to enter into a contract. Should such a representee be entitled to set aside the contract? It is not at all obvious that he should. In practice it is of course extremely unlikely that a representee would be able to prove that he was induced to enter into a contract by an immaterial misrepresentation. But the possibility that a representee could do so might suggest that the courts ought to exercise caution

before abandoning the materiality requirement (fraud of course constitutes an exception here: a person who has been fraudulent cannot be heard to argue that the representation was immaterial).

Whatever doubts we may harbour about the materiality requirement, there is no doubt that the representation must induce the contract, that is to say, it must induce the actual claimant to enter into the contract. In *Edgington* v. *Fitzmaurice* (above) it was held that the misrepresentation need not be the sole inducement; it is sufficient that it was *an* inducement which was actively present to the representee's mind. This requirement was not satisfied in the case of *JEB Fasteners* v. *Marks, Bloom and Co* [1983] 1 All ER 583. The defendants negligently prepared the accounts of a company which was taken over by the claimants. The accounts had been made available to the claimants, who had reservations about them, but they nevertheless decided to proceed with the take-over because they wished to acquire the services of two of the directors of that company. The take-over was not a commercial success and the claimants brought an action against the defendants alleging that they had been negligent in the preparation of the accounts. The Court of Appeal dismissed the action on the ground that the defendants' representation did not play a 'real and substantial' part in inducing the claimants to act. They had taken over the company, not in reliance upon the accounts, but because of their desire to acquire the services of the two directors.

There are at least three situations in which a claimant will be unable to show that the representation induced the contract. The first is where the claimant was unaware of the existence of the representation (*Horsfall* v. *Thomas* (1862) 1 H & C 90), the second is where the claimant knew that the representation was untrue and the third is where the claimant did not allow the representation to affect his judgment. A claimant does not allow a representation to affect his judgment where he regards the representation as being unimportant (*Smith* v. *Chadwick* (1884) 9 App Cas 187) or where he relies upon his own judgment. In *Atwood* v. *Small* (1838) 6 Cl & F 232, Atwood contracted to sell his mine to Small, but exaggerated its earning capacity. Small appointed agents to verify Atwood's representations and they reported that his statements were true. After the contract was concluded, Small discovered the exaggerations and sought to rescind the contract. He was unable to do so because he had relied upon his agents' report rather than upon Atwood's representation. It should be noted that this rule does not apply to the claimant who has the opportunity to discover the truth himself but does not take it. In such a case, the claimant remains entitled to relief against the misrepresentor (*Redgrave* v. *Hurd* (1881) 20 Ch D 1, although note that Professor Treitel (1999, p.314) argues that, in the light of the decision of the House of Lords in

Smith v. *Eric S Bush* [1990] 1 AC 831, *Redgrave* may no longer apply where it was reasonable to expect the representee to make use of the opportunity and he fails to do so).

13.6 The Types of Misrepresentation

There are four different types of misrepresentation. It is important to distinguish between the different types of misrepresentation because they may give rise to different remedial consequences. We shall see that all types of misrepresentation entitle the representee to rescind the contract but not all types of misrepresentation give rise to an action for damages.

The first type of misrepresentation is fraudulent misrepresentation. Fraudulent misrepresentation, in addition to being a ground on which a contract may be set aside, constitutes the tort of deceit. Although the word 'fraud' bears a wide meaning in common parlance, its meaning in law is much narrower as a result of the decision of the House of Lords in *Derry* v. *Peek* (1889) 14 App Cas 337. In *Derry*, Lord Herschell established the following three propositions. The first is that there must be proof of fraud and nothing short of that is sufficient. The second is that fraud is proved when it is shown that a false representation has been made (i) knowingly or (ii) without belief in its truth or (iii) recklessly, careless whether it be true or false. Unreasonableness of belief does not of itself constitute fraud; it simply provides evidence of dishonesty on the part of the maker of the statement (*Angus* v. *Clifford* [1891] 2 Ch 449). Thirdly, if fraud is proved the motive of the person guilty of it is immaterial. In *Polhill* v. *Walter* (1832) 3 B & Ad 114, the representor knew that his statement was false but his motive in making the statement was to benefit his principal and not to benefit himself, nor to injure anyone else. Notwithstanding his good motives, he was held liable in the tort of deceit. There are relatively few cases brought in the tort of deceit today, largely because of the difficulty of proving that the representor was guilty of fraud.

The second type of misrepresentation is negligent misrepresentation at common law. In the period immediately after *Derry* v. *Peek*, it was thought that negligent misrepresentation was not actionable in tort because liability in tort arose only in cases of fraudulent misrepresentation (*Le Lievre* v. *Gould* [1893] 1 QB 491). However, this view was rejected by the House of Lords in *Nocton* v. *Lord Ashburton* [1914] AC 932. Although the House recognised that negligent misrepresentation could be actionable, they held that it was actionable only where there was a pre-existing contractual relationship between the parties or where the parties were in

a 'fiduciary relationship'. This restrictive approach prevailed in England as late as 1951 (see *Candler* v. *Crane, Christmas and Co* [1951] 2 KB 164, but contrast the powerful dissenting judgment of Denning LJ).

However, in 1964 in *Hedley Byrne* v. *Heller* [1964] AC 465, the House of Lords finally expanded the ambit of liability for negligent misrepresentation. The claimants were advertising agents who booked substantial advertising space on behalf of their clients, Easipower Ltd, on terms that they were personally liable if Easipower defaulted. The claimants became concerned about the financial standing of Easipower and, through their bank, sought from the defendants, who were Easipower's bankers, a reference on the financial soundness of Easipower. The defendants replied that Easipower were 'considered good for its ordinary business transactions'. In reliance upon the reference, the claimants placed orders which, because of the subsequent default of Easipower, resulted in a loss to them of £17,000. The claimants alleged that the defendants were negligent in the preparation of the reference and were therefore liable to them in damages. Their claim failed because the defendants had provided the reference 'without responsibility'. However the importance of *Hedley Byrne* lies, not in the fact that the claim failed because of the disclaimer, but in the fact that the House of Lords would have allowed the claim to succeed had it not been for the disclaimer. In so concluding, their Lordships significantly widened the scope of liability in tort for negligent misrepresentation. The important task which now remains for us is to ascertain the limits of *Hedley Byrne*.

This is a difficult task because the courts and commentators have not been able to agree upon the precise basis of *Hedley Byrne*. One approach is to utilise the concept of a 'special relationship' between the claimant and the defendant which, it has been argued, is the key to *Hedley Byrne*. The content of this 'special relationship' is, however, a matter of controversy. For some time it appeared that its principal constituent elements were a voluntary assumption of responsibility by the defendant and foreseeable detrimental reliance by the claimant. Then the courts began to distance themselves from the voluntary assumption of responsibility test (see, for example, *Caparo Industries plc* v. *Dickman* [1990] 2 AC 605, 637) and chose instead to rely upon a number of factors in deciding whether or not to impose liability (see, for example, the judgment of Neill LJ in *James McNaughten Papers Group plc* v. *Hicks Anderson & Co* (a firm) [1991] 2 QB 113, 125–8). More recently, the pendulum has swung back in favour of assumption of responsibility as the basis of *Hedley Byrne*, especially in the speeches of Lord Goff in *Spring* v. *Guardian Assurance plc* [1995] 2 AC 296 and *Henderson* v. *Merrett Syndicates Ltd* [1995] 2 AC 145, and also in the speech of Lord Steyn in *Williams* v. *Natural Life Health*

Foods Ltd [1998] 1 WLR 830, 837. It should be noted that the word 'voluntary' has been deleted from the latter formula, thereby seeking to emphasise that the test to be applied in determining whether or not there has been an assumption of responsibility is an objective one. Lord Mustill in his speech in *White* v. *Jones* [1995] 2 AC 207, 283–7, detected four themes in the speeches in *Hedley Byrne*, namely 'mutuality', 'special relationship', 'reliance' and 'undertaking of responsibility'. For him, *Hedley Byrne* liability arose 'internally from the relationship in which the parties had together chosen to place themselves' and not as a result of external imposition by the law. This is not the place to seek to resolve this complex issue. Here we shall seek simply to identify some of the principal factors which the courts have employed when attempting to define the scope of *Hedley Byrne*.

The first is the knowledge of the representor. The greater the knowledge which the representor has of the representee and of the purposes for which the representee is likely to rely upon his statement, the more likely it is that the representor will be liable to the representee (contrast, in this respect, the decisions of the House of Lords in *Caparo Industries plc* v. *Dickman* (above) and *Smith* v. *Eric S Bush* [1990] 1 AC 831). It is sometimes argued that the representor must also be possessed of a special skill. In *Mutual Life and Citizens Assurance Co* v. *Evatt* [1971] AC 793, the majority of the Privy Council interpreted this element as requiring that the representor be in the business of giving advice on the subject of his representation. On the facts, the defendant insurance company had given the claimant gratuitous advice on the wisdom of investing in the defendants' sister company. It was held that the defendants were not liable because they were an insurance company and not investment advisers. The status of *Evatt* is, however, unclear because the judgment of the minority, Lord Reid and Lord Morris, has commanded wider support in subsequent cases. The minority held that a duty of care is owed by anyone who takes it upon himself to make representations knowing that another will justifiably rely upon his representation. In *Esso Petroleum* v. *Mardon* [1976] QB 801 Ormerod LJ supported the minority view in *Evatt*, as did Lord Denning and Shaw LJ in *Howard Marine and Dredging Co* v. *A Ogden and Sons* [1978] QB 574. On the basis of these dicta it is suggested that the majority view in *Evatt* will not be followed and that the minority view will be preferred.

The second factor is the purpose for which the statement was made. Where the representor makes the statement with the intention that the representee rely upon it, then liability is likely to be imposed (see *Smith* v. *Eric S Bush* (above)), but where the statement is put into general public circulation with no particular person in mind as the recipient, then it is

unlikely that liability will be imposed (*Caparo* v. *Dickman* (above)). The third factor is that it must be reasonable for the representee to rely upon the representor's statement. Where, for example, the statement is made on a social occasion, the representee will generally find that it is difficult to persuade a court to conclude that it was reasonable to rely on the statement (cf. *Chaudhry* v. *Prabhakar* [1989] 1 WLR 29). On the other hand, where the statement is made in a commercial context the courts will generally be much readier to infer that it was reasonable to rely upon the statement (see, for example, *Smith* v. *Eric S Bush* (above)).

Negligent misrepresentation at common law must be distinguished from the liability which may arise under section 2(1) of the Misrepresentation Act 1967. This is the third type of misrepresentation. Section 2(1) provides that

> 'Where a person has entered into a contract after a misrepresentation has been made to him by another party thereto and as a result thereof he has suffered loss then, if the person making the misrepresentation would be liable to damages in respect thereof had the misrepresentation been made fraudulently, that person shall be so liable notwithstanding that the misrepresentation was not made fraudulently, unless he proves that he had reasonable grounds to believe and did believe up to the time that the contract was made that the facts represented were true.'

Section 2(1) operates independently of the *Hedley Byrne* line of authority. The section is drafted in rather clumsy and unusual terms because it imposes liability by reference to liability for fraudulent misrepresentation, even though the misrepresentor has not been fraudulent (for a discussion of the possible consequences of the 'fiction of fraud' see Atiyah and Treitel, 1967, pp.372–5). But, stripped of its convoluted drafting, the general effect of the section is clear; where a misrepresentation has been made by one contracting party to another, the party making the misrepresentation is liable to the other in damages unless he can prove that he had reasonable grounds to believe and did believe up to the time that the contract was made that his statement was true.

This statutory right has three advantages over a common law negligence claim. The first is that the Act does not require that there be a *Hedley Byrne* relationship between the parties, thus avoiding the difficulties inherent in establishing the existence of such a relationship. This was of crucial significance in *Gosling* v. *Anderson* [1972] EGD 709. The defendant, who was selling her flat, represented to the claimant, through her estate agents, that planning permission had been obtained for build-

ing a garage when, in fact, it had not been obtained. In the Court of Appeal Roskill LJ stated that, had the action been heard before 1967, the claimant's action would have failed unless she had been able to prove fraud, but that she was now able to rely on s.2(1) of the 1967 Act and was entitled to damages for the misrepresentation.

The second advantage of a claim under s.2(1) is that the representor is liable unless he proves that he had reasonable grounds to believe and did believe up to the time that the contract was made that the facts represented were true, whereas at common law it is for the representee to prove that the representor was negligent. It is no easy task for a representor to discharge the onus of proof under s.2(1), as can be seen from the case of *Howard Marine* v. *Ogden* (above). The defendants wished to hire barges from the claimants and, during the course of the negotiations, the claimants' manager represented that the deadweight capacity of each barge was 1600 tonnes when, in fact, it was only 1055 tonnes. The defendants used the barges for six troublesome months but, when they discovered the true deadweight capacity of the barges, they refused to continue to pay the hire. The claimants sued for the hire charges and the defendants counterclaimed, *inter alia*, for damages under s.2(1) of the 1967 Act. The representation of the claimants' manager as to the deadweight capacity of the barges was based upon his recollection of the figures in Lloyd's Register (Lord Denning stated that Lloyd's Register 'was regarded in shipping circles as the bible'). The manager's recollection was correct but, unusually, Lloyds were wrong. The Court of Appeal held, Lord Denning dissenting, that the claimants had not discharged the burden of proof upon them of showing that they had reasonable grounds to believe that the statement was true. This was because the accurate figures were contained in the ships' documents and the claimants had failed to show any 'objectively reasonable ground' for disregarding the figure in these documents and preferring the figure in Lloyd's Register. The burden upon the representor is therefore a heavy one and it is likely to enable a representee to recover where at common law he would have failed (for example, in *Howard Marine* itself, only Shaw LJ was of the opinion that a common law claim would have succeeded).

The third advantage is that the measure of damages recoverable under s.2(1) is the measure of damages for the tort of deceit. Authority for this proposition is derived from the controversial case of *Royscot Trust Ltd* v. *Rogerson* [1991] 2 QB 297. The claimant finance company was induced to enter into a hire-purchase transaction with Mr Rogerson as a result of a misrepresentation by the defendant car dealers. As the defendants knew, it was the claimants' policy not to enter into a hire purchase transaction unless 20 per cent of the purchase price of a car was paid to the dealer

by the customer. Mr Rogerson agreed with the defendants to put down a deposit of £1200 on a car, the price of which was £7600. But that produced a deposit of only some 16 per cent of the purchase price. So the defendants falsely stated that the price of the car was £8000 and that Mr Rogerson had paid a deposit of £1600; thus producing the required 20 per cent deposit (it is vital to note here that there was no allegation that the defendants were guilty of fraud in making these changes: the case proceeded upon the assumption that the defendants had not been fraudulent). On this basis, the claimants agreed to enter into the transaction but Mr Rogerson subsequently, in breach of contract, sold the car and ceased to pay the hire-purchase instalments. The Court of Appeal held that damages under s.2(1) were to be assessed as if the defendants had been fraudulent, so that the claimants were entitled to recover their actual loss directly flowing from the misrepresentation, whether or not that loss was reasonably foreseeable. The remoteness rule applicable was that derived from the tort of deceit, not the tort of negligence (see further 13.9). The court held that the action of Mr Rogerson in dishonestly selling the car was a direct result of the defendants' misrepresentation, in the sense that there was no break in the chain of causation between the misrepresentation and the loss. The claimants were therefore entitled to recover damages of £3625, namely the difference between the £6400 they advanced to Mr Rogerson and the instalments of £2775 they received from him before his default. While there may remain some circumstances in which a representee will gain an advantage by bringing a claim in the tort of deceit rather than under s.2(1) (on which see Hooley, 1992), the effect of *Royscot* must surely be to reduce the practical significance of the tort of deceit. After all, why go to the trouble of proving that the representor was fraudulent when you can recover the same measure of damages under s.2(1) without even having to prove that the representor was negligent?

Yet there is something distinctly odd about the result in *Royscot*. The defendants were not fraudulent, but they were treated as if they had been. The point becomes even more apparent when applied to the facts of *Howard Marine* v. *Ogden* (above). What justification can there possibly be for treating the claimants in *Howard Marine* as if they had been fraudulent, when it was not even proved that they had been guilty of negligence? These anomalies could have been avoided if the court in *Royscot* had accepted that the reference to fraud in s.2(1) was simply a 'fiction'. But Balcombe LJ rejected this argument on the ground that it was inconsistent with the authorities and contrary to the 'plain words of the subsection'. While the intention of Parliament in enacting s.2(1) may well have been to incorporate, by analogy, the rules for the tort of deceit (see

Cartwright, 1987a, pp.429–33), it is almost certain that Parliament could not have foreseen the anomalies which would arise as a result of the analogy drawn. But *Royscot* makes the anomaly plain for all to see. There is no justification for treating an innocent party as if he had been fraudulent. In *Smith New Court Securities Ltd* v. *Scrimgeour Vickers (Asset Management) Ltd* [1997] AC 254, 283 Lord Steyn noted that *Royscot* had been the subject of 'trenchant academic criticism' (by Hooley, 1991) and expressed 'no concluded view' on the correctness of the decision (Lord Browne-Wilkinson also 'expressed no view' (p.267) on the correctness of *Royscot*). So the point remains an open one, at least at the level of the House of Lords. If the House of Lords does not overrule *Royscot* then it is suggested that legislation is required to remove this anomaly. The rules applicable to the assessment of damages should be derived from the tort of negligence, not deceit (see *Gran Gelato Ltd* v. *Richcliff (Group) Ltd* [1992] Ch 560, where an analogy was drawn with the tort of negligence, discussed further at 13.9).

Notwithstanding the advantages which the statutory cause of action affords, there remain certain situations in which a claimant must have recourse to a common law claim. The first situation arises where, as in *Hedley Byrne*, the representation is made by a third party who is not party to the contract. Section 2(1) only applies where the representation has been made by the other party to the contract. The second situation in which it may be necessary to have recourse to the common law arises where the contract between the parties is void *ab intio* (for example, on the ground of *non est factum*). In such a case there is no contract to which s.2(1) can apply.

The final type of misrepresentation is innocent misrepresentation. An innocent misrepresentation is a misrepresentation which is neither fraudulent, nor negligent.

13.7 Remedies

Once the existence of a misrepresentation has been established, consideration must be given to the remedies available for misrepresentation. There are two principal remedies. The first is the setting aside of the contract induced by the misrepresentation (this is called 'rescission' by lawyers). There is a debate, which it is not necessary for us to resolve, as to whether rescission is a contractual remedy or a restitutionary remedy. It is contractual in the sense that it enables the representee to escape from the contract and to set it aside for all purposes. But it can also be characterised as a restitutionary remedy in that, upon its exercise, the claimant

is entitled to recover the value of the enrichment which the defendant has received under the contract prior to it being set aside, and the claimant must in turn make restitution to the defendant for any benefit which the claimant has obtained at the expense of the defendant. However a claimant may not be satisfied with rescission and may also want compensation for the financial loss which he has suffered. A claim for damages does not lie in contract when the contract has been rescinded but a claim for damages may lie in tort or under statute and so we must consider the relationship between these claims.

