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10 Mistake

Aims and objectives

After reading this chapter you should be able to:

- Understand the nature of mistake as a vitiating factor and how an 'operative' mistake arises.
- Know that mistake renders a contract void *ab initio* where there is a mistake of fact.
- Recognise the incidence of mistakes of law and how the effect of this differs from a mistake off act.
- Recognise and understand the different types of mistake, i.e. common mistakes, mutual mistakes and unilateral mistakes, and the effects of each both on the parties to the contract and third parties.
- Appreciate the nature of mistake in equity and how this differs from mistake at common law.
- Know and understand mistake as to the nature of the document signed or *non est factum*.

Introduction

We saw in Chapter 1 that in the nineteenth century the theory of contractual obligation was based on that of *consensus ad idem*. The courts were willing to intervene if it could be shown that the contract lacked consensus, on the basis that genuine consent to the agreement was non-existent. This being the case the courts would find that there was no valid contract, thereby relieving the parties of their rights and liabilities under the contract.

The twentieth century saw a marked change in the willingness of the courts to allow a mistake of the parties to vitiate the existence of a contract. The courts began to realise that many contracts coming before them where mistake was alleged were for the most part commercial contracts entered into by businesspeople at arm's length. The attitude of the judiciary was that such people ought to be held to the bargain they had freely entered into and that, initially, the power lay with these individuals to draft their contracts in such a way as to account for factors that might only come to light after the contract was entered into.

A further aspect that promoted the change of attitude was the effect of the finding of mistake at common law on third parties. At common law where a mistake was found to exist, the finding would be that the contract was void *ab initio*, that is, the common

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law refused to recognise the existence of a contract at all. The effect of this was that if goods were sold to an individual under a contract which was void for mistake then no title to the goods would pass to the other party, and they would then have to return them to the seller.

Between the parties to the alleged contract this created no significant problem. However, if the party who had 'purchased' the goods had sold them to a third party then that third party could be compelled to return the goods to the seller. The reason for this was that if the purchaser did not acquire title to the goods then no title could be passed from the purchaser to the third party. The principle is summed up in the maxim ***nemo dat quod non habet***, that is, no one has power to transfer the ownership of that which they do not own. The result was that a third party's rights to title could be prejudiced by a mistake in a prior contract, the existence of which they may not even be aware of. Thus a third party could be compelled to return goods to the original seller, while at the same time being left with no or very limited rights against the person who had sold the goods.

The constraints that the courts placed on their finding for an operative mistake were clearly well justified in view of the above factors, yet, nevertheless, instances did arise where it was unjustifiable to hold the parties to their contracts. The courts thus evolved an equitable doctrine of mistake where the contract was held not to be void *ab initio* but voidable, thus preserving at least some of the rights of an innocent third party, though not always so.

It should be noted that for a mistake to be an operative one the mistake must be one relating to a fundamental, underlying fact that existed at the moment the contract was entered into. This was so in the following case.

Amalgamated Investment and Property Co. Ltd v *John Walker and Sons Ltd* [1976] 3 All ER 509

A contract was entered into for the purchase of a warehouse which the purchasers wished to redevelop and for which redevelopment both parties knew that planning consent would be required. In the pre-contract inquiries the purchasers asked the vendors whether the building was designated as a building of special architectural interest. This was important because it would render the obtaining of planning consent substantially more difficult. The vendors answered in the negative, a statement which was true on 14 August 1973. In fact later, unknown to both parties, the Department of the Environment decided to give the building such a designation as from 25 September 1973. The parties actually signed their contracts on that date and the purchasers were informed by the Department of the Environment of the change of designation on 26 September 1973. The purchasers claimed that the contract should be rescinded for mistake. The Court of Appeal refused the application on the basis that on the date of the contract both parties believed the property to have no such designation and that since that was in fact the case at that time, there had been no mistake.

The case also illustrates another important point in that there are often great similarities between mistake and misrepresentation. While this latter concept was not pleaded in the case, it is not too difficult to see why very often claims will arise mainly in relation to misrepresentation rather than to mistake.

Given the two divergent approaches of the common law and equity to mistake it is logical and convenient to divide our study of mistake into these two areas.

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Mistake at common law

The courts at common law have become reluctant to grant relief for mistake for the reasons already indicated, but they could be persuaded to find the contract void *ab initio* if satisfied that the mistake was one which was fundamental to the contract. Such a fundamental mistake can occur in two broad ways.

First, a mistake may arise where the parties have entered into a contract on an assumption that a certain state of affairs exists but which it is subsequently discovered does not exist. In this type of mistake there is an undoubted agreement between the parties, but they have both made the same or a **common mistake** as to a fundamental fact on which the agreement is based. This is referred to as *common initial mistake* in what follows.

Second, a mistake may arise in relation to the terms of the agreement and this may preclude the formation of an agreement. This is a mistake that precludes the *consensus ad idem* of the parties. Such a mistake might arise where the parties are at cross-purposes with one another, as, for example, where *A* is offering one thing, whilst *B* is accepting something else. This type of mistake will be referred to as ***mutual mistake***. Another type of mistake may arise where only one party makes a fundamental mistake of fact as to a term of the agreement, the other party being aware, or being presumed to be aware, of the mistake being made by the first individual. This type of mistake will be referred to as ***unilateral mistake***. Mutual and unilateral mistake will be grouped under the heading ***consensus mistake***.

One word of warning needs to be made at this point in that the terms common, mutual and unilateral mistake are used interchangeably by different authors, particularly the first two terms. No confusion should arise, however, if one bears in mind the circumstances in which each arises rather than simply relying on the label given to each type by the different authors.

One last point that should be noted is that in all types of mistake, however labelled or described, the mistake must be a fundamental mistake of either fact or law.

Mistakes of law

Whilst it is firmly established that mistakes of fact can render a contract void, for many years it was considered that mistakes of law did not have the same effect, a principle affirmed in ***Westdeutsche Landesbank Girozentrale* v *Islington Borough Council*** [1996] AC 669. This is no longer the case, however, following the landmark case of ***Kleinwort Benson* v *Lincoln City Council*** [1999] 2 AC 349 where the House of Lords held that money paid under a mistake of law could now be recoverable. The result of this is that money paid under a mistake of law is now to be treated on the same basis as money paid under a mistake of fact.

In ***Brennan* v *Bolt Burdan*** [2004] EWCA Civ 1017 it was held by the Court of Appeal that a mistake of law could render a contract void. The facts of the case were that Miss Brennan, a local authority tenant, sought damages for personal injury sustained by breathing in carbon monoxide fumes from a faulty boiler. She entered into a compromise agreement in the belief that she had brought her action out of time and withdrew her claim. Subsequent to this a legal precedent was overruled by the Court of Appeal and Miss Brennan argued that the compromise agreement was void for mistake in that the parties had been mistaken as regards her action being out of time. The Court of Appeal held that a change in the law was a risk that all parties had to accept and that in any

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event this was not a true mistake of law at all but more a state of doubt. It was considered that the compromise agreement which was possible to perform was a matter of give and take which should not be lightly set aside. The case, however, indicates that the courts have now accepted that mistakes of law can render a contract void.

The general reluctance of the common law to recognise mistake as a vitiating factor invariably gave rise to an equitable doctrine that was more flexible, discretionary and provided that a contract was voidable rather than void *ab initio*. It is perhaps not surprising therefore that the basis of recovery lies within the law of restitution where an overriding principle preventing recovery of money irrespective of the justice of the case is clearly a contradiction to the concept of undue enrichment. The change wrought by the ***Kleinwort Benson*** case, whilst confined to money paid under a mistake of law, is thought to be capable of applying to other areas as well; for instance, it has been extended into the area of misrepresentation in the case of ***Pankhania* v *London Borough of Hackney*** [2002] EWHC 2441. Similarly, in the House of Lords decision in ***Deutsche Morgan Grenfell Group plc* v *Inland Revenue Commissioners*** [2006] UKHL 49 their lordships confirmed that there existed a common law right to restitution of unlawfully demanded tax paid under a mistake of law.

For more on the law of restitution and mistakes of law refer to Chapter 18.

The extent of the change in this area of the law is still very much uncertain and embryonic. In the fullness of time the legal principles applicable to mistakes of law and mistakes of fact may become fully integrated. At the moment at least, relief for mistakes of law is confined to the recovery of money paid under a mistake of law.

Common initial mistake

To reiterate, this type of mistake arises commonly where the parties make a mistake that a certain state of affairs – on which the agreement is based – exists, but which it is subsequently discovered does not exist. Clearly if, unknown to both parties, a fact which is fundamental to the agreement either never existed or ceased to exist prior to the entering into of the contract then no contract can arise and therefore any agreement entered into is void *ab initio*.

It is important to emphasise that the state of affairs must cease to exist prior to the entering into of the contract. Should the state of affairs actually exist at the time the contract is entered into, but then subsequently cease to exist, the contract will be binding, though it may be discharged for subsequent impossibility under the doctrine of **frustration**. The doctrine of frustration will be examined in Part 4 of this book and it is well to bear in mind the difference between initial mistake and subsequent impossibility when reading Chapter 15 on frustration.

For more on the doctrination of frustration and initial/subsequent impossibility refer to Chapter 15.

One should point out that initial mistake rarely causes a contract to fail at common law and whilst it has generally been left to equity to provide a remedy for this type of mistake the position in equity has now been subject to scrutiny in the case of ***Great Peace Shipping Ltd* v *Tsavliris Salvage (International) Ltd*** [2002] 4 All ER 689 to the extent that this means of action is now closed. This is dealt with later on in this chapter. Nevertheless the common law has seen fit to attempt to intervene in three circumstances.

Mistake as to the existence of the subject matter

This type of mistake is often referred to as *res extincta* and it arises where, unknown to both the parties, the subject matter of the contract had ceased to exist at the time the contract was entered into. This principle also has support in the form of the Sale of Goods Act 1979, s 6, which provides:

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> 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 was made, the contract is void.

The application of the principle can be seen in the following case.

Couturier v *Hastie* (1856) HL Cas 673

The plaintiff merchants sold a cargo of Indian corn to the defendant. Unbeknown to either party, a few days before the contract was made, the cargo, which was on board a ship, had overheated and started to ferment, and as a result the captain had sold the cargo in order to prevent it from deteriorating further. The buyer contended that since the subject matter of the contract, the corn, had ceased to exist prior to the entering into of the contract, then the contract was void and he was not liable to pay the price. The vendor, however, argued that the contract was based on the handing over of the shipping documents and that the defendant had not simply bought a cargo of corn but a whole venture in which he took all the risks regarding the shipment of the cargo. It was held by the House of Lords that the purchaser was not bound to pay for the cargo. The contract contemplated that the goods sold actually existed, and, since they did not, the seller could not be required to deliver the goods, nor the buyer to pay for them. Lord Cranworth stated:

> The whole question turns upon the construction of the contract . . . Looking to the contract itself alone, it appears to me clearly that what the parties contemplated, those who bought and those who sold, was that there was an existing something to be sold and bought . . . The contract plainly imparts that there was something which was to be sold at the time of the contract, and something to be purchased. No such thing existing . . . there must be judgment . . . for the defendants.

One of the problems with the use of this case to illustrate mistake as to the existence of the subject matter is that nowhere in the judgment is mistake mentioned, let alone discussed. Furthermore the contract was not held to be void at all, the judgment being based on the fact that since the seller was unable to produce the goods, he was unable to recover the price for them. The result of such a decision is that in reality this was not a case based on *res extincta* but one based on a total failure of consideration, where the question as to whether the contract is a nullity or valid would not arise. The reasoning is clear in that, if the cargo has ceased to exist then it cannot be delivered, in which case the seller can neither claim the contract price from the purchaser, nor, indeed, retain any moneys paid. The position, however, becomes very different if the action becomes that of the purchaser who claims for non-delivery of the goods. This might easily have been the case in ***Couturier* v *Hastie*** if the case had been regarded as simply a case of a sale of specific goods from the outset, rather than an attempt by the seller to claim that it was a sale of a venture. Whether the purchaser can claim here depends largely on the terms of the contract. The position of the purchaser can be seen in the Australian case of ***McRae* v *Commonwealth Disposals Commission***.

McRae v *Commonwealth Disposals Commission* (1951) 84 CLR 377

The Commission, the defendants, invited tenders for the sale of a wreck of an oil tanker which was said to be lying on the Journand Reef. The plaintiff, the successful bidder, was unable to find the reef on the marine charts and therefore asked for the ship's position, and this he was duly given. The plaintiff then spent a considerable sum of money equipping a

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salvage operation but, on arriving at the position given, found there was no tanker, nor had there ever been such a tanker. The plaintiff sued for breach of contract and this was resisted by the defendants who claimed the contract was void for *res extincta* on the basis of ***Couturier* v *Hastie***.

The plea of the defendants was accepted by the court at first instance but rejected on appeal to the High Court in which Dixon and Fullagar JJ decided that ***Couturier*** provided authority for the existence of *res extincta*. They stated that the case did not concern itself with the validity of the contract, being based on the existence of a total failure of consideration, but the court did consider the situation where the validity of the contract could be called into question. It was stated that this might arise if the purchaser had brought the action for non-delivery in ***Couturier***. In this context Dixon and Fullagar stated:

> If it had so arisen, we think that the real question would have been whether the contract was subject to an implied condition precedent that the goods were in existence. Prima facie, one would think, there would be no such implied condition precedent, the position being simply that the vendor promised that the goods were in existence . . .

In the ***McRae*** case no such implied condition precedent arose, nor was it required, since the buyers clearly relied on an assertion made by the defendants that the tanker existed. It was not a case, as would have arisen in ***Couturier***, had the purchaser brought the action, of a contract being entered into on the basis of a common assumption of fact as to the existence of the subject matter being a condition precedent to the entering into of that contract. In *McRae* the defendants had contracted on the clear basis that the tanker existed and therefore were liable for breach of contract.

The actual basis of ***Couturier* v *Hastie*** remains open and several theories have been expounded by as many commentators as to what this basis is. As was shown above, the decision could amount to authority either as to the existence of a common mistake as to the existence of the subject matter; or a case providing an example of a total failure of consideration; or a case involving an implied condition precedent as to the existence of the subject matter. Whatever that basis is, it would seem extreme to suggest that the analysis of the decision in ***McRae*** results in the questioning of the existence of *res extincta* itself as a legal concept. Both Dixon and Fullagar acknowledge the fact that in ***Couturier***, Coleridge J in the Court of Exchequer Chamber and Cranworth LJ in the House of Lords talk in terms of the judgment turning 'entirely on the reading of the contract'.

The true position is probably as stated by Beatson (2002) when he comments:

> When properly construed, the contract may indicate that the seller assumed responsibility for the non-existence of the subject matter. This was so in ***McRae's*** case, where the seller was held to have guaranteed the existence of the tanker. Or it may indicate that the buyer took the risk that the subject matter might not exist and undertook to pay in any event. This was the point at issue in ***Couturier* v *Hastie***, where the House of Lords was called upon to decide whether or not the buyer had purchased merely the expectation that the cargo would arrive.

As in many areas of the law of contract, the whole question is ultimately reduced to deciding who should bear the loss in a contract based on the assumption that certain facts exist when they do not. In deciding the issue one asks if either party had accepted responsibility for the existence of the assumed facts. If one party did so, then clearly that is the end of the matter and the action lies for breach of contract against that individual. If neither party has assumed responsibility under the contract then ultimately the court

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has to decide whether either party can be regarded as having taken the risk. The court may consider, and it is submitted that this is a rare occurrence, that neither party can be regarded as having assumed the risk. Should this be the case the contract will be void for common mistake. This process of questioning would seem to have the support of Steyn J in ***Associated Japanese Bank (International) Ltd* v *Crédit du Nord SA*** [1988] 3 All ER 902, which is discussed more fully below, where he states:

> Logically, before one can turn to the rules as to mistake . . . one must first determine whether the contract itself, by express or implied condition precedent or otherwise, provides who bears the risk of the relevant mistake. It is at this hurdle that many pleas of mistake will either fail or prove to have been unnecessary. Only if the contract is silent on the point is there scope for invoking mistake.

A factor that complicates the above summary is the existence of s 6 of the Sale of Goods Act 1979. This provision gives statutory authority for what was commonly assumed to be the position in ***Couturier* v *Hastie*** regarding the common mistake as to the existence of the subject matter of the contract. In ***McRae*** the judges considered that the provision did not apply to that case since s 6 talks in terms of goods having perished and since the tanker in ***McRae*** never existed in the first place the facts of the case fell outside the provision.

In relation to s 6, Atiyah (2003) argues that the provision amounts only to a prima facie rule which may be overturned by the express agreement of the parties. There is no suggestion whatsoever that Parliament intended this within the Act and therefore the assertion by Atiyah must be considered guardedly, though he is undoubtedly correct in the light of the above that s 6 is something of an anachronism today. See also Treitel (2003) and Beatson (2002) on this point.

Mistake as to title

This type of mistake is sometimes referred to as ***res sua***. It is described by Lord Atkin in ***Bell* v *Lever Bros*** [1932] AC 161 as follows:

> Corresponding to mistake as to the existence of the subject-matter is mistake as to title in cases where, unknown to the parties, the buyer is already the owner of that which the seller purports to sell to him. The parties intended to effectuate a transfer of ownership: such a transfer is impossible: the stipulation is *naturali ratione inutilis*.

An example of this type of mistake may be seen in the following case.

Cooper v *Phibbs* (1867) LR 2 HL 149

An individual agreed to lease a fishery from another. Unbeknown to either party the purchaser already owned the fishery. In fact the case was not decided on common law principles at all, the court granting rescission of the contract, though Lord Atkin considered the contract to be void for *res sua* when he discussed the case in *Bell* v *Lever Bros*.

The principle so far seems very straightforward, but one must be careful not to jump to conclusions and immediately think in terms of invoking the principle. In many contracts the seller often warrants that they do have title, in which case the proper action is to sue for breach of contract. In contracts for the sale of goods, in particular, s 12(1) of the Sale of Goods Act 1979 implies a condition that in such contracts the seller has the right to sell or that in executory contracts they will have the right to sell at the time when the property is to pass.

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Mistake as to quality only arises where there is neither an implied condition nor a warranty as to title. At the same time title must be regarded as an integral part of the contract to the extent that the contract becomes meaningless without it.

Mistake as to the quality of the subject matter of the contract

The question that arises here is whether it is possible for the contract to be void on the basis that the subject matter of the contract does not have the quality it is thought to have by the parties to the contract. The leading case on this area is that of ***Bell* v *Lever Bros***.

Bell v *Lever Bros* [1932] AC 161

The appellant was employed on a fixed-term contract as chairman of a subsidiary company of the respondents. The respondents decided to amalgamate the subsidiary with another company so that the appellant's services were no longer required, despite the fact that there was a substantial period of time of his contract to run. The respondents paid the appellant compensation amounting to £50,000 for the early termination of his contract. It later transpired that the appellant had been involved in certain speculative deals which would have entitled the respondents to dismiss the appellant summarily without compensation. Neither party had considered this as a possibility when the contract terminating his employment was entered into. The respondents, on discovering the truth, sought to have the contract rescinded and the moneys paid returned. At first instance it was acknowledged that the appellant did not fraudulently conceal his breach of duty and did not consider it as a relevant factor when the severance agreement was being entered into. It was found that there was a mistake as to a fundamental fact that would enable the respondents to avoid the contract and recover the compensation money. The fundamental fact in question was that both parties assumed that the contract was one that could be terminated with compensation, whereas it was capable of being terminated without such compensation being payable. This decision was affirmed by the Court of Appeal who found that Lever Bros had clearly contracted under a fundamental mistake.

In the House of Lords it was held, by a majority decision, that the contract was valid and binding. Lord Atkin's judgment is generally regarded as being the principal one. He concluded that 'it would be wrong to decide that an agreement to terminate a definite specified contract is void if it turns out that the contract had already been broken and could have been terminated otherwise'. He stated that Lever Bros got what they bargained for, that is, early release from the contract (the similarity of reasoning in ***Saunders* v *Anglia Building Society*** [1970] 3 All ER 961 under *non est factum* should be noted here). He thought it was irrelevant that they could have arrived at a similar conclusion by some other means or that if they had known the true facts they would not have entered into the contract at all.

Both Lord Atkin and Lord Thankerton, who also considered there to be no mistake, went further and discussed the circumstances in which common mistake might arise. They considered that for an operative mistake to arise there had to be a mistake as to a fundamental assumption on which the contract was based and which *both* parties considered to be the basis of the agreement. As Lord Thankerton stated, mistake as to the subject matter of the contract 'can only properly relate to something which both must have necessarily accepted in their minds as an essential and integral element of the subject matter'. He considered that this test was not satisfied in the case since there was nothing to indicate that Bell regarded the validity of the original contract as vital to that of the severance contract – only Lever Bros considered this to be 'essential and integral' and therefore there was no common mistake.

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Lord Atkin expressed, at least initially, an equally wide test. He stated:

> Mistake as to quality of the thing contracted for raises more difficult questions. In such a case a mistake will not affect assent unless it is the mistake of both parties, and is as to the existence of some quality which makes the thing without the quality essentially different from the thing as it was believed to be.

In isolation the test is very clear, but the waters have become muddy by the fact that this test was discussed in the context of *res extincta* and *res sua*, not mistake as to quality. Further, Lord Atkin later on in his judgment produces a more restrictive test whereby the question is posed: 'Does the state of the new facts destroy the identity of the subject-matter as it was in the original state of facts?'

The inconsistencies set out have produced much debate as to whether ***Bell*** **v** ***Lever Bros*** is authority for a separate concept of mistake as to quality or not. The fact that there was no finding as to this type of mistake in the case has caused much debate as to when this type of mistake will arise since the facts of ***Bell*** seem to fall within the first broad test enunciated by Lord Atkin. One hypothesis put forward by *Cheshire, Fifoot and Furmston* (2006) is that since there was no finding as to mistake as to quality in ***Bell*** **v** ***Lever Bros*** within the tests of Lord Atkin, it follows that it is difficult to come to such a finding in any case, and that therefore the test confines mistake to that of the subject matter of the contract only: 'the only false assumption sufficiently fundamental to rank as operative mistake is the assumption that the very subject matter of the contract is in existence'.

On this basis Cheshire, Fifoot and Furmston cast doubt on whether common mistake as to the quality of the thing contracted for exists at all in law, and if it does it must be a very rare bird indeed! Further, they point to later cases as supporting their proposition, notably that of ***Solle*** **v** ***Butcher*** [1950] 1 KB 671 where the parties negotiated for the lease of a flat. There was a mistaken belief that the rent was not subject to the control of the Rent Acts and it was agreed that the rent should be fixed at £250 per annum. Later it was discovered that the flat was subject to a controlled rent of £140 per annum and the plaintiff claimed to recover the overpayments made as a result of his living in the flat for two years after entering into the contract. The defendant counter-claimed that the contract was void for mistake. It was held that the contract was not void for mistake, though it could be agreed, and was in *Cheshire, Fifoot and Furmston*, that this was a case clearly falling within Lord Thankerton's expression of mistake as being something 'which both must necessarily have accepted in their minds as an essential and integral element of the subject matter'. The majority of the Court of Appeal, however, held that the contract could be rescinded on equitable principles (*see* 'Mistake in equity', below).

Further evidence was also produced in the form of ***Leaf*** **v** ***International Galleries***.

Leaf v *International Galleries* [1950] 1 All ER 693

It will be recalled that in this case the parties contracted for the sale and purchase of a picture which both mistakenly believed to be by Constable. The plaintiff based his claim in misrepresentation, but what would the result have been if the plaintiff had claimed as to common mistake as to the quality of the thing contracted for? This case would seem to fall squarely within Lord Atkin's test, that is, 'it is the mistake of both parties, and is as to the existence of some quality which makes the thing without the quality essentially different from the thing as it was believed to be'. The Court of Appeal did not consider the facts to amount to a mistake within the definition. Almost certainly Lord Atkin would have come to

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a similar conclusion since in *Bell* v *Lever Bros* he set out a series of examples where he thought there would be no operative mistake. One example bore remarkable similarity to the ***Leaf*** case:

> A buys a picture from B; both A and B believe it to be the work of an old master, and a high price is paid. It turns out to be a modern copy. A has no remedy in the absence of representation or warranty.

Lord Atkin's argument here no doubt is that *A* thinks that they are buying a painting from *B* and that was what they got, a painting, therefore there is no mistake. Treitel, however, considers this to be erroneous. He also quotes an example of where *A* purchases a painting from *B* for £5 million which both believe to be a Rembrandt. On the completion of the contract if one were to ask *A* what he has bought he will reply that he has bought 'a Rembrandt' not 'a painting'. If it transpires that the painting is not a Rembrandt then quite clearly there is fundamental common mistake as to the quality of the thing contracted for. Treitel considers that this contract is void despite Lord Atkin's comment and the *dicta* in ***Leaf* v *International Galleries***. This debate has been the subject of much scrutiny by Steyn J in ***Associated Japanese Bank (International) Ltd* v *Crédit du Nord SA***.

Associated Japanese Bank (International) Ltd v *Crédit du Nord SA* [1988] 3 All ER 902

The facts were that a fraudster, Jack Bennett, entered into a sale and lease-back transaction with the plaintiff bank. The bank agreed to buy four precision engineering machines for £1 million and then to lease them back to him, but before doing so required a guarantor, the defendant bank agreeing to this position. The whole arrangement was a fraud by Jack Bennett since the machines did not exist at all, and on receiving the £1 million he disappeared and made no attempt to keep up the repayments. The plaintiff bank then attempted to enforce the guarantee against the defendants. The defendants claimed that the transaction was void since it was based on four specific pieces of equipment which both believed to exist but which in reality did not.

On the face of things this appears to be a case based on *res extincta* and has all the hallmarks of the ***McRae*** case since Jack Bennett was actually guaranteeing that the machines existed, as did the Commission with regard to the tanker in ***McRae***. In the ***Associated Japanese Bank*** case, however, the party alleging the mistake, the defendants, were not guaranteeing the existence of the machines. They had entered the guarantee contract on the basis that the machines did in fact exist, a conclusion which they had apparently reached from their discussions with Bennett. The subject matter of the contract was not therefore the machines themselves but the obligations undertaken by Bennett and in particular his representation that the machines actually existed. Steyn J dismissed the claim and found the defendants to be not liable on the basis that he considered that the guarantee was based on an express condition precedent that the machines did in fact exist and that if such an express term did not exist there was an implied term to that effect. He did, however, also consider the issue of common mistake and concluded, following Lord Atkin in ***Bell* v *Lever Bros***, that the contract would be void on the basis that the subject matter of the guarantee was 'essentially different from what it was reasonably believed to be'. He then concluded that 'for both parties the guarantee of obligations under a lease with non-existent machines was essentially different from a guarantee of a lease with four machines which both parties at the time of the contract believed to exist'.

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Steyn J in the course of his judgment made a close examination of ***Bell* v *Lever Bros*** and of the proposition set out in *Cheshire, Fifoot and Furmston*. He considered the analysis by the latter to be 'too simplistic' and that the actual decision in ***Bell* v *Lever Bros*** was founded on the particular facts of the case. He considered that the courts should attempt to uphold rather than destroy apparent contracts although this did not preclude the possibility of mistake. He considered that the common law rules regarding mistake as to the quality of the subject matter were designed to cope with unexpected and wholly exceptional circumstances that occur within contracts. He stated that for a plea of mistake to be operative in this context it had to be a mistake of both the parties and, given this, the judgments of Lords Atkin and Thankerton were to be regarded as the *ratio decidendi* of ***Bell* v *Lever Bros***. He considered that mistake as to quality could produce a nullity in a contract but confined it to the test enunciated by Lord Atkin, that is, a mistake will not affect assent unless it is 'as to the existence of some quality which makes the thing without the quality essentially different from the thing as it was believed to be'. Steyn J concluded that the tests for common mistake as to the subject matter and that of common mistake as to quality could be reduced to one single principle: 'the mistake must render the subject matter of the contract essentially and radically different from the subject matter which the parties believed to exist'. The use of the term 'subject matter' here apparently encompassed both types of mistake.

Steyn J added a final qualification in that a party seeking to rely on the mistake had to show that he had reasonable grounds for his belief that gave rise to the mistake. This qualification is useful since it produces an approach that is consistent with that of equity, where the fault of either party precludes the quality of equitable relief. He was at pains to point out that this last qualification was not based on notions of estoppel or negligence but 'simply because policy and good sense dictate that positive rule regarding common mistake should be so qualified'.

The decision in the ***Associated Japanese Bank*** case has been affirmed in ***Great Peace Shipping Ltd* v *Tsavliris Salvage (International) Ltd.***

Great Peace Shipping Ltd v *Tsavliris Salvage (International) Ltd* [2002] 4 All ER 689

The facts of the case were that a ship, the *Cape Providence*, suffered severe structural damage whilst in the South Indian Ocean and was in danger of sinking. The ship owners engaged the defendants to salvage the vessel; however, a tug they engaged to carry out the salvage was four to five days from the sinking vessel. Fearing the ship would sink with the loss of the crew, the defendants asked its brokers to locate a ship near to the stricken vessel which would assist, if necessary, with the evacuation of the crew. The brokers consulted a reputable organisation, Ocean Routes, which provided weather forecasting information to the shipping industry and received reports of vessels at sea, for the location of vessels in the vicinity of the *Cape Providence*. The names of four vessels were provided and the broker was informed that the nearest ship was the *Great Peace*, a vessel owned by the claimants. It was estimated that the *Great Peace* was within 12 hours' sailing of the *Cape Providence*. However, this position was wrong. On the basis of the position of the ship given to them, the defendants entered into a contract with the claimants to hire the *Great Peace* for a minimum of five days. It later transpired that the *Great Peace* was several hundred miles from the *Cape Providence*. The defendants therefore cancelled the contract and refused to pay for any hire. The claimants therefore sued, claiming five days' hire. The defendants argued, first, that the contract was void at common law for a fundamental mistake, or, second, that the contract was voidable in equity for common mistake. This second issue will be dealt with in 'Mistake in equity', below.

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With regard to the first issue, the case turned on the question of whether the mistake as to the distance apart of the two vessels had the effect that the services that the *Great Peace* was to provide were something essentially different from that which the parties had agreed. The Court of Appeal concluded that the analysis of Lord Atkin and Lord Thankerton in ***Bell* v *Lever Bros*** was correct and endorsed the comments of Steyn J in ***Associated Japanese Bank***, and that to establish mistake as to the quality of the subject matter the mistake must render the contract essentially and radically different from the subject matter which the parties believed to exist and that this was not present. The mistake as to the distance between the two vessels did not render the services to be provided by the claimants' vessel essentially different from what the parties had agreed.

The judgment is important since it emphasises the need to consider the terms of the contract and its surrounding circumstances in order to determine whether or not the parties themselves had allocated the risk under the contract. An example of this can be seen in ***McRae* v *Commonwealth Disposals Commission***, the facts of which have already been considered above. It will be recalled that here there was no mistake because the defendants were deemed to have promised that the tanker in the case actually existed. The risk of the tanker not existing had been clearly placed in the court of the defendants and they could not therefore escape liability on the basis that the contract was void for mistake.

In *Great Peace* the claimants were not aware of any condition precedent as to the distances between the two ships by the defendants. This was of vital importance to the defendants but not to the claimants, who had simply agreed to charter a ship to the defendants and they were therefore entitled to their five-day hire fee. They had fulfilled their part of the bargain. Furthermore this bargain could not be nullified by mistake. The fact that the *Great Peace* was further away from the *Cape Providence* did not in their eyes render the contract 'essentially and radically different'. It should also be borne in mind that both Lord Atkin and Lord Thankerton had stressed in ***Bell* v *Lever Bros*** that a mistake had to be the mistake of both parties and here it was the mistake of the defendants only.

Lord Phillips in ***Great Peace*** provided a statement as to the criteria needed to establish a common mistake as to quality. He stated:

> . . . the following elements must be present if common mistake is to avoid a contract: (i) there must be a common assumption as to the existence of a state of affairs; (ii) there must be no warranty by either party that that state of affairs exists; (iii) the non-existence of the state of affairs must not be attributable to the fault of either party; (iv) the non-existence of the state of affairs must render performance of the contract impossible; (v) the state of affairs may be the existence, or a vital attribute, of the consideration to be provided or circumstances which must subsist if performance of the contractual adventure is to be possible.

Lord Phillips thought the second and third factors were exemplified by the decision in the ***McRae* v *Commonwealth Disposals Commission*** case since in that case the assumption that the tanker existed was created by the Commission without any reasonable grounds for believing it was true. Lord Phillips approved of the judgments of Dixon and Fullagar JJ in that case which considered that whether impossibility of performance discharged obligations under the contract depended on the construction of the contract and, anyway, if this was not correct, they stated that:

> . . . a party cannot rely on mutual mistake where the mistake consists of a belief which is, on the one hand, entertained by him without any reasonable ground, and, on the other hand, deliberately induced by him in the mind of the other party.

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Dixon and Fullagar JJ considered that on a proper construction the contract contained a promise that the tanker existed but considered that if the doctrine of mistake was to be applied:

> . . . then the Commission cannot in this case rely on any mistake as avoiding the contract, because any mistake was induced by the serious fault of their own servants, who asserted the existence of a tanker recklessly and without any reasonable ground.

Lord Phillips considered this to be the correct approach and that the doctrine of mistake fills a gap where the parties enter into a contract that proves impossible to perform without the fault of either party and they have not either expressly or impliedly dealt with their rights and obligations within the contract themselves. This also concurs with the approach of Steyn J in the ***Associated Japanese Bank*** case, as stated above on p. 266.

Lord Phillips considered, therefore, that once a court has determined that unforeseen circumstances have occurred that have resulted in the contract becoming impossible to perform it is then necessary, on the construction of the contract, to determine if one or other party has assumed responsibility for the risk that it might not be possible to perform the contract. If that is the case then no recourse to the doctrine of mistake is required – the construction of the contract determines the outcome. This also accords with the notion that the law should uphold contracts in the first instance and concurs with the view of Steyn J. As Lord Phillips stated:

> Supervening events which defeat the contractual adventure will frequently not be the responsibility of either party. Where, however, the parties agree that something shall be done which is impossible at the time of making the agreement, it is much more likely that, on true construction of the agreement, one or other will have undertaken responsibility for the mistaken state of affairs. This may well explain why cases where contracts have been found to be void in consequence of common mistake are few and far between.

It is clear from the above that instances of common mistake as to quality are going to be very exceptional. The cases seen until now have concerned mistake of fact but in cases where mistakes of law arise, particular problems may arise in the context of common mistakes as to quality and *res extincta*.

In the case of ***Brennan* v *Bolt Burdan*** [2004] EWCA Civ 1017, the facts of which have already been considered, the Court of Appeal held that this was not a case involving impossibility of performance since at all time the compromise agreement was capable of performance and, as such, that put it beyond the decision of ***Great Peace*** and common mistake. The court considered that there could not be an operative mistake where there is doubt as to the law. A state of doubt was considered to be different from that of a mistake since a person who pays when in doubt of the law assumes the risk that he may be wrong. The Court of Appeal thought that it was possible for a compromise agreement to be void for a mistake of law, though it could not envisage how the test in ***Great Peace*** could operate in such a scenario. Sedley LJ considered that maybe another test was required in the case of mistakes of law. He considered that a test which reflected that in ***Great Peace*** was required, that is, had the parties, when negotiating the contract, known then what the law states now; would there still have been an intelligible basis for the agreement? He thought this came close to the issue in ***Great Peace***, that is, is there 'a common assumption (in that case one of fact) which renders the service that will be provided if the contract is performed something different from the performance that the parties contemplated[?]'. He thought his proposed test also echoed the question posed by Lord Atkin in ***Bell* v *Lever Bros***: 'Does the state of the new facts destroy the identity of the subject matter as it was in the original state of facts? if for "facts" one reads "law".'

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Another case involving compromise agreements is that of ***Kyle Bay Ltd (t/a Astons Nightclub)* v *Underwriters Subscribing under Policy No. 019057/08/01*** [2007] EWCA 57.

Kyle Bay Ltd (t/a Astons Nightclub) v *Underwriters Subscribing under Policy No. 019057/08/01* [2007] EWCA Civ 57

The facts of the case were that Kyle Bay Ltd ('K Ltd') had operated a nightclub and had taken out insurance cover from the defendant. A fire ensued and, on claiming, K Ltd found that the cover was different from that requested by them. They were advised to enter into a compromise agreement for £205,000, which was about one-third less than the amount they would have been able to claim had the cover they had envisaged actually been entered into. Later on it transpired that the type of policy and cover they had originally requested had actually been in place and K Ltd could have claimed the full amount. This meant that the compromise agreement and settlement had been entered into by mistake. K Ltd sought to have the agreement overturned and declared void on the basis of mistake.

At first instance the judge found that the settlement had been entered into on the basis of a mistake, but held that the mistake was not of a nature to justify vitiation of the agreement. The Court of Appeal dismissed K Ltd's appeal and stated that the judge had been correct to dismiss the claim insofar as it was based on common mistake. It was appropriate to apply the test in the ***Associated Japanese Bank*** and ***Great Peace*** cases. The mistake in the case did not render what the parties believed to be the subject matter of the agreement 'essentially and radically different' from what it was. K Ltd's mistake was that they were getting one type of cover as opposed to another type and, whilst the difference between the actual and assumed subject matter of the agreement could be characterised as significant, it was not an 'essential and radical' difference. It was considered that what was wrongly assumed was a detail, and that this did not go to the validity of the policy. Whilst K Ltd received a third less than it should have done, which was a significant amount, this could not fairly be characterised as an 'essentially or radically' different sum from its entitlement.

In ***Bell* v *Lever Bros*** Lord Atkin suggested that another basis for common mistake was the notion that a contract may be void because of an implied term that the validity of the contract depends on the existence of a certain state of affairs at the time of the contract and during its performance and that this implied term was of fundamental importance. In ***Great Peace*** this implied term approach was rejected, just as it has been in the doctrine of frustration (*see* Chapter 15), and, as we have seen, the case established that common mistake is now founded on 'a rule of law under which, if it transpires that one or both of the parties have agreed to do something which it is impossible to perform, no obligation arises out of that agreement'. Lord Phillips considered it was unrealistic and inappropriate for the court in ***Great Peace*** to make inquiries as to whether the parties had included a term that provided that a contract would not exist in certain circumstances. It will be recalled that the second element in Lord Phillips' criteria stated that for a common mistake to exist there must be 'no warranty by either party that a state of affairs existed'. Thus a court, in considering whether a common mistake existed, must have regard as to what the parties expressly agreed would be performed. If, therefore, the parties included such a term in the contract that a particular state of affairs exists then this would preclude the operation of a common mistake. This was the position in ***McRae* v *Commonwealth Disposals Commission*** where there was a term in the contract that

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warranted the existence of the tanker on the Jourmand Reef. This particular approach was also supported by Steyn J in the ***Associated Japanese Bank*** case.

The position, therefore, is that once the court has determined that a contract is impossible to perform because of unforeseen circumstances, the court must then consider if one of the parties has, either expressly or impliedly, undertaken responsibility to accept the risk for the mistake. If that is the case then a plea of common mistake will not be allowed. This approach can be seen in the case of ***Graves* v *Graves*** [2007] EWCA Civ 660.

Graves v *Graves* [2007] EWCA Civ 660

The facts of ***Graves* v *Graves*** were that the parties had been married for five years when they got divorced. As part of the divorce a 'clean break' settlement order was made by consent under which Mr Graves had to pay his wife a substantial amount of capital, together with £300 per month by way of maintenance. Subsequently Mr Graves agreed that his ex-wife and children could return to the former matrimonial home and thereafter Mrs Graves lived in a series of houses owned either by Mr Graves alone or by Mr and Mrs Graves jointly. In June 2003 Mr Graves transferred his half-share of a house in Fleet to his wife for £8,500. Under the agreement Mrs Graves waived the children's future maintenance, which at the time was assessed as having a value of £50,000. Later the wife ran into financial difficulties and was unable to pay the mortgage repayments on the house and so she sold the house in 2004. Mr Graves then agreed that Mrs Graves could live in another house owned by him. An assured shorthold tenancy was entered into by the parties whereby Mrs Graves would pay a deposit of £12,000 and a monthly rent of £1,150. Mr Graves, however, was concerned as to his ex-wife's ability to pay the rent, particularly as he was no longer paying any maintenance to her. The tenancy had been entered into on the basis that Mrs Graves would be entitled to housing benefit from the local council. Whilst the local authority had initially indicated that she would be entitled to such benefit it transpired that she was not in fact entitled to it. Mrs Graves now found herself in a situation where she had paid nearly all her capital to Mr Graves and had no money to pay the rent. Mr Graves then brought proceedings for possession of the house and Mrs Graves in her defence argued that the tenancy agreement was void on the grounds of mistake or, alternatively, had been frustrated.