13.8 Rescission

Rescission is, in principle, available for all types of misrepresentation (subject to the discretion of the court to award damages in lieu of rescission under s.2(2) of the Misrepresentation Act 1967, see 13.9). It is however, very important to be clear about the precise meaning of the word 'rescission'. Atiyah and Treitel (1967) helpfully distinguish two types of rescission. The first type, entitled 'rescission for misrepresentation', arises where the contract is set aside for all purposes, that is to say, the contract is set aside both retrospectively and prospectively. Here the aim is to restore, as far as possible, the parties to the position which they were in before they entered into the contract and in particular to ensure that the claimant is not unjustly enriched at the defendant's expense. The second type of rescission, called 'rescission for breach', arises where one contracting party terminates performance of the contract because of the breach by the other party. In the latter case the effect of rescission is to release the parties from their obligations to perform in the future but the contract is not treated as if it had never existed. Therefore rescission for breach does *not* operate retrospectively (see further Chapter 19). In this chapter we shall discuss only rescission for misrepresentation.

Rescission does not occur automatically when a misrepresentation is made. Misrepresentation renders a contract voidable. Therefore the representee can elect either to rescind or to affirm the contract. If he decides to rescind, the general rule is that he must bring his decision to rescind to the notice of the representor. This can be done in a number of ways: for example, by seeking a declaration that the contract is invalid, by restoring what he has obtained under the contract or by relying upon the misrepresentation as a defence to an action on the contract (*Redgrave* v. *Hurd* (above)). However, where the representor deliberately absconds and so makes it impossible for the representee to give him notice of his decision to rescind, then it is sufficient that the representee evidences his

intention to rescind by some overt means, falling short of communication, which is reasonable in the circumstances. So, where a thief persuades an owner to part with his car by a fraudulent misrepresentation and the thief cannot subsequently be traced, the owner can validly rescind by notifying the police or the Automobile Association (*Car and Universal Finanace Co* v. *Caldwell* [1965] 1 QB 525, but contrast the Scottish case of *MacLeod* v. *Kerr* 1965 SC 253).

There are, however, certain limits to the right to rescind. The right to rescind may be lost by affirmation of the contract by the claimant after he discovered the truth, by the intervention of innocent third party rights where the third party acted in good faith and gave consideration, or by lapse of time (*Leaf* v. *International Galleries* [1950] 2 KB 86, although lapse of time does not, of itself, bar rescission in cases of fraudulent misrepresentation). The principal ground on which the right to rescind may be lost arises where it is impossible to restore the parties to their pre-contractual position. A claimant who wishes to recover the value of a benefit which he has conferred upon the defendant must be prepared to make restitution to the defendant for any benefit which he has received at the expense of the defendant. In other words, a claimant cannot both get back what he has parted with and keep what he has received in return. The aim of this rule is to ensure that the claimant is not unjustly enriched as a result of rescission: it does not have as its aim the avoidance of loss on the part of the defendant (*McKenzie* v. *Royal Bank of Canada* [1934] AC 468). At common law the courts insisted upon precise restitution, but the harshness of this rule is mitigated by the intervention of equity. In equity a party who can make substantial, but not precise, restitution can rescind the contract if he returns the subject-matter of the contract in its altered form and gives an account of any profits made through his use of the product together with an allowance for any deterioration in the product (*Erlanger* v. *New Sombrero Phosphate Co* (1878) 3 App Cas 1218). So, for example, where the claimant has made use of the asset which he obtained from the defendant under the contract, the claimant obviously cannot return the use which he has made of the chattel but he can make a money payment to the defendant which represents the use which he has made of the chattel. Given that almost any use or alteration to a product can be valued in money terms, it may be that the law should recognise that, provided the claimant is prepared to restore to the defendant the benefit which he has obtained at the defendant's expense, the transaction should be set aside (provided that no other bar to rescission is applicable on the facts).

We have already noted that the effect of rescission is to set aside the contract for all purposes. A consequence of this is that *contractual*

damages cannot be claimed because the contract has been set aside for all purposes and so there is no basis for any claim on the contract. But rescission may give rise to a personal restitutionary claim. In *Whittington* v. *Seale-Hayne* (1900) 82 LT 49, the claimants took a lease of premises for the purpose of breeding prize poultry. They were induced to do so by representations of the defendant's agent that the premises were in good sanitary condition. Under the lease, the claimants covenanted to execute all such works as might be required by the local authority. The premises were not, however, in a sanitary condition and were in a state of disrepair. The water supply was poisoned and, as a result, the poultry died or became valueless and the manager of the farm became ill. The local authority declared the premises unfit for habitation and required the claimants to renew the drains. It was held that the claimants were entitled to an indemnity in respect of the rates which they had paid and the cost of carrying out the repairs ordered by the local authority because these were obligations which were actually created by the lease. It was expenditure on their part which resulted in a benefit to the defendant and he would have been unjustly enriched had he not been required to pay for these benefits when the premises were returned to him. On the other hand, the claimants were not entitled to recover in respect of the value of the lost stock or their loss of profit because these were not losses on their part which resulted in a benefit to the defendant. Such losses can, in principle, be recovered in a damages action in tort but, on the facts, a claim in damages was not available.

13.9 Damages

A contractual claim for damages does not lie for misrepresentation, unless the misrepresentation has been subsequently incorporated into the contract as a term, in which case damages can be claimed for breach of contract (see 8.1 and 8.6). But damages may be recoverable in *tort* where the misrepresentation was made fraudulently or negligently. Sections 2(1) and 2(2) of the Misrepresentation Act 1967 also make provision for the recovery of damages for misrepresentation. Provided there is no element of double recovery, a claimant may rescind and claim damages (except under s.2(2) of the Misrepresentation Act 1967, see below). When considering the entitlement of a claimant to damages for misrepresentation, it is vital to give separate treatment to each type of misrepresentation.

Where the misrepresentation is fraudulent then damages may be recovered in the tort of deceit. The aim of an award of damages in deceit is to put the claimant in the position which he would have been in had

the tort not been committed; that is to say, it aims to protect his reliance interest. The defendant is also liable for all the damage directly flowing from the fraudulent inducement which was not rendered too remote by the claimant's own conduct, whether or not the defendant could have foreseen such consequential loss (*Doyle* v. *Olby* [1969] 2 QB 158, as approved by the House of Lords in *Smith New Court Securities Ltd* v. *Scrimgeour Vickers (Asset Management) Ltd* [1997] AC 254). Exemplary (or punitive) damages cannot be recovered for fraudulent misrepresentation because there appears to be no case prior to *Rookes* v. *Barnard* [1964] AC 1129 in which such damages were awarded (*AB* v. *South West Water Services Ltd* [1993] QB 507). Aggravated damages may, however, be awarded to compensate the claimant for the injury to his feelings (*Archer* v. *Brown* [1985] QB 401).

In the case of negligent misrepresentation at common law, the misrepresentor has committed a tort and damages can therefore be claimed. Once again the award of damages seeks to put the claimant in the position which he would have been in had the tort not been committed. The representor will be liable for all losses which are a reasonably foreseeable consequence of the misrepresentation (*The Wagon Mound (No. 1)* [1961] AC 388). Where the representee has also been at fault, the damages payable may be reduced on the ground of contributory negligence (Law Reform (Contributory Negligence) Act 1945, s.1; *Gran Gelato Ltd* v. *Richcliff (Group) Ltd* [1992] Ch 560). Punitive damages are not recoverable (*AB* v. *South West Water Services Ltd* (above)).

In the case of a claim under s.2(1) of the Misrepresentation Act 1967, there was initially some controversy relating to the measure of damages recoverable. Some argued that damages should seek to put the claimant in the position he would have been in had the representation not been made (thus protecting the reliance interest), while others argued that damages should put the claimant in the position he would have been in had the representation been true (thus protecting the expectation interest). In *Gosling* v. *Anderson* (above) and *Jarvis* v. *Swan's Tours* [1973] QB 233, Lord Denning appeared to suggest that the measure of recovery was the expectation measure and this view was followed by Graham J in *Watts* v. *Spence* [1976] Ch 165. But this view has since been rejected and it is now clear that the measure of recovery is the reliance measure (*Royscot Trust Ltd* v. *Rogerson* [1991] 2 QB 297 and *Sharneyford Supplies Ltd* v. *Barrington Black and Co* [1987] Ch 305, 323). It is suggested that this is the correct approach because, as we have already noted (13.1), promises and representations are functionally different. A representor does not promise anything; he simply asserts the truth of his statement and invites *reliance* upon that statement. It is therefore appropriate that the measure

of damages should be the reliance measure (see Taylor, 1982). Although damages are confined to the reliance measure, it must be remembered that damages are assessed as if the representor had been fraudulent (*Royscot Trust Ltd* v. *Rogerson* [1991] 2 QB 297), so that the remoteness rules applicable are those pertaining to the tort of deceit, not the tort of negligence. It has also been held that damages payable under s.2(1) may be reduced on the ground of the representee's contributory negligence (*Gran Gelato Ltd* v. *Richcliff (Group) Ltd* [1992] Ch 560), although it should be noted that Sir Donald Nicholls v-c reached his conclusion by drawing an analogy with the tort of negligence. This reasoning does not appear to be consistent with the approach of the Court of Appeal in *Royscot* where it was held that the appropriate analogy was with the tort of deceit. The point is an important one because it appears that contributory negligence is not available as a defence to an action in deceit (see *Alliance and Leicester Building Society* v. *Edgestop Ltd* [1994] 2 All ER 38), and so, on the reasoning in *Royscot*, it should not have been in issue in *Gran Gelato* as a possible defence to the s.2(1) claim.

In cases of innocent misrepresentation, the traditional common law rule was that damages were not available. Innocent misrepresentation is not a tort and therefore the only remedy was rescission and an indemnity. In practice the courts tended to mitigate the rigours of this rule, either by finding that the representation was in fact not a representation at all but a contractual term (see further 8.1–8.4), or by finding that the representation was enforceable as a 'collateral contract'. The latter technique can be illustrated by reference to the case of *De Lassalle* v. *Guildford* [1901] 2 KB 215. The claimant was induced to enter into a lease by an oral statement made by the defendant that the drains were in good order. The drains were not in good order but the lease contained no reference to the drains. It was held that the defendant's representation was enforceable as a warranty which was collateral to the lease. Thus there were two contracts between the parties. The first one was the written lease and the second consisted of the oral statement that the drains were in good order, the consideration for which was the entry by the claimant into the lease. However, the courts were not able to find the existence of such a collateral contract in every case (see *Heilbut Symons and Co* v. *Buckleton* [1913] AC 30).

The need to seek out the existence of a collateral contract has been reduced by s.2(2) of the Misrepresentation Act 1967 which provides that

> 'where a person has entered into a contract after a misrepresentation has been made to him otherwise than fraudulently, and he would be entitled, by reason of the misrepresentation, to rescind the contract,

then, if it is claimed in any proceedings arising out of the contract, that the contract ought to be or has been rescinded, the court or arbitrator may declare the contract subsisting and award damages in lieu of rescission, if of opinion that it would be equitable to do so, having regard to the nature of the misrepresentation and the loss that would be caused by it if the contract were upheld, as well as to the loss that rescission would cause to the other party.'

Thus the courts now have a discretion to award damages in lieu of rescission in the case of innocent misrepresentation. The following points should be noted about s.2(2). The first is that the power to award damages is discretionary. The representee has no right to damages, in contrast to s.2(1) where damages are available as of right. The second point is that damages are in lieu of rescission, so that if the claimant wishes to rescind he cannot recover damages as well (although he may be able to recover the value of any benefits which he has conferred upon the defendant, see 13.8). Thirdly, the discretion which has been conferred upon the court is a 'broad one, to do what it is equitable' (per Hoffmann LJ in *William Sindall plc* v. *Cambridgeshire County Council* [1994] 1 WLR 1016, 1036). The courts are directed by the wording of s.2(2) to consider the nature of the misrepresentation, the loss that would be caused by the misrepresentation if the contract were upheld and the loss which would be caused to the misrepresentor by rescission, but the weight to be attached to these factors very much depends upon the facts of the case. The courts are most likely to invoke s.2(2) in a case where a representee has been induced by a misrepresentation to enter into what has turned out to be a bad bargain for him. Such was the case in *William Sindall* itself where the value of the land which the claimants had purchased had dropped dramatically in value and they alleged that they were entitled to withdraw from the contract because the defendant had innocently failed to disclose the existence of a private foul sewer running across the land. On the facts of the case, the Court of Appeal found that there had been no misrepresentation by the defendant, but, had there been, they would have exercised their discretion to grant the claimants damages in lieu of rescission because the loss caused to the claimants by the (relatively insignificant) innocent misrepresentation was trifling in comparison to the loss which the defendant would have experienced had the contract been rescinded. This leads us on to the fourth problem, which is the measure of damages to be awarded in lieu of rescission under s.2(2). This is a difficult issue. The measure should be less than the measure available under s.2(1) because the representor is less culpable. The temptation is simply to award the representee some protection for his reliance interest, but the court must

proceed carefully here because the award of full reliance damages might have the effect of protecting the representee from his bad bargain, which the court has just refused to sanction by its decision not to grant rescission. In the event the Court of Appeal in *William Sindall* failed to provide us with clear guidance on this point. Hoffmann LJ thought that damages under s.2(2) should never exceed a sum which would have been awarded if the representation had been a warranty, while Evans LJ was of the view that the correct measure was the contract measure, that is to say, the difference between the actual value received and the value which the property would have had if the representation had been true. The position may be that damages are limited to the loss in value of what is bought under the contract and that damages for consequential loss are not recoverable (*Thomas Witter Ltd* v. *TBP Industries Ltd* [1996] 2 All ER 573, 591).

The final point relates to the situation where the claimant had the right to rescind but has lost it, for example because of lapse of time. Does such a claimant also lose the right to claim damages under s.2(2)? The point is the subject of a conflict of authority. In *Thomas Witter Ltd* v. *TBP Industries Ltd* (above) Jacob J held that he does not, provided that he had a right to rescind in the past. But in *Floods of Queensferry Ltd* v. *Shand Construction Ltd* [2000] BLR 81 Judge Humphrey Lloyd QC refused to follow *Thomas Witter* and stated that loss of the right to rescind has the consequence that the court has no jurisdiction to award damages under s.2(2). The arguments are finely balanced (see Beale, 1995). The latter view is consistent with a literal reading of the subsection, but may be undesirable in policy terms because it will mean that a claimant who has lost the right to rescind will, as far as this subsection is concerned, always go away empty-handed.

13.10 Excluding Liability for Misrepresentation

At common law a person could not exclude liability for his own fraudulent misrepresentation (*S Pearson & Son Ltd* v. *Dublin Corporation* [1907] AC 351), but he could exclude liability for negligent or innocent misrepresentation, although such exclusion clauses were subject to strict rules relating to incorporation and construction (see 9.4 and 11.4–11.7). However s.3 of the Misrepresentation Act 1967 (as amended by s.8 of the Unfair Contract Terms Act 1977) limits the freedom of the parties to exclude liability for the consequences of a misrepresentation. It provides that

'If a contract contains a term which would exclude or restrict –
(a) any liability to which a party to a contract may be subject by reason

of any misrepresentation made by him before the contract was made; or

(b) any remedy available to another party to the contract by reason of such a misrepresentation

that term shall be of no effect except in so far as it satisfies the requirement of reasonableness as stated in section 11(1) of the Unfair Contract Terms Act 1977; and it is for those claiming that the term satisfies that requirement to show that it does.'

This section applies both to business liability and to non-business liability. It should be noted that, once again, the Act is drafted in defensive terms (see 11.1) so that it attacks attempts to 'exclude or restrict' a 'liability' or a 'remedy'. Clauses which seek to define the duty may therefore fall outside the scope of the Act, but it is unlikely that a representor will be able to evade the clutches of the Act merely by stating that the representee must satisfy himself as to the correctness of any statement made (*Cremdean Properties* v. *Nash* (1977) 244 EG 547; *South Western General Property Co Ltd* v. *Marton* (1982) 263 EG 1090; and *Walker* v. *Boyle* [1982] 1 All ER 634).

Summary

1 A misrepresentation may be defined as an unambiguous false statement of fact (or possibly of law) which is addressed to the party misled, which is material (although this requirement is now debatable) and which induces the contract.
2 Mere puffs, statements of opinion and statements of intention are not statements of fact.
3 A representation does not induce the contract if the representation was unimportant, the representee was unaware of its existence or did not allow it to affect his judgment.
4 A fraudulent misrepresentation is made when it is proved that a false representation has been made (i) knowingly or (ii) without belief in its truth or (iii) recklessly, careless whether it be true or false.
5 Negligent misrepresentation is actionable at common law where there is a *Hedley Byme* relationship between the claimant and the defendant. The existence of such a relationship depends upon a number of factors, including the knowledge of the representor, the purpose for which the statement was made and the reasonableness of the reliance by the representee.
6 Section 2(1) of the Misrepresentation Act 1967 states that where a misrepresentation has been made by one contracting party to another, the party making the misrepresentation is liable to the other in damages unless he can prove that he had reasonable grounds to believe and did believe up to the time that the contract was made that his statement was true.
7 The principal remedies for misrepresentation are rescission and damages. Rescission is in principle available for all types of misrepresentation. The effect of rescission is generally to put the parties as far as possible into the position which they

would have been in had the contract not been concluded and in particular to ensure that the claimant is not unjustly enriched at the defendant's expense.

8 Damages can be claimed for fraudulent and negligent misrepresentation and under s.2(1) of the 1967 Act. In all cases the measure of damages is the reliance measure. In the case of innocent misrepresentation the court has a discretion to award damages in lieu of rescission under s.2(2) of the 1967 Act.

9 The ability of a contracting party to exclude liability for misrepresentation is controlled by s.3 of the Misrepresentation Act 1967 which subjects any term which purports to exclude or restrict liability or a remedy for misrepresentation to the reasonableness test.

Exercises

1 What is a misrepresentation?
2 What is a statement of existing fact? Give examples to illustrate your answer.
3 Distinguish between fraudulent, negligent and innocent misrepresentation.
4 What are the advantages to a claimant in invoking s.2(1) of the Misrepresentation Act 1967 rather than the common law of negligent misrepresentation? Are there any disadvantages?
5 What are the principal remedies for misrepresentation? What is the difference between damages and an indemnity?
6 Can a defendant exclude liability for misrepresentation?

14 Common Mistake and Frustration

14.1 Introduction

Parties occasionally enter into a contract on the basis of a common assumption which they later discover was false. Alternatively, events occur after the formation of the contract which were not within the contemplation of the parties when they entered into the contract. In these circumstances, are the parties bound to carry out their contract according to its terms, even though the events which have occurred were not within their contemplation when they entered into the contract? The answer to this question is that the courts may, in certain circumstances, release the parties from their obligations to perform. But it is very important to understand the basis of the intervention of the courts in these cases. The basis is not that the parties failed to reach agreement. These cases are not like the mistake cases which we discussed at 4.6, where one party is claiming relief on the basis that he was mistaken and that mistake negatived his consent and so prevented a contract coming into existence.

Here the parties do actually reach agreement and a valid contract is initially concluded. But an event occurs which was unforeseen by the parties and which destroys the basis upon which they entered into the contract. In such a case the courts must decide who bears the risk of such an unforeseen event (see Swan, 1980). Where the courts intervene to grant relief they do so on the ground that it is no longer fair or just to hold the parties to their agreement in such radically changed and unforeseen circumstances.

Where the common misapprehension is present *at the date of entry* into the contract, the contract may be set aside on the ground of common (or, as it is sometimes called, 'mutual') mistake. On the other hand, where events have occurred *after* the making of the contract which render performance of the contract impossible, illegal or something radically different from that which was in the contemplation of the parties at the time at which they entered into the contract, then the contract may be discharged on the ground of 'frustration' (on which see generally Treitel, 1994).

Common mistake is often treated separately from frustration on the ground that the latter is concerned with the discharge of a contract, whereas mistake relates to the formation of a contract. It is true that

mistake relates to events which exist or occur prior to the making of the contract, and frustration applies to events which occur after the making of the contract. But there is, in fact, a strong link between these two doctrines, as can be seen from a brief analysis of the following case.

In *Amalgamated Investment & Property Co Ltd* v. *John Walker & Sons Ltd* [1977] 1 WLR 164, the defendants sold property to the claimants for £1,710,000. The property was advertised as being suitable for occupation or redevelopment and the defendants knew that the claimants wished to redevelop the property. In their pre-contract enquiries the claimants asked the defendants whether the property was designated as a building of special historic or architectural interest. The defendants replied that it was not but, unknown to both parties, officials at the Department of the Environment had, on 22 August 1973, unconditionally included the property in a list of buildings to be designated as buildings of special architectural or historical interest. The parties signed the contract of sale on 25 September 1973. On the following day the Secretary of State wrote to the defendants informing them that the building had been listed and that the listing would take effect the next day when signed by the Secretary of State. The effect of the listing was to cause the value of the property to drop by £1,500,000 to approximately £200,000.

In these circumstances, the claimants sought to have the contract set aside. They argued that the contract should be set aside on the ground of mistake or, alternatively, that the contract was frustrated by the listing of the building. But into which category did the case fall? If the listing took effect before the contract was signed on 25 September 1973 the ground on which the claimants sought relief was common mistake, but, if the listing took effect after the contract had been signed on the 25th, the ground upon which relief was sought was frustration. The Court of Appeal held that the building did not become a listed building until it was signed by the Secretary of State on 27 September. The ground on which relief was sought was therefore frustration. But the court held that the contract was not frustrated because the claimants knew of the risk that the buildings could be listed, as was evidenced by their pre-contract enquiries and it was a risk which they had to bear. The listing of the building was not an unforeseen event which rendered the performance of the contract something radically different from that which had been contemplated by the parties (see 14.10).

This case demonstrates that there is a strong relationship between common mistake and frustration. The point at issue in the case was: who should bear the risk of the listing of the building? Whether the case is treated as one of common mistake or frustration, the issue is exactly the same. In the remaining sections of this chapter we shall give separate

treatment to the doctrines of common mistake and frustration, and conclude by identifying the relationship between the two doctrines.

14.2 Common Mistake

Where the mistake is common to both parties, the parties have reached agreement, but that agreement is based upon a fundamental mistaken assumption. In such a case the court may nullify the consent of the parties and set aside the contract which they concluded. The leading case on common mistake is *Bell* v. *Lever Brothers Ltd* [1932] AC 161. The defendants, Bell and Snelling, entered into a contract with the claimants under which they agreed to serve for five years as chairman and vice-chairman respectively of a subsidiary company of the claimants. One of the terms of their service agreements was that they must not make any private profit for themselves, by doing business on their own account, while working for the subsidiary. But the defendants, unknown to the claimants, did engage in business on their own account and did not disclose their profits to the claimants. The claimants later decided that they wished to terminate the defendants' contracts because of a reorganisation of their business. So they entered into compensation agreements with the defendants under which they agreed to pay Bell £30,000 and Snelling £20,000 in exchange for their consent to the termination of their service agreements. After the money had been paid, the claimants discovered the breaches by the defendants of their service agreements. The significance of the breaches by the defendants was that they would have entitled the claimants to terminate the service agreements without the payment of any compensation. In these circumstances the claimants sought to recover the money which they had paid to the defendants. A crucial feature of the case was the finding of the jury that, when they entered into the compensation agreements, the defendants had forgotten about their breaches of duty. The parties therefore entered into the compensation agreements under a common mistake that the service agreements were valid when they were, in fact, voidable.

The House of Lords held, by a majority of three to two, that the claimants could not recover the money. Lord Atkin and Lord Thankerton held that the mistake was not sufficiently fundamental to avoid the contract. Lord Blanesburgh held that the claimants could not recover because they had not pleaded common mistake, but he also expressed his 'entire accord' with the judgments of Lord Atkin and Lord Thankerton. The test established by the majority was well expressed by Lord Thankerton when he said that the common mistake must 'relate to something

which both [parties] must necessarily have accepted in their minds as an essential element of the subject matter'. Yet, even applying this test, why was the claimants' mistake not fundamental? They had paid £50,000 to the defendants, which in 1929 must have been a colossal sum of money, when they could have dismissed them without paying any compensation. The answer to this question is not entirely clear. A partial answer is that the House of Lords did not want to lay down a principle which would enable parties to escape from what was merely a bad bargain. They wanted to hold men to their bargains and to emphasise the exceptional nature of the jurisdiction of the court to set aside a contract on the ground of mistake. But why did they not recognise that this was, in fact, such an exceptional case? After all, the claimants had made a spectacular mistake. But a closer analysis of the facts suggests that the mistake may not have been as significant as it appears at first sight. It seems that the claimants were very anxious to carry through the reorganisation and to secure the defendants' consent to the termination of their service agreements. This anxiety and urgency suggested to the majority of their Lordships that the claimants *might* have entered into the same agreements, even if they had known of the defendants' breaches of duty. Since it was for the claimants to establish that the mistake was a fundamental one, the existence of such a doubt was fatal to their claim (see the useful analysis of *Bell* adopted by Steyn J in *Associated Japanese Bank (International) Ltd* v. *Crédit du Nord* [1989] 1 WLR 255).

Nevertheless, it must be said that the test adopted by the majority is a relatively open-textured one and that it can admit of varying interpretations. This is demonstrated by the judgments in *Bell* itself because the minority, Lord Warrington and Lord Hailsham, held that the claimants' mistake *was* sufficiently fundamental to avoid the contract. In the following sections (14.3–14.6), we shall seek to ascertain the circumstances in which the courts have held a common mistake to be sufficiently fundamental to avoid a contract.

14.3 Mistake as to the Existence of the Subject-matter of the Contract

A mistake may be sufficiently fundamental to avoid a contract where both parties are mistaken as to the existence of the subject-matter of the contract. For example, in *Galloway* v. *Galloway* (1914) 30 TLR 531, the defendant, assuming his wife to be dead, married the claimant. The defendant and the claimant later separated and entered into a deed of separation under which the defendant promised to pay a weekly allowance to the

claimant. The defendant subsequently discovered that his first wife was still alive and fell into arrears. When the claimant sued to recover the arrears it was held that she could not do so because the separation agreement was void on the ground that it was entered into under the common mistake that the parties were, in fact, married.

Greater difficulties arise in the case of a contract for the sale of non-existent goods. Section 6 of the Sale of Goods Act 1979 provides that

> 'where there is a contract for the sale of specific goods, and the goods without the knowledge of the seller have perished at the time when the contract is made, the contract is void.'

This section was thought to give effect to the decision of the House of Lords in *Couturier* v. *Hastie* (1856) 5 HLC 673. The parties entered into a contract for the sale of a cargo of corn, which was believed to be in transit from Salonica to the United Kingdom. But, before the contract was made and unknown to both parties, the corn had deteriorated to such an extent that the master of the ship sold it. The seller argued that the buyer remained liable for the price of the corn because he had bought an 'interest in the adventure' or such rights as the seller had under the shipping documents. The House of Lords rejected the seller's argument, holding that the subject-matter of the contract was not the rights of the seller under the shipping documents but the corn and that, since the corn did not exist, there was a total failure of consideration and the buyer was not liable to pay the price. But the precise legal basis of the decision of the House of Lords in *Couturier* has been the subject of some debate and controversy among lawyers. We shall now consider the principal interpretations which have been placed upon *Couturier*.

The first interpretation is that a mistake as to the existence of the subject-matter of a contract inevitably renders a contract void. This appears to be the interpretation placed upon *Couturier* by the draftsman of section 6 of the Sale of Goods Act 1979. However the word 'mistake' was not used in any of the judgments in *Couturier*. The court was principally concerned with the construction of the contract and the question whether the consideration had totally failed. The court did not establish such an all-embracing proposition.

The second interpretation, adopted by Denning LJ in *Solle* v. *Butcher* [1950] 1 KB 671, 691, is that the contract in *Couturier* was void because there was an implied condition precedent that the contract was capable of performance. In *Couturier*, the parties proceeded upon the assumption that the goods were capable of being sold when, in fact, they were not and the effect of the implied condition precedent was to render the

contract void. The difficulty with this interpretation is that it does not tell us when, or on what basis, the courts will imply such a condition precedent.

The third interpretation is that the question whether or not a contract is void depends upon the construction of the contract. Such an interpretation was placed upon *Couturier* by the High Court of Australia in *McRae* v. *Commonwealth Disposals Commission* (1951) 84 CLR 377. In this rather bizarre case the defendants purported to sell to the claimants the wreck of a tanker which was lying on the Jourmand Reef and was said to contain oil. The claimants embarked upon an expedition in an attempt to salvage the vessel but no tanker was found and, indeed, no such tanker had ever existed. The claimants succeeded in their action for damages for breach of contract. The defendants had argued that there could be no liability for breach of contract because the alleged contract was void owing to the non-existence of the subject-matter of the contract. This argument was rejected by the court on the ground that the defendants had promised that such a tanker was in existence and they were liable for breach of that promise. *Couturier* was distinguished on the ground that there the parties had entered into the contract under the shared assumption that the corn was still in existence and could be sold by the seller; that assumption proved to be unfounded and the contract was held to be void. But in *McRae*, the defendants had actually promised that the tanker was in existence. They had assumed the risk of the non-existence of the tanker and for the breach of their promise they were held liable in damages.

But would an English court follow *McRae*? It seems clear that it is factually distinguishable from *Couturier* for the reasons already given. The result in *McRae* seems perfectly just because the defendants assumed the risk of the non-existence of the tanker and the effect of the decision was to place that risk upon the defendants. In policy terms there is little doubt that *McRae* should be followed. The difficulty lies in reconciling *McRae* with the wording of section 6 of the Sale of Goods Act 1979 (above). Section 6 does not provide an insuperable obstacle, however, because it can be argued that a case such as *McRae* is not caught by the actual wording of section 6 since the tanker never existed and therefore it could not have 'perished'. On this interpretation only contracts for the sale of goods which once existed but have since perished would be governed by section 6. Contracts for the sale of goods which never existed would not be caught by section 6 but would instead be governed by the more flexible approach adopted in *McRae*. But such a distinction has little to commend itself in policy terms.

Alternatively, it could be argued that section 6 is only a rule of construction which can, in a case such as *McRae*, be ousted by proof of

contrary intention (see Atiyah, 1957). The difficulty with this argument is that many sections of the Sale of Goods Act 1979 explicitly state that they are subject to contrary agreement but there is no such provision in section 6. Finally, it could be argued that, although the main contract in a case such as *McRae* is void, the defendants could be liable to the claimants under a collateral contract, the terms of which would be that the tanker was in existence. The consideration provided by the claimants would be the entry into the void contract. It is doubtful whether entry into a void contract can constitute consideration (but see *Strongman (1945) Ltd* v. *Sincock* [1955] 2 QB 525 and see the more flexible approach to consideration adopted in *Williams* v. *Roffey Bros. & Nicholls (Contractors) Ltd* [1991] 1 QB 1, see 5.11). Even if the consideration hurdle could be overcome, such a solution would be inelegant and horribly artificial. The contortions which are required to evade section 6 and to achieve a satisfactory solution in a case such as *McRae* suggest that English contract law would be radically improved by the reform of section 6 of the Sale of Goods Act 1979.

14.4 Mistake as to Identity of the Subject-matter

A mistake as to the identity of the subject-matter of the contract may be sufficiently fundamental to avoid a contract if both parties thought that they were dealing with one thing when in fact they were dealing with another. There is no English case on this point (but see the discussion in the Canadian case of *Diamond* v. *British Columbia Thoroughbred Breeders' Society* (1966) 52 DLR (2d) 146).

14.5 Mistake as to the Possibility of Performing the Contract

A mistake may be sufficiently fundamental to avoid a contract where both parties believe that the contract is capable of being performed when, in fact, it is not. Professor Treitel (1999) helpfully divides these cases into three categories.

The first category is physical impossibility. In *Sheikh Brothers Ltd* v. *Ochsner* [1957] AC 136, the appellants granted to the respondents a licence to enter and cut sisal growing on their land and in return the respondents agreed to deliver to the appellants 50 tons of cut sisal per month. Unknown to both parties, the land was incapable of producing an average of 50 tons of sisal per month throughout the term of the licence.

The Privy Council held that the contract was void because the mistake of the parties related to a matter which was essential to the agreement and neither party had assumed the risk of the land being incapable of producing such a yield.

The second type of impossibility is legal impossibility, that is to say, the contract provides for something to be done which cannot, as a matter of law, be done. In *Cooper* v. *Phibbs* (1867) LR 2 HL 149, the appellant agreed to take a lease of a salmon fishery which both parties believed to be the property of the respondents. It was subsequently discovered that the appellant, as the tenant in tail, was the owner of the fishery. The contract was set aside on the ground that the contract was legally incapable of performance because the appellant was already the owner of the fishery.

The third type of impossibility is commercial impossibility. In *Griffith* v. *Brymer* (1903) 19 TLR 434, the parties entered into a contract for the hire of a room for the purpose of viewing the coronation procession of Edward VII. The procession was cancelled because of the illness of Edward VII. The parties had concluded their contract at 11 am but, unknown to both parties, the decision to operate on Edward VII was taken at 10 am. It was held that the contract was void because the mistake of the parties went to the root or the heart of their agreement. Although the contract was still physically and legally capable of performance, the cancellation of the procession had undermined the commercial object of the contract.

14.6 Mistake as to Quality

A mistake as to the quality of the subject-matter of the contract may be sufficiently fundamental to avoid a contract. But the courts are extremely reluctant to conclude that a mistake as to quality renders a contract void, as can be seen from *Bell* v. *Lever Brothers* itself (see 14.2). A further difficulty is created by the fact that the cases are not easy to reconcile. A brief account will be given of some of the leading cases and then an attempt will be made at some reconciliation.

In *Leaf* v. *International Galleries* [1950] 2 KB 86, the Court of Appeal stated that a contract for the sale of a picture would not be set aside on the ground of mistake if both parties entered into the contract erroneously believing the picture to be a Constable. In *Harrison and Jones* v. *Burton and Lancaster* [1953] 1 QB 646, the parties entered into a contract for the sale of a particular brand of kapok which was believed to be pure

kapok whereas, in fact, it also contained some brush cotton which made it a commercially inferior product. It was held that the mistake was not sufficiently fundamental to avoid the contract. In *Oscar Chess Ltd* v. *Williams* [1957] 1 WLR 370 (see 8.4) both parties entered into a contract for the sale of a car under the belief that the car was a 1948 model when in fact it was a 1939 model. Once again the mistake was not sufficiently fundamental to avoid the contract. Finally, in *Solle* v. *Butcher* [1950] 1 KB 671, the defendant agreed to lease a flat to the claimant for seven years at an annual rental of £250. The parties entered into this agreement under the mistaken assumption that the flat was free from rent control. When the claimant discovered that the flat was subject to rent control and that the rent payable under the legislation was only £140, he sought to recover the rent which he had overpaid. The defendant counterclaimed for rescission of the lease on the ground of mistake. The Court of Appeal held that the landlord was entitled to set aside the lease on terms (on which see 14.7) but the ratio of the case is not easy to discern because the judges all took different approaches. Jenkins LJ dissented on the ground that the mistake was one of law, not fact, and a mistake of law at that time did not entitle the landlord to set aside the lease (although today a mistake of law would entitle the landlord to seek relief: see *Kleinwort Benson Ltd* v. *Lincoln City Council* [1999] 2 AC 349). Denning LJ held that the contract was valid at law but voidable in equity. The judgment of Bucknill LJ is more difficult. He held that the landlord was entitled to set aside the lease on the ground that 'there was a mutual mistake of fact on a matter of fundamental importance, namely, as to the identity of the flat'. Some have concluded that Bucknill LJ was of the view that the contract was void at law, but that view cannot be reconciled with the fact that Bucknill LJ agreed with Denning LJ as to the terms on which the lease was to be set aside. Had the lease been void at law, the court could not have set it aside on terms in equity (see 14.7). Although the matter is not free from doubt, it is suggested that *Solle* can best be understood as a case in which the lease was valid at law but voidable in equity. One particularly noteworthy feature of *Solle* is that Lord Denning clearly wished to restrict the scope of the doctrine of common mistake at law because of the drastic effect which nullity has both for the parties themselves and for innocent third parties (see 4.6).

On the basis of these cases it would appear to be extremely difficult, if not impossible, to establish that a common mistake as to quality renders a contract void. But there are cases in which a mistake as to quality has been held to be sufficiently fundamental to avoid the contract. One such case is *Scott* v. *Coulson* [1903] 2 Ch 249. A contract for the sale of a life

assurance policy was held to be void when, unknown to both parties, the assured had died and the value of the policy had consequently increased from £460 to £777. Secondly, in *Nicholson and Venn* v. *Smith-Marriott* (1947) 177 LT 189, the defendants put up for auction table napkins 'with crest of Charles I and authentic property of that monarch'. In reliance upon this description, the claimant bought the napkins for £787. It was later discovered that the napkins were Georgian and were worth only £105. Hallet J held that the claimant was entitled to damages for breach of contract but he also held that the claimant could have avoided the contract on the ground of mistake. The authority of this case has been weakened, however, by doubts cast upon its correctness by Denning LJ in *Solle* v. *Butcher* (above).