At first instance the judge considered that the requisite elements set out by Lord Phillips in ***Great Peace*** were present and therefore the tenancy agreement was void for common mistake. He found that there was a common assumption by both parties that housing benefit would be available to pay most of the rent and that neither party had made any warranty that the contract had been entered into on that basis. Neither party was at fault in believing the housing benefit would be made since both Mr and Mrs Graves had made separate inquiries about this prior to Mrs Graves moving into the premises. Finally, the judge considered that tenancy had become impossible because of the non-payment of the housing benefit in that the purpose of the contract was to provide Mrs Graves and her children with an affordable home given that access to both income and capital was very limited. The result of this reasoning was that the tenacy agreement was void for common mistake and, as a consequence, Mrs Graves was a trespasser and Mr Graves was entitled to possession.

In the Court of Appeal it was held that the tenancy agreement was not void for common mistake. It was contended by Mr Graves that his wife had warranted that she would

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receive the housing benefit and could pay the rent. In court Thomas LJ gave the leading judgment and stated that the starting point was to look at the nature of the agreement and whether the contract itself had made provision as to who should bear the risk of the relevant mistake as per the *dicta* of Steyn J in ***Associated Japanese Bank***. Thomas LJ considered that neither Mr nor Mrs Graves assumed any risk as to the housing benefit. Mr Graves knew his wife could not pay the rent without the housing benefit, whilst Mrs Graves knew Mr Graves would never have allowed her to occupy the house without the housing benefit being available. Thus the basis of the agreement was that Mr Graves would provide a house and his wife would be able to live in it on the basis of most of the rent being met by the housing benefit. Thomas LJ considered that there was an implied condition in the contract that if the housing benefit ceased to be payable then the tenancy would also end. He stated that on the basis of ***Bell* v *Lever Bros*** such a condition could only be implied if the 'effect of the new state of facts [that is the lack of housing benefit] was such that performance of the agreement was impossible or the agreement was something different in kind from the agreement in the original state of facts'. In ***Bell* v *Lever Bros*** Lord Atkin considered that such a term could only be implied if it were necessary since otherwise this would undermine contractual certainty and allow the courts to rewrite a contract. This caution of course accords with that seen in the application of the 'officious bystander' test. Thomas LJ considered that it was not impossible for Mrs Graves to pay her rent – 'inability to perform a contract because of impecuniosity does not make performance impossible'; however, the agreement was made on the basis that most of the rent would be paid by way of the housing benefit. It was clear in his mind that the basis for the agreement was one that did not exist because of the absence of the housing benefit and therefore he considered that the agreement was different in kind to that originally contemplated. Thomas LJ therefore thought that these were circumstances in which a condition would be implied into the agreement to the effect that the tenancy would come to an end if the housing benefit was not payable. Thus the tenancy was determined on the basis of the implied condition and therefore it was unnecessary to consider the issue as to whether the contract was void for mistake or frustration.

For more on the 'officious bystander' test, refer to Chapter 7.

From ***Graves* v *Graves*** it can be seen that the implied term approach as set out by Lord Atkin in ***Bell* v *Lever Bros*** is still a valid way of proceeding even though Lord Phillips in ***Great Peace*** considered that this was not the correct way forward, finding that common mistake existed by way of a rule of law rather than a rule of construction. Nevertheless it can be seen that even with Lord Phillips' criteria the implied term approach still has some validity providing the new state of facts is such that performance of the contract is impossible or, alternatively, the agreement is something different in kind from the agreement in the original state of facts; however, such implied terms 'are to be no more than are necessary for giving business efficacy to the transaction . . .' (*per* Lord Atkin).

Consensus mistake

It has already been stated that this type of mistake arises because there is a mistake as to the terms of the contract. The effect of this is to preclude an agreement from arising, that is, there is a lack of *consensus ad idem*.

There are two basic categories, mutual mistakes and unilateral mistakes, though prima facie these types of mistake do not render the contract void unless the mistake induces the contract and constitutes a mistake of fact which is fundamental to the contract.

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Mutual mistake

This type of mistake occurs where the parties are at cross-purposes where, to use the example given above, *A* is offering one thing while *B* is accepting something else. It is clear in such a circumstance that the contract is void because the offer and acceptance of *A* and *B* respectively do not coincide.

An example of the above principles can be seen in the following case.

Raffles v *Wichelhaus* (1864) 2 H&C 906

The defendants had agreed to purchase '125 bales of Surat cotton . . . to arrive ex *Peerless* from Bombay'. From the agreement it appeared that the defendants thought they were purchasing a cargo of cotton from the SS *Peerless* which had set sail from Bombay in October. In fact the plaintiffs thought they had sold a cargo of cotton on another ship called the SS *Peerless* which had set sail from Bombay in December. It was held that the contract was void for a fundamental mistake of fact that had prevented the formation of agreement – the offer and acceptance of the parties had failed to coincide.

In order to establish a mutual mistake one has to show that there is such a degree of ambiguity that it is impossible, on applying the objective test of a reasonable person, that the parties intended to be bound by one set of terms or the other. If, on an objective view, the parties could only have come to a single, common understanding of the terms of the contract then they will be bound by the contract, despite the actual view of a party that they were mistaken as to the terms. The test was expressed by Blackburn J in ***Smith* v *Hughes*** (1871) LR 6 QB 597. He stated:

> If whatever a man's real intention may be, he so conducts himself that a reasonable man would believe that he was assenting to the terms proposed by the other party, and that other party upon that belief enters into a contract with him, the man thus conducting himself would be equally bound as if he intended to agree to the other party's terms.

The application of the objective test approach can be plainly seen when the case of ***Scriven Bros & Co.* v *Hindley & Co.*** is compared with that of ***Smith* v *Hughes*** (above).

Scriven Bros & Co. v *Hindley & Co.* [1913] 3 KB 564

The defendants wanted to purchase a quantity of hemp being sold at auction by the plaintiffs. Two lots were put up for sale from the same ship; however, one lot consisted of hemp and one of tow, though the identification marks on the bales were precisely the same. Closer examination would have revealed the distinction, but the defendants, having inspected the first lot and found it to contain hemp, immediately mistakenly considered that the other lot also contained hemp. The auction catalogue itself did not reveal the distinction and as a result the defendant paid a high price for a lot thought to contain hemp but in fact containing tow, which would normally have attracted a far lower price. The auctioneer at the time of the sale realised that the defendants had made a mistake, but one which related to the market value of tow rather than as to the nature of the lot per se. The defendants refused to pay, alleging mutual mistake. On applying the objective test the court found that one could not state with any degree of certainty which commodity formed the basis of the contract since it was clear that a reasonable person would have been misled as to the nature of each lot. The contract was thus held to be void for mistake.

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Smith v *Hughes* (1871) LR 6 QB 597

In this case the defendant, a racehorse owner, wished to purchase a quantity of oats. A sample of the oats was inspected and the defendant agreed to purchase the whole amount. When the oats were delivered it was discovered they were 'green', that is, that season's oats. The defendant refused to pay for them, saying he thought he was buying 'old', or the last season's oats. When sued for the price the defendant argued that the contract was void for mistake. The court held that on an objective test basis there was a valid contract. On a finding of fact the seller had not misrepresented the oats as being old, nor was there any suggestion that there was a term of the contract to this effect. The purchaser could not establish mistake on the basis of the fact that he had been careless and as a result misled himself as to the nature of the oats.

A further matter that may be seen to operate in these two cases is that of negligence. It is possible to discern a line of authority that appears to present evidence of an underlying policy that the courts will find for mistake, or not, as the case may be, because of the negligence of one of the protagonists to the contract. Thus in the ***Scriven*** case the contract was held to be void, not only on the basis of a lack of consensus, but also because the mistake was in effect promoted by the inaccurate or incomplete description attached to the two lots in the catalogue. In the ***Smith*** case, however, the purchaser, who was no doubt mistaken as to what he thought he was purchasing, was nevertheless held to his bargain, bad though it was, because his mistake was carelessly self-induced. Certainly in the latter case this line of reasoning conforms to the common law notion of *caveat emptor* and is seen in the judgment of Cockburn CJ when he states:

> I take the true rule to be, that where a specific article is offered for sale, without express warranty, or without circumstances from which the law will imply a warranty . . . and the buyer has full opportunity of inspecting and forming his own judgment, if he chooses to act on his own judgment, the rule *caveat emptor* applies . . . The buyer persuaded himself they were old oats, when they were not so . . . He was himself to blame.

In both cases, carelessness precludes the rights of a party from arising and must therefore be regarded as a relevant consideration in applying the objective test as to whether he has entered into a contract or not.

Unilateral mistake

In this type of mistake the objective test discussed above is replaced with a subjective one since we are concerned here with a situation in which one party is actually aware of the other party's mistake. This type of mistake arises directly out of the classical analysis of contract in that where one party contracts on the basis of a mistake as to the nature of a promise made by the other party and that other party is aware of the mistake of the first, the contract is void for there is no conjoining link between the offer and the acceptance of the parties concerned.

It should be noted carefully that for this type of mistake to operate there must be a fundamental mistake as to the nature of the promise made by the other party – a mistake as to quality will not suffice. The mistake must also be one which induces the other party to enter into the contract. It should also be borne in mind that, as with other types of mistake, the overwhelming presumption is to find for the existence of a valid and binding contract. It is for the person seeking to avoid the contract to rebut this presumption. This burden of proof is indeed an onerous one and the reported instances of this being done are few and far between.

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The instances of unilateral mistake fall into two categories: mistake as to the terms of the contract and mistake as to the identity of the person contracted with.

1. Mistake as to the terms of the contract

Such a mistake will arise where one party makes an offer to another and he is aware that that other person is fundamentally mistaken as to the nature of the promise contained in the offer.

An example is the case of ***Hartog* v *Colin and Shields*** [1939] 3 All ER 566 where the defendant mistakenly offered to sell a number of hareskins, the price to be determined at a certain sum per pound, an offer which the plaintiffs accepted. In fact, preliminary negotiations had been concluded on the basis that the skins would be sold at a certain sum per piece, which accorded with normal trade usage. The plaintiffs attempted to enforce the contract on the basis of a price per pound since this was financially advantageous to them. It was held the plaintiffs could not do so since they must have known when they accepted the offer that the defendant had made a mistake.

It should be stated that this type of mistake is now very rare indeed. The common law rule of *caveat emptor* and the development of statutory provisions relating to consumer protection have substantially reduced the need to plead this type of mistake.

2. Mistake as to the identity of the person contracted with

A contract may become a nullity where a party is mistaken as to the identity of the person contracted with and the other party is aware of that mistake. It should be stressed that the question of the other party's identity must be of fundamental importance to the innocent party for the type of mistake to operate. It is a question of fact as to whether the identity of the other party is fundamental or not. It is for the person seeking to have the contract set aside for mistake to rebut this presumption. As with other types of mistake the presumption is that there exists a valid contract between the parties to the contract.

The last point is particularly important in this type of mistake, which is perhaps the most common of all alleged mistakes. Related to this point is the fact that the courts have in mind the protection of third parties who may be adversely affected by the finding of a contract being void *ab initio* for mistake, as was indicated at the start of this chapter. The courts, however, are often faced with a conflict of interest since frequently the problem of identity arises because a rogue misrepresents his identity to obtain goods from the innocent party. The balance that the courts have to make between mistake as to identity, fraudulent misrepresentation and the rights of innocent third parties produces some interesting results.

Example

The typical situation that arises occurs where *A* accepts an offer to sell goods to *B*, who pretends to be *X*. *B*, having obtained the goods, now sells them to an innocent third party, *Z*. At this point *B* usually disappears although, even if they can be traced, any rights that *A* has against them are very often worthless since such rogues are usually 'men of straw'. *A*'s action will therefore be framed in terms of an action in the tort of conversion against *Z*, alleging that they, *A*, have a better title to the goods than *Z*. In order to prove the case *A* will attempt to prove that the contract with *B* is void *ab initio* for mistake as to identity. If *A* is able to do this then it follows that *B* never acquired good title to the goods, in which case they cannot convey good title to *Z* – *nemo dat quod non habet* – so *Z* will have to surrender the goods to *A*. *Z*'s action here will lie against *B* for breach of the implied condition as to title under s 12 of the Sale of Goods Act 1979.

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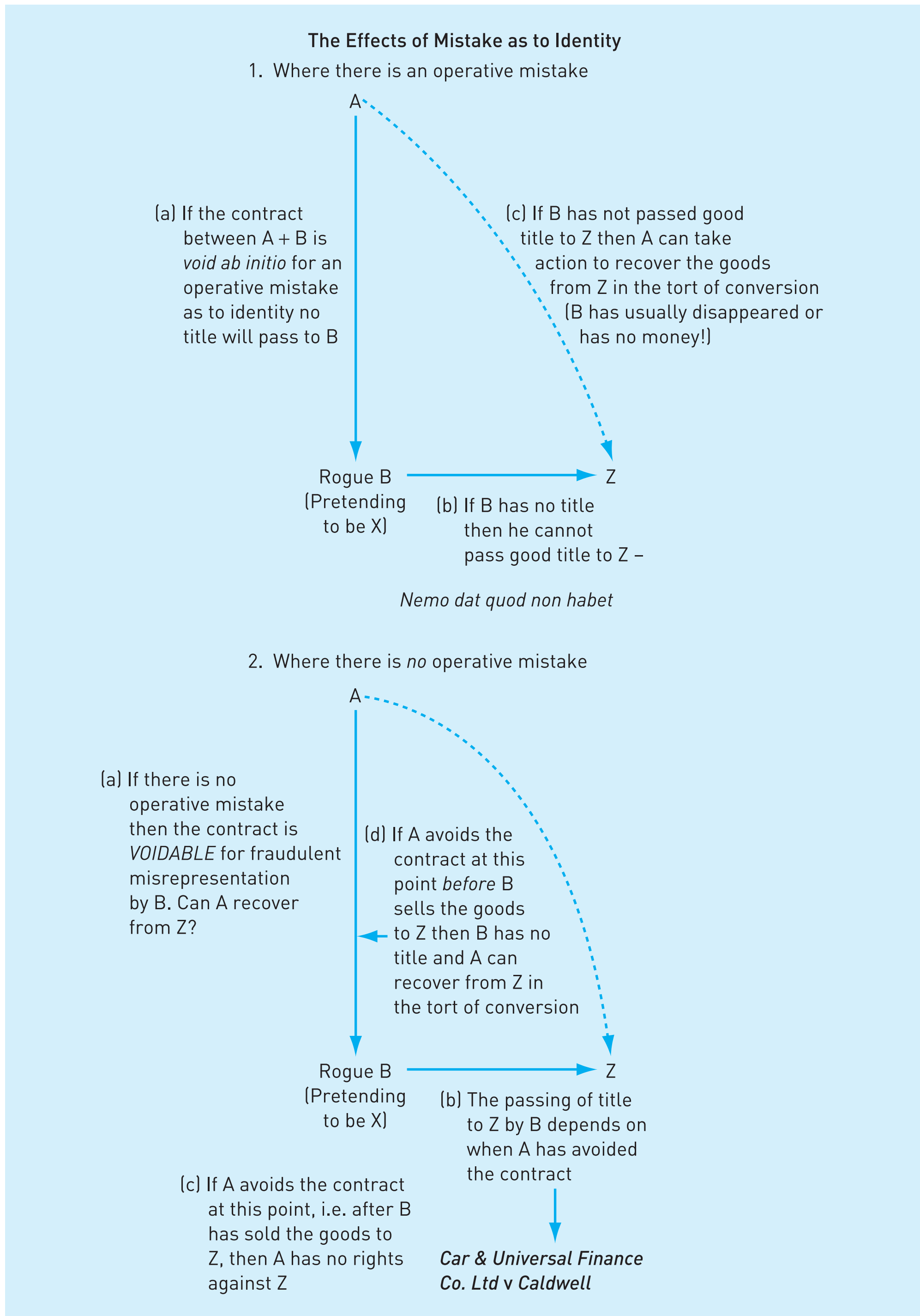

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For more on fraudulent misrepresentation see Chapter 9.

If *A* is unable to prove that the contract is void for mistake as to identity, *A* will generally be able to show that there is a fraudulent misrepresentation on the part of *B*. As we have already seen (in Chapter 9), this renders the contract voidable. In these circumstances timing becomes crucial, since here *A* must take steps to show the intention to rescind the contract as soon as they have discovered the deception perpetrated upon him. Invariably they will be seeking to rescind out of court and, as already indicated in ***Car and Universal Finance Co. Ltd* v *Caldwell*** [1964] 1 All ER 290 (also discussed in the last chapter), *A* may display such intention by informing the police, for instance. If *A* manages to avoid the contract *before B* sells the goods to *Z* then the same situation as for mistake exists, since ownership in the goods will revert to *A* and *B* will not have any title to convey to *Z*, who again will have to surrender the goods to *A*. If, however, *A* rescinds the contract only *after B* has sold the goods to *Z*, then up to this point *B* will have had good title to the goods which *B* will have transferred to *Z*. In such a case *A* will be unable to recover the goods from *Z* and would have to sue *B* for breach of contract for non-payment which, as has already been noted, is not usually worthwhile. In any event *A* should consider tracing the proceeds of the sale to the bank accounts or some other fund of *B*, assuming he has one! Tracing would give *A* a procedural advantage since if *B* has other creditors the effect of a tracing order will be to give *A* priority over other creditors. The right to trace will be lost if the fund has been dissipated, though here it may be possible to trace in equity. It should also be borne in mind that *A* may be able to trace against *Z* even in these circumstances if *A* can show that *Z* was not a bona fide purchaser in that *Z* knew of the defective title of *B*.

The basic rule as set out is, on the face of things, very simple in that the seller can only pass good title if they possess good title in the first place – the *nemo dat* rule. Of course this principle can produce some very unfair results for the innocent third party, even if they are a bona fide purchaser. For this reason exceptions to the strict rule have been developed which allow a non-owner to pass good title to a purchaser provided the non-owner has the authority of the owner. Many of these exceptions are now found in the Sale of Goods Act 1979. The case of ***Shogun Finance Ltd* v *Hudson*** illustrates the effect of another example contained in the Hire Purchase Act 1964, s 27, and the differences between void and voidable contracts as set out above. This provision applies specifically to motor vehicles held on hire purchase terms. It should be noted that a person who buys goods under a hire purchase agreement is not the owner of the goods but merely hires them until the last payment is made, the goods being owned by the finance company. Thus the hirer does not normally have ownership of the goods to be able to pass good title to a purchaser when they sell them since the *nemo dat* rule applies. Under s 27, however, a private purchaser, who, while acting in good faith and without notice of the hire purchase agreement, buys a car from a seller (described in the Act as the 'debtor') who in turn holds the vehicle under a hire purchase agreement, will obtain good title.

Shogun Finance Ltd v *Hudson* (2001) *The Times*, 4 July (CA)

The facts of the case were that a rogue visited a car dealer and purchased a Mitsubishi Shogun on hire purchase terms. In order to verify his identity he produced a stolen driving licence in the name of Mr Patel. The dealer contacted Shogun Finance Ltd, the claimant, requesting finance for 'Mr Patel'. The claimant finance company then conducted a finance search against the name of 'Mr Patel' and subsequently accepted a hire purchase agreement signed by the rogue, giving him finance to purchase the car. The rogue then paid a deposit of 10 per cent and drove the car away. The rogue sold the car to Mr Hudson, the

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defendant. The rogue then disappeared and the finance company brought an action for conversion from Hudson, who claimed that he had acquired good title to the car under the Hire Purchase Act 1964, s 27. The County Court gave judgment in favour of the claimant finance company and Hudson appealed.

The Court of Appeal, by a majority, dismissed the appeal, stating that s 27 of the Hire Purchase Act 1964 only protects a purchaser from a 'debtor' and the question then arose as to whether the rogue was in fact the 'debtor'. The court was divided on this issue, Dyson LJ and Brooke LJ deciding that the rogue, having forged Mr Patel's signature, was not the debtor – this was Mr Patel himself. The agreement could not be enforced against Mr Patel since the fact that his signature had been forged precluded this. Their Lordships relied on a rather peculiar judgment in ***Hector* v *Lyons*** (1988) P & CR 156, which stated the principle that in a written contract the identities of the parties are established by the names on the contract. The problem with the use of the case in this context is that it really is not relevant to an action involving a seller and a third party, as in this case and as pointed out by Sedley LJ, who gave the dissenting judgment.

The Court of Appeal also considered the issue of unilateral mistake as to identity. As can be seen later, it is easier to prove unilateral mistake where the parties are not in each other's presence (*inter absentes*). Dyson LJ stated that the identity of the hirer was of crucial importance to the finance company in that it only intended to deal with Mr Patel. The claimant company was therefore able to show that the hire purchase agreement between themselves and the rogue was void for unilateral mistake and therefore Hudson could not rely on s 27. Since the rogue would not have had ownership of the car under the hire purchase agreement he could not pass good title to Hudson.

The Court of Appeal decision was upheld in the House of Lords (Lords Nicholls and Millett dissenting) ([2004] 1 All ER 215). Lord Hobhouse gave the leading judgment and stated that the relevant question is whether the rogue was the debtor under the hire purchase agreement relating to the car. Mr Hudson considered he was, whilst the finance company considered otherwise. He stated that the agreement emphasised that the customer/hirer could only be the person named on the front of the document; that the agreement was the written agreement contained in the written document; the offer being accepted by the creditor is that contained in the written document, that is the offer of Mr Patel; that for the offer to be made the form had to have been signed by Mr Patel; and most importantly the question in issue revolves around the construction of the written document alone.

Taking each point in turn, Lord Hobhouse considered that the document referred to nobody else but Mr Patel. The finance company was only willing to do business with the person identified in the written document and no one else. This is what the rogue expected since the company was willing to deal with Mr Patel but not with the rogue. Lord Hobhouse considered that Sedley LJ in the Court of Appeal was wrong in concluding that this was a case of a rogue using an alias 'to disguise the purchaser rather than to deceive the vendor as seen in the case of ***King's Norton Metal Co. Ltd* v *Edridge, Merrett & Co. Ltd***' (*see* below). Thus it is Mr Patel who is the debtor, not the rogue.

Of course it is not disputed that the rogue had no authority to deal on behalf of Mr Patel, nor that he was Mr Patel. Mr Hudson dealt with this issue by stating that it was the rogue that came into the showroom, not Mr Patel. Mr Patel knew nothing of the agreement, had not signed the agreement and therefore Mr Patel could not be the debtor. Lord Hobhouse considered that this was an attempt to adduce oral evidence in order to overturn a written agreement. He did not consider that this was possible where a party is specifically named in the agreement. In arriving at this conclusion he also referred to the

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case of ***Hector* v *Lyons*** (1988) 58 P & CR 156, referred to in the Court of Appeal. It is useful to look at this case in more detail in order to understand the position more clearly.

The case concerned the purchase of a piece of land in which Mr Hector Senior negotiated with Mrs Lyons. Originally they negotiated over the telephone and then on a face-to-face basis. In fact Mr Hector Senior was negotiating on behalf of his son because he was under age. In due course Mr Hector Senior instructed his solicitors to act for him in his son's name and in due course contracts were signed and exchanged. The name of Mr Hector Junior was given as the purchaser and Mr Hector Senior signed in his son's name. Mrs Lyons then failed to complete the sale and Mr Hector Senior brought an action for specific performance in his own name. His action failed on the basis that there was no contract with Mr Hector Senior. The identity of the parties was established by the names in the contract – Mrs Lyons and Mr Hector Junior – as held by Lords Woolf and Browne-Wilkinson.

Mr Hudson in ***Shogun*** contended that this decision was wrong and should be overruled; however, Lords Hobhouse, Phillips and Walker considered the decision to be correct. Lord Browne-Wilkinson in ***Hector* v *Lyons*** was very clear about the distinction between contracts concluded in a face-to-face sale and those concluded in writing. In a face-to-face sale he stated that the law is well established in that the mere fact that the vendor is under a misapprehension as to the identity of the person in front of them does not in itself render the contract void for mistake. This type of mistake is one as to the attributes of the person with whom they are dealing – a mistake as to creditworthiness – which may be voidable for misrepresentation. The only time a contract becomes void for a mistake as to identity is when the identity of the person contracted with is 'of a direct and important materiality in inducing the vendor to enter into the contract'. He went on to state:

> In my judgment the principle [there enunciated] has no application to a case such as the present where the contract is wholly in writing. There the identity of the vendor and of the purchaser is established by the names of the parties included in the written contract. Once those names are there in the contract, the only question for the court is to identify who they are.

Lord Woolf concurred with this position:

> Parties to the contract are normally to be ascertained from the document or documents containing the contract. There can be limited circumstances where it is possible to allow oral evidence to be given in relation to a written contract, but those circumstances are recognised as being exceptional and should, in my view, be strictly confined.

Where does this leave Mr Hudson? Since Mr Patel was named in the agreement he was a party to it. The delivery of the car to the rogue was wrongful since the dealer only had the authority of the finance company to deliver it to Mr Patel and no one else. Delivering the car to the rogue was a tortious act, even though the dealer had acted under an innocent mistake induced by the fraud of the rogue. The exception contained in the Hire Purchase Act 1964, s 27 only protects a purchaser from a debtor. The debtor here is Mr Patel, but of course he did not sell the car to Mr Hudson. This was done by the rogue. Essentially the rogue was a thief, who had no title to the car and could not therefore confer any title on Mr Hudson – *nemo dat quod non habet*. Mr Hudson was therefore liable to the finance company for the value of the car.

In order to prove unilateral mistake as to identity, the person alleging mistake must prove *each* of the following:

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1 an intention to deal with some other person;
2 that the other party knew of this intention;
3 that the identity was of fundamental importance;
4 that reasonable steps had been taken to verify the identity.

One has to show that there was *an intention to deal with some other person* than the one with whom they appear to have made the contract. In other words, it has to be shown that there is confusion between two identities. The point is well illustrated by the following case.

King's Norton Metal Co. Ltd v *Edridge, Merrett & Co. Ltd* (1897) 14 TLR 98

A rogue by the name of Wallis set up a business under the name of Hallam & Co. with the sole purpose of defrauding the plaintiffs. He had letterheads drawn up and printed which depicted the firm as being one of some substance. He then obtained goods from the plaintiffs after sending an order on one of the sheets of letterheaded notepaper. Wallis then sold the goods to the defendants, who bought them in good faith. The plaintiffs now sued the defendants alleging that the contract with Hallam & Co. was void for mistake and that no title could be conveyed to the defendants. It was held that their action should fail since there was no mistake as to identity – they had intended to contract with Hallam & Co. and that was whom they had in fact contracted with. The plaintiffs failed to show that there was some other person with whom they had intended to do business; the court therefore rejected their claim.

The mistaken party must prove that *the other party was aware of the above intention*. Usually there is little problem in proving this since, where mistake as to identity is pleaded, it is usually the result of a fraud being perpetrated on the mistaken party. It is clear that one cannot present oneself as a party to a contract knowing that the other party had no intention of entering into a contract with that person. It follows from this that an offer can only be accepted by the party to whom it is addressed. The case of ***Boulton* v *Jones*** illustrates the point and provides a rare example of a case in which no fraudulent misrepresentation arose.

Boulton v *Jones* (1957) 2 H & N 564

The facts were that the plaintiff, Boulton, had bought the business belonging to Brocklehurst. The defendant, Jones, had formerly dealt with Brocklehurst with whom he had a running account. One feature of the business relationship between Jones and Brocklehurst was that Jones could set against the account moneys owed to him by Brocklehurst. Jones sent an order for goods from Brocklehurst but on the day the order was received the business was sold to Boulton, who executed the order. When Jones was presented with the bill he refused to pay since he had intended the order to go to Brocklehurst so that he could set off against the value of the order moneys owed to him by Brocklehurst. It was held that Jones was not liable for the price.

The actual basis for the decision in ***Boulton* v *Jones*** is ambiguous in that it could be based on either unilateral or mutual mistake. If the decision is based on unilateral mistake then it is undoubtedly correct, but if based on mutual mistake then it is highly questionable. In mutual mistake the finding of mistake in the contract is assessed in objective terms rather than subjectively as in unilateral mistake. Translated into a test the

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question that has to be asked is whether the reasonable person in the position of the offeree would have considered the offer to be intended for them, *not* whether the offeror intended to deal with the person to whom the offer was made. On this basis a reasonable person would no doubt have concluded that the identity of the seller was a matter of indifference to the purchaser. Such a conclusion would result in there being no *operative* mistake, and thus Jones would have been bound by the contract despite the fact that he could prove that he had made a mistake. The point is affirmed in ***Upton-on-Severn RDC* v *Powell*** [1942] 1 All ER 220.

In order to prove mistake the party alleging it must show that at the time of contracting *the identity of the person they were dealing with was of fundamental and crucial importance to them*. This is not easy to prove since the mistaken party clearly has to produce evidence of the fact from their conduct before or at the time of contracting. In these circumstances such individuals are generally mistaken more as to the attributes of the person they are dealing with, such as creditworthiness, rather than as to identity. Further it should be noted that it is usually easier to prove this where the parties contract *inter absentes*, for example by post. Where the parties contract *inter praesentes*, for example in a shop, the presumption is that the mistaken party intends to deal with the person before them, whoever they are, and very strong evidence indeed is required to rebut the presumption.

Can a person deal with another *inter absentes* but actually contract *inter praesentes* via an agent? In ***Shogun Finance Ltd* v *Hudson*** above, Sedley LJ, who gave the leading judgment, thought so. Whilst the majority of the Court of Appeal considered that the contract was made *inter absentes* between the rogue and the finance company, Sedley LJ considered that the car dealer acted as the finance company's agent. The dealer, he said, was the finance company's eyes and ears for the purposes of establishing the rogue's identity, faxing his driving licence and obtaining his signature of the hire purchase agreement. This, Sedley LJ stated, 'amounted to face-to-face dealing as if they had been carried out at the [finance company's] office'. Whilst this is only a dissenting judgment it is nevertheless a credible conclusion in arrangements of this nature.

If we look at cases involving alleged mistake, *inter absentes* first of all, in the case of ***King's Norton Metal Co.***, the facts of which have already been discussed, it is clear that the party alleging mistake was not mistaken as to the identity of the person they had contracted with. They were merely mistaken as to the creditworthiness of that party. They thought they were contracting with a solvent and substantial business as portrayed on the letterhead, not some insolvent rogue. They were ready and willing to deal with anyone and were concerned not as to the identity per se but as to whether they would get paid on the contract. The case can be contrasted with that of ***Cundy* v *Lindsay***.

Cundy v *Lindsay* (1878) 3 App Cas 459

A rogue set up a business by the name of Blenkarn at 37 Wood Street and sent an order for goods to the plaintiffs. The order was signed by the rogue in such a way that it looked like the name Blenkiron and Co. which traded at 123 Wood Street, a firm which the plaintiffs knew to be highly respectable. The plaintiffs accepted the order and despatched them to 'Messrs Blenkiron and Co., 37 Wood Street'. The rogue, having received the goods, sold them to the defendants, who took the goods in good faith. The plaintiffs now attempted to recover the goods from the defendants in conversion. The House of Lords held that they would succeed in their action in that they had intended only to contract with Blenkiron and Co. and nobody else and that the identity of the person they were to contract with was of fundamental and crucial importance at the time of entering into the contract. The position was summed up by Lord Cairns:

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> I ask the question, how is it possible to imagine that in that state of things any contract could have arisen between the Respondents and Blenkarn the dishonest man? Of him they knew nothing, and of him they never thought. With him they never intended to deal. Their minds never even for an instant of time rested on him, and as between him and them there was no consensus of mind which could lead to any agreement or any contract whatsoever.

In ***Cundy* v *Lindsay*** there was clearly confusion as to which of two distinct entities had been contracted with. In the ***King's Norton*** case this was not apparent since there existed only one entity, Hallam & Co. On this basis, then, to establish mistake it is not enough for the party alleging mistake merely to show that they did not intend to contract with a particular individual. They must show also that they intended instead to contract with some other person capable of being identified, though it may be questionable whether this person must actually exist or whether the person may remain completely fictitious.

Turning our attention to cases where the parties are *inter praesentes* we find, as already indicated, that it is particularly difficult to refute the presumption that the party alleging mistake intended to deal with the person in front of them. As a result, successful actions are fairly rare. One of the early cases exemplifying this problem is that of ***Phillips* v *Brooks Ltd***.

Phillips v *Brooks Ltd* [1919] 2 KB 243

The facts of the case were that a rogue named North entered the jewellery shop owned by the plaintiff and selected some pearls valued at £2,500 and a ring valued at £450. He then proceeded to write out a cheque and as he did so stated, 'You see who I am, I am Sir George Bullough', giving an address in St James's Square. The plaintiff had heard of Sir George Bullough and on checking the telephone directory confirmed the address given. The plaintiff then asked if he would like to take the articles with him, to which the rogue replied, 'You had better have the cheque cleared first, but I should like to take the ring, as it is my wife's birthday tomorrow.' The plaintiff let North take the ring, and North then pawned it to the defendant, who took it in good faith. The plaintiff, on discovering the fraud, now sued the pawnbroker defendant in conversion, alleging that the contract was void for mistake. It was of course imperative that he successfully establish mistake since otherwise the contract would only be voidable for fraudulent misrepresentation, in which case the contract would be valid until disaffirmed and rescinded by the plaintiff jeweller. In such a case the plaintiff would not be able to recover the ring from the defendant since the rescission would have come after the goods and the ownership to them were transferred to the defendant pawnbroker, thereby leaving the plaintiff with a worthless claim against the rogue North.

It was held that while the jeweller believed he was dealing with Sir George Bullough he would in fact have contracted with anyone present in the shop. Evidence of this decision can be seen in the fact that the contract had already been completed when the question of identity arose. The rogue had selected the items and offered to buy them. The plaintiff had accepted the offer and the rogue was writing out the cheque in payment for the goods when the question of identity arose. The identity of the person in front of the jeweller was not of fundamental or of crucial importance before or at the time of contracting. The jeweller thus failed in his action in conversion against the defendant.

Two other cases also illustrate the problems that arise in this context. The first is that of ***Ingram* v *Little*** [1960] 3 All ER 332, where two sisters jointly owned a car which they

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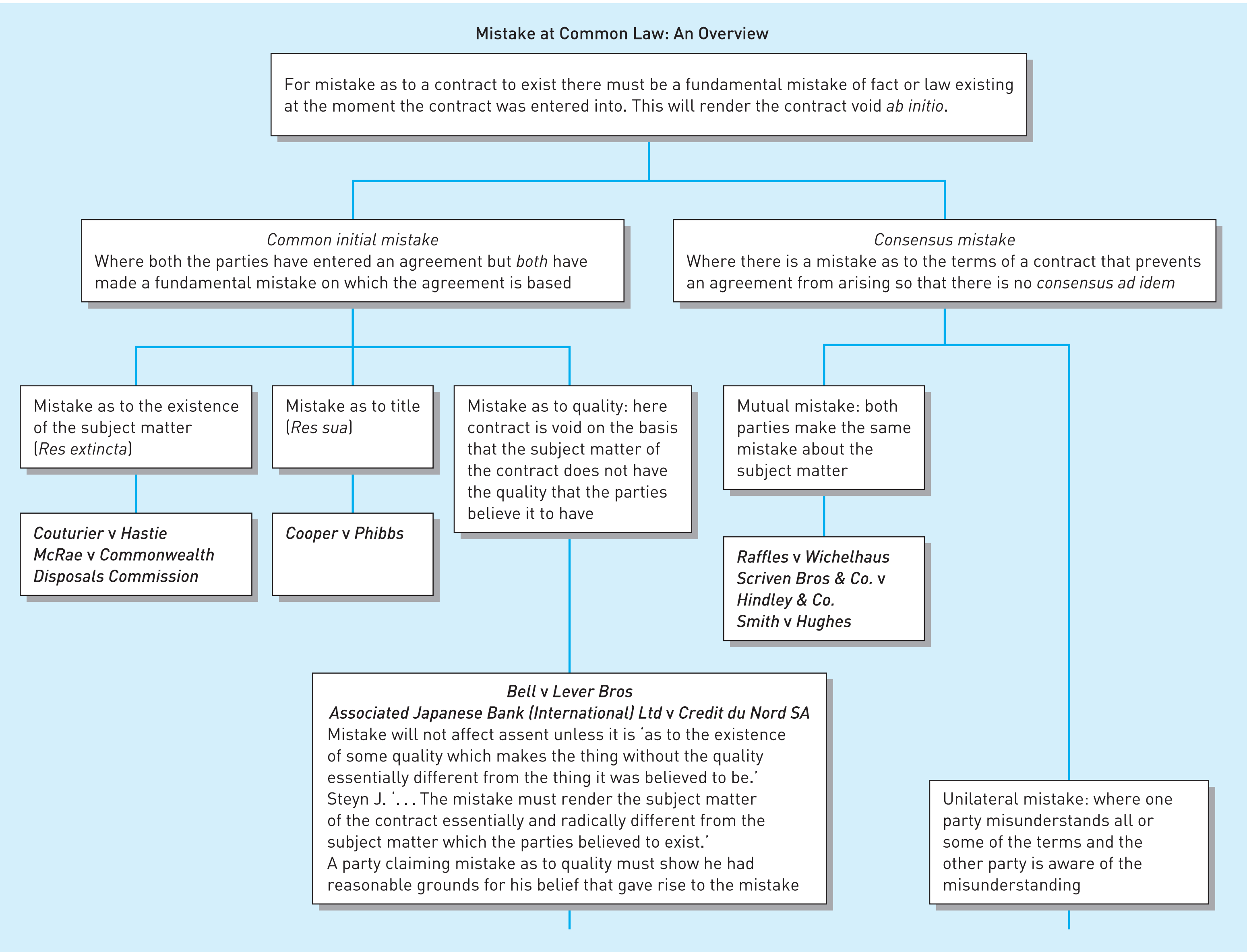
advertised for sale. A rogue called and agreed with one of the sisters to purchase the car for £717. When he proffered a cheque for the amount the sister adamantly refused to accept it, whereupon the rogue stated that he was P G M Hutchinson and that he had substantial business interests. Whilst the discussions were taking place the other sister checked the name and address of P G M Hutchinson in the telephone directory which seemed to corroborate his story. The sisters then agreed to let him have the car and accept his cheque. The cheque was subsequently dishonoured and the rogue, who was of course not P G M Hutchinson, sold the car to a third party who purchased the vehicle in good faith. The plaintiffs sued the defendant in conversion, alleging that the contract was void for mistake as to the identity and succeeded. The case, however, is largely regarded as being at best decided on the facts of the particular case and at worst, wrongly decided. It is suggested that in fact the latter is the only appropriate description of the case. It has been clearly established that the mistake as to identity must be of fundamental or crucial importance before or at the time of contracting to be operative. In this case the contract was complete, the sale agreed, and it was only when the rogue proffered a cheque that the question of identity arose. There may have been a dispute as to the mode of payment but identity was not at issue until this point.

The second case is that of ***Lewis* v *Averay*** [1971] 3 All ER 907 where the facts were very similar to those of ***Ingram* v *Little***. Here again the plaintiff was the owner of a car that he wished to sell, and to do so he advertised it in the local newspaper. A rogue arranged to see the car and on doing so offered to buy it at the stated price. The plaintiff accepted the offer and the rogue then wrote out a cheque signing it 'R A Green'. The rogue asked if he could take the car straight away but at this the plaintiff became hesitant and did not want to part with the car until the cheque had cleared. The plaintiff asked the rogue whether he had some evidence as to his identity. The rogue produced a pass to Pinewood Studios as proof that he was Richard Greene, the well-known actor. The plaintiff, on examining the pass, allowed the rogue to take the car. The rogue then sold the car to an innocent third party and the cheque was subsequently dishonoured. The plaintiff then claimed the goods from the third party in conversion on the basis that the contract between himself and the rogue was void for mistake as to identity.

The Court of Appeal held that his action must fail since the plaintiff intended to deal with the person in front of him irrespective of his identity and that the contract was subsequently only voidable for fraudulent misrepresentation. Since the plaintiff had disaffirmed the contract only after the third party had purchased the car, the third party acquired a good title in the vehicle. Megaw LJ based his decision on the traditional analysis that the identity of the rogue was not of fundamental and crucial importance before or at the time of contracting and only became relevant when the rogue paid by cheque and wanted the car immediately. Lord Denning MR arrived at the same decision though on a somewhat different basis. He considered that the fine distinction between identity and attributes, or creditworthiness, and the time when the identity became important was to miss the point of the principle of mistake, which was ultimately to protect innocent third party purchasers. He considered that the effect of mistake as to identity was not to render the contract void but merely voidable, 'that is, liable to be set aside at the instance of the mistaken person, so long as he does so before third parties have in good faith acquired rights under it'. There would appear to be considerable merit in such an approach since the cases clearly tend to reflect this situation in any event.

The following is a rather more modern case that deals with the distinction between identity and attributes.



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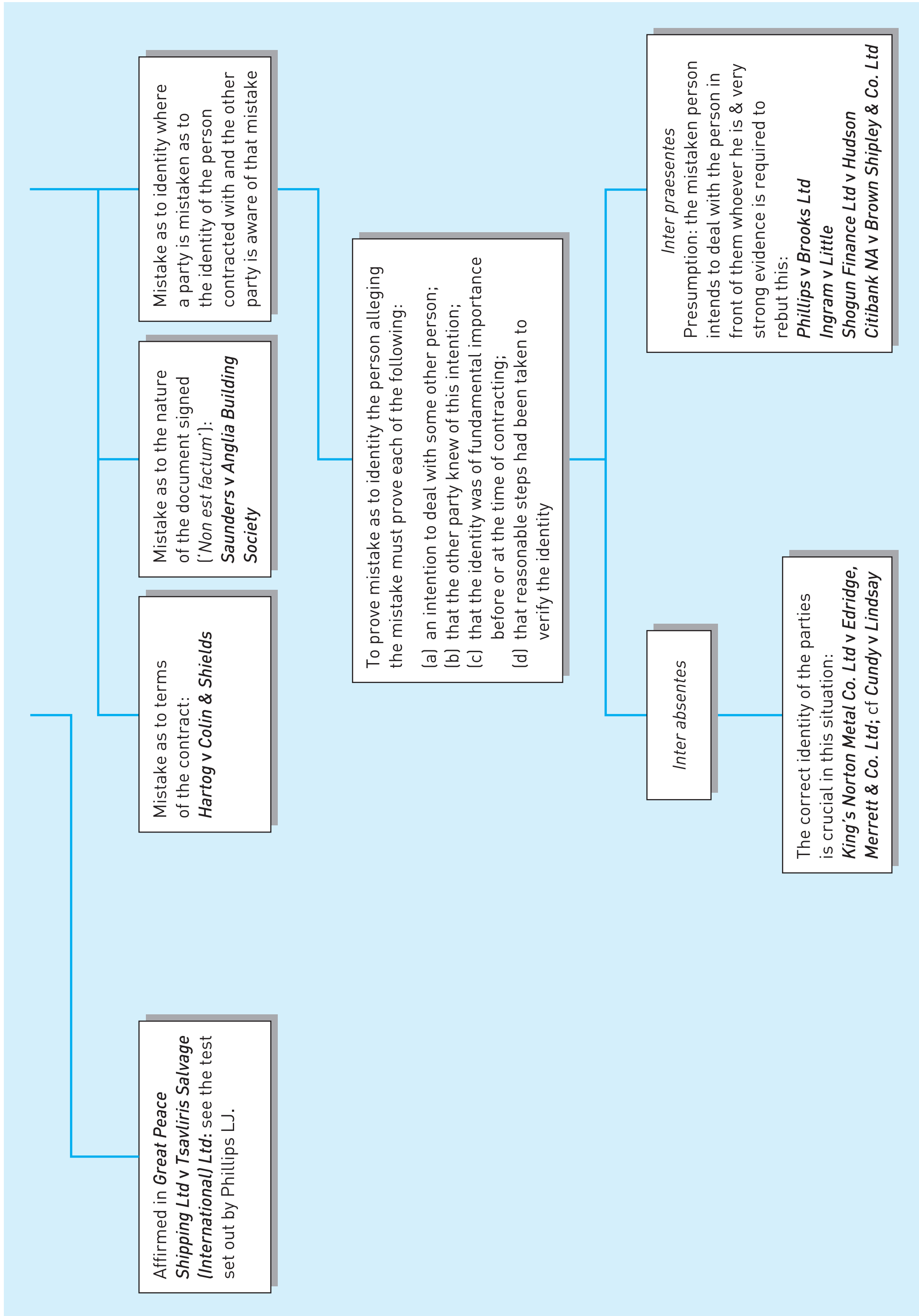

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Citibank NA v *Brown Shipley & Co. Ltd; Midland Bank plc* v *Brown Shipley & Co. Ltd* [1991] 2 All ER 690

Here a rogue claimed to be a signatory on a company account held with the plaintiff bank. The rogue telephoned the defendant bank and asked to purchase some foreign currency which he would pay for by a banker's draft drawn on the company account held by the plaintiff. The rogue then telephoned the plaintiff requesting the banker's draft, which it handed to a 'messenger' whom the plaintiff thought was from the company. In exchange for the draft, a forged letter of authority was given. The draft was then paid to the defendant who, after confirming that the draft had in fact been issued by the plaintiff in the ordinary course of business, paid the cash to the rogue. In due course the defendant presented the draft to the plaintiff bank and was subsequently paid. When the fraud was eventually discovered, the plaintiff bank brought an action to recover the value of the draft from the defendant. The action was based on the allegation that title had never passed to the defendant bank as it could not derive a good title from the rogue and that there was no contract between the two banks. The court held that the fact that the plaintiff had mistakenly dealt with a rogue instead of the company which the plaintiff bank thought they were dealing with did not prevent the formation of a contract between the two banks. The court agreed that the rogue had no title because of mistaken identity but they found that he was a 'mere conduit'. Title did not pass from the rogue to the defendant. The important factor was the identity of the paying bank, the defendant, and that there was no mistake here.

The party alleging mistake must last of all show that they have taken *reasonable steps to attempt to verify the identity* of the person with whom they are about to contract. This requirement must be shown whether or not the contract is made *inter absentes* or *inter praesentes*.

In ***Shogun Finance Ltd* v *Hudson*** Lords Phillips and Walker, however, considered that the present law as to mistake as to identity was correct. The presumption that in a contract made face to face (and possibly in telephone conversations) the offer (or in an appropriate case the acceptance) was made to the person present whoever he or she was, as in ***Phillips* v *Brooks*** [1919] 2 KB 243. They considered that ***Ingram* v *Little*** was wrongly decided, something which lawyers for many years have considered to be the case. The presumption, however, did not apply in written contracts, since the offer and acceptance was derived from the written correspondence. In such cases, where the rogue passes himself or herself off as an existing individual or company of reputable standing, the offer is intended to be with the individual or the company, not the rogue, as held in ***Cundy* v *Lindsay*** (1878) 3 App Cas 459. Lord Hobhouse, however, did not consider mistake as to identity to be an issue in the case, basing his judgment on the issue of the construction of a written contract.

The dissenting judges, Lords Nicholls and Millett, considered that it was unsatisfactory to decide the issues by reference to the mode by which the contract was concluded. The notion that there was a difference between mistake as to identity and mistake as to attributes was untenable and the face-to-face presumption should be abolished. A person should be deemed 'to intend to contract with the person with whom he is actually dealing, whatever mode of communication' (*per* Lord Nicholls). On this basis both their Lordships considered that ***Cundy* v *Lindsay*** was wrongly decided and should no longer be followed. In some respects the arguments put forward by Lords Nicholls and Millett are attractive propositions since here the vendor will bear the loss. This is considered to be fair since, given that the vendor and third party are both innocent, the vendor is not only usually better able to bear the loss but also it is the vendor who has taken the risk of parting with the goods without recovering payment for them.

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Mistake in equity

It has been seen that the effect of mistake at common law is to render the contract void *ab initio*, whereas mistake in equity has the effect of merely rendering the contract voidable. Furthermore, equity is generally prepared to come to such a conclusion despite the fact that the common law itself might refuse to intervene. Thus in ***Solle* v *Butcher*** [1950] 1 KB 671, Lord Denning stated:

> Let me next consider mistakes which render the contract voidable, that is liable to be set aside on some equitable ground. Whilst pre-supposing that a contract was good at law, or at any rate not void, this court of equity would often relieve a party from the consequences of his own mistake, so long as it could do so without injustice to third parties. The court had power to set aside the contract whenever it was of the opinion that it was unconscientious for the other party to avail himself of the legal advantage which he has obtained . . .

This position has now been subject to challenge in ***Great Peace Shipping Ltd* v *Tsavliris Salvage (International) Ltd*** [2002] 4 All ER 689. As stated earlier in relation to mistake as to the quality of the subject matter of the contract, the case was based, first, on the ground that the contract was void at common law and, second, that it was voidable for mistake in equity. Counsel for the defendants had proposed that if the contract was not void at common law there was an equitable jurisdiction to grant rescission on grounds of common mistake. This was always the acknowledged view; indeed this was recognised by Steyn J in the ***Associated Japanese Bank*** case where he stated:

> No one could fairly suggest that in this difficult area of the law there is only one correct approach or solution. But a narrow doctrine of common law mistake (as enunciated in ***Bell* v *Lever Bros Ltd***), supplemented by the more flexible doctrine of mistake in equity (as developed in ***Solle* v *Butcher*** and later cases), seems to me to be an entirely sensible and satisfactory state of the law.

In the first instance decision in ***Great Peace***, Toulson J took a different view entirely after examining the basis on which Denning LJ formed his decision in ***Solle* v *Butcher***, which he found to be defective. This was taken up by the Court of Appeal by Lord Phillips MR, who also examined ***Solle* v *Butcher*** and the many cases that followed it. He stated:

> the premise of equity's intrusion into the effects of the common law is that the common law in question is seen in the particular case to work injustice.

Phillips MR queried whether there was a legal basis for the equitable doctrine of mistake as set out in ***Solle* v *Butcher***. He disapproved of the decision and considered it to be not good law. More will be stated about this decision later but for the moment it is useful to assess how mistake in equity evolved.

The circumstances in which equity grants relief tend to be categorised not on the nature of the mistake per se but according to the manner of the relief that is within the discretion of the court.

Rescission

This remedy is available widely outside the sphere of mistake, as may be seen in relation to misrepresentation. As with all equitable remedies its award is discretionary and it thus follows that the courts can apply rescission subject to any terms they feel appropriate in order to fulfil the principle of *restitutio in integrum*. The remedy is lost where a party fails

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to apply for it within a reasonable time, or where the granting of rescission would have the effect of depriving a third party of their rights in the subject matter or where *restitutio in integrum* is impossible.

On the face of things rescission may also be used where the contract has been held to be void and an order of the court is required to place the parties back in their original positions, as has already been seen in ***Cooper* v *Phibbs***, the facts of which have already been discussed above. In that case the court in deciding to grant rescission considered that *restitutio in integrum* could only be achieved by making the order of rescission subject to the respondents having a lien over the fishery to the value they had spent improving it.

In the case of ***Cooper* v *Phibbs***, Lord Westbury commented:

> If parties contract under a mutual mistake [*sic*] and misapprehension as to their respective rights, the result is that the agreement is liable to be set aside as having been proceeded upon a common mistake.

The effect of the case is thus often upheld as providing a general authority for the use of rescission in cases of a common and material mistake irrespective of the presence of *res extincta* or *res sua*. The case of ***Huddersfield Banking Co. Ltd* v *Henry Lister & Son Ltd*** also provides authority for this proposition.

Huddersfield Banking Co. Ltd v *Henry Lister & Son Ltd* [1895] 2 Ch 273

The defendant's company had mortgaged its mills and the fixtures contained in them to the bank. Eventually the company went into insolvent liquidation. The bank claimed that it was entitled to 35 looms in the mills on the basis that since these were bolted to the floor they represented fixtures and thus fell within their security for the loans. If this was the case they could not fall into the hands of the Official Receiver to be sold to pay off the general creditors. On touring the factory premises, the agent of the bank and of the liquidator found that the looms were not in fact bolted to the floor and thus fell outside the fixtures capable of being claimed by the bank. The bank therefore gave a consent order for the looms to be sold. It then became apparent that the looms had in fact been bolted to the floor but had been wrongfully disconnected by some unauthorised person. The bank immediately applied for the consent order to be rescinded. The court held that the order had been made on the basis of a common and mutual mistake and gave an order for rescission. Lord Kay stated:

> It seems to me that, both on principle and on authority, when once the Court finds that an agreement has been come to between parties who were under a common mistake of a material fact, the Court may set it aside, and the Court has ample jurisdiction to set aside the order founded upon that agreement.

A similar decision was arrived at in ***Solle* v *Butcher*** [1950] 1 KB 671 where, as we have already seen, the contract was not held to be void for common mistake at common law. In equity, however, it was decided that the lease should be set aside. If equity had allowed the contract to be void, as in common law, this would clearly have resulted in an inequitable solution as far as the tenant was concerned since he would be dispossessed of his lease. The court thus offered him a choice of either surrendering the lease or continuing it but on the basis of paying the full rent allowable, which would have been £250 once statutory notices allowing for the increase had been served. The decision was similar in ***Grist* v *Bailey*** [1966] 2 All ER 875, where the mistake, while not being fundamental enough to render the contract void at common law, was sufficiently fundamental to render the contract voidable in equity.

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The problem with the above cases is that they are difficult to reconcile with the case of ***Bell* v *Lever Bros***, where the contract was held to be valid and binding rather than void at common law or voidable in equity. Following the case of ***Associated Japanese Bank (International) Ltd* v *Crédit du Nord*** it may be possible to find that in ***Bell*** the contract should have been void at common law. Failing this, why should it not have been held to be voidable in equity?

The latter point was considered in the case of ***Magee* v *Pennine Insurance Co. Ltd*** [1969] 2 All ER 891 in which the plaintiff bought a car on hire purchase terms for his son. At the time of purchase a proposal form for the insurance of the vehicle was filled out by the manager, who made several errors amounting to innocent misrepresentation. Some time later the car was written off in an accident and the plaintiff claimed £600, though he agreed to accept a lesser sum of £385 after negotiations with the defendant. The defendant then discovered the misrepresentations and claimed to repudiate the agreement. The majority of the Court of Appeal found that the agreement had been reached on the basis of a common mistake though not one that was so fundamental as to render the contract void at common law, as in ***Bell* v *Lever Bros***. The court, however, considered that the mistake was sufficiently fundamental to render the contract voidable in equity, though no terms were imposed on the parties. Lord Winn dissented and considered the case no different from ***Bell* v *Lever Bros*** and as such it should be regarded as binding. Lord Denning MR reconciled the decision in ***Magee*** with ***Bell*** by stating that there was an underlying doctrine of equity, which was never expressly referred to in ***Bell***, that allowed equity a discretion to set a contract aside on the basis of a common mistake as to quality. Such a proposition is somewhat radical given the stature of the judges sitting in the ***Bell*** case since, if such a doctrine existed, then surely such judges would have referred to it. The view put forward by many commentators is that such a doctrine is a figment of Lord Denning's lively and radical legal imagination.

So far we have been considering the effect of rescission in the context of shared mistakes, that is, those arising in both mutual mistake and common mistake. In assessing the intervention of equity in unilateral mistake in relation to the exercise of rescission, we find that there also arises a level of doubt as to the circumstances in which equity will exercise its discretion. One view is that such discretion should only be exercised where there has been some misrepresentation or fraudulent conduct by the other party. Another view is that rescission is available in a unilateral mistake where the other party is guilty of conduct that would make any insistence on their part that the contract be performed inequitable.

The Court of Appeal decision in ***Riverplate Properties Ltd* v *Paul*** [1975] Ch 133 tended to suggest the first narrower approach and held that equitable relief was not available simply on the ground of unilateral mistake unless the party against whom relief was being sought knew that the other party had contracted under a mistake. The case tended to lean against the establishment of a general doctrine of equitable relief in mistake, whereby the court would exercise its discretionary jurisdiction where the circumstances of the case and justice demanded it. Such a proposition was suggested in ***Solle* v *Butcher*** by Lord Denning when he stated:

> It is now clear that a contract will be set aside if the mistake of one party has been induced by a material misrepresentation of the other, even though it was not fraudulent or fundamental; or if one party, knowing that the other is mistaken about the terms of the offer, or the identity of the person by whom it is made, lets him remain under his delusion and concludes a contract on the mistaken terms instead of pointing out the mistake . . . A contract is also liable in equity to be set aside if the parties were under a common misapprehension

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> either as to facts or as to their relative and respective rights, provided that the misapprehension was fundamental, and that the party seeking to set it aside was not himself at fault.

It is, however, fair to say that Lord Denning's proposals provided a degree of flexibility that is highly desirable when balancing the interests of the contracting parties together with those of third parties. Indeed in the ***Associated Japanese Bank*** case, Steyn J, as stated, concurred with this view.

In ***William Sindall plc* v *Cambridgeshire County Council*** [1994] 1 WLR 1016, Evans LJ considered that there existed 'a category of mistake which is "fundamental", so as to permit the equitable remedy of rescission, which was wider than the kind of "serious and radical" mistake that rendered the agreement void and of no effect in law'. He suggested that the difference between these two types of mistake lay in the fact that mistake at common law is confined to those types of mistake that have regard to the subject matter of the contract. Mistake in equity, however, he considered to be a wider concept that arose where the mistake was sufficiently 'fundamental' as regards a material fact and that this category appeared to have unlimited application. This wider notion of mistake in equity was not accepted in ***Clarion Ltd* v *National Provident Institution*** [2000] 2 All ER 265, where Rimer J considered that whilst equity may relieve a party from an unconscionable bargain, it was ordinarily no part of the function of equity to provide relief from a bad bargain. Thus equity only extended to modify relief when the nature of a party's mistake related to the contract's subject matter or terms, and not to the commercial consequences of the contract irrespective of whether this mistake was 'fundamental' or not.

It is clear that the basis of mistake in equity is the subject of substantial confusion and that its whole rationale required reviewing. This long-awaited review took place in the Court of Appeal in ***Great Peace Shipping Ltd* v *Tsavliris Salvage (International) Ltd*** [2002] 4 All ER 689. The leading judgment was delivered by Lord Phillips MR, who considered the extent to which Denning's doctrine stood alongside the decision in ***Bell* v *Lever Bros***. He considered that Denning's doctrine was based on an error that arose in the case of ***Cooper* v *Phibbs*** by Lord Westbury. It will be recalled that Lord Westbury stated:

> If parties contract under a mutual mistake [*sic*] and misapprehension as to their respective rights, the result is that the agreement is liable to be set aside as having been proceeded upon a common mistake.

This comment was considered by the Court of Appeal in the decision in ***Bell* v *Lever Bros*** [1931] 1 KB 577. Here Lords Scrutton and Lawrence considered that, whilst Lord Westbury's comment was generally correct, he should not have stated that the agreement was 'liable to be set aside' but should have stated that it was *void*. In other words, the effect of the mistake is that the agreement fails to become a contract at all. Lord Phillips considered that it was for this reason that when ***Bell*** came before the House of Lords the notion of an equitable doctrine was not considered. There was no awareness of an equitable doctrine at all, only that mistake at common law rendered the contract void. Indeed, this was affirmed by Lord Atkin who also, whilst agreeing with Lord Westbury's statement, commented that the only error in it was that mistake would render the contract void not voidable.

In ***Great Peace***, Lord Phillips, having summarised the relevant sections of the various judgments of the House of Lords, stated:

> We do not find it conceivable that the House of Lords overlooked an equitable right in ***Bell* v *Lever Bros Ltd*** to rescind the agreement, notwithstanding that the agreement was not void for mistake at common law. The jurisprudence established no such right.

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Lord Phillips then turned his analysis to the decision in ***Solle* v *Butcher***, the facts of which have already been considered earlier. In this case Bucknill LJ considered there was a mistake of fact and that this mistake was of fundamental importance that allowed the contract to be rescinded under the principles set out in ***Cooper* v *Phibbs***. Jenkins LJ, however, considered that the mistake was not one of fact at all but one of law and that there was no right of rescission based on an error of law at that time. Lord Denning, however, considered that there was no mistake as to the quality of the subject matter at common law that would render the contract void. He identified the effect of common mistake at common law in ***Bell* v *Lever Bros Ltd*** in the following way:

> The correct interpretation of that case, in my mind, is that, once a contract has been made, that is to say, once the parties, whatever their inmost states of mind, have to all outward appearances agreed with sufficient certainty in the same terms on the same subject matter, then the contract is good unless and until it is set aside for failure of some condition on which the existence of the contract depends, or for fraud, or on some equitable ground. Neither party can rely on his own mistake to say it was a nullity from the beginning, no matter that it was a mistake which to his mind was fundamental, and no matter that the other party knew he was under a mistake. *A fortiori*, if the other party did not know of the mistake, but shared it. The cases where goods have perished at the time of sale, or belong to the buyer, are really contracts which are not void for mistake but are void by reason of an implied condition precedent, because the contract proceeded on the basic assumption that it was possible of performance.

Thus Denning held that in ***Solle* v *Butcher*** there was a contract since the parties had agreed the same terms in relation to the same subject matter and that, whilst there was a fundamental mistake, this was not one that could cause the contract to be void at common law. He then turned to equity and considered that it was possible for the court to set the contract aside or rescind it where it was unconscionable for a party to take advantage of it:

> A contract is also liable in equity to be set aside if the parties were under a common misapprehension either as to the facts or as to their relative and respective rights, provided that the misapprehension was fundamental and that the party seeking to set it aside was not himself at fault.

On this basis Denning ordered the lease in ***Solle*** to be set aside since there was a 'common misapprehension that was fundamental', relying on ***Cooper* v *Phibbs***. In ***Great Peace*** Lord Phillips considered that ***Cooper* v *Phibbs*** did not establish an equitable jurisdiction for common mistake in circumstances that fell short of those that allowed the common law to find the agreement was void. He considered and concurred with Toulson J, the judge at first instance, that Denning was using ***Cooper* v *Phibbs*** to avoid the decision in ***Bell* v *Lever Bros*** so as to grant equitable relief. He expressed some sympathy with Denning's approach:

> We can understand why the decision in ***Bell* v *Lever Bros*** did not find favour with Denning LJ. An equitable jurisdiction to grant rescission on terms where a common fundamental mistake has induced a contract gives greater flexibility than a doctrine of common law which holds the contract void in such circumstances.

Nevertheless Lord Phillips considered that ***Solle* v *Butcher*** and the cases that followed it could not stand alongside ***Bell* v *Lever Bros***, disapproved of it and considered it to be not good law. He concluded that there is scope for legislation to give greater flexibility to the

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law on mistake. On this basis it seems that the equitable doctrine of mistake is a highly questionable one and that it does indeed seem to be a product of Denning's radical legal imagination. This position has not been universally approved and in the Canadian Court of Appeal case of ***Miller Paving Ltd* v *B Gottardo Construction Ltd*** (2007) ONCA 422 Goudge JA stated:

> The loss of flexibility needed to correct unjust enrichment results in widely diverse circumstances that would come from eliminating the equitable doctrine of common mistake would, I think, be a backward step.

Whether this view will be translated back into English law remains to be seen and no doubt the issue must be brought before the House of Lords in order to determine the issue once and for all. It does seem that *Great Peace* takes away part of the armoury that allows the courts a flexible means of providing a remedy where unjust enrichment materialises.

Rectification

The equitable remedy of rectification arises where a written document does not represent the agreement reached between the parties. As in all equitable remedies the exercise of it by the courts is discretionary. It should be noted that the remedy does not lie where there is a mistake as to the subject matter of the contract but where there is an error on the face of the record. It is thus erroneous to talk in terms of rectification of a contract since the remedy only allows alteration of the instrument reflecting the contract.

In order to have a document rectified the parties must be able to demonstrate that four conditions have been satisfied:

1. The parties must have reached agreement

At one time there was a requirement that the parties must have reached an 'antecedent agreement' on all the terms before a court would grant rectification. However, in ***Joscelyne* v *Nissen*** [1970] 2 QB 86 it was held that it was sufficient if there was a common continuing intention as to part of the contract.

The facts of ***Joscelyne* v *Nissen*** were that the plaintiff sought to have the written contract, whereby he made over his car-hire business to his daughter, rectified. It had been expressly agreed that in return for the business she would pay certain coal, gas and electricity bills. This agreement was not contained in the written document and when the daughter failed to pay these bills the plaintiff sought a declaration that she should do so and that the written document should be rectified to this effect. The Court of Appeal held that the agreement should be rectified despite the fact that prior to the written contract being executed no antecedent agreement had been concluded. The court stated that, in order to obtain rectification, some outward sign of a common intention was evident. In this case the father could show that, up to the contract being executed, both parties were agreed that the daughter would pay the bills.

2. The instrument that the application is made to rectify must have failed to reflect the agreement of the parties

It follows that if one party considers that the instrument reflects his intentions but the other does not, then rectification is unavailable. The point was made by Denning LJ in ***Frederick E Rose (London) Ltd* v *William H Pim Jnr & Co Ltd*** [1953] 2 QB 450:

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> Rectification is concerned with contracts and documents, not with intentions. In order to get rectification it is necessary to show that the parties were in complete agreement on the terms of their contract, but by an error wrote them down wrongly; and in this regard, in order to ascertain the terms of their contract, you do not look into the inner minds of the parties – into their intentions – any more than you do in the formation of any other contract. You look at their outward acts, that is, at what they said or wrote to one another in coming to their agreement, and then compare it with the document which they have signed. If you can predicate with certainty what their contract was, and that it is, by a common mistake, wrongly expressed in the document, then you rectify the document; but nothing less will suffice.

3. The party seeking rectification has to provide evidence that the instrument does not reflect the common intention of the parties at the time of contracting

It is important that the issue of rectification relates to the common intention of the parties, not to the individual intention of one of them. In other words, to obtain rectification a party must be able to demonstrate that there is a literal disparity between what was agreed and what was recorded and that the executed instrument has failed to reflect the intentions of both parties. This point needs some qualification, however, since in ***A Roberts & Co. Ltd*** **v** ***Leicestershire CC*** [1961] 2 All ER 545 it was held that the remedy could be used where a plaintiff could show that a term, beneficial to himself, which both parties had intended to be included in the document, had been omitted and that the other party was aware of the omission at the time of the document being executed. This latter point has been reaffirmed in ***Agip SpA*** **v** ***Navigazione Alta Italia SpA*** [1984] 1 Lloyd's Rep 353.

4. Equitable relief must be available

As with all other equitable remedies the acquisition by a third party of rights under the written contract or where there has been a lapse of time in applying for the remedy will cause the remedy to be lost.

Refusal of specific performance

For more on specific performance refer to Chapter 17.

If a person refuses to perform their side of the bargain it is open to the other party to apply to a court of equity for a decree of specific performance to compel that person to carry out their contractual obligations. Since this remedy, like the others, was discretionary, the court would refuse to grant such a decree where the common law remedy of damages was regarded as adequate redress, as it very often was, except where the goods could be regarded as unique goods. Specific performance could, however, also be refused where one of the parties has contracted under such a mistake that it would be regarded as inequitable to compel them to carry out their contractual obligations. The effect of this, then, is to prevent a contract being enforced in circumstances where a mistake is insufficient to render the contract void *ab initio* at common law.

In ***Webster*** **v** ***Cecil*** (1861) 30 Beav 62 the plaintiff was offered several plots of land by the defendant for £1,250. Soon after sending the offer the defendant realised that he should have stated the price as £2,250 and informed the plaintiff immediately. Unfortunately his revocation arrived too late as the plaintiff had already accepted the offer. The court refused to give the plaintiff a decree of specific performance since it decided that he must have been aware of the defendant's mistake as he (the defendant) had already refused an offer of £2,000 from the plaintiff.

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Mistake as to the nature of the document signed

This category of mistake forms a separate and distinct category of mistake at common law. Cases arising in this type of mistake might occur where a person is induced by a false statement made by some other person to sign a written contract that is fundamentally different from the one they thought they were signing. While the person inducing the signing may well be a party to the contract it might be the case that they are a third party to the contract, for instance, where *X* by some fundamental statement induces *Y* to sign a guarantee of *Y*'s indebtedness to *X*'s bank, *Z*. If *Z* attempts to enforce the guarantee against *Y*, *Y* may attempt to avoid liability on the basis of mistake as to the nature of the document signed. It is obvious here that *X* is not a party to the contract between *Y* and *Z*. It is this feature that separates this type of mistake from the others.

Traditionally this type of mistake was often referred to as ***non est factum***, literally translated as 'it is not my deed'. The rule originated as a limited defence to the proposition that a person was bound by any document signed by that person, as we have seen in ***L'Estrange* v *Graucob*** in Chapter 8. In fact the rule developed in medieval times when few people could read or write and were thus dependent on others accurately to describe the contents and meaning of a deed. Thus if the terms of a deed were read or explained in such a way that the deed did not in fact represent the true intention of the signor, the signor could escape liability on the basis that they would not have signed had the true situation been revealed to them.

The growth of literacy as educational opportunities increased raised serious doubts as to whether the plea continued to exist. In the nineteenth century, however, the scope of the plea was widened to include persons who had been tricked into signing a document which they would not have signed had they understood its true nature. The scope of the plea thus widened to include persons who were of low intelligence or mentally infirm, as well as blind persons. Persons of full capacity and literacy cannot generally rely on *non est factum*. The modern leading authority on *non est factum* is ***Saunders* v *Anglia Building Society*** (formerly known as ***Gallie* v *Lee***).

Saunders v *Anglia Building Society* [1970] 3 All ER 961

The plaintiff was an elderly widow who had decided to give the title deeds of her house to her nephew, so that he could use the property as security for a loan in order to go into business. The widow made one stipulation, which was that whatever he did she would be allowed to live in the house for the rest of her life. A document was prepared by a friend of the nephew's, Lee, who was a dishonest managing clerk, whereby the property was to be assigned to the nephew. In fact the document prepared by Lee was a deed of conveyance giving effect to a sale of the property to Lee for £3,000, though this sum was never paid. At the time the deed was signed by Mrs Gallie, she had broken her glasses and thus relied on Lee's explanation of the nature of the document. Lee then mortgaged the property to the building society but never repaid any of the mortgage instalments.

On discovering the truth of the matter the plaintiff sought a declaration that the conveyance of the property was void on the ground of *non est factum*. She alleged that she had signed the document under a fundamental mistake as to its nature. She thought that she was signing a deed of gift to her nephew, whilst what she in fact signed was a deed of conveyance to Lee.

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It was held by the House of Lords, affirming the earlier decision of the Court of Appeal, that her plea would fail. While on the face of things the two documents appear to be very different, the court thought that in assessing whether the nature of the document was different, one had to have regard to the 'object of the exercise'. The object of the exercise in assigning the property to the nephew was to enable him to use it as security to raise money by way of a secured loan. Their Lordships considered that this object would also have been arrived at had Lee acted honestly. There was thus no difference in the nature of the document Mrs Gallie signed and what she thought she was signing.

The case of ***Saunders* v *Anglia Building Society***, however, established that three principles had to be proved before the defence would apply. First, the plea can only rarely be relied upon by a person of full age and capacity; such a person will generally be bound by the document. Generally in order to succeed one has to show that one is signing under some disability, such as illiteracy, blindness or senility. Second, the person relying on the defence has to show that the document signed was different in nature from the one they thought they were signing within the concept of *non est factum* as discussed above. Lastly, the person attempting to rely on the defence has to show that they were not careless in signing and that they took all reasonable precautions to ascertain the contents and significance of the document to be signed.

It has to be stated that *non est factum* is rarely pleaded and even more rarely is it successful. For an example *see* ***Lloyds Bank plc* v *Waterhouse*** [1991] Fam Law 23.

Summary

Mistake at common law

- A contract is void *ab initio* if the mistake was fundamental to the contract.

Common initial mistake

- Where the parties enter a contract wrongly believing that the subject exists.
- If the subject has never existed or ceased to exist prior to the entering into of the contract then no contract can arise and therefore any agreement entered into is void *ab initio*.

Mistake as to the existence of the subject matter (res extincta)

- Occurs where, unknown to both the parties, the subject matter of the contract had ceased to exist at the time the contract was entered into. *See* ***Couturier* v *Hastie*** – fermenting corn. (NB: this case was based on lack of consideration and not mistake.)

Mistake as to title (res sua)

Definition:

- . . . unknown to the parties, the buyer is already the owner of that which the seller purports to sell to him (***Bell* v *Lever Bros***).
- Rescission allowed for rental of a fishery owned by the lessee (***Cooper* v *Phibbs***).

Mistake as to the quality of the subject matter of the contract

- This means mistake as to the bargaining.

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- For mistake as to the quality to arise, the mistake must be as to a fundamental assumption on which the contract was based and must be a mistake of both parties (***Bell* v *Lever Brothers***; ***Leaf* v *International Galleries***; ***Associated Japanese Bank (International) Ltd* v *Crédit du Nord SA***).

Consensus mistake

- Happens where there is a mistake as to the terms of the contract.
- Stops an agreement from arising as there is a lack of *consensus ad idem*.
- The two basic categories are (i) mutual and (ii) unilateral mistakes.

Mutual mistake

- Occurs where the parties are at cross purposes, e.g. two ships with the same name (***Raffles* v *Wichelhaus***).
- To establish a mutual mistake there must be such a degree of ambiguity that it is impossible, on applying the objective test of a reasonable man, that the parties intended to be bound by one set of terms or the other.

Unilateral mistake

- This test is subjective and *not* objective. One party is actually aware of the other party's mistake.
- There *must* be a fundamental mistake *as to the nature of the promise* made by the other party – *a mistake as to quality will not suffice*.
- The mistake must induce the other party to enter into the contract.
- The person seeking to avoid the contract has to rebut the presumption.
- Two types of unilateral mistake:
  1. Mistake as to the terms of the contract:
     - Where the offeror is aware that the acceptor is fundamentally mistaken as to the nature of the promise contained in the offer, e.g. sale of hareskins – per lb or per skin? (***Hartog* v *Colin and Shields***)
  2. Mistake as to the identity of the person contracted with:
     - A contract may become a nullity where a party is mistaken as to the identity of the person contracted with and the other party is aware of that mistake.
     - ***Shogun Finance Ltd* v *Hudson***
     - In order to prove unilateral mistake as to identity, the person alleging mistake must prove each of the following:

       (a) an intention to deal with some other person;
       (b) that the other party knew of this intention;
       (c) that the identity was of fundamental importance;
       (d) that reasonable steps had been taken to verify the identity.
     - He has to show that there was *an intention to deal with some other person* than the one with whom he appears to have made the contract (***King's Norton Metal Co. Ltd* v *Edridge, Merrett & Co. Ltd***).
     - The mistaken party must prove that the other party was aware of the above intention.

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- Trading with a person at a distance:
  - (a) The correct identity of the parties is crucial when trading at a distance.
  - (b) Rogue misleading as to his identity those who intend to deal with some other person may allow for recovery (***Cundy* v *Lindsay***; contrast with ***King's Norton Metal Co. Ltd* v *Edridge, Merrett & Co. Ltd***).
- Trading with a person face to face:
  - Presumption – the mistaken party intends to deal with the person in front of them whoever he is and very strong evidence indeed is required to rebut the presumption (***Phillips* v *Brooks Ltd***; ***Shogun Finance Ltd* v *Hudson***).

3 Mistake as to the nature of the document signed:

- *non est factum*, 'it is not my deed'. Limited defence for a person who was bound, having signed a document.
- ***Saunders* v *Anglia Building Society***.

Mistake in equity

- Mistake in equity renders a contract voidable (***Solle* v *Butcher***).
- This decision is thought to be wrong in law (***Great Peace Shipping Ltd* v *Tsavliris Salvage (International) Ltd***).

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11 Duress, undue influence and inequality of bargaining power

Aims and objectives

After reading this chapter you should be able to:

- Understand and explain the common law concept of duress.
- Understand and explain the equitable concept of undue influence.
- Distinguish between actual and presumed undue influence.
- Recognise the different categories of undue influence and the circumstance in which they arise.
- Understand the requirement of 'manifest' disadvantage and transactions 'calling for an explanation'.
- Explain the effect of undue influence on third parties.
- Know and understand how creditors avoid being fixed with constructive notice of the principal debtor'smi srepresentations.
- Understand Lord Denning's wider concept of equitable intervention where there is inequality ofb argainingp ower.

Introduction

The essence of an agreement and hence a legally binding contract is founded upon the parties giving their free consent to be bound by the terms of the agreement. It follows that where a party is coerced into a contract by threats or undue pressure that stifles the principle of free consent, that individual should not be bound by that contract. Both the common law and equity concurred in this fact, the common law through its strict doctrine of **duress** and equity through the doctrine of **undue influence**, which had a wider sphere of operation than duress. Mere inequality of bargaining power is, as a general rule, insufficient to vitiate a contract entered into, though in more recent years Lord Denning attempted to develop a general concept under this heading whereby relief would be given to an individual who had not entered into a contract as a free agent. Finally, statute has intervened to protect individuals in certain types of contracts.

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The common law concept of duress

Duress at common law relates to contracts induced by violence or the threat of violence. The act or threatened act must be illegal in that it may amount to either a tort or a crime. It follows that if the threatened act is one which would otherwise be lawful then this cannot amount to duress (as, for example, a threat of lawful imprisonment as in ***Williams* v *Bayley*** (1886) LR 1 HL 200). The effect of duress at common law is to render the contract voidable.

At common law it was always considered that duress had to be directed against the person and that a threat to goods could not amount to duress. It follows that in ***Skeate* v *Beale*** (1840) 11 A & E 983 a promise given in return for goods that had been unlawfully detained was held to be valid. This principle has been criticised, however, and in ***Maskell* v *Horner*** [1915] 3 KB 106 it was held that money that had been paid in order to recover goods unlawfully detained could itself be recovered on the basis of money had and received under the law of restitution.

The notion of duress not including duress to goods has also been the subject of a great deal of criticism in more recent years when there has arisen a wider concept of economic duress. An early example of this being recognised was the case of ***D & C Builders Ltd* v *Rees*** [1966] 2 QB 617 which has already been examined in the context of sufficiency of consideration. In that case Lord Denning considered that the actions of the wife had amounted to improper pressure in order to compel the building firm to accept a sum substantially less than the one they were truly owed. In such a situation Lord Denning refused to exercise estoppel because of the wife's inequitable actions since she knew the builders needed the money. The case thus amounted to a crude but crucial step towards the development of the wider doctrine. A more formal doctrine began to emerge in the case of ***Occidental Worldwide Investment Corporation* v *Skibs A/S Avanti, The Sibeon and The Sibotre***.

Occidental Worldwide Investment Corporation v *Skibs A/S Avanti, The Sibeon and The Sibotre* [1976] 1 Lloyd's Rep 293

There was a worldwide recession in the shipping industry with the result that the charter rates had fallen substantially. The charterers of two ships renegotiated the rates of the charters, having warned the owners that they would become insolvent unless this was done, although it was shown that the existing rates would probably not have had this effect on the charterers. They also stated that should action be taken against them for breach of contract no benefit would accrue to the owners since they, the charterers, had insignificant assets against which a claim could be made. The charterers were also cognisant of the fact that, should the charterers break their contract, the owners would be highly unlikely to be able to re-charter the vessels given the depth of the recession. This would result in the ships being laid up and the owners themselves would probably be forced into liquidation. This was a grossly pessimistic outlook, but nevertheless the defendants, the owners, agreed to reduce their hire rates. Later they withdrew both ships from the charters. The charterers sued claiming that the contract had been wrongly repudiated, whilst the owners claimed that they had renegotiated the charters only because of the duress placed upon them by the charterers. It was held that the owners' claim for duress would fail. Kerr J rejected the early doctrine of duress that was based simply on a threat of physical violence. He stated:

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> I do not think that English law is as limited . . . For instance, if I should be compelled to sign a lease or some other contract for a nominal but legally sufficient consideration under an imminent threat of having my house burnt down or a valuable picture slashed, though without any threat of physical violence to anyone, I do not think that the law would uphold the agreement. I think that a plea of coercion or compulsion would be available in such cases . . .

In this statement Kerr J unlocked the door to the development of a notion of economic duress, albeit that he had not pushed the door wide open. He was cautious, stating that mere commercial pressure was inadequate to set up the defence. He considered that there had to be such a degree of coercion of will that the other party was deprived of their ability freely to consent. How was this test to be satisfied? Kerr J identified two questions that had to be asked before the test could be satisfied. First, did the victim protest at the time of the demand and, second, did the victim regard the transaction as closed or did they intend to repudiate the new agreement?

Kerr J stated thus:

> But even assuming, as I think, that our law is open to further development in relation to contracts concluded under some form of compulsion not amounting to duress to the person, the court must in every case at least be satisfied that the consent of the other party was overborne by compulsion so as to deprive him of any *animus contrahendi*. This would depend on the facts of each case. One relevant factor would be whether the party relying on the duress made any protest at the time or shortly thereafter. Another would be to consider whether or not he treated the settlement as closing the transaction in question and as binding upon him, or whether he made it clear that he regarded the position as still open . . . the facts of the present case fall a long way short of the test which would in law be required to make good a defence of compulsion or duress. Believing the statements about the charterers' financial state . . . [the owners] made no protest about having to conclude [the contract] . . . [the owners] regarded the agreement then reached as binding and sought to uphold it in the subsequent arbitration . . . [they were] acting under great pressure, but only commercial pressure, and not under anything which could in law be regarded as a coercion of will so as to vitiate consent. I therefore hold that the plea of duress fails.