How can these cases be reconciled? The general test can be identified reasonably easily. As Lord Thankerton stated in *Bell* v. *Lever Brothers* (above), the mistake of the parties must relate to an 'essential and integral element of the subject matter' of the contract. The difficulty lies in applying that test to the facts of any given case. Professor Treitel (1999, p.267) has put forward the following test: imagine that you can 'ask the parties, immediately after they made the contract, what its subject-matter was. If, in spite of the mistake, they would give the right answer the contract is valid at law'. Such a test works satisfactorily in most cases and helps explain the difference between cases such as *Oscar Chess* and *Nicholson and Venn*. But it does not appear to explain *Leaf*, where the parties would surely have said that they were purchasing a Constable and not simply a picture. Treitel concedes this point, but counters that the dicta in that case are not conclusive because the claimant 'did not claim that the contract was void'. It is also difficult to apply this test to *Scott* where it is arguable that the parties would have given the correct answer, namely an insurance policy. Although this test cannot reconcile all the cases, it does provide some useful guidance in considering whether a mistake as to quality relates to an 'essential and integral element of the subject matter of the contract'.

14.7 Mistake in Equity

As can be seen from our discussion of the case law (14.3–14.6), the decision of the House of Lords in *Bell* v. *Lever Brothers Ltd* has given birth to an extremely narrow doctrine of common mistake in English law. Such a restrictive approach can be justified on the ground that it promotes certainty and protects innocent third party rights. But the narrow approach adopted in *Bell* has since been 'supplemented by the more flexible doc-

trine of mistake in equity' (per Steyn J in *Associated Japanese Bank (International) Ltd* v. *Crédit du Nord* [1989] 1 WLR 255). A more flexible doctrine of mistake in equity has flourished since *Bell* because *Bell* has been interpreted as an authority on the scope of mistake at law and not on mistake in equity. But the relationship between mistake at law and mistake in equity is an uneasy one. Indeed, if the House of Lords in *Bell* had believed that there was a wider equitable jurisdiction to grant relief in cases of mistake, it is difficult to understand why no reference was made to such a jurisdiction. Although the leading cases on the scope of mistake in equity are now of respectable antiquity (for example, *Solle* v. *Butcher* was decided in 1949), the House of Lords has never had the opportunity to consider the relationship between the principles established in *Bell* and the equitable jurisdiction which has been developed since *Bell*. But the relationship has been considered by judges in the lower courts and the clearest rationalisation of the cases has been provided by Steyn J in *Associated Japanese Bank (International) Ltd* v. *Crédit du Nord* (above). Steyn J stated that a court must first decide whether the contract is void at common law. If it is void, then no question of mistake in equity arises. But, if the contract is valid at law, then the court must consider whether the contract can be set aside in equity. The role of the equitable doctrine is therefore a supplementary one, designed to mitigate the hardships caused by the strict approach adopted at law.

Mistake in equity differs in three major respects from mistake at law. The first is that the scope of the doctrine is wider (see Cartwright, 1987b). In *Solle* v. *Butcher* (above) Denning LJ stated that the mistake must be 'fundamental' and that the party seeking to set the contract aside must not himself be 'at fault'. But he also asserted that the court has power to set aside a contract which is valid at law 'whenever it is of the opinion that it is unconscientious for the other party to avail himself of the legal advantage which he has obtained'. Subsequent cases do not appear to support the proposition that 'unconscientiousness' is the basis of the court's jurisdiction to intervene; rather, they suggest that the mistake must be 'substantial', although it need not be so fundamental as to render the contract void at law. Two cases help illustrate the scope of the equitable doctrine.

The first is *Grist* v. *Bailey* [1967] Ch 532, in which the defendant contracted to sell property to the claimant for £850 'subject to the existing tenancy thereof'. At the time the agreement was concluded, both parties believed that the property was in the occupation of a protected tenant. When the defendant discovered that the protected tenant had died, he refused to complete and sought rescission of the contract. The property, with vacant possession, was worth £2250. Goff J set aside the contract in

equity. The second case is *Magee* v. *Pennine Insurance Co* [1969] 2 QB 507. There the Court of Appeal set aside an insurance company's compromise of a claim which had been entered into by both parties in the belief that the policy was binding when, in fact, it was voidable on the ground of innocent misrepresentation.

These decisions are questionable on two grounds. The first is that they do not sit easily with *Bell* v. *Lever Brothers* (above). It is particularly difficult to distinguish between *Magee* and *Bell* v. *Lever Brothers* (and Winn LJ dissented in *Magee* on precisely this ground). In both cases the claimants paid out in the belief that there was a valid contract between themselves and the defendants when the contract was, in fact, voidable: in *Magee* the claimants recovered, in *Bell* they did not. If *Magee* is indeed correctly decided, it is hard to resist the inference that the claimants in *Bell* would have recovered if they had pleaded mistake in equity. Yet if their Lordships in *Bell* had thought that the claimants would have won had they brought their claim in equity, surely they would have said so? Here we see the potential of equity to undermine the common law rules and, indeed, the decision in *Bell* itself. This inconsistency must be faced up to directly. It is no longer sufficient simply to refer to the historical division between law and equity as if that is a justification in itself. It is not. Fusion of law and equity took place over 100 years ago and English law should now develop a uniform set of rules to define the circumstances in which a contract can be set aside on the ground of common mistake.

The second point on which *Grist* and *Magee* are open to criticism is that in both cases the court concluded that the mistake was substantial on rather flimsy evidence. It can be argued that the vendor in *Grist* and the insurance company in *Magee* entered into bad bargains on the basis of inadequate information and then invoked mistake in equity to relieve them from the consequences of their own imprudence. As Hoffmann LJ observed in *William Sindall plc* v. *Cambridgeshire County Council* [1994] 1 WLR 1016, 1035, the Court of Appeal in *Grist* did not 'advert to the question of contractual allocation of risk' and he was 'not sure' that the decision 'would have been the same' if they had. There is a strong case for saying that the courts have gone too far in equity. It is understandable that the courts, when exercising their equitable jurisdiction, should wish to avoid the perceived hardships created by the narrow doctrine of common mistake at law, but they must also be careful that their relaxed approach in equity does not give rise to hardship by enabling fools to escape the consequences of their own folly (see *Clarion Ltd* v. *National Provident Institution* [2000] 2 All ER 265, 281–282).

The second difference between mistake in equity and mistake at law is that mistake in equity renders a contract voidable and not void, so that

when a contract is set aside on the ground of mistake in equity, innocent third party rights can be protected. The third difference is that in equity the courts have greater remedial flexibility because they can set aside the contract 'on terms'. Thus, in *Grist* v. *Bailey* (above) the contract was set aside on terms that the defendant should give to the claimant an opportunity to purchase the property for a 'proper vacant possession price' (see too the terms on which the lease was set aside in *Solle* v. *Butcher*). Despite its dubious legitimacy and the rather liberal way in which it has sometimes been applied, mistake in equity is generally regarded as a useful, flexible supplement to common law mistake (although its practical utility does not detract from the need to develop a uniform set of rules).

14.8 Frustration

A contract can only be set aside on the ground of common mistake where the parties were labouring under the mistake at the time at which they entered into the contract. Unforeseen events which occur after the contract has been concluded cannot form the basis of a claim for relief on the ground of mistake, but, in such a situation, a court may hold that the contract has been discharged by operation of the doctrine of frustration. A contract is frustrated where, *after* the contract was concluded, events occur which make performance of the contract impossible, illegal or something radically different from that which was in the contemplation of the parties at the time they entered into the contract. A contract which is discharged on the ground of frustration is brought to an end automatically by the operation of a rule of law, irrespective of the wishes of the parties (*Hirji Mulji* v. *Cheong Yue SS Co* [1926] AC 497).

It has been argued (14.1) that the principal difference between common mistake and frustration relates to the *time* at which the misapprehension or unforeseen event occurs. Yet it must be conceded that the time at which the misapprehension or unforeseen event occurs does have significant consequences; that is to say, it is easier to discover the true facts at the moment of entry into the contract than it is to foresee future events. Therefore it is to be expected that a court will be readier to discharge a contract on the ground of frustration than it will be to avoid a contract on the ground of mistake. But when one looks at the cases, that expectation is not clearly fulfilled because the doctrine of frustration presently operates within very narrow confines. What is it that explains the reluctance of the courts to invoke the doctrine of frustration?

14.9 Frustration, Force Majeure and Hardship

It is suggested that there are two principal reasons which help explain the reluctance of the courts to invoke the doctrine of frustration. The first is that the courts do not want to allow the doctrine to act as an escape route for a party for whom the contract has simply become a bad bargain. The attitude of the modern courts was well summed up by Lord Roskill when he said that the doctrine of frustration was 'not lightly to be invoked to relieve contracting parties of the normal consequences of imprudent bargains' (*The Nema* [1982] AC 724, 752). An example of this approach at work is provided by the case of *Davis Contractors Ltd* v. *Fareham UDC* [1956] AC 696. The claimant contractors agreed to build 78 houses for the defendants for £94,000. The work was scheduled to last for 8 months but, owing to shortages of skilled labour, the work took an extra 14 months to complete and cost £115,000. The claimants, in an attempt to recover a sum of money in excess of the contract price, argued that the contract had been frustrated. Their argument was rejected by the House of Lords. Lord Radcliffe stated that it was not

> 'hardship or inconvenience or material loss itself which calls the principle of frustration into play. There must be as well such a change in the significance of the obligation that the thing undertaken would, if performed, be a different thing from that contracted for.'

Davis can be said to be the paradigm example of a bad bargain. The deal had undoubtedly turned out to be a poor one for the claimants but the courts refused to rescue them. The decision may seem harsh but, had it gone the other way, it would have created a new principle of uncertain ambit which would have denied to the defendants the fruits of the good deal which they had negotiated. The hardship which *Davis* possibly creates is more than offset by the clear rule which it establishes and the signal which it gives to contracting parties that the courts will not lend their assistance to a party who is looking for a way out of a bad bargain. So frustration can be invoked only where the supervening event *radically* or *fundamentally* changes the nature of performance: it cannot be invoked simply because performance has become more onerous.

The second reason for the narrowness of the doctrine of frustration is that we all know that the future is uncertain; prices may suddenly increase, inflation may rise, labour disputes break out. Contracting parties are expected to foresee many such possibilities when entering into a contract and guard against them in the contract. Contracts today often make

provision for the impact of unexpected events upon contractual performance. A clause which is frequently employed for this purpose is known as a 'force majeure' clause. In *Channel Island Ferries Ltd* v. *Sealink UK Ltd* [1988] 1 Lloyd's Rep 323, the contract between the parties contained the following force majeure clause:

> 'A party shall not be liable in the event of non-fulfilment of any obligation arising under this contract by reason of Act of God, disease, strikes, Lock-Outs, fire, and any accident or incident of any nature beyond the control of the relevant party.'

Another clause which is often found in commercial contracts is known as a 'hardship clause'. Such a clause will generally define what constitutes 'hardship' (usually of an economic variety) and will lay down a procedure to be adopted by the parties in the event of such hardship occurring. Generally the clause will impose an obligation on both parties to use best endeavours to renegotiate the contract in good faith in an attempt to alleviate the hardship which has arisen (although note in this context the difficulties which the decision of the House of Lords in *Walford* v. *Miles* [1992] 2 AC 128 (discussed at 4.1) might create for the enforceability of such an obligation to renegotiate). A further type of clause which is often found in commercial contracts is an 'intervener clause'. Such a clause is similar to a 'hardship clause' except that it gives to a third party (the 'intervener') the authority to resolve the dispute which has arisen between the parties. Intervener clauses are regularly employed as a sanction to be invoked in the event of the parties themselves failing to negotiate their way out of a hardship event.

What advantages can be obtained by the use of such clauses? It is suggested that there are a number of advantages (see McKendrick, 1995). The first is the provision of a degree of certainty. It is often difficult to know whether or not a contract has been frustrated. To an extent this uncertainty can be reduced by the parties agreeing a list of events which are to constitute force majeure or hardship events. The second is that frustration operates within very narrow limits (both in terms of the events which constitute frustrating events and the width of doctrines such as self-induced frustration which deny to a party the ability to argue that the contract was frustrated, see 14.16). On the other hand, force majeure and hardship clauses give to the parties the opportunity, should they want to avail themselves of it, to agree that a wider class of events shall constitute force majeure or hardship events. For example, an unexpected increase in prices does not constitute a frustrating event (see *Davis Contractors* v. *Fareham UDC* (above)) but it is not uncommon for a commercial

contract to state that an 'abnormal increase in prices and wages' shall constitute a force majeure event.

The third advantage is that the parties can make provision for the consequences of the occurrence of a force majeure or hardship event. Frustration operates too drastically because it terminates the contract, irrespective of the wishes of the parties (see 14.8). Very often the parties want to continue their relationship but to adapt the terms to meet the new situation. This cannot be done under the doctrine of frustration. But force majeure clauses often provide for a period of suspension of the contract (to allow more time for performance or to enable the parties to wait for the supervening event, such as bad weather or a strike, to subside) before resorting to the more drastic remedy of termination. Hardship and intervener clauses are particularly well suited to contracting parties who wish their relationship to continue through changing circumstances. The remedial rigidity of the doctrine of frustration contrasts unfavourably with the flexibility which can be obtained by drafting an appropriate force majeure or hardship clause.

It is suggested that the ability of contracting parties to make such provision in their contracts has had a significant impact upon the development of the doctrine of frustration. Indeed, at one point in its history, supervening or unforeseen events were not regarded as an excuse for non-performance because the parties could provide against such accidents in their contract. Once a party had assumed an obligation he was 'bound to make it good' (*Paradine* v. *Jane* (1647) Aleyn 26, 27). This absolutist approach was gradually relaxed during the latter half of the nineteenth century and, commencing with *Taylor* v. *Caldwell* (1863) 3 B & S 826 and culminating in cases such as *Jackson* v. *Union Marine Insurance Co Ltd* (1874) LR 10 CP 125 and *Krell* v. *Henry* [1903] 2 KB 740, the courts developed a wider role for the doctrine of frustration and it became significantly easier to invoke the doctrine. Today, the courts have reverted to a more restrictive approach and it is rare to find frustration being pleaded successfully. For this reason, contracting parties frequently include force majeure and hardship clauses in their contracts so that they can allocate the risk of the occurrence of such unforeseen events (see further 14.16). It is often said that English law does not encourage the adjustment of bargains in the event of contractual performance becoming more onerous. This is not entirely accurate. The issue should not be seen as whether or not English law permits adjustment. The real issue is: who should do the adjusting? Is it the courts or is it the parties? The answer which English law gives is that it is for the parties to do the adjusting. While the courts will not adjust the bargain for the parties, they will not place significant obstacles in the way of attempts by the parties to

adjust their bargain to meet changing circumstances (an exception might be said to be the decision of the House of Lords in *Walford* v. *Miles*, discussed at 4.1).

14.10 Frustration: A Sterile Doctrine?

Although frustration is a difficult defence to invoke, it should not be thought that it has become a sterile doctrine which is incapable of development. The scope of the doctrine was, in fact, expanded by the decision of the House of Lords in *National Carriers* v. *Panalpina (Northern) Ltd* [1981] AC 675. For many years it was thought that the doctrine of frustration could not apply to a lease because a lease created an interest in land and that interest in land was unaffected by the alleged frustrating event. But in *Panalpina* it was held that, as a matter of principle, a lease could be frustrated, although, as a matter of practice, it would be rare for a court to conclude that a lease had been frustrated. Many leases run for a long period of time, such as 99 years, and it is difficult to conceive of such a lease being frustrated because the parties must anticipate that major changes will occur during the 99 year period and so, to a large extent, they will have assumed the risk of supervening events. The type of lease which might be frustrated is a lease of a holiday flat or some other lease of short duration. Although the practical significance of *Panalpina* may be minimal, the decision does display a willingness, in an appropriate case, to expand the horizons of the doctrine of frustration.

14.11 Impossibility

A contract which has become impossible of performance is frustrated. In *Taylor* v. *Caldwell* (1863) 3 B & S 826, the defendants granted to the claimants a licence to use the 'Surrey Gardens and Music Hall' for a series of concerts at a fee of £100 per concert. After the contract had been concluded, but before the first concert was performed, the music hall was accidentally destroyed by fire so that it became impossible to stage the concerts. The claimants argued that the defendants were in breach of contract in failing to supply the hall and sought to recover their wasted advertising expenditure. But the court held that the contract was frustrated because the destruction of the music hall rendered performance of the contract impossible. The frustrating event released both parties from their obligations under the contract and so the defendants were no longer under an obligation to supply the hall and were not in breach of contract.

Partial destruction of the subject-matter may also frustrate a contract where it renders performance of the contract impossible. For example, in *Taylor* v. *Caldwell* the contract was for the hire of the music hall and the 'Surrey Gardens', but it was only the music hall which was destroyed. Nevertheless, because the destruction of the music hall rendered performance of the contract impossible the contract was frustrated.

Contracts for personal services, such as contracts of employment and contracts of apprenticeship, are frustrated by the death of either party to the contract. Similarly, a contract of employment may be frustrated if the ill-health of an employee renders him permanently unfit for work.

A contract may also be frustrated where the subject-matter of the contract is unavailable for the purpose of carrying out the contract. For example, a charterparty was held to be frustrated when the ship was requisitioned and so was unavailable to the charterer (*Bank Line Ltd* v. *Arthur Capel & Co Ltd* [1919] AC 435). Temporary unavailability of the subject-matter may also frustrate a contract. In *Jackson* v. *Union Marine Insurance Co* (1874) LR 10 CP 125, a ship was chartered in November 1871 and was required to proceed with all possible dispatch from Liverpool to Newport, and there load a cargo for carriage to San Francisco. On her way to Newport in early January 1872, the ship ran aground and was not fully repaired until the end of August 1872. It was held that the contract was frustrated because the ship was not available for the voyage for which she was chartered. A voyage to San Francisco in late August 1872 was performance radically different from that originally contemplated.

Where the contract is one of fixed duration and the unavailability of the subject-matter is only temporary, the court must, in deciding whether the contract has been frustrated, consider the ratio of the likely interruption in contractual performance to the duration of the contract. The higher the ratio, the more likely it is that the contract will be frustrated. In *The Nema* (above) a charterparty was frustrated when a long strike closed the port at which the ship was due to load so that, of the six or seven voyages contracted to be made between April and December, no more than two could be completed (see also *Morgan* v. *Manser* [1948] 1 KB 184).