The tests propounded by Kerr J were considered more fully in the following case.

North Ocean Shipping Co. Ltd v *Hyundai Construction Co. Ltd, The Atlantic Baron* [1979] QB 705

The facts of the case were that the defendants had agreed to build a tanker for the plaintiffs at a price to be payable in five instalments in dollars. The plaintiffs paid the first instalment but then the dollar suffered a 10 per cent drop in the international money market. The defendants demanded a 10 per cent increase in the contract price, stating that they would not complete the ship unless this was forthcoming. At the time the defendants were not aware that this threat was particularly damaging to the plaintiffs since they had an agreement to charter the ship when it was completed. The plaintiffs agreed to pay the extra money despite the fact that, as they pointed out to the defendants, they were not legally obliged to do so. Eventually all four of the further instalments were paid, increased by 10 per cent, and the plaintiffs took delivery of the ship. Eight months later the plaintiffs sought to recover the extra moneys paid, but failed in their action. While Mocatta J considered that this was a case of economic duress, he held that they would be unable to recover since their delay in seeking the recovery of the extra moneys paid amounted to affirmation of the contract, even if they had no intention of affirming the contract as such.

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While the judgment of Mocatta J undoubtedly gave additional support to the test propounded by Kerr J, it also produced a serious deficiency in the concept of economic duress as stated by Kerr J. The problem was that the victim was placed on the horns of a dilemma. If the victim protests too vehemently the other party will walk away from the contract, leaving the victim economically disadvantaged, despite their right to sue for breach of contract. A mild protest, however, may be read by the courts as not being sufficient. On the other hand, if the victim fails to refute the contract quickly they will be regarded as having affirmed the contract and will be bound by it.

To a large degree the decision of Kerr J was affirmed in the case of ***Pao On* v *Lau Yiu Long*** [1979] 3 All ER 65 where Scarman LJ stated:

> there is nothing contrary to principle in recognising economic duress as a factor which may render a contract voidable provided always that the basis of such recognition is that it must amount to a coercion of will, which vitiates consent. It must be shown that the payment made on the contract entered into was not a voluntary act.

Further, in assessing whether or not a coercion of will had taken place, he stated:

> it is material to inquire whether the person alleged to have been coerced did or did not protest; whether, at the time he was allegedly coerced into making a contract, he did or did not have an alternative course open to him such as an adequate legal remedy; whether he was independently advised; and whether, after entering the contract, he took steps to avoid it.

It can be seen that his Lordship's judgment did little to remove or reconcile the dilemma set out above; quite the contrary. The judgment presents a significant problem when it talks in terms of the payment made or the contract entered into 'not [being] a voluntary act'. Quite clearly if one does agree to a situation like this then such an act must of necessity be a voluntary act since the party coerced must have formed an intention to enter the situation. Scarman LJ's statement is thus an over-simplification and fails to address this aspect of his judgment in enough detail. He would have done better to express it not merely as a voluntary act but as a voluntary submission compelled by the fact of no other available course of action.

The question arose again in the case of ***Universe Tankships Inc. of Monrovia* v *International Transport Workers' Federation (The Universe Sentinel)*** [1983] 1 AC 366 where both Lord Scarman and Lord Diplock concluded that economic duress may arise where there is an intentional submission to the inevitable and that the pressure used to secure such submission was illegitimate in that there was a suppression of the will of the victim. The problem with the case is that it really failed to address how one tested the differences between legitimate and illegitimate pressure, or how a court is supposed to deal with the dilemma of a victim in the face of such pressure.

Whilst difficulties arise in testing the differences between legitimate and illegitimate pressure, the case did establish that the pressure compelling submission can be legitimate pressure and Lord Scarman specifically stated that duress can exist even if the threat is one of lawful action. In ***Alec Lobb (Garages) Ltd* v *Total Oil Great Britain Ltd*** [1983] 1 WLR 87 the Court of Appeal stated that no duress could arise where legitimate rights were threatened. Presumably the views of the Court of Appeal will now give way to those of the House of Lords and this seems to be confirmed in the case of ***CTN Cash and Carry Ltd* v *Gallaher Ltd*** [1994] 4 All ER 714, where the Court of Appeal confirmed that a lawful act coupled with a demand for payment may amount to economic duress. The court, however, qualified this view by stating that it would be difficult, though not impossible,

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to maintain such a claim in the context of two trading companies dealing at arm's length in a commercial transaction, particularly if the party making the threat was acting in the bona fide belief that its demand was valid and legitimate. The court considered that the development of so-called 'lawful act duress' in pursuing a bona fide claim in a commercial context would create an undesirable level of uncertainty in the commercial bargaining environment.

It is clear from the above that the law as regards economic duress is very uncertain and this probably arises because the boundaries of the doctrine are still being formed. That economic duress is here to stay cannot be doubted, and in fact the doctrine has received further judicial recognition in ***Atlas Express Ltd* v *Kafco (Importers and Distributors) Ltd***.

Atlas Express Ltd v *Kafco (Importers and Distributors) Ltd* [1989] 1 All ER 641

The facts of this case were that the plaintiffs, a firm of road hauliers, contracted with the defendants to deliver cartons of basketware to branches of Woolworths throughout the United Kingdom. Prior to entering into the contract a manager of the plaintiffs, having inspected the cartons, estimated that each load would comprise between 400 and 600 cartons. On this basis he agreed a contract rate of £1.10 per carton. The first load fell well below his estimations, comprising only 200 cartons. The manager then went back to the defendants and stated that his firm would be unable to transport any more loads unless the defendants agreed to a minimum price of £440 per load. The defendants were a small concern that were heavily dependent on their contract with Woolworths and were unable to find another carrier willing to transport their goods, and so they reluctantly agreed to pay the minimum charge. The defendants later refused to pay the minimum charge and when sued claimed economic duress as a defence. It was held that where a defendant had no alternative but to accept revised terms that were detrimental to its interests, this amounted to economic duress that vitiated the apparent consent to the renegotiated terms.

A similar case to the Atlas case is that of ***Vantage Navigation Corporation* v *Suhail and Saud Bahawn Building Materials LLC (The Alev)***.

Vantage Navigation Corporation v *Suhail and Saud Bahawn Building Materials LLC (The Alev)* [1989] 1 Lloyd's Rep 138

The facts of the case were that a ship, *The Alev*, was chartered to carry a cargo of steel by the plaintiffs. The defendants had an interest in the cargo. The charterers of the ship in fact had substantial financial problems, with the result that they defaulted in paying instalments under the terms of the charterparty. This default rendered the plaintiffs, by virtue of the bill of lading, liable to carry the cargo to its destination at considerable loss to themselves, which compounded their losses sustained by the default of the charterers. In order to offset some of the losses, the plaintiffs entered into negotiation with the defendants, with the result that a contract was entered into whereby the defendants would bear the port costs (together with some other costs) and agreed not to detain or arrest the ship while it was in port. This agreement was reached in part by the plaintiffs threatening not to transport the cargo. In fact, when the ship entered port and began unloading its cargo, the defendants arrested the ship and, in defence to a claim for breach of contract by the plaintiffs, pleaded economic duress. It was held that the contract could be avoided by the defendants on the basis of economic duress. The court held that the threat to refuse to transport the cargo was illegal, that the plaintiffs knew this and, as a result, the contract was voidable.

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Both the above cases indicate that there has been a considerable relaxation in the criteria required to prove economic duress. While it is only necessary to prove a suppression of will and voluntary consent to the transaction by the victim, the concept is now very vague and it is not an exaggeration to say that the law in this area is in an unsatisfactory state. The truth is that the concept of economic duress is still evolving and is some way off being formulated into a hard set of principles.

It should be noted that duress and economic duress renders a contract voidable and as such the proper remedy is rescission, this being affirmed in ***The Universe Sentinel***. As already seen in misrepresentation, this remedy may be lost by lapse of time, the intervention of third-party rights and by affirmation, as seen in ***The Atlantic Baron***, above. In order for rescission to be available *restitutio in integrum* or counter-restitution must be available. It is not available if it is no longer possible to restore the parties to substantially the same positions they were in before the contract was made. This principle was affirmed in ***Halpern* v *Halpern*** [2007] EWCA Civ 291.

The equitable concept of undue influence

Equity has always been more flexible in the way it grants or refuses relief. While the common law required concepts to be strictly defined, this was never the case in equity which, partly because it was discretionary and partly because it acted according to the principles of good consciousness, developed concepts that fell short of the requirements of the common law. It was originally defined in ***Allcard* v *Skinner*** (1887) 36 ChD 145 as some unfair and improper conduct, some coercion from outside, some overreaching, some form of cheating and generally, though not always, some personal advantage obtained by the guilty party. An instance of such a concept is undue influence, where equity would grant relief from a contract that had been entered into because improper pressure had been placed on one of the parties.

With regard to undue influence, the courts will intervene where a relationship between the two parties has been exploited by one party in order to gain an unfair advantage. It follows that the exploitation can arise where there is an abuse of a particular confidence placed in a party or where that party is in a position of dominance over the victim. It should be stressed, however, that with regard to the latter category, it was held in ***Goldsworthy* v *Brickell*** [1987] 1 All ER 853 that domination is not a prerequisite of undue influence and that this was merely an example of conduct that might amount to undue influence. In the case of ***Bank of Credit and Commerce International SA* v *Aboody*** [1990] 1 QB 923 it was held that whatever category of undue influence is alleged it is a requirement that the transaction entered into must have been to the manifest disadvantage of the victim, though this must now be read in the light of the House of Lords' decision in ***Barclays Bank plc* v *O'Brien and Another*** [1993] 4 All ER 417, ***CIBC Mortgages plc* v *Pitt*** [1993] 4 All ER 433 and more recently in the case of ***Royal Bank of Scotland* v *Etridge (No 2)*** [2001] 4 All ER 449 ('***Etridge No 2***').

In classifying the different categories of undue influence, it should be noted that undue influence may be either actual or presumed. In ***BCCI* v *Aboody*** [1990] 1 QB 923 the Court of Appeal adopted the following classification:

(a) Class 1: actual undue influence;

(b) Class 2: presumed undue influence, which had two sub-classifications.

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In ***O'Brien*** the Class 2 presumed undue influence was further recognised as being subdivided into types 2A and 2B. This classification was also broadly recognised in ***Etridge No 2*** where Lord Nicholls stated:

> Equity identified broadly two forms of unacceptable conduct. The first comprises overt acts of improper pressure or coercion such as unlawful threats . . . The second form arises out of a relationship between two persons where one has acquired over another a measure of influence, or ascendancy, of which the ascendant person then takes unfair advantage . . . In cases of this latter nature the influence one person has over another provides scope for misuse without any acts of persuasion. The relationship between the two individuals may be such that, without more, one of them is disposed to agree a course of action proposed by the other. Typically this occurs when one person places trust in another to look after his affairs and interests, and the latter betrays this trust by preferring his own interests. He abuses the influence he has acquired.

On this basis one can begin to examine the nature of undue influence by dividing the subject into two areas: actual and presumed undue influence. It should be noted, however, that Lord Nicholls did not approve of this way of classifying undue influence on the basis that he considered it tended to confuse the issues of definition and the requirements of evidence or proof. Moreover, he disapproved of dividing presumed undue influence into two further subdivisions stating that this tended to 'add mystery rather than illumination'. The reasoning behind this re-evaluation is that the expression 'presumed' relates to an evidential requirement and did not point to a conclusion that there was 'undue' influence. Whether or not influence is undue is a factor that has to be evidentially ascertained from the facts. Bearing in mind this reservation, it is nevertheless a convenient tool in understanding the concept of undue influence to divide the concept into two: actual and presumed undue influence.

Actual undue influence

In this classification it is necessary for the claimant to prove affirmatively that the wrongdoer exerted undue influence on the complainant to enter into a particular transaction which is thus impugned. This type of undue influence arises where there is no special relationship between the parties so that there is no abuse of a particular confidence.

The leading case on this area is that of ***Williams* v *Bayley*** (1866) LR 1 HL 200 where a father, to save his son from being prosecuted and possibly transported for giving his bank promissory notes on which he had forged his father's signature, was forced to give security for the debts of the son. It was held that the father's agreement had been extracted by virtue of undue influence being exerted on the father. The agreements were held to be invalid.

Other examples of such undue influence include taking advantage of persons acting under religious delusions, as in ***Norton* v *Reilly*** (1764) 2 Eden 286; or a young man's mentor influencing him to incur liabilities, as in ***Smith* v *Kay*** (1859) 7 HLC 750.

In ***National Westminster Bank plc* v *Morgan*** [1985] 1 All ER 821 it was held that in presumed undue influence (i.e. formerly Class 2 undue influence) a claim to set a transaction aside for undue influence could not succeed unless the claimant could prove that the transaction was manifestly disadvantageous. This requirement was taken up and applied to cases of actual undue influence (i.e. formerly Class 1 undue influence) by the Court of Appeal in ***BCCI* v *Aboody***. In ***CIBC* v *Pitt***, Lord Browne-Wilkinson did not agree with ***Aboody*** and considered the requirement that the undue influence had to be manifestly

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disadvantageous as laid down in ***Morgan*** had no application to cases of actual undue influence. He stated:

> Actual undue influence is a species of fraud. Like any other victim of fraud, a person who has been induced by undue influence to carry out a transaction which he did not freely and knowingly enter into is entitled to have that transaction set aside as of right . . . A man guilty of fraud is no more entitled to argue that the transaction was beneficial to the person defrauded than a man who has procured a transaction by misrepresentation. The effect of the wrongdoer's conduct is to prevent the wronged party from bringing a free will and properly informed mind to bear on the proposed transaction, which accordingly must be set aside in equity as a matter of justice.

Thus, where there is no special relationship and the claimant proves actual undue influence, he is not under a further burden of proving that the transaction induced by this undue influence was manifestly disadvantageous to him and he may have it set aside as of right. ***Etridge No 2***, however, makes it clear that the undue influence, whilst not being manifestly disadvantageous, must not be innocuous. The onus of proof is, however, on the claimant to prove the presence of undue influence. This position was affirmed by the House of Lords in ***Etridge No 2***, where it was stated that the question as to whether a transaction has been brought about by the exercise of undue influence is one of fact. The evidence to discharge this burden of proof depends on various factors, such as the nature of the alleged undue influence, the personalities of the parties, their relationship to one another, the 'extent to which the transaction cannot readily be accounted for by the ordinary motives of ordinary persons in that relationship, and all the circumstances of the case'. This is the general rule regarding the burden of proving the existence of undue influence.

Thus it is not sufficient simply to show 'influence'. The claimant must prove that the influence has been 'undue' as well. In ***Dunbar Bank plc* v *Nadeem and Another*** [1998] 3 All ER 876, it was stated *obiter* that it is not enough simply to show that one party dominated another, but that there had to be an actual unfair advantage exacted over the victim. In this case the Court of Appeal decided that there was no actual undue influence since there was a 'clear finding that Mr Nadeem did not take unfair advantage of his position. Seen through his eyes, the transaction was obviously beneficial to his wife and was intended to be for her benefit.' This approach, however, had the great danger of being too subjective as regards the intentions of the dominant party. Simply because the dominating party considers the transaction to be of benefit to the victim, should this necessarily be so? There is a certain arrogance in assuming that the dominating party knows what is beneficial or advantageous for the victim. The test set out in ***Etridge No 2*** provides a more objective assessment of what is 'undue'.

This type of undue influence is becoming much more rare today since there is a continuing blurring of this area with duress. For example, in ***Flower* v *Sadler*** (1882) 10 QBD 572 a promise to pay a sum of money extracted by the threat of criminal prosecution was held to be invalid for undue influence. Today such conduct would no doubt fall within the ambit of duress. Similarly, the case of ***Williams* v *Bayley*** would probably be considered to be a case of duress today.

Presumed undue influence

As stated earlier, the Court of Appeal in ***BCCI* v *Aboody***, approved by the House of Lords in ***O'Brien*** and ***Etridge No 2***, established that a confidential relationship could arise in two ways, thus creating two sub-classes:

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Class 2A Presumed undue influence

Certain types of relationship automatically presume the existence of undue influence: for instance, the relationship between trustee and beneficiary (***Benningfield* v *Baxter*** (1886) 12 App Cas 167); solicitor and client (***Wright* v *Carter*** [1903] 1 Ch 27); parent and child (***Powell* v *Powell*** [1900] 1 Ch 243); religious leader or adviser and disciple or parishioner (***Allcard* v *Skinner*** (1887) 36 ChD 145).

The use of the expression 'presumption' here is one which describes the shift in the evidential burden of proof on the question of fact. The claimant has to show, first, that there is a relationship of trust or confidence between themself and the wrongdoer and, second, the existence of a transaction which calls for an explanation.

On proof of these two matters there is an inference that the transaction has arisen from undue influence and the evidential burden of proof shifts to the defendant to provide evidence that counters the presumption. Not every type of fiduciary relationship gives rise to such a presumption since it has to be shown that the confidence placed in the wrongdoer gives that person some authority over the victim or that it creates an obligation on the wrongdoer to offer or recommend the victim to seek independent advice. The person in whom the confidence is reposed is in such a position that that person has an obvious opportunity of enhancing their position, to the extent that they must prove that they have not exercised their position of influence in that manner.

There is thus no need for the victim to prove that undue influence has actually taken place, since all they have to do is to prove that a confidential relationship has arisen and that the transaction itself calls for an explanation. Once the victim has done that a rebuttable evidential presumption of undue influence automatically arises at law. The burden of proof then shifts to the wrongdoer to prove that the victim entered into the transaction of their own volition, for instance by showing that the victim had received independent advice. The court in turn then has to draw 'the appropriate inferences of fact upon a balanced consideration of the whole of the evidence at the end of the trial in which the burden of proof rested upon the plaintiff' (*per* Lord Nicholls in ***Etridge No 2***). The second requirement therefore is an evidential presumption which can be rebutted by the so-called wrongdoer.

In ***Etridge No 2*** it was considered that it was only in Class 2A undue influence that a true presumption of influence arises. It was stated that 'the law has adopted a sternly protective attitude' towards the types of relationship described above where one party acquires influence over another vulnerable person. It is sufficient for the claimant to prove the existence of such a relationship and that the the transaction 'calls for an explanation'. 'Alternatively the claimant must demonstrate that the transaction is not one that is readily explicable by the relationship of the parties.' The second presumption found in Class 2A undue influence is a necessary constraint on the width of this type of undue influence. Thus Lord Nicholls stated in ***Etridge No 2***:

> The second pre-requisite . . . is good sense. It is a necessary limitation upon the width of the first requisite. It would be absurd for the law to presume that every gift by a child to a parent, or every transaction between a client and his solicitor or between a patient and his doctor, was brought about by undue influence unless the contrary is affirmatively proved . . . The last would be rightly opened to ridicule, for transactions such as these are unexceptionable. They do not suggest that something may be amiss. So something more is needed before the law reverses the burden of proof, something which calls for an explanation.

Despite the definitive statements by Lord Nicholls, individual cases continue to throw up anomalies, such as that of ***Leeder* v *Stevens*** [2005] EWCA Civ 50. The facts of the case

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are that Denis Stevens, a married man, for many years had an affair with Maureen Leeder. Maureen owned a house worth £70,000 subject to a mortgage of £5,000. The couple discussed marriage and, as part of these discussions, Denis offered to pay off the mortgage in return for which the house would be transferred into joint names. Subsequently, Maureen agreed to the transaction and the house was transferred into joint names as tenants in common in equal shares. At the time of the transfer a Deed of Trust was drawn up under which either party could force a sale of the property subject to a right of pre-emption (a right of first refusal). Soon after the transfer Denis forced a sale and Maureen argued that the Deed of Trust should be set aside on the grounds of undue influence. Her action failed at first instance and she appealed to the Court of Appeal.

It was held that this was a case of presumed undue influence and that there was no evidential reason to rebut it. The decision is remarkable in that in ***Etridge No 2*** it was clearly stated that the presumption of undue influence can only arise in two situations: first, where the relationship is one in which the law presumes the existence of undue influence; second, that the wrongdoer has acquired an influence over a vulnerable party so that the existence of the relationship 'calls for an explanation'. The Court of Appeal considered that the relationship which exists between an engaged couple falls within the type of relationship that presumes undue influence. The court considered that the relationship between Denis and Maureen was analogous to that position. This decision appears to be at odds with ***Etridge No 2*** itself since it was held in the House of Lords that a presumption of undue influence does not apply to a husband and wife relationship. If that is the case then it is clearly anomalous that such a presumption should exist in the case of an engaged couple. This would mean that their relationship in terms of presumed undue influence would change, possibly for the worse, simply because they became married. Furthermore, the relationship of an engaged couple did not fall within Lord Nicholls's examples of relationships that give rise to presumed undue influence in ***Etridge No 2***. The decision also appears to contradict the earlier Court of Appeal decision in ***Zamet* v *Hyman*** [1961] 3 All ER 933 where the court considered that the presumption of undue influence would not arise in the case of engaged couples unless the transaction was clearly unfavourable to the party attempting to avoid the transaction or, in modern parlance, the transaction 'calls for an explanation'.

Class 2B Presumed undue influence

Where there is no special relationship that falls within Class 2A giving rise to an automatic presumption of undue influence, it may nevertheless be the case that the victim can prove the existence of a relationship in which they have placed a trust and confidence in the wrongdoer as a fact. The victim will therefore be able to have the transaction set aside merely by proving that they have placed a trust and confidence in the wrongdoer, without the need to prove that an actual undue influence arose.

The husband and wife relationship is a good example of a category of relationship within Class 2B that does not exist per se but which has to be proved as a fact. This was established in ***Howes* v *Bishop*** [1909] 2 KB 390 and ***Bank of Montreal* v *Stuart*** [1911] AC 120, and again confirmed in ***Midland Bank plc* v *Shephard*** [1988] 3 All ER 17. In ***Kingsnorth Trust Ltd* v *Bell*** [1986] 1 All ER 423 the wife was able to prove undue influence as a fact where the husband was regarded as an agent of the bank in procuring the agreement of the wife to a particular transaction. Similarly, in ***BCCI* v *Aboody*** a wife was able to avoid liability to the bank in respect of a surety transaction, which she was induced to enter by her husband, on the basis that the bank had notice, actual or

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constructive, of the husband's actions in either exercising undue influence over his wife or misrepresenting the extent of his indebtedness to the bank.

But why doesn't the relationship fall into Class 2A? In ***Yerkey* v *Jones*** (1939) 63 CLR 649 Dixon J explained that the courts were not blind to the opportunities that a husband may have in unfairly influencing the decisions of his wife. The actions of a wife, however, could also arise from motives of affection or some other such reason and there was nothing strange or unusual in that. Thus whilst there is no presumption of undue influence in such a relationship the court will note, as a matter of fact, the opportunities a husband may have in abusing his wife's confidence in him. This is taken into account alongside all the other evidence put forward in the case.

While the cases which cause most concern arise out of the husband and wife relationship, Class 2B undue influence may arise in any transaction where the victim can prove as a fact that when he or she entered into a transaction there was a relationship of trust and confidence between the victim and the wrongdoer. This being done, a court will presume that the victim has been subject to undue influence.

Lloyds Bank Ltd v *Bundy* [1975] QB 326

The defendant was an elderly farmer whose only asset comprised a farmhouse that was also his home. The defendant shared the same bank as his son and his son's company. The company ran into financial difficulties and so the defendant gave a guarantee in respect of the company to the bank, the guarantee being secured by a charge over the farmhouse. In fact the fortunes of the company failed to improve and the defendant was then approached by his son and the manager of the bank, who informed him that the bank was unwilling to continue to support the company without additional security. In response to this approach, and without seeking independent advice, the defendant extended the guarantee and with it the charge over his property. Eventually a receiver was appointed in respect to the company and as a result the bank sought to enforce its security against the farmhouse. The defendant pleaded undue influence based on the fact that there was a long-standing relationship between himself and the bank, and as such he had placed confidence in it in that he looked to the bank for financial advice. Clearly the bank in having a financial interest in the company could not present itself as being able to give independent financial advice. It was incumbent upon the bank to advise the defendant to seek such advice, which they failed to do, and therefore could not rebut the presumption of undue influence.

It has to be stated that the ***Bundy*** case is a somewhat exceptional one and turns on its own facts, since the presumption of undue influence does not normally arise between banks and their customers.

National Westminster Bank plc v *Morgan* [1985] 1 All ER 821

A husband and wife were the joint owners of the family home which was mortgaged to a building society. The husband became unable to meet the mortgage repayments because his business began to fail. When the building society began to take proceedings for possession of the property in order to enforce the mortgage, the husband decided to seek new finance from the bank, which had agreed to help. The bank manager then called at the family home to have the relevant documents executed by the wife, who did not receive any independent legal advice before signing the new mortgage. Although the husband was initially present the wife insisted that she wished to discuss the mortgage with the bank manager privately. During her discussions with the manager she stated that she had little

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confidence in her husband's business ventures and that she did not want the legal charge to cover her husband's business liabilities. The manager assured her, incorrectly, that the legal charge would cover only the refinancing of the mortgage and that it did not extend to the business liabilities. The financial difficulties of the husband and wife continued and they again fell into arrears with the mortgage repayments, although the husband's business was not in debt to the bank. The bank sought to enforce their security on the charge by seeking possession of the property. Soon afterwards the husband died. The wife then appealed against the order for possession on the grounds that the mortgage had been obtained by virtue of undue influence and therefore the legal charge should be set aside. The Court of Appeal allowed her appeal but she failed in the House of Lords.

The House of Lords rejected the contention that undue influence arose simply out of the relationship of the parties and that the presence of such undue influence allowed the transaction to be set on one side. Lord Scarman (who delivered the only judgment) referred to the judgment of Sir Eric Sachs in ***Lloyds Bank Ltd* v *Bundy*** where he considered that undue influence does not simply arise because of the relationship of banker and client, as in a simple case of the bank going about its normal duties where it is, for instance, obtaining a guarantee and in the course of that explains the legal effect of the guarantee and the sums involved. For the presumption of undue influence to arise the bank must normally 'cross the line' into the area of confidentiality. Lord Scarman did not approve of the latter expression, preferring to find whether or not a dominating influence was present by a 'meticulous examination of the facts', an expression used by Sir Eric Sachs in determining whether or not an area of confidentiality had been crossed into. He considered that on the facts the bank had not exercised a dominant influence over the wife.

Lord Scarman decided that on a 'meticulous examination of the facts' the bank in the ***Morgan*** case had not crossed the line to where a presumption of undue influence existed. In any event he considered that the presence of this presumption was not of itself sufficient. He stated that one also had to show that the transaction was of itself wrongful in that it constituted a manifest disadvantage to the person influenced. He found that the transaction had not been unfair to the wife; indeed, quite the contrary, since it had allowed Mr and Mrs Morgan to stay in their house on terms that were not substantially different from those of the building society. The transaction, if anything, was to their advantage and thus the bank had no duty to ensure that Mrs Morgan received independent advice.

But what of the effect of ***Etridge No 2*** on this analysis of presumed undue influence? ***Etridge No 2*** provides authority that presumed undue influence merely shifts the evidential burden of proof from the claimant to the wrongdoer. It is *not* a presumption that undue influence exists per se, but rather that the burden of explaining why the transaction was not caused by undue influence is shifted to the wrongdoer. The wrongdoer may therefore dispel any notion of undue influence by producing evidence that the transaction had been properly entered into. Thus the 'presumption' of undue influence, either by way of a 'relationship' (as in Class 2A cases) or demonstrating a relationship of trust and confidence (as in Class 2B cases), arises in circumstances that require 'explanation', for instance because the transaction is manifestly disadvantageous. This then shifts the burden of proof on to the wrongdoer to provide an explanation for the transaction. If the wrongdoer is unable to discharge this burden of proof by providing an explanation then undue influence will be found to exist.

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From this it may be seen that the difference between the 'old' Class 2A and 2B categories is that in the former the relationship of trust and confidence cannot be disputed. In the latter the wrongdoer is entitled to provide evidence that no such relationship existed, which in turn means it is unnecessary to provide an explanation for the transaction.

The requirement of 'manifest disadvantage' and transactions 'calling for an explanation'

To what extent is 'manifest disadvantage' a necessary prerequisite to establishing presumed undue influence? As already stated, there are two prerequisites that bring about a shift in the evidential burden of proof. To reiterate, the first is that the complainant must have placed a trust and confidence in the other party, or that the other party had influence over the complainant. The second prerequisite is that the transaction is not one which is explicable by the relationship of the parties to each other. In the past this second prerequisite was proved by the complainant proving the transaction was to his or her manifest disadvantage. This, as seen in ***Morgan***, was therefore a significant factor in limiting the application of undue influence. The courts would nevertheless enforce a transaction where the potential benefits outweighed the disadvantages.

The requirement to prove manifest disadvantage is a contentious one and has been much criticised. It appears to derive from the case of ***Allcard* v *Skinner*** (1887) 36 ChD 145, where Lindley LJ indicated that the mere existence of influence was not enough – it had to be undue. In the case of small gifts to a person standing in a relationship to the donor some proof of influence had to be shown. Lindley LJ continued:

> if the gift is so large as not to be reasonably accounted for on the ground of friendship, relationship, charity, or other ordinary motives on which ordinary men act, the burden is upon the donee to support the gift.

This was followed in ***Goldsworthy* v *Brickell*** [1987] Ch 378 by Nourse LJ, who stated:

> the presumption of [undue influence] is not perfected and remains inoperative until the party who has ceded the trust and confidence makes a gift so large, or enters into a transaction so improvident, as not to be reasonably accounted for on the ground of friendship, relationship, charity or other ordinary motives on which men act. Although influence might have been presumed beforehand, it is only then that it is presumed to have been undue.

Thus the intention behind this prerequisite is to limit the first prerequisite so that undue influence does not arise from innocuous transactions that take place within the trust and confidence relationship. Not to do so would mean that every transaction between persons in such a relationship, such as children and parents, patient and doctor, client and solicitor and so on, stood to be overturned on grounds of undue influence. Something more is required before a court will reverse the burden of proof. There must be a transaction that requires an 'explanation' as to why the weaker party entered into the transaction. As Nicholls LJ in ***Etridge No 2*** indicates:

> the greater the disadvantage to the vulnerable person, the more cogent must be the explanation before the presumption will be regarded as rebutted.

Lord Nicholls considered that the label 'manifest disadvantage', as used by Lord Scarman in explaining the second prerequisite, was too limited and gave rise to misunderstandings; indeed, he considered that it was not being used in a manner intended by Lord Scarman.

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In the context of a wife guaranteeing her husband's debts, one had to consider whether such a transaction by which she not only guaranteed the debts but charged her share of the matrimonial home was to her manifest disadvantage. He stated that in the narrow sense such a transaction is clearly or 'manifestly' disadvantageous to the wife. She undertakes a 'serious financial obligation' for which 'she personally receives practically nothing'. However, in the wider sense there are advantages to the wife in embarking on such a transaction. If the husband's business is the provider of the main income, the wife has an interest in supporting her husband.

Lord Nicholls considered neither the narrow nor the wider interpretations to be correct in deciding whether or not the transaction is disadvantageous to the wife. He considered that the label 'manifest disadvantage' should be abandoned in favour of the test set out by Lindley LJ in ***Allcard* v *Skinner***, above, and adopted by Lord Scarman in ***Morgan***.

In relation to husband and wife cases, Lord Nicholls considered that, in the ordinary course of things, a guarantee by the wife should not be regarded as a transaction that is explicable only on the basis that it has been procured by undue influence on the part of the husband, unless there is proof to the contrary. The fact that wives enter into such transactions with a pessimistic view of the outcome does not provide prima facie evidence of undue influence. His conclusion is salutary:

> Wives frequently enter into such transactions. There are good and sufficient reasons why they are willing to do so, despite the risks involved for them and their families. They may be enthusiastic. They may not. They may be less optimistic than their husbands about the prospects of the husbands' businesses. They may be anxious, perhaps exceedingly so. But this is a far cry from saying that such transactions are to be regarded as prima facie evidence of the exercise of undue influence by their husbands.

Lord Nicholls states this situation as applying 'in the ordinary course of things' and he acknowledges that there are cases where a husband deliberately misleads his wife as to the proposed transaction, so that he prefers his own interests to those of his wife's. Here the husband abuses his position and the influence he has over his wife and 'fails to discharge the obligation of candour and fairness he owes a wife who is looking to him to make the major financial decisions'.

Rebutting the presumption – what is the effect of independent advice?

While it has been seen that the presumption of undue influence may be rebutted by the person having the dominating influence showing that the other party had had access to independent advice or at least been in a position to exercise free judgment, such advice is not always successful in saving the situation. It must be competent advice and made in the knowledge of all the facts of the case: ***Inche Noriah* v *Shaik Allie Bin Omar*** [1929] AC 127.

The weight the court must place on the advice depends on the circumstances. Ordinarily, advice from a solicitor or a financial adviser might normally be expected to make the complainant aware of the nature of the transaction about to be entered into. This does not necessarily preclude undue influence since a person who is aware of the nature of the transaction may still be acting under the influence of another. Whether or not independent advice precludes the effects of undue influence is a question of fact to be decided by reference to the evidence of the facts of the case.

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The effect of undue influence on third parties

So far the examination of undue influence has been looked at in the context of where the victim is attempting to avoid a transaction entered into with the wrongdoer. However, as alluded to above, it sometimes arises, particularly in the context of a husband and wife relationship, that the victim is persuaded to enter into a guarantee or surety contract with a bank or some other creditor on the basis of some undue influence, misrepresentation or other legal wrong, not by the bank or creditor, but by some third party, for instance a husband. The question arises, therefore, to what extent that undue influence will affect the transaction between the victim and the bank/creditor? If one adopts the usual rule of privity of contract, the actions of the wrongdoer should have no effect on the transaction; however, in certain instances the courts have allowed the victim to have the transaction set aside.

The law whereby creditors have been affected by the actions of the wrongdoer and thus unable to enforce the surety contract/guarantee has evolved in three phases that encompass different approaches – agency, special equity and the doctrine of notice. The first two have now been laid to rest and rejected in ***Barclays Bank plc* v *O'Brien*** where Lord Browne-Wilkinson considered the correct approach in protecting the interests of wives was by way of a more wide-ranging doctrine of notice.

Barclays Bank plc v *O'Brien* [1993] 4 All ER 417

Mr O'Brien wanted to increase the overdraft facility of a company in which he was a shareholder. The bank agreed a loan of £120,000 that was to be guaranteed by Mr O'Brien, his liability in turn being secured by a second charge over the matrimonial home, which was jointly owned by Mr O'Brien and his wife. The bank manager gave instructions for the relevant documents to be prepared, including a legal charge to be signed by both Mr O'Brien and his wife, together with a guarantee to be signed by the husband alone. Instructions were also given that both Mr O'Brien and his wife should be advised as to the nature of the transactions and that, if they had any doubts, they should obtain independent advice. These instructions were not complied with and subsequently both husband and wife signed the documents without reading them. The company's indebtedness then increased beyond the agreed limit and the bank took proceedings to enforce its security against the husband and wife. In her defence the wife contended that her husband had put undue pressure on her to sign the surety agreement and, second, that her husband had misrepresented the effect of the legal charge in that she believed it was limited to a sum of £60,000 over three weeks.

The judge at first instance, and the Court of Appeal and House of Lords, dismissed the wife's contention that she had been subject to undue influence by her husband and therefore the case turned on the misrepresentation of the husband as to the extent and the duration of the liability and whether the bank's ability to enforce the surety contract against the wife was prejudiced by the actions of her husband.

On the facts, the bank was aware that the parties were husband and wife and thus was put on notice as to the circumstances in which the wife would have been asked to stand as surety. The bank failed to warn the wife of the risks she ran in entering into the surety contract or as to her potential liability in respect of her husband's debts. Furthermore, the bank had not advised her to seek independent legal advice. On this basis the bank was fixed with constructive notice of the misrepresentation made by the husband to induce his wife into the surety contract and therefore the wife was entitled to have the legal charge on the matrimonial home securing her husband's liability to the bank set aside.

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Lord Browne-Wilkinson thus considered that the key to whether a creditor is bound by the wrongdoings of the principal debtor, and thereby unable to enforce security as a guarantor or surety, lay in whether the creditor had actual or constructive notice of the equitable right of the surety to have the transaction set aside on the basis of the debtor's wrongdoings. He stated that 'the doctrine of notice lies at the heart of equity' and 'provides the key to finding a principled basis for the law'. He went on to state that where there are two innocent parties, both of whom enjoy rights, the earlier right prevails against the later one if the holder of that later right has actual notice of the earlier one or has constructive notice of it and would have discovered it by making proper inquiries. Translating this to the husband and wife scenario, where the wife has agreed to stand as surety for the debts of her husband by virtue of some undue influence or misrepresentation, then the creditor will be deemed to have constructive notice of the equitable right of the wife to have the surety agreement set aside, provided the circumstances are such as to put the creditor on inquiry. Lord Browne-Wilkinson thus applied the equitable maxim, since undue influence is an equitable doctrine, that 'where the equities are equal the first in time prevails'. Thus since the first equity is the wife's and the second equity belongs to the bank, the wife's interest should prevail. In ***Barclays Bank plc* v *Boulter*** [1997] 2 All ER 1002, however, it was held that the burden of proof lies on the bank to prove that it did not have constructive notice of the undue influence or misrepresentation. It is not incumbent on the surety to prove that the bank does have constructive notice.

Lord Browne-Wilkinson considered that it was at this point that the special position of wives became important since, even today, many wives place a confidence and trust in their husbands in relation to their financial affairs. Thus the relationship between a husband and wife in these circumstances gave rise to an 'invalidating tendency' which meant that a wife was in a better position to be able to establish Class 2B presumed undue influence by her husband. The informality of the dealings between a husband and his wife meant that there was a higher likelihood of the husband misrepresenting the liability of the undertaking to the wife in order to secure her assent to the surety contract. His Lordship considered that the informality of the business dealings between a husband and his wife would be sufficient to put a creditor on notice if two factors are satisfied:

(a) the transaction is on its face not to the financial advantage of the wife; and

(b) there is a substantial risk in transactions of that kind that, in procuring the wife to act as surety, the husband has committed a legal or equitable wrong that entitles the wife to set aside the transaction.

Thus where a creditor is put on inquiry it is incumbent on him to ensure that the wife's consent to act as surety has been properly obtained, since otherwise he will be deemed to have constructive notice of the wife's right to have the surety agreement set aside, on the basis of either undue influence or misrepresentation. This position has now been affirmed by the House of Lords in ***Etridge No 2*** where it was stated that 'a bank should take steps to ensure that it is not affected by any claim the wife may have that her signature . . . was procured by the undue influence or other wrong of her husband'.

But what of the situation outside the husband and wife relationship? Lord Browne-Wilkinson stated that the special position of wives does not arise out of the status of the husband and wife relationship but out of the emotional ties that arise within that relationship. These emotional ties also arise in the case of cohabitees, whether of a

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heterosexual or homosexual nature. Where the creditor knows that a surety or guarantor is cohabiting with the principal debtor, the nature of the surety contract and the relationship of the parties means that the possibility of undue influence or misrepresentation can be inferred, with the consequence that the creditor will have constructive notice of the equitable right of the surety to have the transaction set aside, just as in the husband and wife situation.

Of course, these principles are not confined to cohabitees but will arise in any situation where a creditor is aware that the surety places a confidence and trust in the principal debtor. Lord Browne-Wilkinson gave an example of this type of relationship in the following case.

Avon Finance Co. Ltd v *Bridges* [1985] 2 All ER 281

In this case a son persuaded his parents to act as surety for his debts by means of a misrepresentation. It was held that the surety contract was unenforceable by the finance company, *inter alia*, because the finance company had knowledge of the trust the parents reposed in their son with regard to their financial dealings. One may discern a difference of approach here since there would appear to be a requirement to prove actual knowledge by the creditor of the confidence and trust reposed in the debtor by the surety, while in the cohabitee scenario undue influence or misrepresentation may be inferred.

The problem now remained as to how creditors could avoid the consequences set out above. Lord Browne-Wilkinson considered that the answer to this question lies in good banking practice by the various financial institutions. He stated:

> Where one cohabitee has entered into an obligation to stand as surety for the debts of the other cohabitee and the creditor is aware that they are cohabitees: (1) the surety obligation will be valid and enforceable by the creditor unless the suretyship was procured by the undue influence, misrepresentation or other legal wrong of the principal debtor; (2) if there has been undue influence, misrepresentation or other legal wrong by the principal debtor, unless the creditor has taken reasonable steps to satisfy himself that the surety entered into the obligation freely and in knowledge of the true facts, the creditor will be unable to enforce the surety obligation because he will be fixed with constructive notice of the surety's right to set aside the transaction; (3) unless there are special exceptional circumstances, a creditor will have taken such reasonable steps to avoid being fixed with constructive notice if the creditor warns the surety (at a meeting not attended by the principal debtor) of the amount of her potential liability and of the risks involved and advises the surety to take independent legal advice.

By 'reasonable steps' he considered that financial institutions could lend in confidence on the basis of a surety contract provided the surety is warned, independently of the principal debtor, of the extent of his or her liability and the risks involved. Furthermore, the surety should be advised to seek independent advice. His Lordship also considered that notices in the documentation did not provide an adequate warning, no matter what prominence such warnings are given, since very often such written warnings were not read by potential sureties or they were intercepted by the principal debtor. There is thus a legal requirement on financial institutions to explain the matters indicated above to the potential surety in a personal interview from which the principal debtor is excluded.

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Despite the fact that a creditor took the above precautions, Lord Browne-Wilkinson referred to 'exceptional circumstances' that would still cause the transaction to fail. What sort of 'exceptional circumstances' did he envisage? His Lordship did not give explicit examples but it would appear that such circumstances may arise if the creditor had knowledge of facts that made the presence of undue influence highly likely rather than a mere possibility. In such a situation the transaction would be set aside unless the creditor ensured that the innocent party was *actually* independently advised.

Avoiding constructive notice

The case of ***O'Brien*** contained within it procedures that are required to be taken by creditors when entering surety transactions in order to avoid being fixed with constructive notice of the principal debtor's misrepresentations, undue influence or other wrongdoing. Lord Browne-Wilkinson considered these procedures to be good banking practice. To reiterate, the following procedures had to be taken by the creditor:

1. There is a legal requirement that the innocent party is called in for a personal interview. It is important that the principal debtor is excluded from this interview. Written advice is not regarded as being adequate.
2. The extent of the proposed liability of the innocent party (the potential surety) should be explained at the interview.
3. The risks of entering into the transaction should be explained.
4. The innocent party should be encouraged to seek independent legal advice.

Clearly the procedures are designed to ensure that the innocent party is given a maximum degree of protection; however, the question arises as to whether the procedures are to be regarded as best practice guidelines rather than hard-and-fast rules.

In ***Massey*** v ***Midland Bank plc*** [1995] 1 All ER 929 Steyn LJ made two observations here: first, the guidance given did not need to be exhaustive to satisfy the ***O'Brien*** requirements; second, the guidance requirements in ***O'Brien*** should not be applied mechanically. This position accords with that set out in the earlier decision of ***Bank of Baroda*** v ***Shah*** [1988] 3 All ER 24, where it was stated that the bank can assume that the solicitor is honest and competent and that any conflict between the solicitor and the wife is not one for the bank to concern itself with. This position was also affirmed in the Court of Appeal decision in ***Banco Exterior Internacional*** v ***Mann*** [1995] 1 All ER 936.

The principles applied in these were followed and extended in the subsequent cases of the ***Bank of Baroda*** v ***Rayarel*** [1995] 2 FLR 376 (CA) and ***Halifax Mortgage Services Ltd*** v ***Stepsky*** [1996] 2 All ER 277. In the former it was held that where a surety was advised by a solicitor acting for the alleged wrongdoer, the bank was entitled to assume that the surety had been properly advised as to the nature and extent of the transaction. It was also stated that it was a matter for the solicitor to decide if there was a conflict of interest. In ***Stepsky*** the solicitor was acting for the wife, the husband and the building society. The Court of Appeal decided that the knowledge gained from the husband relating to the true purpose of the loan could not be imputed to the building society since the knowledge had been gained prior to the appointment of the solicitor by the building society.

The issue of whether a bank has taken 'reasonable steps' to avoid constructive notice by ensuring that the surety has obtained independent legal advice continued to be blurred by subsequent cases.

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Barclays Bank plc v *Thomson* [1997] 4 All ER 816

A bank instructed a solicitor to act on its behalf for the purpose of ensuring that the wife received independent legal advice as to her liabilities under a charge in the bank's favour; the bank was entitled to rely on the solicitor's assurance that he had discharged his duty and given her professional independent advice. This was so even where the solicitor was also acting for both the bank and the husband. It was stated that deficiency in the advice given by the solicitor could not be imputed to the bank. On the other hand, in ***Royal Bank of Scotland* v *Etridge*** [1997] 3 All ER 628 it was held that the bank was not discharged of its duty to take reasonable steps to ensure that the wife received independent advice simply by the fact that the solicitor had signed a certificate stating that the nature and effect of the transaction had been explained to her. This was because the wife had signed the charge in the presence of the husband; she regarded the solicitor as employed by her husband; and, lastly, the solicitor had been appointed by the bank and was therefore regarded as being an agent of the bank. The case thus distinguished the cases of ***Massey*** and ***Mann***.

Undoubtedly the contradictory decisions in these two cases are unsatisfactory and produced further uncertainty and confusion in this increasingly complex area of the law. The case of ***Royal Bank of Scotland* v *Etridge*** was followed by the case of ***Crédit Lyonnaise Bank Nederland NV* v *Burch*** [1997] 1 All ER 144 (CA), which applied a principle first set out by Lord Browne-Wilkinson in ***O'Brien***. He stated that in an exceptional case a creditor may be so aware of the fact of undue influence by the third party wrongdoer that it would be inadequate for the creditor simply to advise the wife/surety to obtain independent advice; the creditor must insist upon it so that independent advice is actually received. The case is also authority for the proposition that if the transaction is one for an unlimited guarantee then it must be regarded as onerous. In such circumstances the solicitor is bound to inquire as to the nature of any onerous clauses. If the solicitor does discover such clauses they should advise their client not to enter into the transaction. If the client persists in carrying on with the transaction, the solicitor should then refuse to act any further for the client, unless satisfied that the transaction is one which, given the overall circumstances, the client should sensibly enter into free from improper pressure.

In both the ***Massey*** and ***Mann*** cases the Court of Appeal considered that the ***O'Brien*** principles set out by Lord Browne-Wilkinson were not exhaustive ones that had to be applied in all cases. Both Steyn LJ (in the ***Massey*** case) and Morritt LJ (in the ***Mann*** case), considered the principles in ***O'Brien*** to be simply an indication of 'best practice'. Thus Steyn LJ stated:

> The guidance ought not to be mechanically applied . . . It is the substance that matters.

Morritt LJ stated:

> I do not understand Lord Browne-Wilkinson to be laying down for the future the only steps to be taken which will avoid a bank being fixed with constructive notice of the rights of the wife, rather he is pointing out . . . best practice.

On this basis, the absence of a private meeting will not necessarily be fatal to the agreement, provided the overall objective of the guidelines is met in ensuring that the innocent party is made sufficiently aware of the consequences of entering into the proposed transaction so that the undue influence, misrepresentation or other wrong committed by the principal debtor is counteracted.

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It cannot be doubted that the decisions in the ***Massey*** and ***Mann*** cases considerably weakened the ability of sureties to have transactions set aside following ***Barclays Bank plc*** v ***O'Brien***. Conflicting decisions in subsequent cases such as ***Etridge*** and ***Thomson*** exacerbated the situation. The result was a growing uncertainty that made it almost impossible at times for either the banks or sureties to predict the outcome of their respective positions. The problem appeared to be that the banks and other financial institutions involved in lending money adopted a variety of different practices believing that these met the ***O'Brien*** principles. The other problem was that at times the courts also seemed to produce equally varied responses. If the ***O'Brien*** guidelines were to be viewed as 'best practice' then the confusion being created by subsequent decisions was making the law so confused and unpredictable that it could only be labelled as 'worst practice'.

Into this picture came the case of ***Royal Bank of Scotland*** v ***Etridge (No 2)*** [2001] 4 All ER 449 (HL). As indicated earlier, the leading judgment in the House of Lords was delivered by Lord Nicholls. He first of all directed his attention to the criticisms that had been made of the decision in ***O'Brien***. He reiterated the process in which the doctrine of constructive notice had been applied by Lord Browne-Wilkinson in ***O'Brien***. Usually a bank that takes a guarantee from the wife of a customer will be completely ignorant of any undue influence that might be brought to bear in order to compel her concurrence with the loan arrangements. As we have seen, Lord Browne-Wilkinson used constructive notice as a means of putting the creditor on notice of the wife's rights unless the creditor has taken reasonable steps to satisfy themself that the wife's agreement has been properly obtained.

As Lord Nicholls pointed out, this is an unusual use of constructive notice in that the law does not impose an obligation on one party to check whether the other's agreement was obtained by undue influence. Usually in a situation such as a surety transaction where there are three persons involved, the wife only avoids liability if it can be shown that the bank has been a party to the conduct that caused the wife to enter into the transaction. What ***O'Brien*** essentially does is to introduce a concept that the bank will lose the benefit of a contract if it 'ought' to have known that the other's concurrence has been procured by the misconduct of the third party.

Another unusual feature of constructive notice as applied in ***O'Brien*** was considered by Lord Nicholls. Under conventional principles a person is deemed to have constructive notice of a prior right when they do not actually know of the prior right but would have learned of it had they made those inquiries that a reasonably prudent purchaser would have made. In ***O'Brien***, however, the bank is not required to make such inquiries. The decision merely sets out the steps to be taken by the bank to reduce or eliminate the risks incurred by the wife entering into a transaction by way of some misrepresentation or undue influence by her husband. The steps here are to *minimise* the risk, not *discover* if the husband has exerted influence over his wife by misrepresentation or undue influence. Thus in establishing guidelines as to when a bank is put on inquiry, the use of the expression 'constructive notice' is not technically correct since a bank is not required to make such inquiries but to ensure that the risk of undue influence being exerted upon the wife has been reduced.

Lord Nicholls then set out some principles and guidelines regarding the position of lenders and the duties of solicitors in advising wives in transactions where a wife proposed to charge her share of the matrimonial home as security for a loan to her husband or a company within which the husband operates his business.

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1. When is the bank put on inquiry?

A bank is put on inquiry when a wife offers to stand as surety for her husband's debts. This arises from the fact that the transaction is not, on the face of things, to the wife's financial advantage. Further, in such transactions there is a substantial risk that the husband has committed a wrong that would entitle the wife to set the transaction aside. These two factors provide the underlying rationale for the bank to be put on inquiry. Both do not, however, have to be proved before the bank is put on inquiry.

The above principles apply not just in the case of married couples, but also in the case of unmarried couples, whether homosexual or heterosexual, where the bank is aware of the relationship. Couples do not have to be cohabiting, thus affirming the decision in ***Massey***, above, nor indeed does there have to be a sexual relationship. Lord Nicholls in ***Etridge No 2*** considered that banks will always be put on inquiry in all cases where there is a non-commercial relationship between the surety and the debtor, referring to this as the 'wider principle'. Thus he stated:

> the only practical way forward is to regard banks as 'put on inquiry' in every case where the relationship between the surety and the debtor is non-commercial. The creditor must always take reasonable steps to bring home to the individual guarantor the risks he is running by standing surety. As a measure of protection, this is valuable. But, in all conscience, it is a modest burden for banks and other lenders. It is no more than is reasonably to be expected of a creditor who is taking a guarantee from an individual. If the bank or other creditor does not take these steps, it is deemed to have notice of any claim the guarantor may have that the transaction was procured by undue influence or misrepresentation on the part of the debtor.

Lord Nicholls therefore suggests that in any non-commercial situation a bank/lender must assume that it is put on inquiry and must take appropriate action to avoid being fixed with constructive notice.

In ***First National Bank plc*** v ***Achampong*** [2003] EWCA Civ 487 a wife attempted to establish that a bank was put on inquiry because the loan had been made to benefit her husband's business and that she had received no benefit from the loan. The Court of Appeal considered it was unnecessary to inquire into the latter two matters and considered that undue influence arose on the basis of the 'wider principle' as set out above.

The bank is also put on inquiry if the wife acts as surety for the debts of a company whose shares are held by the wife and her husband, even where the wife is a director or company secretary. Lord Nicholls did not consider this type of situation to be a joint loan since shareholders' interests and the identity of directors did provide an accurate guide as to who had de facto control of the company's business. The case of ***Bank of Cyprus (London) Ltd*** v ***Markou*** [1999] 2 All ER 707 provides an example of such circumstances.

2. What steps should the bank take when put on inquiry?

When a bank has been put on inquiry it need only take such reasonable steps as is necessary to satisfy itself that the practical implications of the proposed transaction have been brought home to the wife in a meaningful way. Lord Nicholls states:

> The furthest a bank can be expected to go is to take reasonable steps to satisfy itself that the wife has had brought home to her, in a meaningful way, the practical implications of the proposed transaction. This does not wholly eliminate the risk of undue influence or misrepresentation. But it does mean that a wife enters into a transaction with her eyes open so far as the basic elements of the transaction are concerned.

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There is no requirement on a bank to discharge its responsibility by having a personal meeting with the wife – provided a suitable alternative means of communicating the necessary information to her is used. Lord Nicholls considered that the risk of litigation ensuing by having a personal meeting with the wife was high and that it was not unreasonable for the bank to insist that she receive advice from an independent financial adviser. Ordinarily it is reasonable for a bank to rely upon confirmation from a solicitor that they have given the wife appropriate advice. It would not, however, be reasonable if the bank knows that the solicitor has not duly advised the wife or from the facts the bank knows that the wife has not received appropriate advice. Normally the deficiencies in the advice provided by the solicitor are a matter between the wife and the solicitor. The solicitor is regarded as acting solely for the wife and is not an agent of the bank. Thus the quality of the advice given is a matter between the wife and the solicitor.

In assessing what steps the bank should take when put on inquiry, Lord Nicholls considered that many of the cases already discussed featured the wife becoming involved at a very late stage of the transaction between the bank and the husband. She often had little opportunity to express a view on the identity of the solicitor who advised her. She was often unaware that the purpose of the interview was for the solicitor to confirm to the bank the fact that she had received advice. It was not unusual for the solicitor to act for both the wife and her husband.

Lord Nicholls considered that in future transactions banks should take the following steps when looking for the protection of legal advice given to the wife by the solicitor. He considered that the bank should take steps to check directly with the wife the name of the solicitor she wishes to act for her. The bank should also communicate directly with the wife informing her that, for its own protection, it will require confirmation by the solicitor acting for her that they have fully explained to her the nature of the documents and the practical implications the transaction may have for her. She should be informed that the purpose of this requirement is that she should not be able to dispute that she is legally bound by the documents once she has signed them. She should be asked to nominate a solicitor whom she is willing to instruct to advise her, separately from her husband, and act for her in giving the necessary confirmation to the bank. She should be informed that, if she wishes, the solicitor may be the same solicitor as is acting for her husband in the transaction. If the solicitor is already acting for both herself and her husband, she should also be asked whether she would prefer that a different solicitor should act for her regarding the bank's requirement for confirmation from a solicitor. The bank should not proceed with the transaction unless it has received an appropriate response from the wife directly.

Since the bank's representatives are likely to have a better idea of the husband's financial affairs than the solicitor, the bank must provide the solicitor with the financial information necessary to provide an explanation to the wife, unless the bank is willing to take on the role itself. In practice it will probably become usual for banks to supply the solicitor with the necessary financial information. The information required will largely depend on the facts of the case. Ordinarily this will include information on the purpose for which the loan is required, the husband's current level of indebtedness, the amount of his current overdraft facility, and the amount and terms of any new facility. If the bank's requirement for security arises from a written application by the husband for a facility, a copy of the application should be sent to the solicitor. Of course the bank would need to obtain the consent of the husband for this confidential information to be circulated, but if this consent is not forthcoming the transaction would not be able to proceed.

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If the bank suspects that the wife has been misled by her husband or is not acting of her own free will, the bank must inform the wife's solicitor of the facts giving rise to that belief or suspicion.

The bank should in every case obtain from the wife's solicitor a written confirmation to the effect above. It should be noted that the steps set out will apply only to future transactions. In respect to past transactions, the bank will usually be regarded as having discharged its obligations if the solicitor acting for the wife has given the bank confirmation to the effect that they have brought home to the wife the risks she is running in acting as surety in the transaction.

In future banks should regulate their affairs on the basis that they are put on inquiry in every case where the relationship between the surety and the debtor is not a commercial one. A bank must always take care therefore to ensure that reasonable steps are taken to inform the individual guarantor as to the risks she is taking by acting as surety. If the bank or other creditor does not take such steps it will be deemed to have any notice of any claim the guarantor may have that the transaction was procured by undue influence or misrepresentation on the part of the debtor.

3. What are the responsibilities of the solicitor in advising the wife?

It must always be remembered that the solicitor is acting solely for the wife and is not an agent of the bank. The solicitor will need to explain to the wife the purpose for which they have become involved. They should also advise the wife that their involvement may be used by the bank to counter any suggestion that she has been compelled to enter the transaction by the husband or that she has not properly understood the implications of the proposed transaction. The solicitor will need to obtain confirmation from the wife that she wishes them to act for her in the matter and to advise her on the legal and practical implications of the proposed transaction. Once the instruction has been obtained from the wife, the content of the advice provided by the solicitor will be dictated by the facts of the case.

As a minimum the solicitor would typically be expected to cover the following matters:

1. The solicitor will need to explain the nature of the documents and the practical consequences these will have for the wife if she signs them. The solicitor should draw her attention to the fact that she could lose her home if her husband's business fails to prosper.
2. The solicitor should advise her that her home may be her only substantial asset, as well as the family home, and that she could be made bankrupt.
3. The solicitor will need to point out the seriousness of the risks involved.
4. The wife should be told the purpose of the new lending facility – its amount and principal terms. She should be informed that the bank may increase the loan facility, change its terms, or grant a new facility without further reference to her. She should be told the extent of her liability under the guarantee.
5. The solicitor should discuss the wife's financial means, including her understanding of the property to be charged, and whether the wife or her husband have any other assets out of which payment can be made if the husband's business fails.
6. The solicitor should explain clearly to the wife that she has a choice whether or not to enter the arrangement and the decision is hers alone. In explaining this choice the solicitor should discuss the current financial position, including the amount of the husband's present indebtedness and the amount of his current overdraft facility.

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7 The solicitor should check whether the wife wishes to proceed. They should ask if she is content for the solicitor to write to the bank confirming that they have explained the nature of the documents and the practical implications they may have for her. They should also ask if she would prefer the solicitor to negotiate with the bank on the terms of the transaction, for instance, the sequence in which various securities are called in or the level of her liability. The solicitor should not give any confirmation to the bank without the wife's authority.

The solicitor's meeting with the wife should take place in a face-to-face meeting without the husband being present. The solicitor's explanations should be in non-technical language in order to ensure that the wife has a clear understanding of her position. The interview should not be regarded as a formality since the solicitor has an important task to perform in such transactions.

The solicitor must ensure that they obtain from the bank any information necessary. If the bank fails to provide this information, then the solicitor must decline to provide the confirmation required by the bank. It is not, however, the solicitor's role to veto the transaction by declining to provide the confirmation. The solicitor's role is to explain the documents to the wife and the risks involved. If the solicitor considers that the transaction is not in the best interests of the wife they should tell her so. Ultimately, the decision whether or not to enter into the transaction is the wife's, not the solicitor's, since the wife may have her own reasons for entering into a transaction that might be regarded as unwise. If it is clearly apparent that the wife is being seriously wronged, then the proper action for the solicitor is to decline to act for her.

Can the solicitor act for the husband or the bank and the wife at the same time? As seen earlier this has been a vexed question that has arisen over the years. Lord Nicholls considered that a clear and simple rule was required to provide an answer to this question. He considered it was confusing to use a rule based on whether the bank deals directly with the husband and the wife, or whether the bank deals with the solicitors acting for the husband and the wife, as seen in ***Bank of Baroda* v *Rayarel*** [1995] 2 FLR 376. He considered that some balance was required here depending on the circumstances. Thus, some factors clearly pointed to the need for the solicitor to act for the wife alone. For example, a wife may be inhibited in discussing the transaction with a solicitor who is also acting for her husband, as in ***Banco Exterior Internacional* v *Mann*** [1995] 1 All ER 936, above. A solicitor may not be able to give the same single-minded attention to the wife's interests as they would if they were acting solely for her. Lord Nicholls considered that as a matter of general understanding 'independent advice' would suggest that the solicitor should not be acting within the same transaction for the person who is the source of any undue influence.

Lord Nicholls thought that there was nothing inherently wrong in the solicitor also acting for the bank or the husband and the wife, provided it is in the wife's best interests and no conflicts of duty or interests arise. For instance, the costs of the transaction may be lower than if the solicitor acts for her solely; the wife may be happier being advised by the family solicitor; sometimes the solicitor who knows the husband and wife and their histories may be better placed to give advice than a solicitor who is a complete stranger.

Lord Nicholls considered that the advantages attached to the solicitor acting for both parties outweighed independent advice being applied prescriptively to each party. Once the solicitor receives instructions from the wife the solicitor assumes legal and professional responsibilities directed towards her alone and is concerned only with her interests. In

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every case the solicitor must consider whether there is any conflict of interest or duty and decide whether it is in the wife's best interests for them to accept instructions from her. The House of Lords, however, did recognise that there could be some circumstances where a solicitor should decline to act for the wife and refuse to supply the bank with confirmation that the wife had been advised appropriately. The court stated that such circumstances arose in 'exceptional cases where it is obvious that the wife is being grievously wronged'. The case of ***Credit Lyonnaise Bank Nederland NV* v *Burch*** [1997] 1 All ER 144 (CA) is often cited as an example here.

The facts were that Mrs Burch was only a modestly paid employee who, despite having no financial interest in a company, was persuaded to act as surety for the company's debts by way of a second charge on her small flat. The flat was valued at £100,000 and was already subject to a charge of £30,000. The second charge exposed her to unlimited liability for an unlimited period of time. At the time she entered into the second charge she was not aware that the current level of indebtedness of the company would have meant that she would have lost her home and incurred a personal debt of £200,000. Clearly this was a transaction which not only was manifestly to her disadvantage but was one which shocked 'the conscience of the court'.

The House of Lords' decision in ***Etridge No 2*** now provides for a coherent process for dealing with surety arrangements. It should be noted that the principles apply to any lender embarking on such a transaction – it is not confined to banks. Effectively both lenders and solicitors are now put on notice that married couples must no longer be considered as a single unit, but as two separate individuals who may have conflicting interests. It is to be hoped that this decision will also put to bed the catalogue of confusion that has arisen since the decision in ***O'Brien***.

The effects of undue influence

The effect of undue influence on a contract is to render it voidable rather than void. It follows that the victim must take steps to avoid the contract by rescinding it. As in other instances where rescission is the remedy it may be lost where *restitutio in integrum* is impossible, or where the contract has been affirmed or where a bona fide third party has acquired the title to any property sold.

For more on restitution refer to Chapter 18.

It should be noted that restitution does not have to be precise but merely substantial, as in ***O'Sullivan* v *Management and Music Ltd*** [1985] QB 428. In ***TSB Bank plc* v *Camfield*** [1995] 1 All ER 951, however, it was stated that where rescission is ordered the whole transaction is to be set aside (*restitutio in integrum*). In that case the wife was persuaded by her husband to charge her beneficial interest as security for a loan facility for the husband's business. The husband, on the basis of an innocent misrepresentation, falsely told his wife that the maximum liability on the loan would be £15,000, being his share of a £30,000 loan to himself and his partner. In fact the charge was an unlimited one. It was held that the charge should be set aside in its entirety and that the wife was not required to make restitution of even the £15,000 she thought the charge amounted to. The basis of the decision was that the wife would not have agreed to the transaction at all had she known that the charge was to secure unlimited liability. In ***Newbiggin* v *Adam*** (1886) 34 ChD 582, Bowen LJ described the principle in the following terms:

> There ought, as it appears to me, to be a giving back and a taking back on both sides, including the giving back and taking back of the obligations which the contract has created, as well as the giving back and taking back of the advantages.

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This principle is important since it is designed to prevent unjust enrichment arising. In ***Camfield***, however, the wife obtained no benefit whatsoever and therefore the principle had no application as regards the wife since she had nothing to give back. By the same token it would be wrong to impose terms on any relief that she sought.

But what of the situation where a benefit is obtained? At what level should the restitution be assessed? At first instance in ***Dunbar Bank plc*** **v** ***Nadeem and Another*** [1997] 2 All ER 253, whilst finding that undue influence was present, the judge refused to set the transaction aside unconditionally, as occurred in ***Camfield***. He found that case to be quite different because there the wife received no benefit from the transaction. Relying on ***Erlanger*** **v** ***New Sombrero Phosphate Co.*** (1878) 3 App Cas 1218, he concluded that there could be no setting aside of the transaction unless Mrs Nadeem accounted to the bank for the benefit she received from the money advanced. Since she had received a half-share in the home the question arose as to whether she should refund either the full amount of the loan or half that plus interest. The judge concluded that the latter should be repaid since otherwise the wife would be funding her husband's share of the loan and interest in the home. In the Court of Appeal it was stated that the judge at first instance was wrong in principle to impose the condition he did. Millett LJ considered that there were two agreements. The first was made between Mr Nadeem and his wife, that he would give her a half-interest in the home on the basis that she would join him in charging the property with the moneys advanced by the bank to effect the purchase. Thus Mrs Nadeem would get a beneficial interest or share in the property. The second transaction was between Mr and Mrs Nadeem and the bank on the terms set out in a letter describing the loan facility.

On the basis of the two agreements Mrs Nadeem obtained, first, an interest in the property and, second, a loan advance of £260,000 on the basis that £210,000 would be used to purchase the property, which she and her husband would charge to the bank to secure the repayment of the loan moneys. In relation to the second agreement there was no question of Mrs Nadeem getting a free-standing loan to do with what she wanted. The loan had to be applied for the purpose of acquiring the property.

In assessing the level of restitution it is necessary to consider the level of Mrs Nadeem's enrichment since it is this which restitution seeks to redress. Millett LJ and Morritt LJ held that this should not be based on the money advanced but on the interest she obtained in the property by way of the loan because this was the extent of her enrichment. They thus concluded that in having the legal charge discharged as against her she should restore the beneficial interest to her husband. It should be noted that her obligation to restore the beneficial interest was not an obligation to restore it to the bank since it was not derived from the bank. The consequence of the beneficial interest being restored to the husband would mean that the whole beneficial interest would come within his charge to the bank. A further consequence, however, would be that the wife would have no defence to claims for possession of the property brought by the bank in order to recoup the loan.

Problems can arise where restitution is ordered but the value of the property in question has changed. Such a situation arose in the case of ***Cheese*** **v** ***Thomas***.

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Cheese v *Thomas* [1994] 1 WLR 129

In this case the plaintiff (Cheese) bought a house with his great-nephew (Thomas) for £83,000. The money for the purchase was raised by the plaintiff contributing £43,000 and the defendant £40,000 by way of a mortgage on the property for that amount. The house was purchased in the defendant's name, though it was agreed that the plaintiff would have sole use of the house for the rest of his life. It was further agreed that on the plaintiff's death the house would belong to the defendant exclusively. Eventually the plaintiff became worried that the defendant was not paying the mortgage repayments, conduct which inevitably would have placed his interest in the property at risk. The plaintiff thus sought to have the arrangement set aside on the basis of undue influence.

The judge at first instance ruled that the agreement could be set aside for undue influence. Normally, where restitution is ordered, the plaintiff should have been able to recover his full £43,000 contribution since the principle behind this remedy is that the parties should be restored to their original positions. In this case, however, the house was sold for £55,400, i.e. a £27,600 loss. Should the plaintiff receive his £43,000 in full or only a proportion of it to reflect the loss sustained on the sale of the property? The Court of Appeal held that it was appropriate that the loss should be shared since each party had contributed to the purchase of a house in which each would have an interest. Further, the defendant's personal conduct was not found to be open to criticism – he had acted as an 'innocent fiduciary' rather than in some unconscionable manner. Presumably the result of this decision is that if the parties can show that they have an interest in the property then, if the property has been sold at a profit, the parties would have likewise been entitled to a share of the profit.

Inequality of bargaining power

In ***Lloyds Bank Ltd* v *Bundy*** [1975] QB 326 Lord Denning MR propounded a wider doctrine of equitable intervention whereby relief would be given where some unfair advantage had been obtained of a party to a transaction because of a substantial difference in the bargaining powers between the parties.

Lord Denning, rather than formulate a judgment in terms of undue influence, decided, having examined various categories of unconscionable bargains, to base his decision on a general theory that the courts could, and should in this case, give relief where the parties were of substantially unequal bargaining strengths. He stated the theory in the following terms:

> Gathering all together, I would suggest that through all these instances there runs a single thread. They rest on 'inequality of bargaining power'. By virtue of it, the English law gives relief to one who, without independent advice, enters into a contract upon terms which are very unfair or transfers of property for a consideration which is grossly inadequate, when his bargaining power is grievously impaired by reason of his own needs or desires, or by his own ignorance or infirmity coupled with undue influences or pressures brought to bear on him by or for the benefit of the other.

The other members of the Court of Appeal, while expressing sympathy with the view of Lord Denning, did not see fit to follow it and based their decisions on an orthodox application of the principles to be found in the doctrine of undue influence. Further, Lord Denning's approach was not followed in ***National Westminster Bank Ltd* v *Morgan*** by Lord Scarman, who stated:

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> The fact of an unequal bargain will, of course, be a relevant feature in some cases of undue influence. But it can never become an appropriate basis of principle of an equitable doctrine which is concerned with transactions 'not to be reasonably accounted for on the ground of friendship, relationship, charity or other ordinary motives on which ordinary men act' (Lindley LJ in ***Allcard* v *Skinner***).

To set up a general doctrine of inequality of bargaining power, Lord Scarman further stated, would require a legislative enactment. Such a doctrine does exist within the United States Uniform Commercial Code, but the only indications of the United Kingdom Parliament moving in this direction have been in very specific instances of hire purchase and consumer protection legislation. For instance, the Consumer Credit Act 2006, s 19 (amending the Consumer Credit Act 1974 by inserting a new s 140A into the 1974 Act) allows the court to adjust a credit agreement if the court decides that the relationship between the creditor and the debtor arising out of the agreement is unfair to the debtor because of any of the terms of the agreement, the manner in which the creditor has exercised or enforced his rights under the agreement, or any other thing done (or not done) by or on behalf of the creditor either before or after the making of the agreement. The Consumer Credit Act 2006, s 20 also inserts a new s 140B into the 1974 Act that gives the courts powers to regulate unfair relationships. Thus, *inter alia*, the court can require the creditor or any associate or former associate to repay in whole or in part any sum paid by the debtor. The court can reduce or discharge any sum payable by the debtor and set aside any duty imposed on the debtor or on a surety by virtue of the agreement. The court may also direct the return to a surety of any property provided by him for the purposes of the security and, finally, the court can alter the terms of the agreement. Further, there are criminal sanctions available under the Fair Trading Act 1973, s 17, in situations where a business practice subjects consumers to undue pressure.

The Unfair Terms in Consumer Contracts Regulations 1999, as considered in Chapter 8, also introduce a concept of unfairness in the law by virtue of reg 5(1) of the 1999 Regulations:

> A contractual term which has not been individually negotiated shall be regarded as unfair if, contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations arising under the contract to the detriment of the consumer.

Thus the regulation provides for a general concept of fairness by imposing a requirement of 'good faith'. The Regulations require that an assessment of the unfair nature of a term should be made taking into account the nature of the goods and services, the circumstances surrounding the conclusion of the contract and all the other terms of the contract or of another contract on which it is dependent. Originally in the 1994 Regulations, in assessing whether a term satisfied the requirement of good faith, reg 4(3) stated that regard had to be made to the guiding factors contained in Sch 2. Thus regard had to be made to:

(a) the strength of the bargaining position of the parties;
(b) whether the consumer had an inducement to agree to the term;
(c) whether the goods or services were sold or supplied to the special order of the consumer; and
(d) the extent to which the seller or supplier has dealt fairly and equitably with the consumer.

Neither this provision nor the Schedule are contained in the 1999 Regulations which simply rely on reg 5(1).

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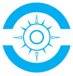

The issues relating to fairness have now been considered in the case of ***Director General of Fair Trading* v *First National Bank plc*** [2001] 3 WLR 1297 (HL), which was considered in detail in Chapter 8 above.

While Lord Denning's views have been virtually dismissed by the courts, some academics have expressed some sympathy with his exposition of a general doctrine. Nevertheless it seems highly unlikely such an approach will be adopted since it is all too easy to deal with cases on the traditional basis of duress (including economic duress) and undue influence. Further, Lord Denning's general doctrine is far too wide and is marked by an absence of governing principles within it, since inequality of bargaining power can exist in a vast number of cases and it is inconceivable that each one of these could be avoided on this basis. There can be a world of difference between a case where a party exercises a superior bargaining position over another and a case where that person's bargaining power is impaired, thus putting the other party in a superior position. The superior or weaker position may also arise from the effects of a completely external commercial source. Lastly, Lord Denning failed to make clear that it is not the fact of inequality of bargaining power that will render a contract voidable, but a state of affairs whereby a party in a superior position has abused that position to the detriment of the weaker individual.

The European Unfair Commercial Practices Directive 2005/29/EC (OJ L 149/22) also appears to impact on the law relating to unfair practices, seeking to achieve a high level of consumer protection by approximating the law and regulations of Member States as regards unfair commercial practices that harm consumers' economic interests. Article 5 prohibits unfair commercial practices which are described as being 'contrary to requirements of due diligence' and which 'materially distorts or is likely to materially distort the economic behaviour with regard to the product of the average consumer whom it reaches or to whom it is addressed, or of the average member of the group when a commercial practice is directed to a particular group of consumers'. All Member States are required to prohibit and provide adequate and effective means of combating unfair commercial practices such as misleading actions (Article 6), misleading omissions (Article 7), aggressive commercial practices (Article 8) and the use of harassment, coercion and undue influence (Article 9). Article 9 is intended to cover means of exploiting a position of power in relation to a consumer so as to apply pressure, even without using or threatening to use physical force, in a way which significantly limits the consumer's ability to make an informed decision. The Directive is of little impact in the law of contract since Article 3(2) indicates that it is 'without prejudice to contract law and, in particular, to the rules on the validity, formation or effect of a contract'. Thus, whilst the Directive will impact on UK consumer protection provisions, it is not intended to provide for civil remedies within the law of contract.

Summary

The common law concept of duress

- Duress relates to contracts induced by violence or the threat of violence.
- The act or threatened act must be illegal:
  - it may amount to either a tort or a crime;
  - the threat must be directed at a person.
- NB: Lawful theats cannot be duress. (Lawful imprisonment as in ***Williams* v *Bayley***)
- Duress renders the contract voidable.

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- Threat to goods cannot amount to duress. (***Maskell* v *Horner***)
- Economic duress. ***D & C Builders Ltd* v *Rees; Atlas Express Ltd* v *Kafco (Importers and Distributors) Ltd; Vantage Navigation Corporation* v *Suhail and Saud Bahawn Building Materials LLC (The Alev)***.

The equitable concept of undue influence

- The transaction entered must be of manifest disadvantage to the victim – ***Bank of Credit and Commerce International SA* v *Aboody*** [1990].
- ***Royal Bank of Scotland* v *Etridge (No 2)*** [2001] (HL) confirmed the two types of undue influence:

  (a) Class 1: actual undue influence.
  (b) Class 2: presumed undue influence, which had two sub-classifications:
    - Class 2A. Overt acts of improper pressure or coercion such as unlawful threats . . .
    - Class 2B. Interparty relationships where one has acquired a measure of influence, or ascendancy over another and then takes unfair advantage . . .

Class 1: Actual undue influence

- Occurs where there is no special relationship between the parties so that there is no abuse of a particular confidence.
- The claimant must prove that the transaction was manifestly disadvantageous.
- ***National Westminster Bank plc* v *Morgan***.
- The exercise of undue influence is one of fact.

Class 2: Presumed undue influence

2A Presumed undue influence

- Examples of automatic presumed undue influence:
  - trustee and beneficiary – ***Benningfield* v *Baxter***;
  - solicitor and client – ***Wright* v *Carter***;
  - parent and child – ***Powell* v *Powell***;
  - religious leader/adviser and disciple/parishioner (***Allcard* v *Skinner***).
- The claimant must show:

  1 a relationship of trust or confidence exists between himself and the wrongdoer, and
  2 the existence of a transaction which calls for an explanation.
- NB: The victim need not prove that the undue influence has actually taken place; all he has to prove is that a confidential relationship has arisen and that the transaction itself calls for an explanation.
- In ***Etridge No 2*** it was considered that it was only in Class 2A undue influence that there was a true presumption of influence.

2B Presumed undue influence

- Example:
  - Husband and wife relationships: ***Midland Bank plc* v *Shephard***.

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- The burden of proof:
  - The victim will be able to set aside a transaction by proving as of fact that he has placed a trust and confidence in the wrongdoer, without the need to prove that an actual undue influence arose.
  - ***Etridge No 2*** provides authority that presumed undue influence merely shifts the evidential burden of proof from the claimant to the wrongdoer.
  - It is *not* a presumption that undue influence exists *per se*, but rather that the burden of explaining why the transaction was not caused by undue influence is shifted to the wrongdoer.

The effect of undue influence on third parties

- Example:
  - Informal business dealings between a husband and wife would be sufficient to put a creditor on constructive notice if two factors are satisfied:

    (a) the transaction is on its face not to the financial advantage of the wife; and
    (b) there is a substantial risk in transactions of that kind that, in procuring the wife to act as surety, the husband has committed a legal or equitable wrong.

Avoiding constructive notice

- A bank must take reasonable steps to avoid constructive notice by ensuring that the innocent party has obtained independent legal advice (***Royal Bank of Scotland*** **v** ***Etridge (No 2)*** [2001]).

  (a) When is the bank put on inquiry?
  (b) What steps should the bank take when put on inquiry?
  (c) What are the responsibilities of the solicitor in advising the wife? The House of Lords decision in ***Etridge No 2*** now provides for a coherent process for dealing with surety arrangements.

The effects of undue influence

- The effect of undue influence on a contract is to render it voidable rather than void.
- The victim must take steps to avoid the contract by rescinding it.
- Rescission may be lost where *restitutio in integrum* is impossible, or where the contract has been affirmed or where a bona fide third party has acquired the title to any property sold to him.
- Restitution does not have to be precise but merely substantial (***O'Sullivan*** **v** ***Management and Music Ltd*** [1985]).

Inequality of bargaining power

- Lord Denning MR proposed a wider doctrine of equitable intervention in ***Lloyds Bank Ltd*** **v** ***Bundy*** [1975] where relief would be given where some unfair advantage had been obtained of a party to a transaction because of a substantial difference in the bargaining powers between the parties. This has been disapproved of by the English courts in ***National Westminster Bank Ltd*** **v** ***Morgan*** by Lord Scarman.
- The European Unfair Commercial Practices Directive 2005/29/EC.

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Use Case Navigator to read in full the key case referenced in this chapter with commentary and questions for comprehension:

Director General of Fair Trading v *First National Bank plc* [2001] 3 WLR 1297 (HL)

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12 Illegality

Aims and objectives

After reading this chapter you should be able to:

- Understand the different effects of illegality of contracts as a vitiating factor.
- Recognise the effects of illegal acts that are illegal by statute.
- Understand the circumstances that render a contract illegal at common law.
- Understand and apply the means by which parties recover money or property in illegal contracts and how the courts apply severance.
- Understand the effects of contracts that are in restraint of trade and the circumstances whent hesea rise.

Introduction

Oliver Cromwell's assertion of the state of English land law in the seventeenth century that it was an 'ungodly jumble' would also be most apt when applied to this area of the law of contract today. The area is a minefield for the student of the subject since it has little in the way of uniform structure and what there is produces tremendous inconsistencies. Students may therefore be forewarned by the words of A P Herbert in *Uncommon Law* who says of the effect of the law relating to lotteries and gaming, 'This department of the law is a labyrinth of which Parliament and the Courts may well be proud!' Thrown into this mêlée is the *coup de grâce* for many people studying this area in that the terms 'illegal', 'void' and 'unenforceable' are not used consistently by the judges and are often used interchangeably.

This topic concerns the fundamental principle that the courts will not enforce contracts that are considered to be **illegal**. Although this principle seems simple enough, the problem is that illegality as a concept covers a multitude of sins. While it is clearly illegal to commission the murder of another, at the same time, at the other end of the spectrum, it is also illegal to commission the theft of a toy from a shop or commit some other minor transgression. Thus there is a wide disparity in the seriousness of **illegal contracts**, but the question arises as to whether the various illegal acts should all have the same degree of effect on the contract. In addition to the problems of reconciling the differences that

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arise in this broad spectrum there looms the spectre of decisions based on the notion of public policy. Thus a transaction is also regarded as illegal where the conduct involved is one which the court regards as being contrary to the public interest even though the conduct itself is not actually unlawful. It is possible therefore to divide the incidence of illegality into two broad categories: contracts that involve the commission of a legal wrong and transactions which are contrary to public policy.