14.12 Frustration of Purpose

Where the common purpose for which the contract was entered into can no longer be carried out because of some supervening event the contract may be frustrated. Examples of frustration of purpose are, however, extremely rare. The reason for this is that the courts do not wish to

provide an escape route for a party for whom the contract has simply become a bad bargain. A rare case in which a plea of frustration of purpose succeeded is *Krell* v. *Henry* [1903] 2 KB 740. The defendant hired a flat in Pall Mall from the claimant for two days. The object in entering into the contract was to view the coronation procession of Edward VII, although this was not actually expressed in the contract. After the contract had been concluded, the coronation of Edward VII was postponed because of the illness of the King. The Court of Appeal held that the contract was frustrated. *Krell* must, however, be contrasted with *Herne Bay Steam Boat Co* v. *Hutton* [1903] 2 KB 683, in which the defendant hired a ship from the claimant 'for the purpose of viewing the naval review and for a day's cruise around the fleet'. After the contract had been concluded, the naval review was cancelled because of the illness of Edward VII. Nevertheless, the court held that the contract was not frustrated. What is the difference between this case and *Krell*?

In answering this question, it is necessary to refer to an example considered by Vaughan Williams LJ in *Krell*. It was put to Vaughan Williams LJ that, if the contract was frustrated on the facts of *Krell*, then it

> 'would follow that if a cabman was engaged to take someone to Epsom on Derby Day at a suitably enhanced price for such a journey . . . both parties to the contract would be discharged in the contingency of the race at Epsom for some reason becoming impossible.'

But Vaughan Williams LJ was of the opinion that such a contract would not be frustrated because he did not think that 'the happening of the race would be the foundation of the contract'. In *Krell*, on the other hand, the 'foundation of the contract' was the viewing of the coronation. However the contract in *Krell* was an extremely unusual one. The rooms were hired out by the day, excluding the night, and the only purpose which *both* parties had in entering into such an unusual contract was to hire the rooms for the purpose of viewing the coronation. So interpreted, the contract was frustrated. On the other hand, in *Herne Bay Steamboat Co* v. *Hutton* (above) the defendant could still see the fleet and, although the defendant's motive in entering into the contract might have been to see the naval review, it could not be said that that was the 'common foundation of the contract'. Similar reasoning explains the example of the cancellation of the Derby. Although the motive of the hirer might have been to see the Derby, that was not of itself sufficient to render the happening of the Derby the 'common foundation' of the contract. Thus interpreted, *Krell* becomes a very narrow decision indeed and it is not surprising that it has been distinguished in modern cases such as

Amalgamated Investment & Property Co Ltd v. *John Walker & Sons Ltd* (above, 14.1).

14.13 Illegality

Supervening illegality can operate to frustrate a contract. In *Fibrosa Spolka Akcyjna* v. *Fairbairn Lawson Combe Barbour Ltd* [1943] AC 32, the respondents agreed to manufacture machines for the appellants and to deliver them to Gdynia in Poland. However before the respondents had completed the manufacture of the machines, Gdynia was occupied by the German army. It was held that the contract was frustrated because in time of war it is against the law to trade with the enemy. The public interest in ensuring that no assistance was given to the enemy in time of war outweighed the fact that it remained physically possible to manufacture and deliver the machines. Where the illegality is only temporary or partial, the contract will be frustrated only if the illegality affects the performance of the contract in a substantial or fundamental way (contrast *Denny, Mott & Dickinson* v. *James B Fraser & Co Ltd* [1944] AC 265 and *Cricklewood Property Investment Trust Ltd* v. *Leighton's Investment Trust Ltd* [1945] AC 221).

14.14 Express Provision

There are a number of limitations upon the scope of the doctrine of frustration. Three such limitations will be considered here (14.14–14.16). The first is that a contract is not frustrated where the parties have made express provision for the occurrence of the alleged frustrating event in their contract. A frustrating event is a supervening, unforeseen event; it is not an event which has been anticipated in the contract itself. But where the contract is frustrated on the ground that further performance of the contract is against the law, because it involves trading with the enemy in time of war, the operation of the doctrine of frustration cannot be excluded by express provision in the contract. Overriding considerations of public policy deny effect to such a clause (*Ertel Bieber and Co* v. *Rio Tinto Co Ltd* [1918] AC 260).

The express provision rule has important consequences for force majeure clauses and hardship clauses. The effect of such clauses may be to exclude the operation of the doctrine of frustration because the contract, on its proper construction, will be held to have covered and made its own provision for the event which has occurred. But the courts have

generally subjected to a narrow interpretation clauses which, it is alleged, make provision for what would otherwise be a frustrating event. In particular, the fact that the contract deals with events of the same general nature as the alleged frustrating event does not mean that the clause deals with every event in that class. A good example of this restrictive approach is provided by the decision of the House of Lords in *Metropolitan Water Board* v. *Dick, Kerr and Co* [1918] AC 119. Here contractors agreed to construct a reservoir in six years. The contract provided that, in the event of delay 'whatsoever and howsoever occasioned', the contractors were to apply to the engineer for an extension of time. When the contractors were required by Government Order to stop the work and sell their plant, it was held that the contract was frustrated because the delay clause was not intended to apply to such a fundamental change of circumstances. It was held that the clause was intended to cover only temporary difficulties and did not cover fundamental changes in the nature of the contract (see too *Jackson* v. *Union Marine Insurance Co Ltd* (above)).

So the courts insist that provision for the event be 'full and complete' before frustration is excluded, and the greater the magnitude of the event, the less likely it is that it will be held to fall within the scope of the contract. One consequence of this approach is that it is extremely difficult, if not impossible, to draft a force majeure clause which will exclude the operation of the doctrine of frustration completely. As the *Metropolitan Water Board* case demonstrates, even the widest of clauses may be held not to encompass a particularly catastrophic event. Similarly, the fact that a force majeure clause makes provision for a temporary suspension of the contract on the occurrence of a force majeure event is likely to be interpreted by the court as an indication that the scope of the clause is confined to temporary interruptions in performance and that it does not apply to an event which renders further performance of the contract 'unthinkable' (*The Playa Larga* [1983] 2 Lloyd's Rep 171, 189).

14.15 Foreseen and Forseeable Events

Given that a frustrating event is a supervening, unforeseen event, the doctrine ought logically not to apply to an event which is within the contemplation of the parties. In *Walton Harvey Ltd* v. *Walker and Homfrays Ltd* [1931] 1 Ch 274, the defendant granted to the claimant the right to display an advertising sign for seven years on the defendant's hotel. Before the seven years had elapsed, the local authority compulsorily purchased the hotel and demolished it. The court held that the contract between the parties was not frustrated by the compulsory purchase and

demolition of the hotel because it was within the contemplation of the defendant, at the time that the contract was concluded, that the property might be the subject of a compulsory purchase order. The proposition that a foreseeable event cannot frustrate a contract has been challenged, however, by Lord Denning in *The Eugenia* [1964] 2 QB 226 (see too *WJ Tatem Ltd* v. *Gamboa* [1939] 1 KB 132). The status of these dicta is uncertain. On the one hand, they suggest that the general rule requires reconsideration, but, on the other hand, they can be reconciled with the orthodox analysis on the ground that the events in these cases were not sufficiently foreseeable to satisfy the very high test of foreseeability which is applicable here. An event is foreseeable and will prevent frustration of the contract only where it is one which 'any person of ordinary intelligence would regard as likely to occur' (see Treitel, 1999, p.841, contrast Hall, 1984). Whatever the precise status of these dicta in *The Eugenia* and *Tatem* v. *Gamboa*, it is clear that the foresight of war is an irrelevant issue where the ground of frustration is trading with the enemy.

14.16 Self-induced Frustration

A party cannot invoke the doctrine of frustration where the alleged frustrating event is brought about through his own conduct or the conduct of those for whom he is responsible. This inability to invoke frustration is generally referred to as 'self-induced frustration'. It is, however, important to be clear about the consequences of concluding that the 'frustration' was 'self-induced'. Frustration is generally invoked by a defendant who has not performed his contractual obligations as a defence to an action for breach of contract. But where the 'frustration' is held to be 'self-induced', the consequence is that the defendant is unable to rely on frustration and so, in the absence of any other defence, will be found to be in breach of contract.

Although the concept of self-induced frustration is clearly established in the cases, the courts have never established its limits with any degree of clarity. In *J Lauritzen AS* v. *Wijsmuller BV (The 'Super Servant Two')* [1989] 1 Lloyd's Rep 148, Hobhouse J defined self-induced frustration as a 'label' which has been used by the courts to describe 'those situations where one party has been held by the courts not to be entitled to treat himself as discharged from his contractual obligations'. On his analysis, frustration was self-induced where the alleged frustrating event was caused by a breach or an anticipatory breach of contract by the party claiming that the contract has been frustrated, where an act of the party claiming that the contract has been frustrated broke the chain of causa-

tion between the alleged frustrating event and the event which made performance of the contract impossible, and where the alleged frustrating event was not a supervening event, by which he meant 'something altogether outside the control of the parties'. Thus a negligent act by the defendant will generally amount to self-induced frustration because such an event is not 'altogether outside the control' of the defendant. On the contrary, it is within his control, notwithstanding the fact that his negligence is a result of his unreasonable failure to exercise that control (see *Joseph Constantine Steamship Ltd* v. *Imperial Smelting Corporation Ltd* [1942] AC 154).

Some insight into the scope of self-induced frustration can be gleaned from an analysis of the following two cases. The first case is *Maritime National Fish Ltd* v. *Ocean Trawlers Ltd* [1935] AC 524. The defendants chartered a ship from the claimants but the vessel could only be used for its intended purpose if it was fitted with an otter trawl. An otter trawl could only be used under licence and, although the defendants applied for licences for the five vessels which they operated, they were allocated only three licences. They elected to apply the licences to the trawlers which they owned directly or indirectly rather than to the vessel chartered from the claimants. The claimants sued for the hire due under the terms of the contract but the defendants denied liability to pay on the ground that the contract had been frustrated by their failure to obtain a licence. The Privy Council held that the contract was not frustrated as a result of the defendants' failure to obtain a licence for the vessel; this was a case of self-induced frustration. But the ratio of the decision remained unclear. On the one hand, it could be argued that it was the fact that the defendants elected to allocate the licences to their own vessels which led the Privy Council to conclude that this was a case of self-induced frustration. On the other hand, it could be maintained that the mere fact that the defendants had a choice as to the distribution of the licences was sufficient to constitute self-induced frustration.

Our second case is *J Lauritzen AS* v. *Wijsmuller BV (The 'Super Servant Two')* [1990] 1 Lloyd's Rep 1, where the Court of Appeal adopted the latter of our two possible interpretations of the *Maritime National Fish* case. The defendants agreed to transport the claimants' oil rig using, at their option, either Super Servant One or Super Servant Two (both of which were self-propelling barges especially designed for the transportation of rigs). Prior to the time for performance of the contract the defendants made a decision, which they admitted was not irrevocable, to allocate Super Servant Two to the performance of the contract with the claimants and to allocate Super Servant One to the performance of other concluded contracts. Unfortunately, after the contract had been

concluded but before the time fixed for performance, Super Servant Two sank while transporting another rig. The contract could not be performed by Super Servant One because of its allocation to the performance of other concluded contracts and so the contract was eventually performed by another, more expensive method of transportation. The claimants brought an action for damages against the defendants, alleging that they were in breach of contract in failing to transport the rig in the agreed manner. The defendants denied liability on two grounds. The first was that they argued that the contract had been frustrated as a result of the sinking of Super Servant Two. This argument was rejected. The Court of Appeal held that the cause of the non-performance of the contract was not the sinking of Super Servant Two but the choice of the defendants to allocate Super Servant One to the performance of other contracts. The existence of such a choice was held to be sufficient to turn the case into one of self-induced frustration. The difficulty with this analysis is that the defendants had no *real* choice as to the allocation of Super Servant One. It was impossible to allocate it to the performance of all concluded contracts and so the sinking of Super Servant Two *compelled* them to make such a decision. The conclusion of the Court of Appeal appears to leave a seller or supplier of goods in an impossible position where his source of supply partially fails due to an unforeseen event.

But at this point it is important to turn to the defendants' second defence, which was that they were entitled to terminate performance of the contract without incurring any liability under the terms of a force majeure clause contained in the contract. One of the force majeure events listed in the contract was 'perils or dangers and accidents of the sea' and the Court of Appeal held that this phrase was apt to encompass the sinking of Super Servant Two *provided that* its sinking was not attributable to negligence on the part of the defendants or their employees. So, provided there was no negligence on the part of the defendants, the force majeure clause gave to the defendants an effective defence to the claimants' claim for damages.

Super Servant Two is an interesting and important case because it provides us with an excellent example both of the narrow confines within which the doctrine of frustration currently operates and of the advantages which can be obtained by the incorporation of a suitably drafted force majeure clause in a contract. Indeed, the latter point was made abundantly clear by Hobhouse J at first instance when he said that if a promisor wished protection in the event of a partial failure of supplies 'he must bargain for the inclusion of a suitable force majeure clause in the contract'. The responsibility for adjusting and regulating the bargain is thus clearly allocated to the parties and not to the courts. Given the narrow

confines within which frustration currently operates, *Super Servant Two* demonstrates that a contracting party who wishes to be released from his obligations to perform in a wider range of circumstances must bargain for the inclusion of a force majeure, hardship or intervener clause in the contract (see 14.9).

14.17 The Effects of Frustration

As we have already noted (14.8), a contract which is discharged on the ground of frustration is brought to an end automatically at the time of the frustrating event. For the purposes of ease of exposition, we shall consider separately the effects of frustration upon a claim to recover money paid prior to the frustrating event and its effects upon a claim to recover the value of goods supplied or services provided prior to the frustrating event.

At common law it was held in *Fibrosa Spolka Ackcyjna* v. *Fairbairn, Lawson Combe Barbour Ltd* [1943] AC 32 (overruling *Chandler* v. *Webster* [1904] 1 KB 493 where it had been held, essentially, that the loss lay where it fell) that money paid prior to the frustration of the contract was recoverable upon a total failure of consideration. A total failure of consideration arises where the party seeking recovery has got no part of what he has bargained for. In *Fibrosa* (see 14.11) the appellants sought to recover the £1000 they had paid to the respondents on the signing of the contract. The House of Lords held that the consideration for the payment had wholly failed because the machines had not been delivered to the appellants and that they were entitled to the recovery of their pre-payment. While it is true to say that *Fibrosa* represented an improvement upon the old common law rule established in *Chandler* v. *Webster* (above), it did not leave the law in an entirely satisfactory state. Two principal defects remained. The first was that the payer could only recover money paid upon a total failure of consideration; where the failure was only partial he could not recover (*Whincup* v. *Hughes* (1871) LR 6 CP 78, see further 21.2). The second defect was that the payee could not set off against the money to be repaid any expenditure which he had incurred in the performance of the contract. For example, on the facts of *Fibrosa*, the respondents had incurred expenditure in making the machines (although it was, admittedly, unclear whether that expenditure had been wasted), yet they were unable to retain any portion of the £1000 which represented their expenditure upon the machines.

This position has been rectified by the enactment of s.1(2) of the Law Reform (Frustrated Contracts) Act 1943. The effect of this subsection is

threefold. The first is that moneys paid prior to the frustrating event are recoverable. The second is that sums payable prior to the time of discharge cease to be payable. The third is that the payee may be entitled to set off against the sums so paid expenses which he has incurred before the time of discharge in, or for the purpose of, the performance of the contract. Section 1(2) meets the two deficiencies of the common law in that the right to recover money is not confined to a total failure of consideration and the payee can set off against the sums repayable any reliance expenditure which he had incurred in the performance of the contract. But certain deficiencies remain (for fuller consideration see Goff and Jones, 1998 and McKendrick, 1995). The first is that the section does not make clear the basis upon which the court is to calculate the amount of expenditure which a payee is entitled to retain. Is it all of it, half of it, some other portion of it, or none of it? In *Gamerco SA* v. *ICM/Fair Warning (Agency) Ltd* [1995] 1 WLR 1226, Garland J considered the various possibilities and concluded (at p.1237) that he could see 'no indication in the Act, the authorities or the relevant literature that the court is obliged to incline towards either total retention or equal division'. Rather, he thought that his task was to do 'justice in a situation which the parties had neither contemplated nor provided for, and to mitigate the possible harshness of allowing all loss to lie where it has fallen'. The emphasis is thus placed on the 'broad nature' of the discretion which the court enjoys and the imperative to do justice on the facts of the case. While this apparent reluctance to structure the discretion of the courts is unfortunate, it is preferable to a rigid insistence upon equal division of the loss (as has been done by legislation in British Columbia: see s.5(3) of the Frustrated Contracts Act 1974). The only point which can be established with any degree of certainty in the present context is that the onus of proof is upon the payee to show that it is just in all the circumstances of the case for him to retain any part of the prepayment (see *Gamerco*, at p.1235). The second difficulty created by s.1(2) is that the payee cannot recover or retain more than the value of the prepayment, so that any reliance expenditure incurred which is in excess of the prepayment cannot be recovered under s.1(2), although it may be recoverable under s.1(3) where the expenditure results in a valuable benefit being obtained by the other party (see below).

We must now consider the effects of frustration upon a claim to recover the value of goods supplied or services provided prior to the frustrating event. At common law the leading case was *Appleby* v. *Myers* (1867) LR 2 CP 651. The claimants contracted to make and erect machinery in the defendants' factory and to maintain the machinery for two years. Payment was to be upon completion of the work. After part of the machinery had

been erected, an accidental fire destroyed the factory and machinery and frustrated the contract. It was held that the claimants could not recover in respect of their work because they were only entitled to payment when performance was completed (called the 'entire obligations' or 'entire contracts' rule, see further 21.2) and, as the fire had prevented completion of the work, they were not entitled to payment. This rule caused obvious hardship to the provider of services under a frustrated contract and it has since been replaced by s.1(3) of the Law Reform (Frustrated Contracts) Act 1943. Section 1(3) states that

> 'where any party to the contract has, by reason of anything done by any other party thereto in, or for the purpose of, the performance of the contract, obtained a valuable benefit (other than a payment of money to which the last foregoing subsection applies) before the time of discharge, there shall be recoverable from him by the said other party such sum (if any), not exceeding the value of the said benefit to the party obtaining it, as the court considers just, having regard to all the circumstances of the case and, in particular –
>
> (a) the amount of any expenses incurred before the time of discharge by the benefited party in, or for the purpose of, the performance of the contract, including any sums paid or payable by him to any other party in pursuance of the contract and retained or recoverable by that party under the last foregoing subsection, and
>
> (b) the effect, in relation to the said benefit, of the circumstances giving rise to the frustration of the contract.'

This subsection is an unnecessarily complex provision (for details see Goff and Jones, 1998 and McKendrick, 1995). Its basic effect is that, where one party to the contract has conferred upon the other party a 'valuable benefit' (other than a payment of money which is governed by s.1(2)) before the time of discharge, he shall be entitled to recover a 'just sum' which shall not exceed the value of the benefit which he has conferred upon the other party. In *BP* v. *Hunt* [1979] 1 WLR 783, Robert Goff J concluded that there were two steps involved in a section 1(3) claim. The first was the identification and valuation of the benefit. The subsection does not define what is to count as a benefit: it could be either the value of the services performed or it could be the end product of the services. In *BP* v. *Hunt* (above) Robert Goff J concluded that in 'an appropriate case' it was the end product which was to be regarded as the benefit. He appeared to envisage two circumstances in which a court could have regard to the value of the services in identifying the benefit; the first arising where the service by its very nature does not result in an end product (for example,

the transportation of goods) and the second where the service results in an end product which has no objective value (for example, a claimant who commences 'the redecoration, to the defendant's execrable taste, of rooms which are in good decorative order'). But he held that, where the end product is destroyed by the frustrating event, the provider of the services has no claim under s.1(3) because the value of the benefit (namely, the end product) has been reduced to zero by the frustrating event. This interpretation of 'benefit' has unfortunate consequences. It means that the result in *Appleby* v. *Myers* (above) would be unaffected by the Act because the claimants' work was destroyed by the fire and so did not result in any end product. Although this interpretation of 'benefit' has 'been heavily criticised (see Treitel, 1999, p.853 and Haycroft and Waksman, 1984), such an interpretation has also been adopted in the Commonwealth (*Parsons Bros Ltd* v. *Shea* (1866) 53 DLR (2d) 86) and it appears to accord closely with the structure of s.1(3), which draws a distinction between the claimant's performance and the defendant's benefit and so it cannot be said that the defendant's benefit is the value of the claimant's performance.

The second step in a s.1(3) claim is the assessment of a 'just sum'. Here it must be remembered that the value of the benefit obtained acts as ceiling on the 'just sum'. Robert Goff J held that the contractual allocation of risk will always be a relevant factor in deciding what is a just sum. But it is very difficult to predict what a court will award as a just sum. Robert Goff J sought to provide a measure of certainty by stating that the aim of the court in assessing the just sum ought to be 'the prevention of the unjust enrichment of the defendant at the [claimant's] expense' and that the assessment should therefore be similar to that undertaken by a court in a *quantum meruit* claim. But this approach seems to have been rejected by the Court of Appeal when Lawton LJ stated that 'what is just is what the trial judge thinks is just' and that an appellate court is not entitled to interfere with the assessment of the just sum by the trial judge 'unless it is so plainly wrong that it cannot be just' (*BP* v. *Hunt* [1982] 1 All ER 925, 980). This leaves the issue to the almost untrammelled discretion of the trial judge. It is regrettable that the Court of Appeal did not establish guidelines to assist trial judges in the exercise of their discretion to ensure a measure of consistency in decided cases and out-of-court settlements.

It must be concluded that s.1(3) is shoddily drafted and that it produces results which are, in principle, undesirable. A benefit should be identified as the value of the services and not as the end product of the services. The focus of the Act is upon the prevention of unjust enrichment (per Robert Goff J in *BP* v. *Hunt* [1979] 1 WLR 783, 799) and, consequently, it does

not address itself to the recovery of reliance losses which do not result in a benefit to the other party, nor does it seek to apportion the losses between the parties. In failing to address itself to these issues, the 1943 Act is sadly deficient and it is no surprise to learn that its restricted approach has recently been rejected in the Commonwealth (see, generally, McKendrick, 1991).

14.18 Conclusion

In this chapter we have sought to argue that in cases of common mistake and frustration the courts are dealing with the same issue; namely the allocation of risk of an unforeseen event. In both groups of cases the courts are faced with an issue of construction: did the contract make provision for the events which have happened? If it has, then the contract governs the situation. But if it has not, then the court must consider whether it has jurisdiction to intervene and grant relief on the basis of mistake or frustration, depending on the point in time at which the event occurred. When the cases are put together in this way it can be seen that mistake in equity is very much the odd man out (note that no one would appear to have argued that there is a corresponding doctrine of frustration in equity). Both mistake at common law and frustration operate within very narrow confines and emphasise the need to hold men to their bargains. Their concern is with the preservation of certainty and the desire to prevent the doctrine from being used as an escape route by those who are looking for a way out of a bad bargain (the point that both jurisdictions employ the 'same concept' has recently been made by Evans LJ in *William Sindall plc* v. *Cambridgeshire County Council* [1994] 1 WLR 1016, 1039). Mistake in equity, on the other hand, is a much broader doctrine. Its concern is not with the preservation of certainty but with doing justice between the parties and preventing unconscientious conduct. Seen in this light, mistake in equity appears even more anomalous and, in fact, its survival as a part of English law may be attributable simply to the fact that there was no appeal from the decision of the Court of Appeal in *Solle* v. *Butcher* (above). To demonstrate this point, reference can be made to the fate of Lord Denning's judgment in *British Movietonews Ltd* v. *London and District Cinemas* [1951] 1 KB 190, 198. Six months after giving judgment in *Solle* v. *Butcher*, Lord Denning sought in *British Movietonews* to give the courts a broader power to qualify obligations in order to do what was just and reasonable after a subsequent uncontemplated turn of events. But, on appeal ([1952] AC 166), the House of Lords firmly rejected Lord Denning's innovation and held that the court had no such broad

qualifying power. They held that the only doctrine which could be invoked to set aside a contract because of a subsequent uncontemplated turn of events was the traditional but narrow doctrine of frustration. There can be little doubt that a similarly constituted House of Lords would have given equally short shrift to Lord Denning's innovations in *Solle*. But the fact that there was no appeal prevented them from considering the issue. Thus the judgment of the Court of Appeal survived and, as has been noted (14.7), it has been applied by the Court of Appeal in subsequent cases. But it cannot be denied that its continued existence is an anomaly which is out of step with the conservative approach adopted in common law mistake and frustration cases. The future of mistake in equity therefore requires careful examination by the House of Lords.

Although it has been argued in this chapter that there is a very close relationship between common mistake and frustration, it is important to acknowledge that this analogy is not accepted by everyone. Thus, Professor Treitel (1999, p.862) has described the analogy between common mistake and frustration as an 'interesting and sometimes helpful' one but argues that it 'should not be pressed too far'. In particular, Treitel argues that mistake and frustration are 'different juristic concepts; the one relating to the formation and the other to the discharge of contracts'. Although it is true that one relates to formation and the other to discharge, they both relate to the same issue, as can be seen from the *Amalgamated Investments* case (14.1) and a comparison of *Griffiths* v. *Brymer* (14.5) and *Krell* v. *Henry* (14.10). Secondly, Treitel argues that events which frustrate a contract may not be sufficient to set aside a contract on the ground of mistake. This point I have already conceded, but the difference is a matter of degree, not kind. Finally, Treitel points out that the effects of frustration and mistake are different; frustration cases being subject to the Law Reform (Frustrated Contracts) Act 1943. This is true. But the 1943 Act was enacted as a response to the particular problems which had emerged in the law relating to the remedial consequences of frustration as a result of the decision of the Court of Appeal in *Chandler* v. *Webster* (above). The Act was not extended to mistake because it was based on a report prepared by the Law Revision Committee, whose terms of reference were confined to a reconsideration of *Chandler* v. *Webster* (see McKendrick, 1991). The fact that Parliament did not or could not see fit to draw the analogy between common mistake and frustration in 1943 should not prevent us from drawing the analogy today. The same principles should be applicable to the remedial consequences of both common mistake and frustration. In both cases unjust enrichments should be reversed and, if this is thought to be insufficient to achieve a satisfactory result in all cases,

consideration should be given to the principles upon which any loss caused by the mistake or the frustrating event should be apportioned between the parties. There is no need to provide a different remedial regime for the consequences of common mistake and frustration.

Summary

1 Where both parties enter into a contract under a common fundamental mistake which relates to an essential element of the subject-matter of the contract then the contract is void at law.

2 A mistake may be sufficiently fundamental to avoid a contract where both parties are mistaken as to the existence (or possibly the identity) of the subject-matter of the contract. Despite the enactment of s.6 of the Sale of Goods Act 1979, a mistake as to the existence of the subject-matter may not inevitably render a contract void; it may depend upon the construction of the contract (see *McRae* v. *Commonwealth Disposals Commission*).

3 A mistake may be sufficiently fundamental to avoid a contract where both parties believe that the contract is capable of being performed when, in fact, it is not. The impossibility may be physical, legal or commercial.

4 A mistake as to the quality of the subject-matter of the contract may be sufficiently fundamental to avoid a contract. But the courts are extremely reluctant to hold a contract void on such a ground. The mistake must relate to an 'essential and integral element of the subject matter' of the contract.

5 Mistake at law is supplemented by the more flexible doctrine of mistake in equity. A contract may be set aside in equity where the mistake is a substantial one. Such a mistake renders a contract voidable and the court may set aside the contract on terms.

6 A contract is frustrated where, after the contract was concluded, events occur which make performance of the contract impossible, illegal or something radically different from that which was in the contemplation of the parties at the time they entered into the contract.

7 A contract is not frustrated where the parties have made express provision for the consequences of the alleged frustrating event in their contract, where the alleged frustrating event was a foreseeable one and where the frustration was 'self-induced'. But express provision for, and foreseeability of, the frustrating event are irrelevant in cases of trading with the enemy.

8 A contract which is discharged on the ground of frustration is brought to an end automatically by the operation of a rule of law, irrespective of the wishes of the parties.

9 Sums paid prior to the frustrating event are recoverable, sums payable prior to the time of discharge cease to be payable and the payee may be entitled to set off against the sums so paid expenses which he has incurred before the time of discharge in, or for the purpose of, the performance of the contract (s.1(2) of the 1943 Act).

10 Where one party to the contract has conferred upon the other party a 'valuable benefit' (other than a payment of money which is governed by s.1(2)) before the time of discharge, he shall be entitled to recover from that other party a 'just sum' which shall not exceed the value of the benefit which he has conferred upon the other party (s.1(3) of the 1943 Act).

Exercises

1 What is the scope of the doctrine of common mistake at law?
2 What is the proper interpretation to be placed upon the decision of the House of Lords in *Couturier* v. *Hastie*?
3 When will a mistake as to the quality of the subject-matter of the contract render a contract void?
4 What is the relationship between mistake at law and mistake in equity?
5 Compare and contrast *Bell* v. *Lever Brothers* and *Magee* v. *Pennine Insurance Co.*
6 When will the courts hold that a contract has been frustrated? Illustrate your answer.
7 What is 'self-induced frustration'?
8 What are the effects of frustration upon a contract?
9 What is the relationship, if any, between common mistake and frustration?

15 Illegality

15.1 Introduction

In this chapter we turn to consider substantive limitations upon the enforceability of contracts. As a general rule, the courts will not enforce a contract which is illegal or which is otherwise contrary to public policy. Nor, as a general rule, will they permit the recovery of benefits conferred under such a contract. It may seem perfectly sensible and just for the courts to refuse their assistance to a party to a transaction which is illegal or contrary to public policy. But the picture is more complex than would at first sight appear.

An example will help to illustrate the issues at stake here. In *Pearce* v. *Brooks* (1866) LR 1 Ex 213, the claimants were coachbuilders who hired out an ornamental brougham (or carriage) to the defendant. The defendant was a prostitute and she planned to use the brougham to attract her customers. This fact was known to the claimants. The defendant returned the brougham in a damaged condition, having paid only the second instalment on it. The claimants' action for damages for breach of contract failed. The contract was illegal and could not be enforced.

A number of justifications can be adduced to support such a rule. The first is that the court cannot be called upon to aid a willing party to an illegal contract or to a contract which is contrary to public policy. The second is that justice would be tainted and the dignity of the court offended by intervention on behalf of the claimants. The third is that a refusal to grant relief will make entry into illegal contracts a hazardous enterprise and will thus deter people from entering into such contracts.

But these arguments are not always persuasive. The first argument does not apply to the party who innocently enters into an illegal contract. Nor is the dignity of the court always offended by intervention on behalf of a party to an illegal contract; there is a vast difference between a contract involving gross immorality or a contract to rob a bank and a contract which innocently infringes a piece of regulatory legislation. The third argument rests upon the rather dubious assumption that everyone knows the law and will take heed of its deterrent effect. Deterrence is also properly the function of the criminal law, not the civil law.

There are other competing policies which must be considered. The first is the argument from freedom of contract; that the parties should be as

free as possible to regulate their own affairs. The second competing policy is the need to prevent unjust enrichment. For example, the defendant in *Pearce* v. *Brooks* obtained the use of the brougham without having to pay the full hire. Now, on the facts of that case, the 'greater goal' of deterring entry into such contracts may have outweighed the need to prevent the unjust enrichment of the defendant. But in other cases we may not be prepared to countenance such unjust enrichment.

It is very important to understand that the legal regulation of illegal contracts and of contracts which are contrary to public policy is characterised by a tension between competing policies. The courts wish, on the one hand, to discourage entry into illegal contracts but, on the other hand, they also wish to uphold freedom of contract and prevent unjust enrichment. The result is tension and a degree of inconsistency in the case law.

15.2 Some Difficulties of Classification

Illegal contracts come in different shapes and sizes. Some involve gross immorality or a calculated attempt to break the law, while others involve innocent infringement of regulatory legislation. A contract to rob a bank has little in common with a contract which is performed by one of the parties in such a way that a statutory instrument is innocently infringed. Indeed, illegal contracts come in so many different shapes and sizes that it is difficult to find an appropriate classification for all the cases (see Furmston, 1965). Treitel (1999) distinguishes between contracts which involve the 'commission of a legal wrong', 'contracts contrary to public policy' and contracts which are declared by statute to be 'void' or 'unenforceable'. Cheshire, Fifoot and Furmston (1996) distinguish between contracts which are 'rendered void by statute', contracts which are 'illegal by statute or at common law' and 'contracts which are void at common law on grounds of public policy'. No two commentators appear to adopt the same classification. But these different classifications do not reflect radical disagreement as to the content of the relevant rules of law. Rather, the categorisation is undertaken largely for the purpose of ease of exposition.

The approach which will be adopted in the present chapter is, first, to discuss illegality in the performance of a contract, and then to distinguish between statutory illegality and common law illegality. The latter division should not be taken to suggest that it is easier to establish the existence of statutory illegality than common law illegality. The function of this division is to emphasise that the techniques employed by the courts in each case are rather different. In the case of statutory illegality, the courts are

seeking to discern the intention of Parliament and the effect of the breach of the statute upon the contract. But in the case of common law illegality, the courts have greater scope to identify their own conceptions of public policy. The limiting feature, however, is that the courts do not wish to be seen to be employing their own idiosyncratic conceptions of public policy and, at the same time, they are aware that Parliament now has the principal role to play in establishing the limits of public policy.

15.3 Illegality in Performance

Illegality may affect a contract in two principal ways. In the first place, the illegality may relate to the formation of the contract, so that the contract is illegal at the moment at which it is formed. Such a contract is void *ab initio* because it is infected with the illegality from the very outset. Secondly, the illegality may arise in the performance of an otherwise valid and enforceable contract. Here the contract is valid at the moment of formation and it is only infected with the illegality when it occurs during the performance of the contract. An example will illustrate the point. Two parties enter into a contract for the transportation of goods. At the moment of formation the contract is good and enforceable. But let us suppose that, while transporting the goods, the carrier commits a criminal offence by speeding. Does such an illegal act, committed in the course of the performance of the contract, invalidate the contract? In *St John Shipping Corporation* v. *Joseph Rank Ltd* [1957] 1 QB 267, 281, Devlin J rejected the argument that violation of the speed limit in the course of performance of the contract would, of itself, render the contract unenforceable by the party guilty of the offence. This must be right. The criminal courts will pass judgment on the offence committed; the civil courts should enforce the contract. But what are the limits of this rule? When will an illegal act committed in the course of performance of the contract invalidate the contract? This is not an easy question to answer. Separate consideration must be given to the position of the party who committed the criminal offence and the position of the other, 'innocent' party.

In deciding whether the party who committed the criminal offence can enforce the contract it is necessary to examine the judgment of Devlin J in *St John Shipping Corporation* v. *Joseph Rank Ltd* (above). A shipowner committed a statutory offence when he overloaded his ship in the performance of certain contracts for the carriage of goods. The shipowner was held to be entitled to sue to recover the freight, despite the illegality. Devlin J held that the purpose behind the statute was to penalise the conduct which led to the contravention of the statute and not to prohibit

the contract itself. The contract therefore remained enforceable. Similarly, in *Shaw* v. *Groom* [1970] 2 QB 504, a landlord committed an offence by failing to give his tenant a rent-book. It was held that the landlord was nevertheless entitled to sue for the rent because the purpose behind the legislation was to punish his failure to issue a rent-book but not to invalidate the tenancy agreement (contrast the more restrictive approach adopted in the earlier case of *Anderson* v. *Daniel* [1924] 1 KB 138, where the 'guilty' party was held to be unable to enforce the contract). Although both of these cases concern statutory illegality, it is suggested that the question which should be asked in all cases is: was it the purpose of the statute (or the common law rule) that a breach committed in the course of the performance of a contract should invalidate the contract?

The claim by the innocent party to enforce the contract is a much stronger one, especially where he does not know of or consent to the illegality. This was recognised by the court in *Archbolds (Freightage) Ltd* v. *S Spangletts Ltd* [1961] 2 QB 374. A contract was made for the carriage of a consignment of whisky and, in performing the contract, the carrier committed a criminal offence because the vehicle which he used to transport the whisky was not licensed to carry goods belonging to a third party. It was held that the claimant could nevertheless sue for breach of the contract of carriage because he was unaware of the illegality and so was not tainted by it (see too *Marles* v. *Philip Trant & Sons Ltd* [1954] 1 QB 29). Devlin LJ stated that he thought that

> 'the purpose of this statute is sufficiently served by the penalties prescribed for the offender; the avoidance of the contract would cause grave inconvenience and injury to members of the public without furthering the object of the statute.'

But where the 'innocent' party has knowledge of the commission of the illegality, then it is more likely that he will be unable to enforce the contract. In *Ashmore, Benson, Pease & Co Ltd* v. *A V Dawson Ltd* [1973] 1 WLR 828, the parties entered into a contract for the transportation of tube banks. The defendants sent articulated lorries which could not lawfully be used to carry the load. The load was damaged in transit. The claimant sued for damages. The action failed because there was evidence that the claimants' transport manager knew of the illegal performance and that, by sanctioning the illegal performance of the contract, he had 'participated' in the illegality. The crucial role played by the knowledge of the innocent party appears, at first sight, to be inconsistent with the maxim that ignorance of the law is no excuse (*Nash* v. *Stevenson*

Transport Ltd [1936] 2 KB 128). It is true that, where at the moment of formation, a contract is declared to be illegal, the knowledge of the parties is irrelevant. Where, on the other hand, the illegality occurs in the performance of a contract which is capable of lawful performance, the knowledge of the innocent party is a relevant consideration because his ignorance relates, not to the *law*, but to the *fact* that the other contracting party has performed the contract in an illegal manner. His knowledge of the illegality is therefore a relevant consideration.