The classification of illegality

In many of the decisions in the cases dealing with illegality much is sometimes made of two general principles summed up in the expressions *ex turpi causa non oritur actio* or 'no action arises from an unworthy cause' and *in pari delicto, potior est conditio defendentis* or 'where the guilt is shared the defendant's position is stronger'. To apply the principles rigidly would clearly cause injustice to parties in some cases and therefore the courts have seen fit to step outside of these rules to arrive at a preferred outcome. This has resulted in a body of law that is inconsistent, often incomprehensible and lacking in certainty – indeed the very antithesis of what a good legal system should represent.

Authors have attempted to classify the circumstances of illegality in many ways, and rarely satisfactorily, since it is a truism to state that the circumstances of illegality probably defy classification in terms of conceptual analysis. In the Law Commission's *Report on the Illegality Defence* (Law Com No 320, 2010) it was stated that the principle of illegality in the law of contract is:

> a body of law made up of an intricate web of tangled rules that are difficult to ascertain and distinguish. Neither litigants not their advisers are able to predict with confidence which particular line of authority the court may follow.

When contracts that involve the commission of a legal wrong are examined, it can be seen that this category in turn also falls into two broad categories: breaches of statutory provisions; and crimes or civil wrongs that arise at common law. Contracts involving transactions that are contrary to public policy covers the type of activity that the law disapproves of as not being in the interests of the public. There are very many examples of these types of transactions so this work will deal with what is probably a very broad selection, though they are categories which are widely recognised.

In this work it has been decided to treat the subject matter under two categories – where an act is illegal by statute and where an act is illegal at common law – though this is subdivided into contracts for the commission of an act that is wrong at common law and contracts that are contrary to public policy. It should be noted that these categories are to some degree arbitrary and must be seen merely as vehicles for providing a descriptive analysis of the law rather than as forming conceptual boundaries.

Acts illegal by statute

Where the contract is prohibited by statute

Where a contract is expressly declared to be prohibited in a statute then there is little doubt that Parliament intended that the contract could not be enforced. An example of such a case is ***Cope* v *Rowlands*** (1836) 2 M & W 149, below. Where the statute is silent

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on the point then it is for the court to interpret the relevant provisions so as to determine whether the legislation impliedly renders the contract unenforceable by either or both parties. It should be noted that whilst the statute in question may involve a criminal offence, this is not necessarily the case for an implied statutory prohibition to apply.

In ***Re Mahmoud and Ispahani*** [1921] 2 KB 716 the Seeds, Oils and Fats Order 1919 prohibited the dealing in linseed oil without a licence from the Food Controller. The plaintiff had a licence to deal in linseed oil with other such licensed dealers. He agreed to sell linseed oil to the defendant and asked him if he held a licence to deal in such oils. The defendant stated that he did, but that was a fraudulent misrepresentation. The defendant subsequently refused to accept the delivery of the linseed oil on the basis that he in fact did not have a licence. The plaintiff sued for damages for non-acceptance. Despite the fact that the plaintiff was unaware that the contract was illegal when the contract was made, it was held that his action would fail. The Court of Appeal stated that the legislation was clear and unequivocal that such contracts were impliedly prohibited by statute and unenforceable.

Frequently, statutes expressly specify the effects that a breach of a particular Act of Parliament has on a contract today. The principle can also be seen in the case of ***Mohamed* v *Alaga & Co. (a firm)*** [2000] 1 WLR 1815, where a firm of solicitors agreed to pay to an individual (M) a fee for introducing refugees requiring legal services to the firm. The payments were to be taken from the legal aid paid to the firm, such payments being expressly prohibited by the Solicitors Practice Rules 1990. M was not aware of the illegality. It was held that public policy prevented recovery for these services either by way of an action for breach of contract or under the law of restitution. The Court of Appeal, however, allowed M to amend his claim so that he could claim on a *quantum meruit* basis for interpreting services, since fees for these were allowable under the legislation. The fact that M was not aware of the breach and the fact that public policy did not preclude him for claiming for his interpretation services was central to this approach.

Contracts performed in an unlawful manner

Illegality may have two principal effects on a contract and the distinction between the two is of the utmost importance. First, a contract may be regarded as illegal if the actual creation of the contract itself is prohibited. The position here is that the contract is void *ab initio*. Thus in ***Cope* v *Rowlands*** (1836) 2 M & W 149 it was provided by statute that anyone acting as a broker in the City of London had to have a licence or pay £25 to the City for any transaction conducted without such a licence. The plaintiff was an unlicensed broker, and when he sued the defendant for his commission in buying and selling the defendant's stock it was held that the action must fail. Parker B stated:

> The legislature had in view, as one object, the benefit and security of the public in those important transactions which are negotiated by brokers. The clause, therefore, which imposes a penalty, must be taken . . . to imply a prohibition of all unadmitted persons to act as brokers, and consequently to prohibit, by necessary inference, all contracts which such persons make for compensation to themselves for so acting.

Second, a contract may be created lawfully but nevertheless be illegal because of the way in which it is performed. In such a situation the validity or invalidity of the contract is not nearly so decisive. In ***Anderson Ltd* v *Daniel*** [1924] 1 KB 138 there was a statutory requirement that vendors of artificial fertilisers had to state on their invoice the chemical breakdown of the fertiliser. In the contract in question the vendors had sold 10 tons of

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fertiliser to the defendants but failed to comply with the statutory requirement. When the defendants failed to pay, the plaintiffs sued for the price, but were met with the defence that the contract was unenforceable due to statutory invalidity. It was held that the plaintiffs would lose in their action since the court stated that where a contract is lawful in its inception but illegal in its execution, then the plaintiff vendors would be unable to rely on their contractual rights. In ***Shaw* v *Groom*** [1970] 2 QB 504, however, it was held that where a landlord had failed to give his tenant a rent book, thereby committing an offence, he could nevertheless claim the rent owed by the tenant. The aim of the legislation here was to punish the landlord rather than to render the lease invalid, which would clearly be detrimental to the tenant.

The test for deciding which approach to take was stated in ***St John Shipping Corporation* v *Joseph Rank Ltd***.

St John Shipping Corporation v *Joseph Rank Ltd* [1956] 3 All ER 683

The defendants withheld part of the freight due to the plaintiffs on the basis that while carrying the cargo the master of the ship had overloaded the ship contrary to the Merchant Shipping Act 1932. The defendants contended that the plaintiffs in an action for the freight withheld could not enforce a contract that had been performed in an illegal manner. The court held that the plaintiffs could succeed, stating that the test in deciding the validity or invalidity was based on the question as to whether the statute intended to penalise the conduct of the offending party or to invalidate the contract itself. Here the court held that the statute did not interfere with the rights and remedies arising under the ordinary law of contract. If a statute does not expressly provide for a contractual claim to be unenforceable then the courts should not imply that it does so. As Lord Devlin, who was then a High Court judge, stated:

> I think that a court ought to be very slow to hold that a statute intends to interfere with the rights and remedies given by the ordinary law of contract. Caution in this respect is, I think, especially necessary in these times when so much of commercial life is governed by regulations of one sort or another, which may easily be broken without wicked intent.

An example of this approach may be seen in the case of ***Hughes* v *Asset Managers plc*** [1995] 3 All ER 669 (CA) where the appellants paid £3 million to the respondents so that they could purchase shares for the appellants. A month later the market fell and the appellants instructed the respondents to sell the shares, which they did at a loss of £1 million. The appellants sued for the recovery of the loss on the grounds, *inter alia*, that although the respondents were licensed to deal in securities by virtue of the Prevention of Fraud (Investments) Act 1958, s 1, the person who made the agreements on behalf of the respondents did not at the time hold a representative's licence as required by s 1(1)(b). As a result the appellants alleged that the agreements were a nullity since the Act prohibited unlicensed persons from dealing in securities.

It was held by the Court of Appeal that the 1958 Act was designed to protect the public by imposing criminal sanctions on those, whether as principals or agents, who dealt in securities without a licence. The public interest was fully met by the imposition of the sanctions. The Act was not directed toward the deals themselves nor against the parties to the deals, but against the employee/agent making the deal. The words of the Act did not show any parliamentary intention that the deals entered into via an unlicensed dealer would be struck down and thereby rendered ineffective. The appellants' claim was therefore rejected.

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It may also be seen that the courts often adopt a more relaxed attitude where the innocent party is attempting to enforce the contract, but is unaware of an illegal act perpetrated by the other party. This was so in ***Archbold's (Freightage) Ltd* v *S Spanglett Ltd*** [1961] 1 All ER 417 where the defendants agreed to carry the goods of the plaintiff, who was unaware that the defendants did not have the requisite licence required by statute for such a transaction. The goods were stolen in transit and the plaintiff sued for compensation for the loss. It was held that he could succeed since the contract itself was not illegal in its inception and in any event the plaintiff was unaware of the illegal performance of the contract by the defendants.

A different attitude may, however, result where the innocent party condoned or otherwise participated in the illegal performance of the contract. This was so in ***Ashmore, Benson, Pease & Co. Ltd* v *A V Dawson Ltd*** [1973] 1 WLR 828 where the plaintiffs engaged the defendant road hauliers to carry a 25-ton tube to a port. The transport manager of the plaintiffs helped to supervise the loading of the tube on to the lorry, which had a maximum load weight of 20 tons. On the journey to the port the lorry overturned, damaging the tube. The plaintiffs sued to recover the losses resulting from the damage to the tube. It was held that the plaintiffs' action must fail since the transport manager had participated in the illegal performance of the contract.

In other situations, an Act may impliedly indicate that the contract will not be rendered ineffective, in that the main sanction of the Act is directed towards the participants to the agreement, as in ***Hughes* v *Asset Managers plc***, above. Where a statute only impliedly declares a contract to be prohibited then the court must examine the Act to find the intention of Parliament in respect of the effects of the prohibition on the contract.

Acts illegal at common law

The concept of a contract being illegal at common law is extremely wide and has its origins in the idea that a contract would not be upheld if its effect was contrary to the common good or it was injurious to society generally. The presence of such a concept in the nineteenth century and the early part of the twentieth century is rather contradictory to the idea of freedom of contract. While the courts supported this idea, they recognised the need to qualify it so that contracts that were regarded as abhorrent or prejudicial to the interests of the community would not be upheld. Very often the decisions in cases falling within this area of concern were declared invalid by the judges on the basis of a vague notion of public policy, a concept which, of course, may cover a multitude of sins.

One of the great problems with the concept of public policy is that it is vague and has extremely wide borders. Even in the nineteenth century it had its critics, thus Burrough J in ***Richardson* v *Mellish*** (1924) 2 Bing 229 stated: 'I, for one, protest . . . against arguing too strongly upon public policy; – it is a very unruly horse, and when you get astride it you never know where it will carry you.' Further, Lord Jessel MR in ***Printing and Numerical Registering Co.* v *Sampson*** (1875) LR 19 Eq 462 counselled caution with its use. Lord Denning MR chose not to be reticent in handling the thorny stem of public policy and presented a reply to Burrough J in ***Enderby Town FC Ltd* v *The Football Association Ltd*** [1971] Ch 591 when he stated: 'With a good man in the saddle, the unruly horse can be kept in control. It can jump over obstacles.' The result has been something of a renaissance of public policy in recent times, though this is not perhaps

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so unusual since the concept lacks continuity. What one generation considers necessary for the common good is not necessarily true of the next generation, so it is inevitable that every so often a brush will make a clean sweep of areas that have, in the past, been subject to public policy and no doubt will introduce the concept to new aspects of commercial and social life.

Before we proceed to analyse contracts contrary to public policy in depth, a word about the organisation of the topic within this text would seem necessary. Some authors, including *Cheshire, Fifoot and Furmston*, discuss this area in two parts, namely contracts illegal on grounds of public policy and contracts void on grounds of public policy. However, there is some disagreement as to which types of contracts are considered illegal and which are considered void. In particular, as was indicated in the introduction to this chapter, authors cannot agree on the effects of contracts being illegal or void at common law. In any event such a classification, as Treitel indicates, is an over-simplification since the effects of such contracts vary so much that it is almost impossible to group them under these two headings. In this work the contracts will be divided into contracts for the commission of an act that is wrong at common law and contracts which are contrary to public policy. However, it must again be stated that such a classification has been adopted in order to aid understanding of the subject matter rather than to place the contracts discussed into watertight compartments. With respect to contracts contrary to public policy, contracts in **restraint of trade** will be treated separately since this area of public policy is not only particularly important, but also somewhat lengthy.

Contracts for the commission of an act that is wrong at common law

It is clear that a contract to commit a crime must itself be illegal and the courts will not enforce such a contract. In ***Bigos* v *Bousted*** [1951] 1 All ER 92 it was held that a contract that was contrary to exchange control regulations would be unenforceable. Similarly, it is well established that a person cannot benefit from their own crime, thus in ***Beresford* v *Royal Insurance Co. Ltd*** [1937] 2 KB 197 it was held that the relatives of a person who had committed suicide could not claim under a life insurance policy, even though the insurance allowed a claim in such circumstances, provided the suicide (which was a crime at this time) did not occur within two years of the making of the policy. The court considered that to allow a claim to succeed would be to allow the deceased to provide for his relatives via a criminal act. The principle, however, must be treated guardedly since there are a great many statutory offences today which often do not require a guilty intention to secure conviction. In such cases it would be harsh to apply a general rule that no one can benefit from their crime. It should be noted that in the field of motoring insurance it is still possible for an insured person to claim against their policy despite the fact that their actions might amount to a crime or incur civil liability, or both. In order for such a claim to be upheld, however, the act of the driver must not be a deliberate act but a negligent or reckless one, as was held in ***Tinline* v *White Cross Insurance Association Ltd*** [1921] 3 KB 327.

A contract will also be illegal if it has as its object the deliberate commission of a civil wrong. Thus a contract to commit an assault was held to be void in ***Allen* v *Rescous*** (1677) 2 Lev 174. Where, however, there is an unintentional commission of a civil wrong it would seem that if both the parties are unaware of the illegality then the contract is enforceable by and against each other. If, however, one party knows the contract to be illegal then it would seem that only the innocent party can enforce the contract.

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Not surprisingly a contract to defraud the HM Revenue & Customs or a rating/polling authority whether national or local is clearly illegal. Thus in ***Alexander* v *Rayson*** [1936] 1 KB 169 there was a lease of a flat in Piccadilly. The rent was £450 per annum but the lease provided that certain other services were to be provided. The 'other services' were detailed in a second document and the defendant had to pay another £750 per annum for these services. A dispute arose and the defendant refused to pay the moneys due under the agreement. When sued the defendant stated that the object of having two documents was to deceive the local authority as to the rent payable since the calculation of the rateable value, and hence the rates, depended on the rent payable. The Court of Appeal held that the plaintiff would not be entitled to recover the moneys owed if the purpose of the two documents was indeed to perpetrate such a fraud.

Contracts contrary to public policy

Contracts prejudicial to the administration of justice

Such contracts are nearly always void and illegal no matter how slight the transgression. There are many examples of the application of this rule: for instance, an agreement not to proceed with divorce proceedings as in ***Cooper* v *Willis*** (1906) 22 TLR 582, an agreement by a wife that she would not apply for maintenance in divorce proceedings as in ***Hyman* v *Hyman*** [1929] AC 601, or an agreement by a witness not to give evidence as in ***Harmony Shipping Co. SA* v *Davis*** [1979] 3 All ER 177.

It is, of course, most important that the exercise of the criminal law should not be capable of being suppressed by virtue of some private agreement. The courts will not hesitate to declare such a contract illegal and void where the agreement results in the withdrawal of a prosecution of a crime. In some cases, however, the courts will allow the question of liability to be compromised by agreement provided the offence is not one which is contrary to public interest. Thus in cases of libel, which may be the subject of a private suit or a criminal prosecution, an agreement compromising a prosecution may well be upheld since the choice of civil or criminal proceedings lies in the hands of the injured party. A similar situation arises in cases involving assault as seen in ***Keir* v *Leeman*** (1846) 9 QB 371. Though in this case it was held that the compromise was void, nevertheless Lord Denman CJ stated that normally a compromise is lawful where the criminal offence is one which also gives rise to civil liability. He stated that compromise is not possible where the offence involves the public interest. The case was not simply a case of assault but involved the public offence of riot and an assault on a public officer (a sheriff's officer) carrying out his duties.

So far our examination of contracts that are prejudicial to the administration of justice has been concerned with the situation where a party attempts by means of a contract to prevent the force of the law being brought against himself. There are, however, two categories of contract which the law regards as unlawful since they tend to promote litigation resulting in actions that are not brought in good faith and may be regarded as speculative. It is regarded as contrary to public policy to allow a person to sell their right of action to another or, in fact, to allow a person to incite the bringing of litigation.

The two categories of contracts falling within this area are known as **maintenance** and **champerty**. A contract of maintenance arises when a person encourages and supports a course of litigation in which they have no interest. Such contracts will, however, be valid if they can show that they have just cause or excuse in promoting and supporting the litigation. Thus in ***Martell* v *Consett Iron Co. Ltd*** [1955] Ch 363 the action of a fishing club in supporting a riparian owner against the pollution of a river was held not to be a contract of maintenance.

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Champerty is a contract in which a person is given assistance in bringing an action, either financially or by the provision of evidence, in return for a share in the rewards arising from the action, if successful. In ***Trendtex Trading Corporation* v *Crédit Suisse*** [1982] AC 679 (HL), Lord Wilberforce stated, at p. 694:

> [champerty] . . . involves trafficking in litigation – a type of transaction which, under English law, is contrary to public policy. I take the definition of 'champerty' . . . is a particular kind of maintenance, namely maintenance of an action in consideration of a promise to give the maintainer a share in the proceeds or subject matter of the action.

Originally both maintenance and champerty gave rise to both criminal and tortious liability but both have now been abolished by the Criminal Law Act 1967, ss 13 and 14. In relation to whether such contracts are treated as contrary to public policy or otherwise illegal, s 14(2) of this Act specifically preserves champerty as a rule of public policy that is capable of rendering a contract as unenforceable:

> The abolition of criminal and civil liability under the law of England and Wales for maintenance and champerty shall not affect any rule of that law as to the cases in which a contract is to be treated as contrary to public policy or otherwise illegal.

In ***Factortame Ltd* v *Secretary of State for the Environment, Transport and the Regions (No 2)*** [2002] EWCA Civ 932 Lord Phillips stated that, because the principle is based on public policy, the law had to be kept continuously under review as public policy changes. Such a situation has been seen to have arisen by the introduction of conditional fee or 'no win no fee' agreements by the Courts and Legal Services Act 1990, s 58, as amended by the Access to Justice Act 1999. This means that, whilst previously officers of the court (solicitors) have had to be inhibited as a matter of public policy from putting themselves in a position where their personal interest conflicted with that of the court, this is no longer an absolute requirement. In certain situations the law expressly restricts the circumstances in which contracts in support of litigation are lawful, as in conditional fee agreements, and in these circumstances there is a clear indication as to the limits of public policy. In other circumstances, however, the courts have to look at the facts and consider whether, in the words of Lord Denning in ***Re Trepca Mines Ltd (Application of Radomir Nicola Pachitch (Pasic))*** [1962] 3 All ER 351, '. . . the champertous maintainer [has been] tempted, for his own personal gain, to inflame the damages, to suppress evidence, or even to suborn witnesses' so as to undermine the administration of justice. Thus for a contract to be champertous it must be in the nature of an agreement which undermines the legal process of litigation by way of providing the expert involved in the case with a significant financial interest in the outcome of the litigation.

Picton Jones & Co. v *Arcadia Developments* [1989] 3 EG 85

The plaintiffs, a firm of chartered surveyors, agreed to act for the defendants in their attempt to acquire some amusement arcades. The contract required the plaintiffs to make applications for gaming licences and planning permission, but their fees were only to be payable 'in the event of ultimate success'. The plaintiffs successfully carried out their part of the contract but when they pressed the defendants for their fee they were told that the contract was one of champerty and unenforceable. Further they maintained that such a method of dealing was contrary to the rules of the plaintiffs' professional body and as such contrary to public policy and void. With regard to the latter defence it was held that an action that is contrary to the rules of a professional association was not necessarily illegal at law. With regard to the allegation that the contract was one of champerty it was held that such contracts only applied to the outcome of litigation. The plaintiffs were thus successful.

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It should be noted that for an agreement to be champertous it must undermine the English judicial system and litigation. Thus a champertous agreement made in England is valid if it relates to litigation in a country where champerty is lawful. The case of ***Re Trepca Mines Ltd*** and more recently ***Papera Traders Co. Ltd* v *Hyundai Merchant Marine Co. Ltd*** [2002] 2 All ER (Comm) 1083 clearly illustrate this point. This also indicates clearly that one is not dealing with an overriding matter of public policy which strikes down wherever such an agreement is made or performed.

Contracts calculated to oust the jurisdiction of the courts

Such contracts have for many years been regarded as contrary to public policy and void. There is, however, no objection to a contract that requires the parties to attempt to resolve their dispute by reference to arbitration, provided there is no attempt to deprive the parties of their right to have their case heard before the ordinary courts of law. It is, however, not unusual for a right to take such action to be the subject of a condition precedent in the contract, whereby an arbitration award must first be made before the course of action can be placed before the ordinary courts of law. Such a clause is known as a '***Scott* v *Avery***' clause and is not per se regarded as ousting the jurisdiction of the courts.

The Arbitration Act 1996, which governs the rules regarding this area, specifically allows for an appeal to the court to challenge an award made in arbitration proceedings on the ground of some serious material irregularity affecting the tribunal, the proceedings or the award (s 68(1)). Section 68(2) sets out various matters that a court is to consider as constituting a serious irregularity. Broadly, these are matters that will cause substantial injustice to the applicant, for instance, where the tribunal exceeds its powers, or fails to conduct the proceedings in accordance with the procedure agreed by the parties, or the tribunal fails to deal with the issues put before it.

Section 69(1) allows for an appeal to the court on a question of law arising out of an award made in arbitral proceedings. This right of appeal is limited in that it can only be brought where all the parties agree to the appeal proceedings or where the leave of the court has been obtained (s 69(2)). Such leave is only granted if the court is satisfied according to the criteria set out in s 69(3):

(a) that the determination of the question will substantially affect the rights of one or more of the parties,
(b) that the question is one which the tribunal was asked to determine,
(c) that on the basis of the findings of fact in the award –
  (i) the decision of the tribunal on the question is obviously wrong, or
  (ii) the question is one of general public importance and the decision of the tribunal is at least open to serious doubt, and
(d) that, despite the agreement of the parties to resolve the matter by arbitration, it is just and proper in all the circumstances for the court to determine the question.

Such a right of appeal is subject to the overriding proviso that the parties may expressly agree to exclude the jurisdiction of the court. Further, the right of appeal under ss 68 and 69 may not be brought if the applicant or appellant has not first exhausted any available appeal or review within the arbitration process itself (s 70(2)).

Contracts tending to corrupt the public service

It is clear that the public has a substantial interest in the negation of activities which tend to corrupt the administration of the state, whether at a central or a local level, or which

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fetter the performance of public officers in exercising their duties. The object of the law here is clear in that it seeks to prevent the sale of public offices or the diversion of the salaries accruing to such offices by way of either assignment or mortgage. The reason for this latter point is thought to arise from the notion that should public officers assign their salaries, they will be open to the possibility of poverty which may lead them to compromise their positions. One wonders how such a principle has escaped the attention of public service pay negotiators in recent years!

Contracts prejudicial to the status of marriage and the family

The action for breach of promise to marry was abolished by the Law Reform (Miscellaneous Provisions) Act 1970, s 1, but even when such contracts existed it was void as contrary to public policy for an individual to enter into a contract to marry while being already married. This being the starting point it is fairly easy to arrive at the point whereby a separation agreement made between parties still living together or contemplating marriage is also void as being inconsistent with the status and sanctity of marriage. Where the parties to the marriage are already separated the sanctity of the matrimonial state is no longer in jeopardy and agreements providing for separation here are valid. It should be noted that where the parties have separated but have become reconciled, any agreement providing for the possibility of future separation will also be valid, as held in ***Macmahon* v *Macmahon*** [1913] 1 IR 428. The apparent logic in finding such agreements to be valid is that unless such an agreement is arrived at the possibility of a reconciliation may be prejudiced.

A further type of contract that may arise in this context is the contract in restraint of marriage. Marriage has a peculiar position in the law and can itself amount to consideration. Historically much of the sanctity afforded to it revolves around the transmission of estates and interests in land. Given this state of affairs it is not surprising that a contract that unjustifiably restricts a person's ability to marry is void as contrary to public policy. Where the restraint is only partial, in that it is for a limited duration or where it merely limits the class or type of person that may or may not marry, then it is possible for the contract to be valid. Under the latter limitation, however, the persons capable or not of being married must be so small or large, as the case may be, as to render the ability to marry or not illusory. Further, a contract is not invalid if it operates not to restrain but merely to deter marriage, as, for example, an allowance of £500 per month until *X* marries.

The rule whereby a contract is void on the grounds of public policy also extends to the relationship between parent and child. Today there are statutory restrictions on agreements made between parents who are not living together as to parental rights and duties, in that such agreements to be enforceable must be for the benefit of the child. One statute providing such restrictions is the Guardianship Act 1973.

Sexually immoral contracts

Traditionally the law does not render any immoral contracts void as being contrary to public policy, except those promoting sexual immorality. Many of the rules found in the common law revolve around the promotion of cohabitation. Contracts in this area have been held to be illegal and void, a conclusion which is not surprising given the attitude of the common law to marriage, above. It is, however, a somewhat dated attitude given the present morality of society with regard to such matters. It was held in ***Benyon* v *Nettleford*** (1850) 3 Mac & G 94 that a promise by a man for a woman to become his

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mistress was illegal. However, it is not uncommon today to find unmarried couples making agreements as regards the purchase of houses and the distribution of their income within the relationship. There would seem to be nothing wrong in principle in these agreements being binding.

Clearly contracts involving prostitutes are void and unenforceable. It is thus highly unlikely that a prostitute could sue for her fees, though prostitution per se is not illegal, unlike the act of soliciting for clients by a prostitute. In ***Pearce*** **v** ***Brooks*** (1866) LR 1 Ex 213 a prostitute was held not to be liable for the charges arising from the hire of a carriage to be used for the purpose of soliciting. Presumably the same would also apply to the hire of a room or a flat for such purposes. However, a contract to hire a room, flat or house to an unmarried couple would be enforceable. The undoubted change in moral principles may well present the courts faced with such situations with something of a dilemma. This change can be seen in the case of ***Armhouse Lee Ltd*** **v** ***Chappell*** (1996) *The Times*, 7 August (CA), where the defendants placed advertisements in a magazine publicising a telephone sex line and sex dating. When they were sued by the publishers for the cost of the advertisements, the defendants resisted the claim on the basis that the advertisements were immoral and illegal. At first instance the judge found for the plaintiffs and the defendants appealed. The Court of Appeal rejected the argument that such contracts were unenforceable on the grounds of public policy. It was stated that 'it was undesirable in such a case, involving an area regarded as the province of the criminal law, for individual judges exercising a civil jurisdiction to impose their own moral attitudes'. The court therefore upheld the decision of the judge at first instance; however, the decision of the Court of Appeal would seem to indicate that sexually immoral contracts should no longer be regarded as unenforceable, except where the immoral conduct amounts to or involves a criminal offence.

The effects of illegality

The general effect

As was indicated at the start of the chapter, the expression 'illegal' covers a multitude of sins, some serious, some minor. It was also stated that the effect of illegality is widely disparate and not always consistent.

The fundamental rule of the courts was stated as long ago as the eighteenth century when Lord Mansfield declared in ***Holman*** **v** ***Johnson*** (1775) 1 Cowp 341 that no person who is aware of an illegality within a contract can enforce it. Furthermore, any money or property transferred under that contract is irrecoverable. Since illegality is founded on public policy such a rule is apparently sound in this context, but with regard to the parties themselves it produces great difficulties, mainly because it provides a defence to a defendant who may not merit such protection. The result of the rule is that the defence of illegality is available to both parties, whatever the rights and wrongs of their respective situations. Thus a plaintiff cannot base their claim on an illegal contract, though they may be able to do so if they can find an additional ground not based on the illegality. Further, a plaintiff will not succeed where they are seen to benefit from the illegality.

The blind approach of the courts, whereby the relative fault of the parties is not taken into account, clearly is very unfair to the innocent party. The courts are now beginning to deal with this problem. Public policy still, however, remains at the forefront of judicial reasoning and under such policy the courts will not grant relief in cases where to do so

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would amount to aiding and abetting a criminal act, an action amounting to an affront to public conscience. This was indicated in ***Thackerell* v *Barclays Bank plc*** [1986] 1 All ER 676 and affirmed by the Court of Appeal in ***Saunders* v *Edwards*** [1987] 2 All ER 651. The effect of this 'affront to public conscience' approach can be seen in the following case.

Howard v *Shirlstar Container Transport Ltd* [1990] 3 All ER 366

The plaintiff, a pilot, made a contract to recover an aircraft that had been impounded in Nigeria. The contract was illegal in that it was not so much a 'rescue' mission as a mission to steal the aircraft from under the noses of the Nigerian authorities. When he had successfully completed the contract the defendants refused to pay; when sued they raised the question of illegality as a defence. Even though the effect of his claim succeeding would have been to allow the plaintiff to benefit from an illegal act, the court decided that his claim should succeed since the conscience of the court in the opinion of Slaughter LJ was not compromised. While this decision has been described and praised as the adoption of a 'pragmatic approach' it does not seem calculated to produce certainty within the law.

The issue of the affront to public conscience approach arose again in the important case of ***Tinsley* v *Milligan*** [1993] 3 WLR 126.

Tinsley v *Milligan* [1993] 3 WLR 126

The facts of the case were that a lesbian couple bought a house together using their joint money but having done that the house was registered in Tinsley's name only. The basis behind this conduct was to allow Milligan to claim social security benefits which she would not otherwise be entitled to. The couple eventually argued and fell out and Tinsley sought to evict her former partner, Milligan, from the property. Milligan claimed that she was entitled to half the purchase money of the house, the beneficial interest, by way of her contributions to the purchase price by way of a resulting trust, which is an equitable principle. Tinsley argued that Milligan was not entitled to that share because she had behaved illegally as regards her claim for the social security payments.

In the Court of Appeal an attempt was made to develop an approach based on a test of public conscience, thus Nicholls LJ stated:

> The court should keep in mind that the underlying principle is the so-called public conscience test. The court must weigh, or balance, the adverse consequences of granting relief against the adverse consequences of refusing relief. The ultimate decision calls for a value judgment . . . I have no doubt that far from it being an affront to public conscience to grant relief in this case, it would be an affront to the public conscience not to do so. Right thinking people would not consider that condemnation of the parties' fraudulent activities ought to have the consequence of permitting the plaintiff to retain the defendant's half share of this house.

Nicholls LJ considered, therefore, that the mere presence of fraud or illegality should not automatically mean that relief should not be granted. He thought that, in deciding where the equitable balance lay, the court should take into account the nature and seriousness of the illegality, the extent to which failure to enforce the claim would result in unjust enrichment, the extent to which enforcement would encourage others to act in an illegal manner and the overall culpability of the parties. This was the majority decision of the Court of Appeal with Gibson LJ dissenting. Whilst Gibson LJ thought that upholding the resulting trust would produce a fairer result, he considered that the proper principle should be that equity should not give effect to an equitable remedy based on an unlawful transaction, i.e. 'he who comes to equity must come with clean hands'.

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The House of Lords unanimously rejected the Court of Appeal's public conscience test. Lord Browne-Wilkinson stated that attempting to assess whether the public conscience would be 'affronted by recognising rights created by illegal transactions' was improper. Lord Goff also considered such an approach would introduce uncertainty, since each court would have to decide where the equitable balance lay on the facts of individual cases.

The majority of the House of Lords came to a decision with reference to the so-called 'reliance principle', that is if a claimant needs to 'rely on' or bring evidence relating to the illegality to prove his or her claim then the claim will fail. Their Lordships considered that a person may recover money or property under an illegal contract if that person can establish his right or title to the property without relying on the contract or on its illegal nature. Thus in this case Milligan won because she could establish her claim by virtue of the resulting trust and she did not have to rely either on an illegal contract (because she already owned the property under the resulting trust) or on the illegal conduct in order to establish her claim. Thus Lord Browne-Wilkinson stated:

> A party to an illegality can recover by virtue of a legal or equitable property interest if, but only if, he can establish his title without relying on his own illegality.

Both Lord Goff and Lord Keith gave dissenting judgments in the House of Lords, preferring to base their judgments on traditional principles, not least that, irrespective of how the resulting trusts arose, whether based on an illegality or not, a court of equity should not intervene to assist someone who transfers property into the hands of another as part of an illegal act in order to establish an equitable claim to the property.

One of the problems arising from the reliance principle is that it is selective in who it will benefit since, in other circumstances, the presumption of advancement may apply and a very different result could arise. Until its abolition by the Equality Act 2010, s. 199, the concept of the presumption of advancement, was really an outdated anomaly within the law of trusts but one which nevertheless continued to have a modern impact. The presumption of advancement applied where a husband or father gave, or 'advanced', money or property to his wife or children. The presumption did not operate in relation to a man and his mistress and here a resulting trust would apply and, as we have seen in ***Tinsley* v *Milligan***, here the man could recover his money or property, any underlying illegality not affecting his claim since this arose by way of the resulting trust.

In such a situation he could not rely on the principle of resulting trust that we saw in ***Tinsley* v *Milligan***. The husband/father was deemed to have made a gift of the property to his wife or children. If the husband or father was to recover his property he had to first overturn the presumption in order to establish a resulting trust. If his gift was made to achieve an illegal purpose, for instance to evade paying taxes, his claim would 'rely' on the presence of the illegality and therefore he was prevented from recovering because of the underlying illegality. The case of ***Chettiar* v *Chettiar*** [1962] AC 294 is a good example where a father transferred land to his son, recording a payment by the son which was not in fact made. The idea behind the transaction was to deceive the authorities that the father had less land than he had in order to avoid restrictions for the production of rubber. The Privy Council dismissed his claim that the son held the land on trust for him since for the father to overturn the presumption of advancement he would have had to rely on the illegal nature of the purpose for the transaction in the first place.

It may also be possible for an innocent party to succeed in a claim, provided the basic notion of public conscience is not broken in other situations. It may be that the contract itself is lawful but there is an intention to use it to further some illegal purpose or where

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one of the parties intends to perform it in some illegal manner. Here the innocent party will be able to recover damages or what is due to them under the contract, provided they were unaware of the illegal intention of the other party as in ***Bloxsome* v *Williams*** (1824) 3 B & C 232, though here it was the subject matter of the contract that was illegal. In ***Cowan* v *Milbourn*** (1867) LR 2 Ex 230 it was also stated that if they discover the illegality before the transaction is performed then the innocent party can withdraw from the contract. An innocent party who discovers the illegality part of the way through performing the contract may withdraw from the contract and sue on a *quantum meruit* basis.

It should be borne in mind that a party to a contract will not be regarded as innocent if, while being fully aware of the facts, they are not aware of the illegality within the contract because they are ignorant of the law. Ignorance of the law is no excuse (*ignorantia juris neminem excusat*), thus in ***J M Allan (Merchandising) Ltd* v *Cloke*** [1963] 2 All ER 258 it was held that the fees for the hiring of a roulette wheel for purposes of a game that was illegal under the Betting and Gaming Act 1960 were not recoverable, despite the fact that both parties were unaware of the illegal nature of the game.

It was seen in our earlier examination of acts declared illegal that a contract either expressly or impliedly prohibited by statute was void and unenforceable. In such a situation the innocent party is not necessarily precluded from obtaining a remedy since it may be that they have been induced into the contract by some misrepresentation. Had such an action been adopted in ***Re Mahmoud and Ispahani*** [1921] 2 KB 716 the result might have been different. Further it may be possible to avoid the effects of the illegality by alleging the existence of a collateral contract. Thus in ***Strongman (1945) Ltd* v *Sincock*** [1955] 2 QB 525 the plaintiffs, who were builders, contracted to modernise some houses for the defendant architect. At that time, due to shortages of materials, it was illegal to do such work without a licence. The plaintiffs were told by the defendant that he would obtain the necessary licences, but in fact he failed to do so. The defendant failed to pay for the work and when sued pleaded that the contract was void and unenforceable on the grounds that it was illegal. The court nevertheless held that there existed a collateral contract based on the promise of the defendant to obtain the appropriate licences and since he had failed to do so he was liable in damages. There are limits to the use of this device since the finding and enforcing of a collateral contract must not equate with the enforcement of the illegal contract. It may be, however, that an action could be sustained in misrepresentation despite such a finding, though of course the measure of damages would be different. Presumably the use of the fiction of collateral contracts would be subject to the 'public conscience' criterion.

An explanation of collateral contracts can be found on page 49.

Recovery of money or property

It has been seen in ***Holman* v *Johnson***, above, that one effect of illegality was to render any money or property irrecoverable, just as a person is not allowed to benefit from an illegal contract, as we saw in ***Beresford* v *Royal Insurance Co. Ltd***, above. In such a case even claims in quasi-contract cannot be maintained. There are, however, three situations in which the parties will be relieved of the illegal nature of the contract.

For more on the topic of quasi-contracts, refer to Chapter 18.

Where the parties are not in *pari delicto*

The Latin maxim *in pari delicto, potior est conditio defendentis* provides that when the parties are equally blameworthy, the defendant has the stronger position. Thus where the parties are not equally in the wrong, it may be possible for the less 'blameworthy' party

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to recover any property transferred or moneys paid under the contract. This result may arise where the statute rendering the contract illegal is designed to give protection to a particular class of individuals, of whom the less guilty party forms a part. Thus under the Rent Act 1977, s 125 allows a premium to secure a lease to be recovered where such a premium could not be lawfully required. This position also applies even if the tenant was a knowing party to a contract to evade the Rent Acts. This was so in ***Kiriri Cotton Co. Ltd* v *Dewani*** [1960] AC 192, where a landlord's acceptance of a premium from the plaintiff to secure a flat was illegal, though the relevant statute did not allow for the recovery of such a premium. The court found that the plaintiff had little choice but to accept the terms of the landlord, who fully intended to exploit the deficiencies in the legislation. In these circumstances the plaintiff could recover the premium paid despite its illegality.

The same criteria also apply where the less culpable party has been induced to enter the contract by virtue of some fraud or undue pressure by the other party. In ***Hughes* v *Liverpool Victoria Legal Friendly Society*** [1916] 2 KB 482 the plaintiff was induced by the fraudulent misrepresentation of the defendant's agent to take out a number of insurance policies against the lives of persons in whom she had no insurable interest, on the basis that such policies were valid and legal. In fact such policies were illegal and void, but nevertheless she could recover the premiums paid in respect of the policies. There is also authority that moneys or property may also be recovered in similar circumstances where the defendant stands in a fiduciary relationship to the plaintiff.

Where the illegal contract has been withdrawn from

Money paid or property transferred under an illegal contract may be recovered if the contract did not take effect because of the plaintiff's decision to withdraw from it. Here the plaintiff relies on the doctrine of *locus poenitentiae*, meaning he is claiming to withdraw from the contract during a 'time for repentance'. In ***Kearley* v *Thomson*** (1890) 24 QBD 742 it was stated that recovery ceases to be possible once the illegal purpose has commenced, whether or not it is completed. This decision overturns an earlier one where it was suggested that recovery will be allowed provided withdrawal occurs before the illegal purpose is carried out. It is suggested that ***Kearley* v *Thomson*** now represents the true position.

In order to claim recovery under this head it must also be shown that the withdrawal from the contract is voluntary. If the execution of the contract is frustrated by the other party failing to carry out their side of the bargain, or where there is some other reason whereby withdrawal occurs other than by a voluntary act, then recovery will not be allowed. This was the case in ***Bigos* v *Bousted*** [1951] 1 All ER 92 in which, as we have already seen, there was an illegal contract to avoid the provisions of the Exchange Control Act 1947. The plaintiffs claimed that they could recover a share certificate deposited with the defendants as security for Italian currency because the currency was never forthcoming. It was held that the certificate could not be recovered because there was no voluntary withdrawal but merely a frustration of the contract by the defendant.

It is not necessary that true repentance of the illegal scheme is required and it is sufficient, as in ***Tribe* v *Tribe***, below, that the fact that the scheme is no longer required is sufficient to raise the exception. Forced withdrawal from the illegal scheme is, however, not sufficient to raise the exception. In ***Q* v *Q*** [2008] EWHC 1874 (Fam) *dicta* suggested that illegal purpose should be broadly defined and that, as soon as any steps are taken towards its accomplishment, then the withdrawal exception cannot be utilised.

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A slightly different variation to the above principles can be seen in ***Tribe* v *Tribe*** [1995] 4 All ER 236. In this case a father transferred shares in his company to his son after a landlord made a substantial claim against the father with respect to the dilapidation of the business premises. The father's motives for this was that he was worried that the landlord's claim would harm the financial viability of the business so that he would have to sell it to pay the landlord's claim. The objective behind the transfer of the shares to the son was to convince the landlord that he, the father, no longer held shares in the business to sell in order to meet the claim. In the end the claim was settled and the landlord was never made aware of the share transfer. The father now demanded the return of his shares from the son, who refused to return them. The father alleged that the son was always aware that he had to transfer the shares back to the father when he demanded their return. The father argued that he retained property rights in the shares, a 'beneficial interest', which he concealed from his creditors. The son argued that his father could not use the unlawful purpose to support his claim to rebut the presumption of advancement. The son argued that there was a general rule of public policy that prevented such evidence from being used. At first instance the court held that the father's claim would succeed since the attempt by the father to deceive his creditors never materialised and therefore the son held the shares on a resulting trust and would have to return them to his father. The son's appeal was dismissed by the Court of Appeal agreeing with the judge at first instance that where a presumption of advancement arose evidence of an unlawful purpose that had not been carried through could be heard.

At one level the decision appears just, in that the son had taken the shares knowing the reason behind the transfer and that it was always the intention of the father that he would retain his beneficial interest. On another level, however, it could be argued that the father had indeed entered into and executed a transfer of the shares for an illegal purpose, though it could be argued, as indeed the father did, that the transfer was not necessarily connected to the illegal intention.

Where the illegal contract is not relied on for recovery

Here the recovery of goods transferred is not based on the illegal nature of the contract but on the existence of a proprietary interest in the goods. In other words, the plaintiff is relying on the fact that they retain some title to the property transferred. This being the case it is clear that recovery will not be allowed in a contract for the sale of goods, since here the property in the goods passes on sale, unless, of course, the seller has retained title by virtue of a *Romalpa* or reservation of title clause. For the most part, however, recovery is limited to circumstances whereby something less than full ownership is delivered up to the other party, such as that found under a hire purchase agreement or lease. Thus in ***Bowmakers Ltd* v *Barnet Instruments Ltd*** [1945] KB 65 the defendants came into the possession of certain machine tools under an illegal hire purchase agreement. They failed to pay the instalments and in fact, contrary to their rights under the agreement, sold some of the tools. The plaintiffs sued under the tort of conversion to recover the value of the tools on the basis of asserting the proprietary rights they retained in the tools. They based their claim purely on the rules of hire purchase and bailment, making no reference to the illegality of the transaction. On this basis the court upheld their claim. If, however, they had made reference to the illegality of the transaction then the claim would probably have been rejected since it would have indicated that they were not relying on their proprietary rights but on the illegality.

The decision has been subject to criticism since it is apparent that in pursuing the claim in conversion they must have had to rely on the contract – which was, of course,

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void and unenforceable for illegality. The position appears to be that when the courts consider the proprietary consequences of an illegal contract the issues of illegality are ignored, though it should be noted that the Court of Appeal in ***Bowmakers Ltd* v *Barnet Instruments Ltd*** distinguished its decision from the earlier one of ***Taylor* v *Chester*** [1945] KB 65, where the plaintiff deposited half a banknote as security for the payment of food and drink he had consumed in a brothel. He then sought to recover the half note relying on his proprietary interest in it. He failed to do so since in order to overturn the defence that the half note had been validly deposited he would be 'obliged to set forth the immoral and illegal character of the contract upon which the half-note had been deposited'. It was therefore impossible for him to recover except through the medium and by the aid of an illegal transaction to which he was himself a party.

It has been suggested that the difference between the two cases is that, in ***Bowmaker***, rights retained by the transferor are being enforced after entering into an illegal contract, which is allowed, whilst in ***Taylor* v *Chester*** the plaintiff is attempting to enforce rights created by the illegal contract, which is not permissible. On the face of things, though, it is difficult to make out a case in ***Bowmaker*** that the plaintiff is not in fact enforcing rights created by the illegal contract.

The Law Commission and the reform of the illegality defence

The intervention of the Law Commission arose principally out of the case of the House of Lords decision in ***Tinsley* v *Milligan*** [1993] 3 WLR 126, which was examined above. In ***Tinsley* v *Milligan*** Lord Goff called for the Law Commission to examine the whole area of the so-called 'illegality defence'. As a result, the wide-ranging difficulties associated with the issue of illegality in the law of contracts (and other areas) subsequently became the subject of a review by the Law Commission in 2010 in its report, *The Illegality Defence* (Law Com No 320). This report proved to be a difficult one to accomplish for the Law Commission and it arose out of three consultative documents. The first, *Illegal Transactions: The Effect of Illegality on Contracts and Trusts* (Law Consultation Paper No 154) in 1999, in which the law relating to the doctrine of illegality as it operates in contract and trusts was examined. The second consultation paper, *The Illegality Defence in Tort* (Law Consultation Paper No 160) was published in 2001 and examined the law relating to illegality and tort. Following from these consultation documents, the Law Commission published a third consultation report entitled *The Illegality Defence* in 2009 (Law Consultation Paper No 189). The reason for the third consultative document was that, because of the length of time from the 1999 and 2001 consultative documents, the Law Commission decided to consult further on its recommendations. It was from its findings in the 2009 consultative document that the final 2010 report emerged.

Clearly the extent of the consultation work carried out by the Law Commission is a good indicator of the difficulty it had in drawing together the strands of illegality and its effects. However, it must be emphasised that not all of the study was directed at the law of contract and it also included the use of the illegality defence in the law of tort, unjust enrichment and the law of trusts.

The Law Commission in its consultative document *Illegal Transactions: The Effect of Illegality on Contracts and Trusts* (Law Consultation Paper No 154) in 1999 came to two principal conclusions: first, the reliance principle as set out in ***Tinsley* v *Milligan*** should

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be abandoned; and, secondly, the courts should have the discretion to take into account the effects of the illegality when making their decisions. The Law Commission considered that the technical and complex rules governing the effects of illegality in the law of contract and trusts should be replaced by a 'discretion'. Under that discretion the court could decide 'whether or not to enforce an illegal transaction, to recognise that property rights have been transferred or created by it, or to allow benefits conferred under it to be recovered'. It proposed that illegality should be allowed to continue to provide a defence to a claim for a breach of contract and that it would not be allowed to be used as a cause of action except in cases of withdrawal from the illegal act (*locus poenitentiae*).

The Law Commission did not consider that the courts should have an open-ended discretion to produce what it considers to be a 'just' solution, since it considered that the discretion should be more structured in order to promote greater certainty. The Law Commission therefore proposed a statutory discretion which a court should take account of in exercising its discretion. A court should take into account the following:

> (i) the seriousness of the illegality involved; (ii) the knowledge and intention of the party seeking to enforce the illegal transaction, seeking the recognition of legal or equitable rights under it, or seeking to recover benefits conferred under it; (iii) whether refusing to allow standard rights and remedies would deter illegality; (iv) whether refusing to allow standard rights and remedies would further the purpose of the rule which rendered the transaction illegal; and (v) whether refusing to allow standard rights and remedies would be proportionate to the illegality involved.

The Law Commission did not consider that it was appropriate for the courts to be able to use the discretion to override the express provisions of a statute where a statute had expressly provided what the effect of illegality on a transaction should be.

It was considered that the proposals had two advantages. First, a court would be able to reach its decision on the facts of a case using open and explicit reasoning that gave full effect to the relevance of the illegality on the transaction. Secondly, it considered the proposals would be more likely to result in illegality being used less so as to deny a claimant his or her usual rights or remedies. Thus the Law Commission considered that illegality could only be used as a defence where there was a clear and justifiable public interest reason for it to do so.

In its 2010 report the Law Commission resiled from its previous recommendation for the introduction of a statutory discretion, as set out above. The Law Commission recognised that the body of case law that had sprung up was an intricate web of tangled decisions that created uncertainty in the law. The Commission, however, acknowledged that it was rare for courts to reach an 'unjust' result and that, for the most part, the courts applied the illegality defence in a fair manner. It considered that in most cases the illegality defence was applied according to the policies that underpin its use. The Commission, however, considered that the courts did not articulate the policy reasons behind their decisions very well. This resulted in decisions that were not as transparent as they could have been and it was rare for the courts to refer to the policy reasons that justified their decisions in their judgments. The Commission therefore recommended that in future the courts should consider whether the illegality defence can be justified on the basis of the policies that underlie the defence, base their decisions on those policies and refer to them openly so as to come to a transparent decision. The Law Commission considered that the courts were moving in this direction in any event and referred to two House of Lords decisions as evidence of this: ***Gray* v *Thames Trains*** [2009] UKHL 33 and ***Stone & Rolls* v *Moore Stephens*** [2009] UKHL 39.

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The case of ***Gray* v *Thames Trains*** [2009] UKHL 33 illustrates the use of the illegality defence in the law of tort and therefore it may be said to have limited relevance to the law of contract. It is, however, useful to see how the principles set out in the Law Commission report were applied here. The facts of the case were that the claimant (G) sustained minor injuries in the Ladbroke Grove rail crash in London and as a result suffered post-traumatic stress disorder that led to a dramatic change in his personality. He became unemployed and after two years stabbed a stranger to death. He was convicted of manslaughter on the grounds of diminished responsibility. He then claimed damages for his loss of earnings from the date of the crash but also claimed general damages for his detention, conviction, feelings of guilt plus an indemnity against any actions that might be brought against him by any relatives of his victim. The defendant admitted liability for the crash and G's loss of earnings up to the date of the killing but not for earnings after that date or the general damages. It was not disputed that, but for the rail crash, G would not have suffered psychiatric damage and killed someone.

It was held by the House of Lords that, as a matter of public policy based on the principle of *ex turpi causa*, G was precluded from recovering compensation either for losses suffered in consequence of his own criminal act or for damage that was the consequence of a sentence imposed on him for a criminal act. On this basis, a claimant who had committed manslaughter as a result of psychological problems and post-traumatic stress disorder caused by the negligence of a third party could not recover general damages and loss of earnings arising from his crime. Lord Hoffmann explained, with Phillips LJ and Scott LJ concurring, that the illegality defence in this context existed in a narrow form and in a wider form.

Lord Hoffmann stated that the narrow form provides that:

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

Their Lordships considered that such an approach was important for consistency, since as a matter of penal policy it would be inconsistent for the law to award compensation for damage that has resulted from the law imposing a penalty. This meant that G could not recover compensation for his loss of earnings after the date of the killing nor general damages for conviction and detention.

The wider form of the rule is that a 'person cannot recover compensation for loss suffered as a consequence of your own criminal act' and, as a consequence, G was precluded from recovering general damages for his conviction, detention, feelings of guilt and an indemnity against claims brought by the dependants of the victim. Lord Hoffmann did not consider the expression *ex turpi causa* to be useful. He considered it more appropriate to draw a distinction between cases where, although the damage would not have happened but for the tortious act of the defendant, it was in fact caused by the criminal act of the claimant; and cases where, although the damage would not have happened without the criminal act of the claimant, it was in fact caused by the tortious act of the defendant.

In terms of the illegality defence generally, however, Lord Hoffmann considered that it is a defence based on several policy justifications and that these could vary in different circumstances. Thus he did not find any discussions around the reliance principle in ***Tinsley* v *Milligan*** useful in this case. All the judges rejected the notion that the reliance principle can be applied mechanically as a formal test and reinforced the principle that, at least in the law of tort, the illegality defence must be justified in terms of public policy and that a range of factors would determine whether those policy factors would apply,

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thus the seriousness of the offence or the mental state of a claimant may deliver a different set of results.

The judgment in ***Gray* v *Thames Trains*** mirrors very much what the Law Commission was attempting to achieve in its 2010 report and it was fairly easy to extract principles from the case.

The House of Lords decision involving the illegality defence in ***Stone & Rolls Ltd* v *Moore Stephens (a firm)*** [2009] UKHL 39 was not so clear-cut. The facts of the case were that Stone & Rolls (R) was managed and effectively controlled by a Mr Stojevic (S), who used the company as a vehicle for defrauding banks. Moore Stephens (M) acted as auditors for R. An action was brought against R and S for deceit and both were found to be liable but, as a result of that judgment, R went into liquidation. R brought an action against M for negligence in that it failed to detect the fraudulent activities of S. M accepted that it owed a duty of care to R but contested that R's action should fail, in that the fraud itself was committed by R. M stated that S's fraudulent acts as the controller of R were directly attributable to R. M relied, *inter alia*, on the illegality defence in that R would have to rely on the illegal acts of S to prove its claim, i.e. the reliance defence.

The majority of the House of Lords held that the acts of S should be attributable to R and therefore S's illegal acts would bar the claim by R. Of the majority, Lord Phillips stated that the illegality defence should not be applied automatically and, whilst he held that the illegality defence applied, it was because M's duty did not extend to creditors but only to the company and its shareholders. Since these had acted fraudulently, they could not take advantage of M's duty to them. With regard to the illegality defence, though, Lord Phillips stated:

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

Thus, according to Lord Phillips, the essential issue was that, in applying *ex turpi causa*, one should look behind the company to discover whose interests the relevant duty was intended to protect. The sole person for whose benefit such duty was owed was S, who was responsible for the fraud and therefore, in those circumstances, *ex turpi causa* provided a defence to the claim.

Of the minority judges, Lord Scott considered that the illegality defence had no application, since M's duty only applied to the company and the shareholders and therefore if R succeeded in its claim the only beneficiaries would be the creditors of R, to whom M owed no duty of care. Lord Mance decided the case on other issues.

One other interesting aspect of the case was the attempt by R to raise what has become known as the 'very thing' principle. The principle is that where a defendant (M) is under a duty to prevent a claimant (R) from committing an illegal act and the claimant goes on to commit that act, the claimant should always have a remedy against the defendant since to decide otherwise would be to render the duty invalid. Thus in ***Stone & Rolls Ltd* v *Moore Stephens*** it was argued that the 'very thing' the auditors were employed to prevent was the commission of a fraud. Thus M could not rely on the fraud they were employed to prevent as a means of avoiding the liability they owed to R for breach of their duty. Clearly the use of such a principle would effectively trump the use of the illegality defence by M. All their Lordships, except Scott LJ, rejected the use of this principle in this way. Their Lordships agreed that the 'very thing' principle was a principle of causation and could not operate to neutralise the illegality defence.

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In ***Stone & Rolls Ltd* v *Moore Stephens*** their Lordships all stressed the importance that the illegality defence should not be applied in a mechanistic manner and that the policies underlying the defence should be considered.

The Law Commission considered that this approach and that adopted in ***Gray* v *Thames Trains*** signalled an important new era in the use of the illegality/reliance defence in that there is a movement away from the mechanistic application of the defence as seen previously. The Commission recognised that the courts were now more willing to explore the relevant policies that lie at the heart of the defence; further, that the courts were now also more willing to consider the importance of the links between the illegality and the claim itself, together with the seriousness of the illegal act. The Law Commission also considered that, in the law of contract, tort and unjust enrichment, the courts had applied the illegality doctrine in a fair and appropriate way and often applied the correct policy decision. At the end of the day, the Law Commission considered that, in the face of that shift in approach by the courts towards a more transparent process in their judgments, it did not think that any legislative reform was required.

Contracts in restraint of trade

General principles

Such contracts are prima facie void as being contrary to public policy, which intervenes on two grounds. First, the common law seeks to protect an individual from negotiating away his livelihood to another, possibly contractually stronger, party, particularly where the restraint is a general one. Second, the law understood, even in the earliest days of the doctrine in the sixteenth century, that it was not in the public interest for the state to be deprived of a valuable benefit in allowing a person to be restricted in carrying out his lawful trade or business. It is possible that the degree of interference in such contracts may be closely associated with the prevailing economic theory of the day, as regards the encouragement or discouragement of competition, though as Beatson, *Anson's Law of Contract*, emphasises, there are no judicial authorities pointing out such fluctuations of policy.

Contracts in restraint of trade are defined in *Cheshire, Fifoot and Furmston* as:

> A contract in restraint of trade is one by which a party restricts his future liberty to carry on his trade, business or profession in such manner and with such persons as he chooses.

The modern doctrine of restraint of trade is to be found in the case of ***Nordenfelt* v *Maxim Nordenfelt Guns and Ammunition Co***.

Nordenfelt v Maxim Nordenfelt Guns and Ammunition Co. [1894] AC 535

A machine-gun manufacturer sold his business and agreed in the contract of sale to restrict his future activities in that business worldwide for 25 years. The covenant was held to be valid and binding, even though prior to this case the general principle was that general restraints of this nature were prima facie void, while partial restraints were prima facie valid. The leading judgment in the case comes from Lord MacNaghten who stated:

> The true view at the present time I think, is this: The public have an interest in every person's carrying on his trade freely: so has the individual. All interference with individual liberty of action in trading, and all restraints of trade of themselves, if there is nothing more, are

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contrary to public policy, and therefore void. That is the general rule. But there are exceptions: restraints of trade and interference with individual liberty of action may be justified by the special circumstances of a particular case. It is a sufficient justification, and indeed it is the only justification, if the restriction is reasonable – reasonable, that is, in reference to the interests of the parties concerned and reasonable in reference to the interests of the public, so framed and so guarded as to afford adequate protection to the party in whose favour it is imposed, while at the same time it is in no way injurious to the public.

The result of this decision, together with a number of other later ones, is that the doctrine of restraint of trade can be reduced to a number of principles. First, all contracts in restraint of trade are prima facie void. Second, it is a matter of law for the court to decide whether any special factors exist which may or may not justify the restraint. If the view is taken that such special factors do not justify the restraint then the contract will be void as being contrary to public policy. Third, however, if the special circumstances do point to the restraint being valid, then it must be reasonable not only as regards the parties to the contracting, but also as regards the interests of the public. Lastly, the burden of proving that the restraint is reasonable lies on the party alleging it to be so. If that burden is satisfied then it is always open for the party attempting to avoid the restraint to prove that the restraint is, in any event, contrary to the public interest and therefore void on this basis.

The above principles are now well established where the contract is in restraint of trade, though the obvious qualification is that the contract must be regarded as being in restraint of trade in the first place. In ***Esso Petroleum Co. Ltd*** v ***Harper's Garage (Stourport) Ltd*** [1968] AC 269 Lord Wilberforce stated:

> It is not to be supposed, or encouraged, that a bare allegation that a contract limits a trader's freedom of action exposes a party suing on it to the burden of justification. There will always be certain categories of contracts as to which it can be said, with some degree of certainty, that the 'doctrine' does or does not apply to them. Positively, there are likely to be certain sensitive areas as to which the law will require in every case the tests of reasonableness to be passed; such as . . . contracts between employer and employee as regards the period after the employment has ceased. Negatively . . . there will be types of contracts as to which the law should be prepared to say with some confidence that they do not enter into the field of restraint of trade at all.

The court must therefore decide whether the contract is in restraint of trade before considering the reasonableness or not of the restraint.

Reasonableness of the restraint

Reasonableness as regards the parties to the contract

A covenant found to be in restraint of trade can only be regarded as reasonable if it is designed only to protect the legitimate interests of the covenantee. While the basis for such a finding will undoubtedly vary from case to case, in ***Herbert Morris Ltd*** v ***Saxelby*** [1916] AC 688 Lord Shaw identified two types of contracts which illustrate the types of interests capable of being protected by a covenant in restraint of trade. First, in contracts for the sale of a business, together with its goodwill, it is clearly proper for the purchaser to restrain the vendor from acting in competition with the business just sold to the purchaser since the goodwill is a proprietary interest legitimately capable of protection.

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Second, in contracts of employment an employer, while not legitimately able to prevent a former employee from acting in competition with the employer, is able to prevent the former employee from making use of trade secrets acquired during a period of employment. Similarly, the employer can prevent a former employee from soliciting the former employer's customers. In these two examples one can clearly see that the law is attempting to balance the rights of the individual and the requirements of the state in respect of trade.

Once it has been established that there is a legitimate interest capable of being protected it has to be remembered that the courts will allow only the covenantor to impose such a restraint and will do no more than protect their interest. If the covenant is excessive then it will be void. In assessing the reasonableness of the restraint the court will have regard to its nature, area and duration (*see* below). Lastly the covenantee has to show that the restraint must be reasonable as regards both parties at the time of contracting. The effect is that the question of reasonableness is one which is directed towards the contract as a whole, and a contract will not be held to be reasonable if it is found to be unreasonable as regards one of the parties.

Reasonableness as regards the public interest

Contracts that are void as being unreasonable as regards the public interest are extremely uncommon. One such example is that of ***Wyatt* v *Kreglinger and Fernau*** [1933] 1 KB 793 where the defendants promised the plaintiff a pension provided that he would not compete against them in the wool trade. The plaintiff eventually agreed and the pension was paid for nearly nine years, when the defendants then refused to pay. The plaintiff sued for breach of contract. The defendants denied there was a contract and stated that in any event such a contract was void since it was an unreasonable restraint of trade. The Court of Appeal held for the defendants and agreed that the restraint was too wide and in any event it was contrary to the public interest. One must, however, wonder to what degree the public was affected by this restraint. The decision would seem to stretch the notion of public interest beyond the realms of reality.

Other factors influencing the degree of reasonableness

The courts will also consider the following factors in deciding whether or not the covenant is reasonable or not:

1 the duration of the restraint;

2 the area of the restraint.

The restraint of trade covenant will be struck down if it is found to be unreasonably extensive as to its *duration*. It is clear that an employee's connections with his former employer's customers must wane in time, and, similarly, one cannot protect one's trade secrets indefinitely. The question of duration is largely one of fact, depending on the nature of the business. Thus in the ***Nordenfelt*** case 25 years was upheld as being reasonable. It is nevertheless possible for the restraint to last indefinitely as in ***Fitch* v *Dewes*** [1921] 2 AC 158, where a covenant by a solicitor's clerk agreed that he would not practise within seven miles of Tamworth town hall was held to be reasonable, even though it was for an unlimited duration. The court considered that this restraint did no more than protect the legitimate interests of the solicitor, given the knowledge acquired by the clerk in respect to the clients of his former employer. On the face of things, however, this period seems excessive and the decision should probably be considered to be exceptional.

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The covenant must not be excessive in respect of the *area* to which the restraint applies. Again in the ***Nordenfelt*** case a worldwide ban was appropriate given the reputation of the covenantor in that business. In ***Forster & Sons Ltd* v *Suggett*** (1918) 35 TLR 87 a covenant by a works manager, who had acquired knowledge of a secret glass-making process, not to engage in glass making anywhere within the United Kingdom was held to be reasonable. On the other hand, in ***Mason* v *Provident Clothing and Supply Co.*** [1913] AC 724 a covenant by a canvasser not to work in a similar trade or business within 25 miles of London was held to be unreasonable given the covenantor's limited sphere of influence in his employment.

The construction of covenants in restraint of trade

In considering whether or not a contract is void as being contrary to public policy, the task of the court is to construe the contract in order to determine the nature and the extent of the restraint contemplated by the parties in the circumstances of the situation at the time. If the restraint of trade clause is too wide then it will be void; however, in arriving at this conclusion the courts will apply a literal interpretation to the clause and, in common with the general tenets of contract law, the court will not re-draft the clause for the parties to make the clause reasonable. Sometimes it is possible to see what the parties had in mind although the wording of the clause does not reflect those objectives; nevertheless, the court will apply the literal meaning. A good example of this is the case of ***Home Counties Dairies Ltd* v *Skilton*** [1970] 1 All ER 1227, where a milkman agreed 'not at any time during the period of one year after the determination of his employment . . . either on his own account or as a representative or agent of any person or company, to serve or sell milk or dairy produce to . . . any person or company'. Clearly the expression 'dairy produce' includes butter and cheese and therefore the contract would preclude him from taking employment as a grocer's assistant where the grocer traded in those products. The Court of Appeal held that, whilst the parties had not contemplated such a restraint, this was the effect of the literal interpretation of the clause and it was held that the restraint was valid.

The literal approach set out above has not always been followed. In ***Littlewoods Organisation Ltd* v *Harris*** [1977] 1 WLR 1472 the Court of Appeal took a more flexible approach to the construction of restraint of trade clauses. In this case Harris was employed by Littlewoods and agreed as part of his contract that he would not, if he left the company, go to work for its rival Great Universal Stores (GUS) for a period of 12 months. Harris was privy to many of the strategic policy decisions behind the running of Littlewoods mail order business and therefore had an important role. The business of Littlewoods was confined to the mail order business within the United Kingdom whilst GUS was a multinational firm whose business was wider than that of the mail order business. The Court of Appeal held that the application of the clause should be construed so as only to apply to the UK mail order business, since this was the interest that the parties had only intended to protect even though on a literal interpretation the clause itself was very much broader than this. This decision was not welcomed by the whole court and Browne LJ stated: 'rewriting [the clause] so as to make it enforceable that which would otherwise be unenforceable . . . I think that this is something which this court cannot do.'

Maybe it is possible that the decision can be countenanced on the basis that this restraint in the ***Littlewoods*** case applied to a particular competitor as opposed to a general restraint; however, the decision of the Court of Appeal has not been totally accepted, as can be seen in the case of ***J A Mont (UK) Ltd* v *Mills*** [1993] IRLR 173.

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J A Mont (UK) Ltd v *Mills* [1993] IRLR 173

The defendant was a man aged 43 who had been employed for 20 years in the paper tissue industry. It was the only work he knew and he had risen to become marketing and managing director of the company. In 1991 that company amalgamated with the plaintiffs and he became redundant. In 1992 he entered into a severance agreement with the plaintiffs in which he was paid a year's salary and released from working for them for 12 months. This agreement was subject to a restriction that he was not to join another company in the paper tissue industry within one year of leaving the plaintiff's employment.

The defendant contended that the restraint was unreasonable as being too wide in that it not only operated worldwide but also restrained him from being involved in the paper tissue industry in any capacity at all. It was held at first instance that an interlocutory injunction should be granted in that there was a possibility that the defendant could have used confidential information in his new position. The judge, however, stated that the parties should cooperate with each other in drafting the restraint of trade clause in more reasonable terms. The plaintiffs contended that the judge should have construed the clause as being reasonable.

The Court of Appeal (Simon Brown LJ giving the leading judgment) found that there was no attempt to draft the covenant in terms that restrained the defendant from using confidential information, which was the only legitimate way in which the defendant could be restrained should he obtain future employment in the paper tissue industry. The Court of Appeal decided that as a matter of policy it would not attempt to discover whether there was any implicit limitation in the clause that rendered the clause narrower and, therefore, reasonable such that it could be enforced by injunction.

The Court of Appeal by the above decision took a highly restrictive view of its ability to construe restraint of trade clauses. However, the Court of Appeal in ***Hanover Insurance Brokers Ltd and Christchurch Insurance Brokers Ltd* v *Schapiro*** indicated that a rather more liberal approach should be taken in construing such clauses.

Hanover Insurance Brokers Ltd and Christchurch Insurance Brokers Ltd v *Schapiro* [1994] IRLR 82

The facts of the case were that the business of Hanover Insurance Brokers Ltd (the first plaintiffs) was sold to Christchurch Insurance Brokers Ltd (the second plaintiffs) in June 1993. The defendants were all employees of the first plaintiffs (HIB); indeed three of the defendants were also directors of HIB, who all resigned once the sale had been completed. It was alleged by the plaintiffs that the defendants were attempting to solicit clients and employees of HIB both prior to and after leaving the employment of HIB. These activities were explicitly forbidden by a restrictive covenant in their contracts of employment. Subsequently the plaintiffs obtained an *ex parte* injunction (now called a without notice injunction) against the defendants, which they then attempted to get discharged.

There was a difference in the wording between the restrictive covenants in the contracts of the first and second defendants and those of the third and fourth. In the latter the covenants were expressed to protect not only HIB, but also Hanover Acceptances Ltd (which was the holding company of HIB) and any of its subsidiaries. In the former the operation of the covenants was expressed to protect only HIB itself. The third and fourth defendants argued that by further restricting the non-solicitation of clients to Hanover Acceptances Ltd and its subsidiaries, there was an attempt to impose far wider protection than was necessary and that the clause was thus void for being an unreasonable restraint of trade. Their reasoning was based on the argument that the restrictive covenant could also operate in

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fields of economic activity other than the insurance brokerage business. The plaintiffs argued that the court should adopt a purposive approach to its construction of the clause, so that a narrow interpretation could be given to the clause in order that it reflect the intention of the parties, thereby rendering the clause enforceable.

Both the judge at first instance and the Court of Appeal considered that the only true intention of the parties was to restrict the defendants in soliciting insurance broking clients. Since HIB was the only subsidiary involved in this activity the court decided that the parties only intended to protect the clients of this company, and therefore by applying this purposive approach the clause was enforceable to this degree. In arriving at this decision the Court of Appeal referred to ***Littlewoods Organisation Ltd* v *Harris*** [1977] 1 WLR 1472, where the Court of Appeal decided that a clause stating 'Great Universal Stores Ltd or any company subsidiary thereto' limited the protection of the clause to that part of the plaintiffs' business activities to which they were reasonably entitled.

It should be noted that the decision of the Court of Appeal in the ***Schapiro*** case took place in relation to interim proceedings. The court considered that the cases of ***J A Mont Ltd*** and ***Littlewoods*** needed to be reconciled in a full hearing.

It would appear that whilst the traditional approach of the courts of not rewriting restraint of trade clauses persists, in principle at least, the courts are willing to provide a more relaxed approach to rewriting a clause in order to provide a commercial logic to the contract by enforcing the perceived intentions of the parties. Such an approach can be seen in the case of ***ChipsAway International Ltd* v *Errol Kerr*** [2009] EWCA Civ 320. The facts of the case are that ChipsAway had rights to a system for repairing bodywork on cars, as well as providing paints and other products used in the system. ChipsAway franchised the system and the supply of the products to others but was not actually involved in the repairing process itself. ChipsAway and Kerr (K) entered into a franchise arrangement in 2002. As part of that agreement, K agreed that, for a period of 12 months following termination of the agreement for whatever reason, he would not, without ChipsAway's prior written consent, 'be engaged in any capacity in any business which competes with the business (as carried on at the date of termination . . .) within the territory'. At the end of the franchise period, K informed ChipsAway that he did not wish to continue with the franchise. Nevertheless he continued to undertake bodywork repairs to cars at his premises. He did not use ChipsAway's name or products in carrying out the repairs. ChipsAway brought an action against K, stating that by carrying on bodywork repairs in the same area as the former franchise territory K was in breach of the restraint of trade clause even though ChipsAway did not have a franchisee in the territory nor was it contemplating appointing one.

At first instance the judge considered that the clause was a nonsense since, when read with the agreement, it appeared to state that K could not engage in any business that competed with K – in other words, it appeared to say that he could not compete with himself. The judge concluded that in order to avoid such a conclusion it was necessary to depart from the literal meaning of the words in order to arrive at an interpretation that gave effect to the underlying intention behind the restraint of trade clause. The judge therefore modified the clause to the effect that K was restrained from engaging in any business which competed with a franchise business that was 'a successor to or otherwise has the characteristics of' the business conducted by K as part of the franchise agreement at the time of its termination. The court therefore held that, following the termination of a franchise agreement, K was not acting in breach of a restrictive covenant by operating

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his own car care business where the claimant had no businesses in the area with which the franchisee could compete. The court stated that the position would have been different if the claimant had appointed a new franchisee in the territory, or did so within the 12-month term of the covenant. There was no breach of the covenant unless and until that happened. The crucial words in the covenant were 'which competes' and referred to competing on the facts as they were, not to the possibility that competing might begin to happen in the future if the facts changed.

ChipsAway appealed and the Court of Appeal has overturned the judgment of the lower court, making it clear that contracts should be construed according to their ordinary meaning and give effect to the obvious business intentions of the parties. In this case it stated that the apparent intention of the restrictive covenant was to prevent former franchisees such as K from engaging in any business which competed with that of the franchisor for the period of 12 months after termination of the franchise agreement. The court considered that the purpose of the clause was to protect the goodwill of ChipsAway in that territory and allow it adequate time to find a new franchisee and that it was irrelevant to the operation of the provision that the franchisor did not look for one.

The application of covenants in restraint of trade in various situations

The categories of contract discussed below are merely examples of the application of such covenants. The categories of restraint are never closed.

1. Contracts of employment

Covenants restraining an employee while actually engaged by their employer cannot usually be called into question since the employer can require an employee to maintain confidentiality in the course of his employment. Similarly, in contracts of employment an employer can demand that an employee does not act in competition to the employer's business. In these circumstances the doctrine of restraint of trade has no bearing on the validity or otherwise of the restraint.

It is only after an employee has left the covenantee's employment that the doctrine comes to bear. It has already been stated that an employer has a legitimate interest in protecting confidential information or preventing a former employee from soliciting customers so as to protect the goodwill of the employer's business. It is not legitimate, however, to prevent the former employee from exercising a personal trade or skill, even though that may have been acquired during the period of employment, as in an apprenticeship, for instance.

An interesting variation on this theme arose in ***Hanover Insurance Brokers Ltd and Christchurch Insurance Brokers Ltd* v *Schapiro*** [1994] IRLR 82, as already discussed. One of the arguments put forward by the first defendant, who was the former chairman of HIB, was that he should not be restricted from soliciting clients that he brought to HIB when he began working there. In putting forward this argument he relied on the following case.

M & S Drapers (A Firm) v *Reynolds* [1957] 1 WLR 9

A sales representative, when taking up employment with the plaintiffs, brought with him customers from his previous employment. On joining the plaintiffs he entered into a contract that contained a restrictive covenant which stated that on terminating his employment with the firm he would not, for the period of five years, solicit former customers on whom he had called during his employment. It was held that the clause was unenforceable in that the duration of the restraint was unreasonable.

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The Court of Appeal in ***Hanover*** distinguished that case from that of ***M & S Drapers*** on the basis that in the latter case it was considered that a sales representative's customer connections amounted to the equivalent of his tools of the trade, so that he could not be unreasonably deprived of them. In ***Hanover***, however, the Court of Appeal considered that one of the reasons for employing the first defendant was the fact that he would bring clients into the business of the company; indeed, his salary reflected this commitment. The Court of Appeal therefore dismissed the arguments put forward by the first defendant.

One other aspect of the ***Hanover*** case that is relevant in the context of restraints in contracts of employment arose in relation to the third and fourth defendants, who argued that the restraint was unreasonable since it prevented them from soliciting clients with whom they had had no contract whilst employed by HIB. In arriving at its decision the Court of Appeal considered two apparently conflicting Court of Appeal cases: ***G W Plowman & Son Ltd*** v ***Ash*** and ***Marley Tile Co.*** v ***Johnson*** [1982] IRLR 75.

G W Plowman & Son Ltd v *Ash* [1964] 1 WLR 568

The defendant, a sales representative, was employed under a contract that contained a restrictive covenant that he would not, for two years after the termination of his contract, solicit any farmer or market gardener who had been a customer of his employers at any time during the course of the defendant's contract. The defendant argued that this clause was too wide in that it sought to restrain him from soliciting customers who were not known to him. The court rejected this argument since it considered that he could easily avoid innocently breaching the covenant by simply asking a potential customer whether or not he had been a customer of the plaintiffs. If the answer was in the affirmative he could then avoid attempting to solicit business from that customer.

In ***Marley Tile*** there was a similar covenant against soliciting or dealing with former customers, but on this occasion the Court of Appeal held that this clause was too wide and unenforceable. The court found that of the 2,500 customers of the plaintiffs, the defendant could only have known or come into contact with a small proportion of them. In considering this case, though, it has to be noted that the restraining clause was wider than that in the ***G W Plowman*** case in two respects: first, the restriction prevented the defendant not only from soliciting former customers, but also from dealing with them; second, the restriction attempted to restrain the defendant from engaging in activities other than those for which he had been employed by the plaintiffs.

In the ***Hanover*** case Dillon LJ, in considering ***G W Plowman*** and ***Marley Tile***, thought that the decisions in these cases clearly showed that every case has to be decided on its own facts. His Lordship therefore resiled from making a decision, since in dealing with interim proceedings the full facts were not known to him, i.e. he was not aware of what proportion of HIB's clients the defendants had contact with. This was not the problem in another case on this issue, ***Austin Knight (UK) Ltd*** v ***Hinds*** [1994] FSR 52, where Vinelott J had detailed knowledge of the extent of the employee's knowledge about her employer's clients. This information showed that she knew only a third of the clients and therefore Vinelott J distinguished the case before him from ***G W Plowman***. The basis of the decision was that it is an unreasonable restraint of trade to prevent a defendant from approaching or dealing with customers of a former employer whom the defendant had no knowledge of or contact with during his or her employment.

The distinction between a personal skill or knowledge and confidential information obtained during employment can be exceedingly difficult to make, especially since

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'know-how' is not widely regarded as a commodity in its own right. In ***Leng & Co. Ltd*** **v** ***Andrews*** [1909] 1 Ch 763 a journalist covenanted not to work for any other newspaper within 20 miles of Sheffield. The principle behind the covenant was to protect so-called 'sources of information'. It was held that such interests could not be protected.

In ***Rock Refrigeration Ltd*** **v** ***Jones*** [1997] 1 All ER 1, it was held by the Court of Appeal that a restrictive covenant purporting to restrain an employee from working for a competitor would be extinguished where the employer committed a repudiatory breach of contract that was accepted by the employee as terminating the contract.

2. Contracts for the sale of a business

Covenants in restraint of trade are far more likely to be upheld where they are contained in a contract for the sale of a business. It should be borne in mind, however, that restraints attempting to prevent competition per se are not valid, since there must be shown to be a legitimate interest worthy of protection. It follows from this that the restraint can only protect the legitimate interests of the business actually sold. This being the case, in ***British Reinforced Concrete Engineering Co. Ltd*** **v** ***Schelff*** [1921] 2 Ch 563 a manufacturer of a specialised road improvement product could not be restrained from engaging in the manufacture or sale of road reinforcements generally when he sold the business to the plaintiffs. The sale of the business concerned the specialised product only and therefore the restraint could curb his activities only in relation to that product.

Very often the restraint is designed to protect the goodwill that may be purchased with the business and this does, of course, form a proprietary interest capable of protection, though, again, regard must be had to the area and duration of the restraint in assessing its reasonableness.

3. Exclusive trading

Such contracts commonly arise where a manufacturer, or sometimes a wholesaler, attempts to restrict the retailer in a method of distribution or pricing policy or simply to tie the retailer so closely to the chain of supply that they are prevented from selling similar goods produced by competing manufacturers or distributed by competing wholesalers. Such agreements are traditionally termed '**solus agreements**', or, more recently, 'vertical agreements'. Technically there is no difference between the two in that they generally take the form of a person entering into an agreement to purchase all requirements as regards certain types of goods from a particular manufacturer. Alternatively, they may be required to sell all that they produce of a particular item to an individual buyer. The leading case in this area is that of ***Esso Petroleum Co. Ltd*** **v** ***Harper's Garage (Stourport) Ltd***.

Esso Petroleum Co. Ltd v *Harper's Garage (Stourport) Ltd* [1967] 1 All ER 699

The respondent owners of two garages entered a solus agreement with the appellants whereby they contracted to purchase all their petrol from the appellants. The agreement was to last for four years and five months in respect of one garage, during which the owners would receive a discount in the price of petrol purchased from the appellants. In respect of the second garage the 'tie' was to last for 21 years in return for a mortgage of £7,000 but covenants in the second agreement stated that they had also to comply with covenants contained in the agreement made in respect of the first contract. Further, the respondents were not entitled to redeem the 21-year mortgage before the end of the term of the mortgage. When the respondents started to sell another brand of petrol they were sued by the appellants. The respondents argued that they were not bound by the contracts since they were an unreasonable restraint of trade.

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The House of Lords held that both transactions fell within the doctrine of restraint of trade and were thus prima facie void. Their Lordships decided that there was nothing unlawful per se in a solus agreement since very often both parties benefited from the transaction. One party benefited from acquiring a chain of distribution which made the supply of its products efficient and economical. On the other hand, the other party, the respondents in this case, gained by acquiring extra capital finance and a preferential wholesale price. On this basis there were clearly interests that merited protection. Nevertheless the restrictions could only be enforced if they could be reasonable, not only between the parties, but also as regards the public interest. With regard to the first agreement they found that it was reasonable since it protected a legitimate interest of the parties and at the same time it was not contrary to the public interest. The court, however, decided that such agreements would become unreasonable if they operated for an excessive period and in this regard considered the second agreement to be unreasonable and void.