15.4 Statutory Illegality

A contract is illegal if its formation is expressly or impliedly prohibited by statute. Where the making of the contract is expressly prohibited, no difficulties arise; the contract is illegal. Greater difficulties arise where it is alleged that Parliament has impliedly prohibited the *making* of such a contract (see Buckley, 1975). The function of the court in such a case is to interpret the statute to discern whether, on its proper construction, the Act prohibits the making of such a contract. The difficulty is that Parliament has often not addressed itself to this issue. So the process of 'finding' the 'intention' of Parliament is frequently an extremely artificial one.

In *Re Mahmoud and Ispahani* [1921] 2 KB 716, the Seeds, Oils and Fats Order 1919 stated that 'a person shall not . . . buy or sell or otherwise deal in' linseed oil without a licence. The defendant misrepresented to the claimant that he had a licence. The defendant later refused to accept delivery of the order. The claimant sued the defendant for damages. The defendant argued that the contract was illegal because he did not have a licence. The court held that the claimant could not maintain his action for damages because such an action would undermine the purpose behind the statute. Bankes LJ stated that the Order was 'a clear and unequivocal declaration by the Legislature in the public interest that this particular type of contract shall not be entered into'. Yet the consequences for the claimant were extremely harsh and it has been doubted whether the court correctly identified the intention of Parliament (see Greig and Davis, 1987, p.1117). In an effort to avoid the possibility of a court misinterpreting the intention of Parliament, Acts of Parliament now frequently specify the consequences for a contract which has been entered into in breach of the Act. However, the courts are generally reluctant to conclude that a statute impliedly prohibits the making of a contract (see *Archbolds (Freightage) Ltd* v. *Spanglett Ltd* (above) and *St John Shipping Corp* v. *Joseph Rank Ltd* [1957] 1 QB 267, 289).

15.5 Gaming and Wagering Contracts

Parliament will occasionally declare a particular type of contract to be 'void'. For example, s.18 of the Gaming Act 1845 states that 'all contracts or agreements, whether by parole or in writing, by way of gaming or wagering shall be null and void'. The section further provides that no action can be maintained in any court for the recovery of 'any money or valuable thing alleged to be won upon any wager'. Finally, the section provides that no action can be brought to recover any money or valuable thing which has been deposited in the hands of any stakeholder, although the interpretation placed upon this part of the section is that a deposit can be recovered before it has been paid over to the winner (*Diggle* v. *Higgs* (1877) 2 Ex D 442).

15.6 Illegality at Common Law

A contract may be illegal at common law. The scope of the doctrine of illegality at common law is extremely wide. It is often summed up in the maxim that a court will not enforce a contract which is 'contrary to public policy'. 'Illegality' at common law therefore goes beyond contracts to commit a crime and extends, for example, to contracts which are contrary to good morals and contracts which are prejudicial to the institution of marriage. Some commentators seek to divide the cases into two distinct compartments (see Cheshire, Fifoot and Furmston, 1996), namely, contracts which are 'illegal' at common law on grounds of public policy and contracts which are 'void' at common law on grounds of public policy. But this division is a troublesome one because 'those who use the classification cannot always agree' on which contracts are 'illegal' and which are 'void' (see Treitel, 1999, p.393). In this chapter we shall not attempt to divide the cases up in such a manner. Rather, we shall analyse the cases under the title of contracts which are 'illegal' at common law because they are 'contrary to public policy' (often referred to, for the sake of brevity, as 'illegal' contracts) and we shall seek to identify the scope of the doctrine of public policy at common law.

In deciding whether a particular contract is 'contrary to public policy', the courts cannot shelter behind the argument that they are simply giving effect to the intention of Parliament. They must evolve their own conceptions of public policy. Here the courts are open to the charge of usurping the function of Parliament and of giving effect to their own personal opinions on what is, and what is not, morally justifiable. Thus, we find that Burroughs J once described public policy as 'a very unruly horse, and

when once you get astride it you never know where it will carry you' (*Richardson* v. *Mellish* (1824) 2 Bing 229, 252). On the other hand, Lord Denning has argued that: 'with a good man in the saddle, the unruly horse can be kept in control. It can jump over obstacles' (*Enderby Town Football Club Ltd* v. *The Football Association Ltd* [1971] Ch 591, 606).

The courts have, in fact, been extremely cautious and conservative in their formulation of public policy. We shall now survey the different grounds upon which the courts have held a contract to be contrary to public policy and conclude with an examination of the scope of the doctrine of public policy at common law.

15.7 Contracts Contrary to Good Morals

A contract to promote sexual immorality is illegal on the ground that it is contrary to public policy. We have already noted that in *Pearce* v. *Brooks* (above) it was held that a contract to supply goods to a prostitute to be used by her in the furtherance of her profession was illegal. Similarly, a promise by a man to pay a woman if she will become his mistress is illegal (*Franco* v. *Bolton* (1797) 3 Ves 368). At one point in time, contracts between cohabiting couples who were not married were contrary to public policy. But the attitude adopted by the courts towards extra-marital relationships has gradually changed to reflect the growing incidence of such relationships. Where the parties are living together in a 'stable' extra-marital relationship, it is highly unlikely that a court today would conclude that an agreement entered into by them in relation to the purchase of property is contrary to public policy (so, for example, in *Tinsley* v. *Milligan* [1994] 1 AC 340, it was not argued that the parties' agreement to purchase property was unenforceable on the ground that they were lovers, see further 15.18).

15.8 Contracts Prejudicial to Family Life

Contract law is also protective of family relationships. Contracts which are prejudicial to the institution of marriage are contrary to public policy; thus a contract which restrains a party from marrying (*Lowe* v. *Peers* (1768) 2 Burr 2225) or a contract under which one person undertakes to procure the marriage of another in return for a fee is illegal (*Hermann* v. *Charlesworth* [1905] 2 KB 123, although it is questionable whether this case would be followed today as society's attitude to introduction agencies has changed considerably). But a promise to pay a sum of money to

a person for as long as they remain single is valid (*Gibson* v. *Dickie* (1815) 3 M & S 463). In *Spiers* v. *Hunt* [1908] 1 KB 720, a promise by a man to marry the claimant after the death of his wife was held to be contrary to public policy because it encouraged sexual immorality and was likely to encourage the break-up of his marriage (although it should be noted that the action for breach of promise to marry has now been abolished by s.1 of the Law Reform (Miscellaneous Provisions) Act 1970). A separation agreement entered into by spouses who are living together is invalid (*Brodie* v. *Brodie* [1917] P 271), although such an agreement can validly be made once the parties have separated. Similarly, a parent cannot by contract transfer to another adult his rights and duties in relation to a child (although, in an appropriate case, an adoption order can be made by a court).

15.9 Contracts to Commit a Crime or a Civil Wrong

A contract to commit a crime is illegal on the ground that it is contrary to public policy. In *Bigos* v. *Bousted* [1951] 1 All ER 92, the parties entered into a contract which was contrary to the exchange control regulations. The contract was held to be unenforceable. Similarly, contracts to defraud the revenue are contrary to public policy (*Miller* v. *Karlinski* (1945) 62 TLR 85). In *Alexander* v. *Rayson* [1936] 1 KB 169, the parties entered into a contract to defraud the rating authority by showing the value of the property at less than its actual value. The contract was held to be illegal and unenforceable. A contract is also illegal where it makes provision for the payment of money to a person as a result of his commission of an unlawful act. In *Beresford* v. *Royal Exchange Assurance* [1938] AC 586, a person who had insured his life for £50,000 committed suicide. It was held that his estate was not entitled to enforce the policy even though it expressly covered death by suicide because, at that time, suicide was a criminal offence (the reasoning is now practically obsolete because suicide is no longer a crime). To permit a person, or his estate, to benefit from his own crime was held to be contrary to public policy.

A contract to commit a tort is illegal, for example a contract to publish a libel (*Clay* v. *Yates* (1856) 1 H & C 73). Where neither party knows that the performance of the contract involves the commission of a tort then the contract is not illegal.

A contract to indemnify a person against criminal liability is illegal where the criminal offence is committed with a guilty intent, but the position is unclear where the crime is committed with no guilty intent.

A contract to indemnify a person against liability in tort is illegal if the tort is intentionally and knowingly committed.

15.10 Contracts Prejudicial to the Administration of Justice

Contracts which are prejudicial to the administration of justice are illegal. Thus a contract to stifle a prosecution may be illegal and a contract under which one party promises to give false evidence in criminal proceedings is illegal (*R* v. *Andrews* [1973] QB 422). Agreements to obstruct bankruptcy proceedings are illegal (*Elliott* v. *Richardson* (1870) LR 5 CP 744). Agreements which tend to abuse the legal process by encouraging litigation which is not bona fide are contrary to public policy.

Also contrary to public policy are contracts which seek to oust the jurisdiction of the courts by stipulating that a contracting party is not entitled to access to the courts in the event of a dispute between the parties. But contracting parties may validly provide that a dispute must be referred to arbitration before it can be brought to court (*Scott* v. *Avery* (1855) 5 HLC 811). The scope of judicial control over arbitration proceedings has now been radically reduced. While a party to an arbitration remains entitled to apply to the court to challenge an award in the arbitral proceedings 'on the ground of serious irregularity affecting the tribunal, the proceedings or the award' (Arbitration Act 1996, s.68(1)), the entitlement to appeal to a court on a point of law has been severely curtailed (see s.69 of the Arbitration Act 1996 and the guidelines laid down in *The Nema* [1982] AC 724). The parties to the arbitration can even contract out of this limited right of appeal to the court, although in the case of a 'domestic arbitration agreement' such an agreement can only be made after the commencement of the arbitration (see s.87 of the Act).

15.11 Contracts Prejudicial to Public Relations

Contracts which are prejudicial to foreign friendly countries are contrary to public policy and unenforceable. Thus a contract to facilitate the forcible overthrow of the government of a friendly country is unenforceable (*De Wutz* v. *Hendricks* (1824) 2 Bing 314). A similar rule applies to contracts which are prejudicial to the interests of the State; trading with the enemy is declared to be illegal under the Trading with the Enemy Act 1939.

Contracts which seek to further or promote corruption in public life are illegal. Thus a contract to sell a public office or a public honour is illegal. In *Parkinson* v. *College of Ambulance Ltd* [1925] 2 KB 1, the parties entered into a contract under which one party promised to procure a knighthood for the other. The contract was held to be contrary to public policy.

15.12 Contracts in Restraint of Trade

A contract or a covenant in restraint of trade is an undertaking whereby one party agrees to restrict his freedom to trade or his freedom to conduct his profession or business in a particular locality for a specified period of time. A contract which is in restraint of trade is void and unenforceable unless it can be shown to be reasonable. The doctrine of restraint of trade is based upon considerations of public policy. But every contract contains an element of restraint of trade. Let us suppose that I enter into a contract to give a course of fifty lectures over a two-year period. The contract restricts my freedom to trade during the hours in which I have agreed to give the lectures. But such a contract is not caught by the restraint of trade doctrine.

What types of contract are caught by the doctrine? The question is an important one because, while the courts have no general power to review contract terms in the name of reasonableness, the restraint of trade doctrine gives them the power to strike down a clause unless the party relying upon it can show affirmatively that it is reasonable. The doctrine is a powerful one and the question of its scope is therefore one of fundamental importance (see Smith, 1995). It is generally accepted that there are two principal types of contract to which the doctrine applies. The first is a covenant by an employee not to compete with his employer either during or after his employment, and the second is a covenant by the seller of a business and its goodwill not to carry on a business which will compete with the business bought by the purchaser. The doctrine can also apply to other contracts but it is extremely difficult to define its limits. In *Esso Petroleum Co Ltd* v. *Harper's Garage (Stourport) Ltd* [1968] AC 269, the doctrine was applied to a contract under which a garage agreed to accept all of its petrol from one supplier for a considerable period of time. Lord Reid stated that he 'would not attempt to define the dividing line between contracts which are and contracts which are not in restraint of trade' and that the better approach was 'to ascertain what were the legitimate interests of the [suppliers] which they were entitled to protect and then to see whether these restraints were more than adequate for that purpose'.

Once it is decided that the contract is subject to the doctrine then it is for the party who is seeking to rely on the clause to show that it is reasonable in two respects. The first is that it must be reasonable as between the parties and the second is that it must be reasonable in the public interest (although the latter requirement has been criticised by Smith, 1995). In analysing the reasonableness requirements, we shall discuss separately covenants in contracts of employment, covenants in contracts for the sale of a business and, finally, other contracts to which the doctrine applies.

15.13 Contracts of Employment

A contract of employment may contain a covenant which purports to restrict the freedom of the employee to work either during or after the termination of his employment. Such covenants are scrutinised with great care by the courts. In deciding whether the restraint clause is reasonable as between the parties, two factors are particularly relevant. The first is that the covenant must seek to protect some legitimate interest of the employer. Lord Parker stated in *Herbert Morris Ltd* v. *Saxelby* [1916] 1 AC 688, that an employer must establish that he has: 'some proprietary right, whether in the nature of a trade connection or in the nature of trade secrets, for the protection of which such a restraint is . . . reasonably necessary'. Thus, an employer can legitimately restrain an employee who has come into contact with customers of the employer in such a way as to acquire influence over them (*Fitch* v. *Dewes* [1921] 2 AC 158) or who has acquired trade secrets or confidential information belonging to the employer (*Forster and Sons* v. *Suggett* (1918) 35 TLR 87). But an employer is not entitled to protect himself against the use of the 'personal skill and knowledge' acquired by the employee in the course of the employer's business. Such skills belong to the employee and he is free to exploit them in the market-place.

The second factor is that the restraint must be reasonable in terms of subject-matter, locality and time. An employer is not generally entitled to restrain an employee from carrying on a business which is different from that in which he was employed. Similarly, the restraint must not be wider in area than is necessary to protect the employer's interest (see *Mason* v. *Provident Clothing and Supply Co* [1913] AC 724, in which a clause restraining an employee from working in a similar business within 25 miles of London was held to be unreasonable). The restraint must also be reasonable in terms of time, although it is possible for the restraint clause to be unlimited in time and still be reasonable (*Fitch* v. *Dewes* (above)).

Once it is demonstrated that the restraint is reasonable as between the

parties, it must also be demonstrated that it is reasonable in the interests of the public. However, the courts are extremely reluctant to conclude that an agreement, which is reasonable as between the parties, is unenforceable because it is contrary to the interests of the public, especially in the case of a restraint clause in a contract of employment (but see *Wyatt* v. *Kreglinger and Fernau* [1933] 1 KB 793).

15.14 Contracts for the Sale of a Business

A contract for the sale of a business frequently contains a clause under which the vendor of the business agrees not to set up a similar business in the immediate vicinity for a period of time. The purchaser has bought the goodwill in the business and he is entitled to protect his purchase by an appropriately drawn restraint clause. Such a clause is not viewed with the hostility of a restraint clause in a contract of employment.

The restraint clause must be reasonable as between the parties and two factors are of particular relevance here. The first is that the buyer must establish a proprietary interest which the clause is seeking to protect. That is to say, when a buyer purchases a business and pays for the goodwill of the business, he is entitled to take reasonable steps to protect that interest. The second factor is that the clause must be reasonable in the light of all the circumstances of the case. It will be unreasonable if it goes further than reasonably necessary for the protection of his interest in point of space, time or subject-matter. The reasonableness of a clause depends upon all the facts of each case (see *Nordenfelt* v. *Maxim Nordenfelt* [1894] AC 535, in which a worldwide restraint was upheld because of the limited number of manufacturers in the particular industry).

Once the clause is shown to be reasonable as between the parties, it must be shown to be reasonable in the public interest. The courts have, once again, been reluctant to conclude that an agreement which is reasonable as between the parties is unenforceable because it is contrary to the public interest.

15.15 Restrictive Trading and Analogous Agreements

We have already noted that it is extremely difficult to define the limits of the doctrine of restraint of trade. For example, it was once thought that exclusive dealing agreements were not within the scope of the doctrine or, if they were, they were valid because they were not contrary to the

public interest. But that view received a fatal blow as a result of the decision of the House of Lords in *Esso Petroleum Ltd* v. *Harper's Garage (Stourport) Ltd* (above). A garage company, which owned two garages, entered into a solus agreement with Esso under which it agreed to buy all its petrol from Esso, to keep the garage open at all reasonable hours and not to sell the garage without ensuring that the purchaser entered into a similar agreement with Esso. One agreement was to last for 5 years and the other for 21 years. In effect, the garage owners were tied to Esso for 21 years. It was held that the agreements were governed by the restraint of trade doctrine, that the 5 year agreement with Esso was valid but that the 21 year agreement was invalid. Although the courts have been prepared to extend the scope of the doctrine of restraint of trade to such contracts, they have not subjected them to stringent scrutiny (but contrast the more interventionist approach adopted by the House of Lords in *Schroeder Music Publishing Co Ltd* v. *Macaulay* [1974] 1 WLR 1308, where there was a considerable disparity in bargaining power between the parties). The courts are willing to find the existence of a legitimate interest which such exclusive dealing agreements seek to protect, such as maintaining retail outlets or protecting a competitive position in the market-place, and they have adopted a *laissez faire* approach to the reasonableness requirements (see *Alec Lobb (Garages) Ltd* v. *Total Oil (Great Britain) Ltd* [1985] 1 WLR 173). The consequence of this *laissez faire* approach has been that the courts have played a secondary role in the regulation of anti-competitive practices and the primary role is now played by Parliament (see the Competition Act 1998) and by European Community law (see Article 81 of the Treaty of Rome). There is no doubt that Parliament is better equipped than the common law to engage in the regulation of such allegedly anti-competitive practices (see Trebilcock, 1976, where he subjects the decision of the House of Lords in *Schroeder* v. *Macaulay* (above) to substantial criticism).

15.16 The Scope of Public Policy

The doctrine of public policy at common law is an extremely conservative one and operates within relatively rigid confines. Indeed, Lord Halsbury once stated that the courts cannot 'invent a new head of public policy' (*Janson* v. *Driefontein Consolidated Mines Ltd* [1902] AC 484). Such a restrictive approach is no longer generally accepted. The courts are prepared gradually to adapt the existing categories to reflect changing social and moral values (see, for example, the discussion of contracts

between cohabiting couples at 15.7), although they remain extremely reluctant to extend the doctrine to a contract of a type to which the doctrine has never been applied before. Such a rigidly controlled doctrine has the merit of limiting the ability of individual judges to develop their own idiosyncratic conceptions of public policy. The task of placing limits upon freedom of contract in the name of public policy is therefore left largely to Parliament. A judge in a modern case would not conclude that a contract which was supported by 'inadequate consideration' was void because it was 'contrary to public policy'. But he might be able to say that the contract was voidable because it had been procured by undue influence or as a result of 'inequality of bargaining power' (see 17.3 and 17.4). Doctrines such as undue influence, the rules relating to contractual capacity (Chapter 16), the legal regulation of exclusion clauses (Chapter 11) and the penalty clause rule (21.7) can all be regarded as 'disguised extensions or applications of the doctrine of public policy' (Treitel, 1999, p.442). While the courts remain reluctant to expand the doctrine of 'public policy' beyond the contracts to which it has traditionally been applied, the influence of 'public policy' in English law is more likely to be found in cases of alleged undue influence or 'inequality of bargaining power' than in the cases which we have discussed in this chapter.

15.17 The Effects of Illegality

We have already noted the general rule that an illegal contract will not be enforced by the courts. Although the courts will not enforce the contract, they may be prepared to give to the 'innocent party' a remedy on some alternative basis. In *Strongman (1945) Ltd* v. *Sincock* [1955] 2 QB 525, the defendant stated that he would obtain the necessary licences to enable the claimant builders lawfully to modernise his house. The defendant failed to obtain all the licences and he refused to pay for some of the work which the claimants had done, arguing that the contract was illegal. The claimants were unable to sue on the building contract because of the failure to obtain all the licences, but they were able to recover the value of the work which they had done on the ground that the defendant had breached a *collateral warranty* that he would obtain the necessary licences. In *Shelley* v. *Paddock* [1980] QB 348, it was also recognised that an innocent party to an illegal contract could recover damages for fraudulent misrepresentation. By searching out the existence of remedies other than on the contract itself, the court can take steps to protect an innocent party who has relied to his detriment upon a contract which he has subsequently discovered to be illegal.

15.18 The Recovery of Money or Property

A further question which must be asked is: do the courts permit a party to an illegal contract to recover any benefits which he has conferred upon the other party to the contract? The general rule is that the courts will not permit the recovery of benefits transferred under an illegal contract (*Holman* v. *Johnson* (1775) 1 Cowp 341). Once again the courts are seeking to reconcile two competing policies, namely the prevention of unjust enrichment and the need to deter entry into illegal contracts. The general rule reflects the latter policy (for a particularly strong expression of that policy see the judgment of Sir Stephen Brown P in *Taylor* v. *Bhail* [1996] CLC 377, 380). But there are a number of exceptions to the general rule and these exceptions reflect the former policy (see, for example, *Mohamed* v. *Alaga & Co (a firm)* [1999] 3 All ER 699, where the Court of Appeal held that the claimant was entitled to proceed with his restitutionary claim and, in so doing, emphasised the fact that the claimant was less blameworthy than the defendant and that the restitutionary claim did not substantially undermine the rule which rendered the contract unenforceable because the claimant in his restitutionary claim was not seeking to enforce the contract (on the basis that the restitutionary claim was for the reasonable value of the services rendered and not the contract price)).

Before analysing the general rule and the exceptions, a further question must be asked. That question is: on what ground can a party who has conferred a benefit on the other party to the contract seek recovery? The illegality does not, of itself, confer a cause of action. In many cases the illegality is employed as a *defence* to an action for the recovery of the benefit. It could be argued that the general rule denying recovery is based upon considerations of public policy but that, where the parties are not *in pari delicto* (equally guilty), the policy objection to recovery simply disappears. However it is suggested that the preferable view is that in the cases which follow, the grounds on which recovery is sought are the normal grounds of restitution, such as mistake or duress, and that the illegality is used simply as a *defence* to a restitutionary action which would otherwise have succeeded (see Birks, 1985).

Although the precise basis of the claim may not be clear, there are three exceptional cases in which a party can recover benefits conferred under an illegal contract. The first exception arises where the parties are not *in pari delicto*. There are two groups of cases here. The first is where the claimant was under a mistake of fact which rendered him unaware of the illegal nature of the contract (*Oom* v. *Bruce* (1810) 12 East 225). The second arises where the claimant was induced to enter into the illegal

transaction by the fraudulent representation of the defendant which had the effect of concealing the illegal nature of the transaction from the claimant (*Hughes* v. *Liverpool Victoria Legal Friendly Society* [1916] 2 KB 482) or where the claimant was induced to enter into the contract under some form of compulsion amounting to oppression (*Smith* v. *Cuff* (1817) 6 M & S 160). Another aspect of the *in pari delicto* rule is that recovery is permitted where a transaction is rendered illegal under a statute which was enacted in an effort to protect parties in the position of the claimant (*Kasumu* v. *Baba-Egbe* [1956] AC 539 and *Kiriri Cotton* v. *Dewani* [1960] AC 192).

Secondly, a claimant is entitled to recover a benefit conferred under an illegal contract if he repudiates the illegal purpose in time. The payer has a *locus poenitentiae* (a space or time for repentance) and may withdraw from the illegal contract and recover his payment (see *Taylor* v. *Bowers* (1876) 1 QBD 291 and *Kearley* v. *Thomson* (1890) 24 QBD 742, usefully discussed by Beatson, 1975). The justification for this exception is that the parties to an illegal contract should be provided with an incentive to refrain from performing an illegal contract. The scope of the exception is, however, the subject of some uncertainty: for example, it is not clear whether the claimant must genuinely repent (probably not, see Millett LJ in *Tribe* v. *Tribe* [1996] Ch 107, 135) and the exact point in time at which the right to withdraw is lost is difficult to identify (complete performance is a bar to recovery but partial performance, apparently, is not: how 'partial' the performance can remain before the right to withdraw is lost is a matter of conjecture).

Thirdly, a claimant may be able to recover money paid or property transferred under an illegal contract if he can establish his right to the money or the property without relying upon the illegal nature of the contract. The source of this exception lies in the difficult case of *Bowmakers Ltd* v. *Barnet Instruments Ltd* [1945] KB 65 (see also *Belvoir Finance* v. *Stapleton* [1971] 1 QB 210 and the discussion by Hamson (1949) and Higgins (1962)). In *Bowmakers*, the claimants bought machine tools in contravention of the Defence Regulations and they delivered the tools to the defendants under three illegal hire-purchase agreements. The defendants, in breach of the agreements, sold some of the tools and refused to return the remainder. The claimants sued successfully for damages in the tort of conversion. The defendants' right to possess the goods terminated on their breach of the hire-purchase agreements and so the claimants were able to establish their title to the machine tools without placing any reliance upon the illegal transactions.

Bowmakers was a case in which the claimants were able to establish their title to the goods at law: but the same principle has since been held

to be applicable to a party who can establish the existence of an *equitable* proprietary interest in the goods. This was the conclusion reached by the House of Lords in *Tinsley* v. *Milligan* [1994] 1 AC 340. Miss Tinsley (the claimant) and Miss Milligan (the defendant) were lovers. They jointly purchased a house which was registered in the sole name of the claimant in order to enable the defendant, with the knowledge of the claimant, to make false benefit claims from the Department of Social Security. The defendant later repented of her fraud and informed the DSS of what she had done. The parties subsequently quarrelled and the claimant moved out. She then brought an action seeking possession of the house, asserting that she was the sole owner. The defendant could not argue that she had an interest in the property at law (because it was registered in the sole name of the claimant) but she asserted that she had an equitable interest in it by virtue of her contributions to the purchase price. The claimant argued that the defendant was not entitled to assert any such equitable interest because of her participation in the fraud: she could not invoke the assistance of a court of equity because she had not come to equity 'with clean hands'. While this argument was accepted by Lord Goff and Lord Keith, it was rejected by the majority. The majority refused to draw a distinction between the rule at law and the rule in equity. Thus Lord Browne-Wilkinson stated that

> '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.'

Applying this proposition to the facts of the case, the majority held that the defendant was entitled to succeed because she did not have to rely on the illegality to establish her equitable interest. Her equitable interest arose on ordinary principles of the law of trusts. This is because English law presumes that where two parties provide the purchase money to buy a property which is conveyed into the name of only one of them, the latter is presumed to hold the property on a resulting trust for both parties in shares proportionate to their contributions to the purchase price (known as the 'presumption of resulting trust'). The defendant was therefore able to establish her equitable interest by virtue of the common intention of the parties and her contribution to the purchase price. She did not need to rely on the illegality. On the contrary, it was the *claimant* who was forced to rely on the illegality to rebut the presumption of resulting trust and this she could not do. The defendant's counterclaim therefore succeeded.

In different ways both *Bowmakers* and *Tinsley* illustrate the inadequacy of the present remedial regime concerning illegal contracts. Although *Tinsley* may be said to have produced a degree of coherence by its refusal to draw a distinction between law and equity, in another respect the decision is arbitrary. A simple example will illustrate the point. Suppose the parties in *Tinsley* had been husband and wife. If the husband had been in the position of the defendant in *Tinsley*, his claim would have failed unless he had withdrawn from the transaction before the illegal purpose had been carried into effect (*Tribe* v. *Tribe* [1996] Ch 107). His claim would have failed because English law presumes that, when a husband advances money to his wife, he does so as a gift (known as the 'presumption of advancement'). While the presumption is rebuttable, the husband could only have done so by relying on the illegality, which the courts say cannot be done (although it could be argued that the presumption can be rebutted by the simple expedient of showing that no gift was intended, which need not involve the disclosure of the illegality). Yet, why should it matter whether the parties are husband and wife or lovers? Surely the answer ought to be the same in both cases? The law currently focuses attention on the state of the pleadings and has little or no regard to the merits of the case. There is little to commend in such an approach and it has few supporters. It has recently been rejected by the High Court of Australia in *Nelson* v. *Nelson* (1995) 70 ALJR 47, where the court preferred to adopt a more flexible approach in preference to both the majority and minority approaches in *Tinsley*. Speaking of the majority approach, McHugh J stated (at p.87) that 'the results produced by such a doctrine are essentially random and produce windfall gains as well as losses'. On the other hand, it could be argued that the source of this problem lies in the law of trusts; that the presumption of advancement and the presumption of resulting trust are outmoded presumptions which no longer reflect modern life (see, for example, *Silverwood* v. *Silverwood* (1997) 74 P & CR 453, 458 and *Lowson* v. *Coombes* [1999] Ch 373, 385 where the Court of Appeal noted that the presumptions are out of date in modern social and economic conditions: in *Lowson* it was held that the presumption did not apply between a married man and his mistress, but it would of course have applied as between himself and his wife). Although there is a degree of truth in this argument, it should be noted that it does not deny that the law is presently in an unsatisfactory state.

Nor is the decision in *Bowmakers* entirely free from difficulty. The principal problem is that, by awarding damages assessed by reference to the value of the machine tools, the result was *de facto* enforcement of the contract. On the other hand, to refuse a remedy would have been to confer a *de facto* gift upon the defendants. As Coote has pointed out (1972), 'the

real difficulty lies in the arbitrary, all-or-nothing character of the common law governing illegal contracts'.

The common law is, in fact, a poor instrument for the regulation of illegal contracts because of the lack of remedial flexibility. For some time it appeared that English law was moving in the direction of a more flexible, discretionary test under the guise of the so-called 'public conscience' test which was adopted by the Court of Appeal on a number of occasions (see, for example, *Euro-Diam Ltd* v. *Bathurst* [1990] 1 QB 1). According to this test the court should consider the public conscience in deciding whether or not to afford the claimant a remedy and should refuse to grant relief only where 'it would be an affront to public conscience . . . because the court would thereby appear to assist or encourage the claimant in his illegal conduct or to encourage others in similar acts'. In *Tinsley*, Lord Goff rejected such a test, stating that it was 'little different, if at all, from stating that the court has a discretion whether to grant or refuse relief'. He held that such a test could not be accepted because it was inconsistent with a long line of authority going back to *Holman* v. *Johnson* in 1775, where it was clearly established that the courts will not lend their aid to someone who founds their cause of action upon an illegal act.

Yet it is important to note that Lord Goff did not rule out reform completely. Indeed, he acknowledged that the present rules are 'indiscriminate in their effect, and are capable therefore of producing injustice' but he concluded that the introduction of major reform was the province of Parliament, not the courts. There is a precedent for reform. New Zealand has enacted the Illegal Contracts Act 1970, which gives to the court wide discretionary powers to grant such relief as the court 'in its discretion thinks just' (see Furmston, 1972). Lord Goff referred to this Act in his speech in *Tinsley* and continued:

> 'your Lordships have no means of ascertaining how successful the Act has proved to be in practice . . . . In truth, everything points to the conclusion that, if there is to be a reform aimed at substituting a system of discretionary relief for the present rules, the reform is one which should only be instituted by the legislature, after a full inquiry into the matter by the Law Commission, such inquiry to embrace not only the perceived advantages and disadvantages of the present law, but also the likely advantages and disadvantages of a system of discretionary relief, no doubt with particular reference to the New Zealand experience.'

The 'New Zealand experience' would appear to have been rather mixed. Professor Coote has written (1992) that the 'choice of relief and the criteria for its application have in practice turned out to be significantly

different from what the reformers appear to have expected or intended' and that the courts like to have 'broadly expressed discretions and to apply them broadly'. He concludes by saying that widely drafted legislation, such as the 1970 Act, 'quickly assumes a life of its own and that implied constraints which would once have appeared obvious can as quickly be ignored or forgotten'. This underlines the need for clearly articulated principles to guide the courts if they are to be entrusted with discretionary powers.

The Law Commission has now taken up Lord Goff's invitation and embarked upon the process of reforming the law relating to the effect of illegality on contracts and trusts. Their provisional recommendation contained in their Consultation Paper (1999) is that the courts should be given broader discretionary powers but that the discretion so given should be structured and limited in the sense that the courts should not be given the power to apportion any losses between the parties to an illegal contract. In outline, the Commission propose that the courts should have a discretion to decide whether or not illegality should act as a defence to:

(a) a claim for contractual enforcement where the formation, purpose or performance of the contract involves the commission of a legal wrong;
(b) a claim for the reversal of an unjust enrichment in relation to benefits conferred under a contract which is unenforceable for illegality; and
(c) the recognition of contractually transferred or created property rights where the formation, purpose, or performance of the contract involves the commission of a legal wrong (other than the mere breach of the contract in question) or is otherwise contrary to public policy but that illegality should not invalidate a disposition of property to a third party purchaser for value without notice of the illegality.

However the Law Commission provisionally recommend that this discretion should be structured so that, when exercising its discretion in any given case, the court must have regard to: (i) the seriousness of the illegality involved; (ii) the knowledge and intention of the claimant; (iii) whether denying relief will act as a deterrent; (iv) whether denying relief will further the purpose of the rule which renders the contract illegal; and (v) whether denying relief is proportionate to the illegality involved. It is also important to note that the discretion is limited to the question of

whether or not a contract should be enforced, an unjust enrichment should be reversed or a property right should be recognised. It specifically does not give the courts the power to apportion any losses between the parties or to re-adjust the contract (and, in this sense, does not go as far as the New Zealand Act). As far as the *locus poenitentiae* is concerned, the Law Commission provisionally recommend that a court should have a discretion to allow a party to withdraw from an illegal contract and to have restitution of benefits conferred under it where allowing the party to withdraw would reduce the likelihood of an illegal act being completed or an illegal purpose being carried out, but that to succeed in a withdrawal claim the claimant must first satisfy the court that the contract could not be enforced against him. Further, they recommend that in deciding whether or not to allow a party to withdraw and have restitution, a court should consider whether the claimant genuinely repents of the illegality (although this should not be a necessary condition for the exercise of the discretion) and also the seriousness of the illegality. These proposals represent an attempt to provide a principled foundation for the law, while at the same time giving the courts some flexibility in order to achieve a just resolution of cases which come before them. Two points can be made about these proposals. The first is that the attempt to structure the discretion of the courts may fail because the relevant factors are stated at such a high level of generality. Secondly, it can be argued that the proposals go too far in that they bring too many contracts within the scope of this discretionary regime (especially the fact that the proposals extend to illegality in performance as well as formation). To this extent the proposals can be criticised on the ground that they represent an undue interference with both freedom of contract and sanctity of contract (they may also involve a violation of human rights, on which see 1.8). Perhaps one way of resolving the problem might be to provide that the courts should start off with a presumption in favour of enforcement of the contract and that this presumption should only be rebutted by clear countervailing factors.

15.19 Severance

Finally, it may be possible to 'sever' the illegal part of the contract and enforce the remainder. If the illegal part of the contract can be separated from the rest of the contract, without rendering the remainder of the contract radically different from the contract which the parties originally concluded, then the court may be prepared to sever the illegal part, provided

that severance is not contrary to the public policy which rendered the contract illegal (see further Treitel, 1999, pp.465–71).

Summary

1 As a general rule the courts will not enforce a contract which is illegal or which is otherwise contrary to public policy.
2 Where the illegality arises in the performance of a contract which was valid at the moment of formation, the contract can be enforced by the guilty party only when it was not the purpose of the statute broken or the common law rule violated that the contract should be invalidated. In the case of the innocent party, the contract can generally be enforced by him where he had no knowledge of the illegality.
3 A contract is illegal if its formation is expressly or impliedly prohibited by statute. The function of the court is to interpret the statute to discern whether, on its proper construction, the Act prohibits the making of such a contract.
4 A contract may be illegal at common law on the ground that it is contrary to public policy. Contracts which are contrary to public policy include contracts which are contrary to good morals, contracts which are prejudicial to family life, contracts to commit a crime or a civil wrong, contracts which are prejudicial to the administration of justice, contracts prejudicial to public relations and contracts in unreasonable restraint of trade.
5 A contract which is in restraint of trade is void and unenforceable unless it can be shown to be reasonable. The doctrine applies principally to a covenant by an employee not to compete with his employer either during or after his employment and to a covenant by the seller of a business and its goodwill not to carry on a business which will compete with the business bought by the purchaser. A clause which is caught by the doctrine is void unless it is reasonable as between the parties and reasonable in the public interest.
6 Although the courts are prepared gradually to adapt the doctrine of public policy to reflect changing social and moral values, they remain extremely reluctant to extend the doctrine to a contract of a type to which the doctrine has never been applied before.
7 The general rule is that the courts will not permit the recovery of benefits conferred under an illegal contract. But recovery will be allowed where the parties were not *in pari delicto*, where the claimant has effectively repudiated the illegal purpose or where the claimant can establish his right to the money or the property without relying upon the illegal nature of the contract.

Exercises

1 Will the courts ever enforce an illegal contract? Should the courts ever enforce an illegal contract?
2 Compare and contrast the decisions in *Re Mahmoud and Ispahani* and *Archbolds (Freightage) Ltd* v. *S Spanglett Ltd.*
3 What impact does illegality in performance have on the enforceability of a contract?
4 When will a contract be held to be contrary to public policy? Does the doctrine of public policy reflect any values other than the idiosyncratic values of the judiciary?
5 A 35-year-old employee agrees with his employer that he will not work for the rest

of his life if the employer pays him a lump sum of £1 million. The employer pays the money but the employee has now decided that he wishes to return to work. Discuss. (See *Wyatt* v. *Kreglinger and Fernau* [1933] 1 KB 793.)

6 Joe employs six travelling salesmen. They sell insurance policies. Joe wishes to insert a restraint of trade clause in their contracts of employment. Advise him and draft a clause which will be suitable to his needs.

7 Can the value of benefits conferred under an illegal contract be recovered?