The stance taken by the House of Lords with regard to the second agreement is also consistent with the general principle in relation to the law of mortgages. Here equity will not allow a 'clog or fetter' on the equity of redemption. Any attempt to postpone the right of redemption or to render it illusory is void here. The court, however, stated that the doctrine of restraint of trade still applied even though it crossed into the field of land law. Their Lordships then adopted an unusual stance and stated that the doctrine did not apply where the restriction was applied to covenants contained in leases or conveyances of land. Thus if one purchases a garage, for instance, or takes a lease of such a garage and the oil company imposes covenants akin to those found in the ***Harper's Garage*** case, then such restrictions will be prima facie valid. This presumption as to validity will only be rebutted if it can be shown that the restrictions are contrary to the public interest, as stated in ***Cleveland Petroleum Co. Ltd* v *Dartstone Ltd*** [1969] 1 All ER 201, where the Court of Appeal considered that to find otherwise would be to allow the doctrine of restraint of trade to be sidestepped by the adoption of a conveyancing device.

An attempt to make use of the above distinction between a person who is already in possession of their business premises entering into a solus agreement, thereby surrendering rights, and a person who enters into restrictions as they acquire their business premises can be seen in the case of ***Alec Lobb (Garages) Ltd* v *Total Oil Great Britain Ltd*** [1983] 1 WLR 87 where the plaintiff company was a petrol filling station. In 1969 it found itself in financial difficulties and turned to the defendants for help. This help took the form of the defendants taking a 51-year lease of the garage forecourt for £35,000 plus a nominal rent. There was an immediate lease-back arrangement whereby the directors of the plaintiff company acquired a 21-year sublease at a rent of £2,500 per annum, together with a solus clause whereby the plaintiffs agreed to buy all their petrol from the defendants. The reason the sublease was granted to the two directors of the plaintiff company was to avoid the solus clause being challenged, since if the clause was contained in what might be considered a separate transaction, namely the sublease, it would not be subject to the doctrine of restraint of trade.

The plaintiff company relied on an earlier decision of the Privy Council in ***Amoco Australia Pty Ltd* v *Rocca Bros Motor Engineering Co. Pty Ltd*** [1975] AC 561 that a lease and a lease-back were held to be a single transaction, and that since the result of the solus clause was to render the sublease unenforceable, the effect was to render both transactions, that is, the lease and the sublease, unenforceable. This decision was followed in the ***Alec Lobb*** case, although the effect of the solus clause was not quite so fundamental as to render both transactions unenforceable. The Court of Appeal decided that the solus

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clause was severable from the sublease, with the result that both the lease and the sublease were upheld as valid but without the benefit of the solus clause.

4. Anti-competitive agreements and abuse of a dominant position

Despite the fact that the public interest must be considered in assessing the validity of an agreement in restraint of trade, most cases decide the validity of the restraint in such agreements by reference to their reasonableness as regards the parties. The result is that it is possible for restraints to go unchecked despite the fact that the public may be adversely affected by such an agreement. Since the validity is decided as a matter of private law should the case come to court (which it may not do, of course), there is no possibility of such restraints being challenged by third parties. The result of this state of affairs was the intervention of Parliament by the passing of, first, the Monopolies and Restrictive Practices (Inquiry and Control) Act 1948. Subsequently a series of other statutes impacted upon **cartel** and monopoly activities. The Competition Act 1998 reformed the whole regime in these areas to bring United Kingdom law into line, from 1 March 2000, with Arts 81 and 82 of the Treaty of Rome. The Enterprise Act 2002 has made significant changes to competition law enforcement and rights in the United Kingdom.

In general terms the Competition Act outlaws any agreements, business practices and conduct that damage competition. Chapter I of the Act prohibits agreements between undertakings, decisions by associations of undertakings, and concerted practices which prevent, restrict or distort competition or are intended to do so, and which may affect trade within the United Kingdom. Chapter II prohibits the abuse by one or more undertakings of a dominant position in a market which may affect trade within the United Kingdom.

Under the Act, the Office of Fair Trading has powers to investigate undertakings suspected of being involved in anti-competitive activities. Breach of either prohibition may result in an order to terminate or amend the offending agreement or to cease the offending conduct. Additionally, undertakings found to have infringed either prohibition may be liable to a penalty of up to 10 per cent of their turnover in the United Kingdom. There is the possibility of appeal to the Competition Appeal Tribunal against the Office of Fair Trading's findings and penalties. Of particular importance to contract law is the fact that parts of any agreement found to infringe the Chapter I prohibition are null and void and therefore cannot be enforced. In addition, third parties who consider that they have been harmed as a result of any unlawful agreement, practice, or conduct may have a claim for damages in the courts or before the Competition Appeal Tribunal.

Many types of 'cartel' agreement may be caught by the Chapter I prohibition and the Act lists specific examples. These include agreeing to: fix prices or other trading conditions; limit or control production, markets, technical development or investment; share markets or supply sources; apply different trading conditions to equivalent transactions, thereby placing some parties at a competitive disadvantage; and make contracts subject to unrelated conditions. Abuse of a dominant position under the Chapter II prohibition includes: imposing unfair purchase or selling prices; limiting production, markets or technical development to the prejudice of consumers; applying different trading conditions to equivalent transactions, thereby placing certain parties at a competitive disadvantage; and attaching unrelated supplementary conditions to contracts.

It is important to note that the Competition Act does provide for exemption of certain agreements from the Chapter I prohibition and that certain categories of agreement and conduct are specifically excluded from the scope of the Act.

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5. Commercial agency agreements

A more extensive description of such agreements may be found in Chapter 20. However, it is appropriate to state at this point that the Commercial Agents (Council Directive) Regulations 1993 control the use of restraint of trade clauses in such agreements. Regulation 20(1) provides that restraint of trade clauses in this context will only be valid if they are expressed in writing and are limited to the geographical area and/or group of customers and to the kind of goods covered by the agency contract. Furthermore, reg 20(2) provides that the restraint of trade clause must not last for more than two years after the termination of the agency contract. It should be noted that reg 20(3) preserves other enactments and rules of law and thus it would seem that, as regards the application of the Regulations in English law, the requirement that restraint of trade clauses have to be reasonable as between the parties is still a necessity for such clauses to be valid.

6. Other situations

Contracts that incorporate covenants in restraint of trade are found in many other situations, though of course the same principles apply. Two cases which illustrate the flexibility of the law in dealing with restraints are ***Schroeder Music Publishing Co. Ltd* v *Macaulay*** and ***Panayiotou* v *Sony Music International (UK) Ltd***, where the principles were extended to service contracts.

Schroeder Music Publishing Co. Ltd v *Macaulay* [1974] 1 WLR 1308

Macaulay, an unknown songwriter, entered into a contract with Schroeder. The contract, which was a standard-form contract, was very much in Schroeder's favour in that it engaged Macaulay's services for five years during which time he assigned full copyright for all his compositions to Schroeder, which was not obliged to publish or promote any of his work. Further, if Macaulay's royalties exceeded £5,000 the contract was to be automatically extended for a further five years. Schroeder was free to terminate the agreement at any time with one month's notice, whilst Macaulay had no such right. Macaulay subsequently alleged that the contract was an unreasonable restraint of trade and void.

It was held by the House of Lords that the agreement fell within the doctrine of restraint of trade and that it was unreasonable and therefore void. It was agreed in the case that the contract was in a standard form that was widely used and that there was never any indication that it caused injustice. Lord Reid acknowledged that whilst full weight should be given to standard-form contracts established by way of commercial practice, this did not apply where the parties were not bargaining on equal terms. He further stated:

> Any contract by which a person engages to give his exclusive services to another for a period necessarily involves extensive restriction during that period of the common law right to exercise any lawful activity he chooses in such manner he thinks best. Normally the doctrine of restraint of trade has no application to such restrictions: they require no justification. But if contractual restrictions appear to be unnecessary or to be reasonably capable of enforcement in an oppressive manner, then they must be justified before they can be enforced.

Lord Reid considered on this basis that the restraint was unreasonable. Macaulay was bound to assign the fruits of his endeavours to Schroeder for five years, but what did Schroeder have to do in return? The answer to this question was simply, 'nothing'. It did not have to publish the songs, and if it did not Macaulay got nothing by way of remuneration, nor was there anything he could do about this. Lord Reid considered that 'the public interest requires in the interest both of the public and of the individual that everyone should be free so far as practicable to earn a living and to give to the public the fruits of his particular abilities'.

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Panayiotou v *Sony Music International (UK) Ltd* [1994] 1 All ER 755

In this case a different decision was arrived at. The facts were that in 1983 the plaintiff, George Michael, and Andrew Ridgeley, comprising the pop group 'Wham', sought to have their recording contract with Inner Vision declared void on the basis that it was in restraint of trade. This dispute was subsequently compromised by agreement and Wham entered into a new contract with CBS in 1984. In 1987 George Michael became established as a successful solo artist, and in 1988 a new contract was entered into so as to give effect to his 'superstar' status. Also in 1988 CBS was taken over by Sony. The 1988 agreement was renegotiated in 1990 so as to improve the plaintiff's financial terms still further. In 1991 George Michael wished to change his personal and musical image and in so doing became dissatisfied with Sony. He sought to have the 1988 agreement declared void and unenforceable as an unreasonable restraint of trade and not in his interest.

It was held that it would be incorrect to treat the 1988 agreement as separate from the 1984 agreement since it was a renegotiation of that agreement. The court regarded the 1984 agreement as enforceable and that it would be contrary to public policy to find otherwise. This conclusion was based on the reasoning that it was in the public interest to uphold proper and genuine compromises. If it were possible for the plaintiff to challenge the compromise of the restraint of trade dispute with Inner Vision on the basis that the compromise itself was in restraint of trade, then any restraint of trade dispute could never be compromised by the substitution of a new agreement as had occurred in this case. No improper pressure had been placed on George Michael to enter into the agreement and, unlike in Macaulay's case, he had the benefit of being advised by a person who was regarded as being one of the most experienced and toughest negotiators in the business. It followed from this that these arguments could not be used as against the 1988 agreement, which did not therefore attract the doctrine of restraint of trade. It would be unfair and unconscionable to allow George Michael to assert that the 1988 agreement was unenforceable. Furthermore, there was no evidence to suggest that the 1988 agreement was detrimental to George Michael's interests.

Severance

Generally

Severance amounts to the removal of the illegal elements of the contract, leaving behind a valid and enforceable agreement. The application of severance is particularly important in contracts in restraint of trade, enabling an objectionable restraint to be removed. There are, of course, limitations on the principle since, as we have seen in relation to implied terms, it is not for the court to rewrite the contract for the parties in order to produce something entirely different from what they intended. Should it be impossible to sever the objectionable parts of the contract so as to leave a contract that is capable of being carried out, then the whole contract will be void and unenforceable.

Before we assess the specific rules relating to the application of severance it should be noted that severance can only be used where it is consistent with the rule of public policy that renders the contract illegal in the first place. In ***Napier* v *National Business Agency Ltd*** [1951] 2 All ER 264 there was a contract in which an employee's wages were supplemented with an inflated figure for expenses far beyond those which he would normally incur. This arrangement was arrived at with the sole aim of defrauding HM Revenue &

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Customs. It was held that the contract was so tainted with illegality that the court refused to apply severance, with the result that the whole contract was vitiated. The employee could not recover wages owed to him despite the fact that he withdrew his claims in respect of 'expenses' outstanding. It should also be noted that severance is not permitted if the contract involves serious moral turpitude such as the deliberate commission of a serious criminal offence. See ***Bennett* v *Bennett*** [1952] 1 KB 249 below.

The requirements necessary for the exercise of severance

The 'blue pencil' rule

The effect of this rule is that an objectionable part of a contract can be severed only where it leaves the remaining part verbally and grammatically correct and capable of standing alone. A case commonly quoted as an example of this rule is that of ***Goldsoll* v *Goldman*** [1915] 1 Ch 292 where a defendant sold his imitation jewellery business to the plaintiff, at the same time agreeing that he would not, for a period of two years, deal in real or imitation jewellery in the United Kingdom, France, the USA, Russia or within 25 miles of Potsdammerstrasse, Berlin, or St Stefans Kirche, Vienna, either on his own account or jointly. It was held by the Court of Appeal that the restraint was valid notwithstanding that the area of the restraint was too extensive. They therefore removed the restriction as to real jewellery and confined the area of the restraint to the United Kingdom.

The illegality must not comprise the main part of the contract

The objectionable part of the contract must not form the main part of the contract since the effect of severance would be to remove a central aspect of the contract. This is expressed by Beatson (2002) in terms of the severance effectively reducing the consideration within the contract. The effect would be to compel the other party to continue with a bargain that represents far less than originally contracted for.

Bennett v *Bennett* [1952] 1 KB 249

In this case, a wife petitioned for a divorce, claiming maintenance for herself and her son. Prior to the hearing for the decree nisi she entered a deed with her husband whereby she agreed to withdraw the application for maintenance in return for the husband paying an annuity to her and the son and, at the same time, conveying certain property to the wife. The husband did not keep to the arrangement and was sued by the wife. The court found that the covenant entered into by the wife not to apply for maintenance was contrary to public policy and void. Severance of the offending covenant was considered but it was found that this played a central part in the agreement – it effectively represented the consideration for the agreement – therefore severance was not feasible. The agreement was thus held to be unenforceable and void, so that the wife could not claim the annuity.

The agreement must not be altered by the act of severance

It was stated in ***Attwood* v *Lamont*** by Lord Sterndale MR that the operation of severance must not 'alter entirely the scope and intention of the agreement'.

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Attwood v *Lamont* [1920] 3 KB 571

The plaintiff operated a general outfitter's business in Kidderminster, which was divided into different departments. The defendant had been employed as a tailor and cutter in the tailoring department. His contract of service contained a restraint of trade clause whereby he agreed that he would not, at any time, be concerned in the trade or business of a 'tailor, dressmaker, general draper, milliner, hatter, haberdasher, gentlemen's, ladies' or children's outfitter' within 10 miles of the plaintiff's store. It was held by the Divisional Court that the clause was too wide but that it could become enforceable by the severing of all the trades except that of tailor. The Court of Appeal also found the clause to be too wide in that it sought to restrain the defendant from trades in which he had not been employed. The court, however, refused to apply severance, stating that this was not possible where the covenant formed a single covenant, which they found to be the situation here, rather than a 'combination of several distinct covenants'.

The basis of the Court of Appeal's decision seems to be that severance would have altered the entire nature of the covenant. The original covenant was intended to protect the entire business, while severance would have had the effect of protecting only that part of the business, namely tailoring, in which the defendant had been employed. In other words, the Court of Appeal considered the covenant to be entire, standing or falling in that entirety.

The case is extremely difficult to reconcile with ***Goldsoll* v *Goldman***, which in many respects is virtually identical. On the face of things it would appear that the idea of dividing covenants into those which are entire and those which are several is unsatisfactory. Each case should be examined on its own facts and a decision made as to whether the effect of severance is to alter the scope and intention of the agreement.

Summary

The classification of illegality

Acts illegal by statute

Where the contract is prohibited by statute

- Where a contract is expressly or impliedly declared to be prohibited in a statute then there is little doubt that Parliament intended that the contract could not be enforced (***Re Mahmoud and Ispahani***).

The unlawful manner of performance

- Illegality may have two principal effects:
  - (i) A contract may be regarded as illegal if the actual creation of the contract itself is prohibited. Result – void *ab initio* (***Cope* v *Rowlands***).
  - (ii) A contract may be created lawfully but nevertheless be illegal because of the way in which it is performed (***Anderson Ltd* v *Daniel***).

Acts illegal at common law

- Where the courts will not uphold a contract if its effect was contrary to the common good or it was injurious to society generally.

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Contracts for the commission of an act that is wrong at common law

Contracts contrary to public policy

Contracts prejudicial to the administration of justice

Contracts calculated to oust the jurisdiction of the courts

Contracts tending to corrupt the public service

Contracts prejudicial to the status of marriage and the family

Sexually immoral contracts

The effects of illegality

The general effect

- An illegal contract cannot be enforced.
- The rule: . . . no person who is aware of an illegality within a contract can enforce it (***Holman* v *Johnson***).
- Money or property transferred under an illegal contract is irrecoverable.
- The defence of illegality is available to both parties regardless of their situations.
- A claimant cannot succeed if he is to benefit from the illegality (***Saunders* v *Edwards***).
- Innocent party can withdraw before the transaction is performed if the contract is illegal. Likewise if part performed (***Cowan* v *Milbourn***).
- Illegality may be avoided by using a collateral contract (***Strongman (1945) Ltd* v *Sincock***).

Recovery of money or property

- Illegality renders any money or property irrecoverable just as a person is not allowed to benefit (***Beresford* v *Royal Insurance Co. Ltd***).
- There are three situations where the parties will be relieved of the illegal nature of the contract:
  - (i) Where the parties are not in *pari delicto*.
  - (ii) Where the illegal contract has been withdrawn from.
  - (iii) Where the illegal contract is not relied on for recovery.

The Law Commission and the Reform of the Illegality Defence

Contracts in restraint of trade

General principles

- Such contracts are prima facie void as being contrary to public policy on two grounds:
  - (i) The common law seeks to protect an individual from negotiating away his livelihood.
  - (ii) It is not in the public interest for the state to be deprived of a valuable benefit in allowing a person to be restricted in carrying out his lawful trade or business.
- The doctrine of restraint of trade can be reduced to a number of principles.
  - (i) All contracts in restraint of trade are prima facie void.
  - (ii) The courts decide whether any special factors exist which may or may not justify the restraint.

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(iii) If the special circumstances do point to the restraint being valid, then it must be reasonable not only as regards the parties to the contracting, but also as regards the interests of the public.
(iv) The burden of proving that the restraint is reasonable lies on the party alleging it to be so.

- The court must therefore decide whether the contract is in restraint of trade before considering the reasonableness or not of the restraint.

Reasonableness of the restraint

- Reasonableness as regards the parties to the contract.
- Reasonableness as regards the public interest.
- Other factors influencing the degree of reasonableness.
  - The courts will also consider the following factors in deciding whether or not the covenant is reasonable or not:
    1 the duration of the restraint;
    2 the area of the restraint.

The construction of covenants in restraint of trade

- The construction of covenants and ***Hanover Insurance Brokers Ltd and Christchurch Insurance Brokers Ltd*** **v** ***Schapiro*** for a more liberal application.

The application of covenants in restraint of trade in various situations

- The categories of restraint are never closed.
- Contracts of employment.
- Contracts for the sale of a business.
- Exclusive trading.

Severance

Generally

- Severance removes the illegal elements of the contract, leaving behind a valid and enforceable agreement.
- Severance can only be used where it is consistent with public policy that renders the contract illegal in the first place (***Napier*** **v** ***National Business Agency Ltd***).

The requirements necessary for the exercise of severance

- The 'blue pencil' rule.
- The illegality must not comprise the main part of the contract.
- The agreement must not be altered by the act of severance (***Attwood*** **v** ***Lamont***).

Further reading

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Part 4

Discharge of contracts

13 Discharge by performance and breach
14 Discharge by agreement
15 Discharge by frustration

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13

Discharge by performance and breach

Aims and objectives

After reading this chapter you should be able to:

- Understand how contracts are discharged by performance with particular reference to the time of performance.
- Understand the different circumstances in which a breach of contract arises.
- Know and understand the effects of breach on a contract and when the right to treat a contract as discharged arises and when it is lost.

Performance

Introduction

The basic rule in relation to performance of a contract is that it must be carried out strictly in accordance with the terms of the contract. Failure to do so will entitle the innocent party to allege that the contract has not been performed and will give them the right to claim damages or to repudiate the contract and treat themself as discharged from it, as well as entitling them to claim damages, as we saw in Chapter 7. In the case of ***Re Moore & Co.* v *Landauer & Co.*** [1921] 2 KB 519 there was a contract for the sale of tins of canned fruit which were to be packed in cases of 30 tins. On delivery it was found that a number of the cases contained only 24 tins. It was held that the defendants could reject the entire consignment even though the total number of tins delivered was correct.

Arcos Ltd v *E A Ronaasen & Son* [1933] AC 470

In this case there was a contract for a consignment of wooden staves to be used in barrel making, described in the contract as being half an inch thick. At the time of delivery the price of timber had fallen, and this meant that it was in the interests of the purchaser to be able to reject the cargo, since he could then renegotiate the contract at a lower price or go elsewhere for the timber. When the timber was measured it was found that most of it was 9/16 of an inch thick, though this difference would not have had any effect on the usefulness of the timber. The purchaser nevertheless was held to be entitled to reject the cargo. Lord Atkin stated the position in the following terms:

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> A ton does not mean about a ton, or a yard about a yard. Still less when you descend to minute measurements does half-an-inch mean about half-an-inch. If a seller wants a margin he must, and in my experience does, stipulate for it . . . No doubt there may be microscopic deviations which businessmen and therefore lawyers will ignore . . . But apart from the consideration the right view is that the condition of the contract must be strictly performed.

The position maintained by Lord Atkin needs qualifying in two ways. First, and Lord Atkin hints at this qualification in the above passage, the law will not take notice of 'microscopic' deviations. This practice is sometimes expressed in the maxim *de minimis non curat lex*, though even where the deviation is minimal the innocent party may still reject where the contract expressly provides for precise performance. Second, in ***Reardon Smith Line Ltd*** v ***Yngvar Hansen-Tangen*** [1976] 1 WLR 989 there was a reaction against an over-excessive exercise of the right to rescind the contract. In a contract for the sale of goods by description, words which merely identify the goods may not be regarded as being part of the description, thus preventing a breach of condition from arising. In the case there was a charter of a tanker ship that was under construction. Since the ship had not been named it was described as 'Yard No 354 at Osaka'. In fact the ship was not built at this place, though it met the contractual specifications and was built under the control of Osaka. The tanker market collapsed and the charterers sought to repudiate the contract. It was held that they could not do so since the phrase 'Yard No 354 at Osaka' was only a means of identifying the ship and a substitute for a name, not a description of the ship. Lord Wilberforce commented on the ***Landauer*** and ***Ronaasen*** cases, stating that their decisions were 'excessively technical and due for fresh examination in this House'.

Despite the above means of limiting the strict approach to performance it should be borne in mind that the approach does have some statutory authority in certain circumstances. In contracts for the sale of goods, the Sale of Goods Act 1979, s 30(1), provides that 'where the seller delivers to the buyer a quantity of goods less than he contracted to sell, the buyer may reject them, but if the buyer accepts the goods so delivered he must pay for them at the contract rate'. Conversely, s 30(2) states that 'where the seller delivers to the buyer a quantity of goods larger than he contracted to sell, the buyer may accept the goods included in the contract and reject the rest, or he may reject the whole'. However, s 4(2) of the Sale and Supply of Goods Act 1994 now provides for an additional provision to be inserted into s 30 of the Sale of Goods Act 1979. The new provision states:

> (2A) A buyer who does not deal as a consumer may not –
>
> (a) where the seller delivers a quantity of goods less than he contracted to sell, reject the goods under subsection (1) above, or
>
> (b) where the seller delivers a quantity of goods larger than he contracted to sell, reject the whole under subsection (2) above,
>
> if the shortfall or, as the case may be, excess is so slight that it would be unreasonable for him to do so.

By s 30(2B) it is for the seller to show that a shortfall or excess is so slight that it would be unreasonable for them to reject the goods. There is thus now a statutory basis for the ***de minimis rule*** in non-consumer contracts.

The right to reject will still exist where there is a breach of the implied conditions that arise under the 1979 Act. In the context described above, s 13 (implied condition as to description) is particularly appropriate, especially in a contract for the sale of unascertained goods, since these are invariably sales by description. One should be aware,

For more on implied conditions, refer to Chapter 7.

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however, that in non-consumer sales, s 15A of the Sale of Goods Act 1979 (as inserted by s 4(1) of the Sale and Supply of Goods Act 1994) limits the right to reject for a breach of condition where the breach is so slight that it would be unreasonable for the buyer to reject the goods, subject to contrary intention either express or implied in the contract.

The strict rule relating to performance is also relevant in what may be described as 'entire' contracts. In such contracts a person's contractual obligations are conditional on the other party performing his side of the contract completely and entirely.

Cutter v *Powell* (1756) 6 Term R 320

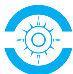
In this case, there was a contract by a seaman to serve on a ship bound from Jamaica to Liverpool. He was to be paid 30 guineas 'provided he proceeds, continues and does his duty . . . from hence to the port of Liverpool'. Unfortunately he died at sea prior to reaching Liverpool. The defendants refused to pay for the work he had completed prior to his death and were sued by the administratrix. It was held that her action would fail since the terms of the contract meant that he would be paid only if he sailed the ship to Liverpool and since he did not do so no pay was owed.

Clearly the application of the rule requiring strict performance is particularly harsh when seen in the light of the above case and for this reason the courts have developed several rules which have mitigated the effects of the general rule.

Mitigating the strict performance rule

The doctrine of substantial performance

In many respects this doctrine is really an offshoot of the *de minimis* rule outlined above. It arises where a person in fully performing their side of the bargain hopes that they have done all they were required to do under the contract, or supplied everything they were supposed to supply, but there are nevertheless minor defects in the performance of the contract. In such a case the court will find that the person has substantially performed their side of the contract and allow them to claim the contract price, less an amount by which the value of the contract has been diminished by the breach. Clearly such a solution is more equitable since it protects the interests of the innocent party while allowing the individual concerned an amount for work actually completed. If such a position was not adopted by the courts it could well mean that many sound businesses could be drawn into insolvency by virtue of minor breaches of contract. In any event it is unfair to allow a party to take the substantial benefit of the contract while at the same time escaping liability to pay for that benefit by reason of minor, technical breaches of the contract.



Clearly this area of performance is closely linked to the remedy of damages for breach of warranty or breach of an innominate term under the principle in ***Hong Kong Fir Shipping Co. Ltd* v *Kawasaki Kisen Kaisha Ltd*** [1962] 1 All ER 474, since in both situations it might be considered that there is substantial performance. An example of the application may be seen in the following case.

Hoenig v *Isaacs* [1952] 2 All ER 176

In this case, there was a contract by the plaintiff to decorate and furnish the defendant's flat for £750. The defendant alleged that the workmanship was poor and defective but paid £400. The plaintiff sued for the balance. The court found that there were defects in the

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work but that these could be cured for some £55, and thus awarded the plaintiff the full amount of the contract less the cost of putting right the defects and, of course, the amount already paid.

Partial performance

It may happen that an individual only partially performs their side of the contract yet nevertheless the other party, rather than reject the work, decides to accept the work that has actually been done. In these circumstances the promisee will be obliged to pay for the work done on a *quantum meruit* basis. It should be borne in mind that the promisee has complete discretion as to whether to accept the partial performance or not.

Sumpter v *Hedges* [1898] 1 QB 673

The plaintiff, who had agreed to erect certain buildings for the defendant, could not claim on a *quantum meruit* basis for work completed before he abandoned the contract. The defendant had gone on to the premises and completed the work himself, making use of materials left on the site by the plaintiff. The defendant had no option but to complete the buildings, though the plaintiff could recover for the materials used by the defendant since the defendant had the option of using those materials or not. Since he had decided to use them the court held that he should pay a reasonable price for them.

Tender of performance

To offer a tender to perform is regarded as equivalent to actual performance. It is clearly wrong to allow the promisee to avoid a contract for non-performance where the promisee has refused to accept the offer of performance. Where such a situation arises it is open to the promisor to treat the refusal as discharging them from any further obligations under the contract. The promisor is also entitled to raise the promisee's refusal to accept their offer of performance as a defence to an action by the promisee for breach of contract.

Startup v *Macdonald* (1843) 6 Man & G 593

The parties had contracted for the sale of 10 tons of linseed oil, which was to be delivered 'within the last fourteen days of March'. The plaintiffs delivered the oil at 8.30pm on 31 March, a Saturday. The defendant refused to accept delivery and it was held that the plaintiffs were able to recover damages for the non-acceptance of the delivery of the oil. This decision needs, however, to be qualified in the context of the modern law contained in the Sale of Goods Act 1979, s 29(5), whereby 'Demand or tender of delivery may be treated as ineffectual unless made at a reasonable hour; and what is a reasonable hour is a question of fact.'

So far **tender of performance** has been examined in the context of performance of a service or delivery of goods. Performance may also be tendered by the payment of money. Where money is proffered for tender of performance but refused by the promisee, it should be borne in mind that the promisor is not discharged from the debt and must remain willing and ready to discharge the debt, and that any special terms regarding payment must be complied with. Should the promisor tender payment and this is refused, they should wait until they are sued on the debt and then pay the moneys

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owed into court, raising the offer of payment as a defence to the action brought by the promisee. This will result in the promisee recovering the debt and no more, while the promisor will be entitled to claim legal costs.

It may also arise that the promisor commences performance of the contract but is subsequently prevented from completing it because of the fault or actions of the promisee. In such a situation the promisor will be able to sue for breach of contract and gain damages on a *quantum meruit* basis for work actually completed. In ***Planché* v *Colburn*** (1831) 8 Bing 14 where the defendants had embarked on the publication of a series of books entitled *The Juvenile Library* the plaintiff was engaged to write a volume on ancient armour and costume for £100, the sum being payable on completion of the manuscript. When he had researched and written part of the book, the defendants abandoned the project. It was held that the plaintiff had accepted the abandonment of the project as discharging the contract, and that therefore he was entitled to be paid for the work actually completed at the acceptance of the breach. The court therefore awarded him £50 for his work.

Divisible contracts

The means of mitigating the rule requiring strict performance of a contract, as discussed above, have also been augmented by the development by the courts of a distinction between entire and divisible contracts. A **divisible contract** may be defined as a contract in which partial performance attracts an obligation to provide payment of part of the consideration. Such a state of affairs may be expressly provided for in the contract, where, for instance, large quantities of a particular commodity may be required. Here it could be agreed that the promisor will be paid for each ton of the commodity delivered or that a proportion of the contract price is payable on the delivery of each instalment of the item in question. If the promisor fails to complete the whole contract he will nevertheless be entitled to a proportion of the moneys owed under the contract.

A further example of such a contract arises in contracts of employment where the terms of the contract state that a particular worker is to be paid weekly. If this term had applied to a case such as ***Cutter* v *Powell***, the administratrix would have been able to claim the seaman's wages for each week of work completed before his death. Whether a contract is entire or divisible depends on the intentions of the parties as discovered by the courts.

The time of performance

At common law time was regarded as being 'of the essence' in a contract, unless the parties had agreed otherwise. Equity did not, however, regard time as being of the essence and would apply equitable remedies to the contract even where there was a failure to comply with the time fixed for completion of the contract.

The position is now governed by the Law of Property Act 1925, s 41, which provides:

> Stipulations in a contract, as to time or otherwise, which according to rules of equity are not deemed to be or to have become of the essence of the contract, are also construed and have effect at law in accordance with the same rules.

The result of this provision is to fuse the rules of equity and those of the common law, producing the effect that if time is not of the essence there arises only a right to damages rather than a right to terminate the contract, as was held in ***Raineri* v *Miles*** [1981] AC 1050.

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Equity did, however, regard time as being of the essence in three situations, stated in *Halsbury's Laws of England* (4th edn) para 481 to be where:

1 the parties expressly stipulate that conditions as to time must be strictly complied with; or
2 the nature of the subject of the contract or the surrounding circumstances show that time should be considered to be of the essence; or
3 a party who has been subjected to unreasonable delay gives notice to the party in default making time of the essence.

This statement of law has been stated to be correct and confirmed by the House of Lords in ***United Scientific Holdings Ltd*** **v** ***Burnley Borough Council*** [1978] AC 904 and in ***Bunge Corporation*** **v** ***Tradax Export SA*** [1981] 2 All ER 513.

It is possible on the basis of the above for time in a contract to be initially not of the essence but to become so on the giving of reasonable notice. The case of ***Charles Rickards Ltd*** **v** ***Oppenheim*** [1950] 1 All ER 420, more fully discussed on p. 396, provides authority for this point. When does the right to give such notice arise? The Court of Appeal in ***British and Commonwealth Holdings plc*** **v** ***Quadrex Holdings Inc.*** [1989] 3 All ER 492 considered that before an innocent party could give such notice there had to be an unreasonable delay in the performance of the contract. This requires some qualification where a specific date for performance is given in the contract, albeit that the time is not stated as being of the essence. In ***Behzadi*** **v** ***Shaftesbury Hotels Ltd*** [1991] 2 All ER 477 the Court of Appeal stated that reasonable notice could be given making time of the essence as soon as the contractual date for performance had passed.

Where time is of the essence in a contract then any delay will amount to repudiation of the contract.

Union Eagle Ltd v *Golden Achievement Ltd* [1997] 2 All ER 215

The appellant entered into a written contract to purchase a flat in Hong Kong for $HK4.2 million from the respondent vendor. A deposit of 10 per cent was paid and the date for completion of the contract was set as 30 September 1991 before 5pm. Time was stated to be of the essence and non-compliance would result in the deposit being absolutely forfeited 'as and for liquidated damages (and not a penalty)'. The appellant was 10 minutes late in tendering the cheques and the relevant documents required to complete the purchase. The vendor's solicitor refused to accept the cheques and the documents and informed the purchaser that the contract had been rescinded and the deposit forfeited. The purchaser appealed to the Privy Council, contending that he was entitled to specific performance of the contract and entitled to relief against forfeiture in respect of both the agreement and the deposit. It was held by the Privy Council that, in the absence of a waiver of the breach of contract by the vendor, the court would not grant an order of specific performance where there was a rescission of a contract for sale of land because of a failure to comply with an essential condition as to time. The court held that the purpose of the condition and the right to rescind was to give the vendor the certainty of knowledge that he could resell the property which, in a rising property market, was 'a valuable and volatile right'.

Time of performance is also important in consumer contracts conducted by means of distance communications. Regulation 19 of the Consumer Protection (Distance Selling) Regulations 2000 provides that, unless the parties agree otherwise, contracts must be performed within 30 days, taking effect after the day in which the consumer sent the

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order to the supplier. If the supplier is unable to perform the contract because the goods or services are unavailable within the period for performance, they are required to inform the consumer of this and return any sums paid by or on behalf of the consumer. The reimbursement must take place as soon as possible and in any event no later than 30 days commencing with the day after the day on which the period for performance expired. If the contract is not performed within the period for performance it is treated as if it had not been made. The consumer may of course take action against the supplier for breach of contract for non-performance in the usual way as already described above.

Breach

Where a person fails to perform their side of the contract then, subject to the mitigating factors, they will be in breach of contract. A breach of contract will always give rise to a claim for damages, no matter how minor or serious the nature of the breach. Whether an innocent party is also entitled to treat the contract as at an end, so that they can treat the contract as discharged, depends on whether the breach is so serious that it goes to the root of the contract, that is, there is a breach of a primary obligation, or whether the other party has repudiated the contract prior to the performance of the contract.

Breach of primary obligation

For more on breach of a primary obligation refer to Chapter 7.

It has already been shown in Chapter 7 that the innocent party may treat the contract as discharged where there has been a breach of a primary obligation of the contract. A primary obligation is often expressed as a condition. Such an obligation will give the parties this right if they have expressly agreed that it will do so, or where this effect is implied by the parties simply expressing a term to be a 'condition'. Such an effect may also be implied by the courts, as in ***The Mihalis Angelos*** [1970] 3 All ER 125, or by statute, as in the condition implied by the Sale of Goods Act 1979. Furthermore, a contract may be treated as discharged where a term is found to be an innominate term and its breach has had the effect of depriving the innocent party of substantially what it was intended that party should obtain under the contract, as in the ***Hong Kong Fir Shipping*** case.

Repudiation prior to performance of the contract

The types of breaches that have been discussed so far are those that have arisen by virtue of the fact that a party has not performed the contract in compliance with the terms of the contract when the time for performance has arrived. It may, however, occur that a party may indicate, either expressly or impliedly, by words or conduct, that they do not intend to honour their obligations under the contract. Such a repudiation is known as an **anticipatory breach**.

An example of an explicit repudiation can be seen in ***Hochester* v *De La Tour*** (1853) 2 E & B 678 where the defendant entered into a contract in April to employ the plaintiff in June as a courier. In May he wrote stating that he no longer required the plaintiff's services. The plaintiff brought his action prior to the date on which he was supposed to start work and succeeded. He was entitled to elect to treat the contract as discharged immediately and to sue for damages although the date of performance had not arisen.

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An example of an implied repudiation may be seen in ***Frost* v *Knight*** (1872) LR 7 Exch 111 where the defendant promised to marry the plaintiff as soon as his father died. When the defendant retracted his promise by breaking off the engagement prior to his father's death, it was held that the plaintiff could immediately sue for damages for breach of contract, although the father was still alive.

Some care needs to be taken in deciding whether or not the anticipatory breach amounts to repudiation since it needs to be established beyond reasonable doubt from the circumstances of the case that the other party does not intend to perform their side of the contract. Thus in ***Freeth* v *Barr*** (1874) LR 9 CP 208, Keating J stated:

> It is not a mere refusal or omission of one of the contracting parties to do something which he ought to do, that will justify the other in repudiating the contract; but there must be an absolute refusal to perform his part of the contract.

Similarly Lord Selbourne in ***Mersey Steel and Iron Co.* v *Naylor Benzon & Co.*** (1884) 9 App Cas 434 stated:

> You must look at the actual circumstances of the case in order to see whether one party to the contract is relieved from its future performance by the conduct of the other; you must examine what that conduct is so as to see whether it amounts to a renunciation, to an absolute refusal to perform the contract . . . and whether the other party may accept it as a reason for not performing his part.

While an express intention may well be taken as amounting to repudiation it is always possible, just as where the repudiation is implied, that a misinterpretation may arise. If the innocent party treats such an anticipatory breach as an actual breach and treats the contract as at an end they would render themself in anticipatory breach no matter that the motives in taking such action were in good faith, as is illustrated in the ***Hong Kong Fir Shipping*** case. In ***Federal Commerce and Navigation Co. Ltd* v *Molena Alpha Inc.*** [1979] 1 All ER 307, a charter authorised the charterer to sign bills of lading stating that cargo had been prepaid. During the dispute the shipowners withdrew the authority of the charterers to sign the bills of lading so that the charterers were unable to issue bills of lading. Without these bills they would be unable to operate the ship. The shipowners believed they were entitled to take such action, but the charterers claimed that the action by the shipowners amounted to a wrongful repudiation of the contract. The House of Lords agreed with the charterers since even though the owners believed that they could take such action, this belief could not be reconciled with the disastrous effects of such a course of action on the business of the charterer.

The decision in the ***Molena Alpha*** case was, however, thrown open to doubt a year later by the House of Lords' decision in ***Woodar Investment Development Ltd* v *Wimpey Construction (UK) Ltd***.

Woodar Investment Development Ltd v *Wimpey Construction (UK) Ltd* [1980] 1 All ER 571

In this case there was a contract for the sale of land which allowed Wimpey, the purchasers, to rescind the contract should proceedings compulsorily to purchase the property commence before the completion of the sale. On the date the contract was signed the local authority had already commenced compulsory purchase proceedings in respect of part of the land. In the meantime the state of the market had changed, with land prices becoming depressed, so Wimpey wanted to escape from the contract. Just as in the ***Molena Alpha***

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case, Wimpey took legal advice and proposed to Woodar that they should renegotiate the contract, but that if these negotiations failed they would rescind the contract. Woodar alleged that Wimpey had no right to take such action, at which point Wimpey wrote back rescinding the contract because they alleged that the contract had become discharged by way of the local authority's action. Woodar then alleged that the action of Wimpey amounted to repudiation which they (Woodar) had accepted and that they were therefore entitled to claim damages. The House of Lords held that Wimpey had not repudiated the contract. Lord Wilberforce stated:

> So far from repudiating the contract, Wimpey were relying on it and invoking one of its provisions, to which both parties had given their consent. And unless the invocation of that provision were totally abusive or lacking in good faith (neither of which is contended for), the fact that it has proved wrong in law cannot turn it into a repudiation.

On the basis of this judgment it would seem that if a party is mistaken as to their rights then this, provided they have acted in good faith, cannot amount to a repudiation of the contract. Lord Wilberforce was thus effectively drawing a distinction between a threatened breach, which would result in serious consequences for the other party, as in the ***Molena Alpha*** case, and a situation where a party exercised what he erroneously, but in good faith, believed to be a right under the contract, as in the ***Woodar*** case. This point has also been approved in the Privy Council decision in ***Vaswani* v *Italian Motor Cars Ltd*** [1996] 1 WLR 270 (PC).

The decision in the case is a majority one, with Lord Salmon and Lord Russell dissenting, alleging that the case was identical to that of ***Molena Alpha***. They stated that in both the cases one party was determined to depart from the terms of the contract on the basis that the contract entitled them to do so, though this view of the contract was an erroneous one. *Cheshire, Fifoot and Furmston* (2006) points to three distinguishing factors between the cases. First, in ***Woodar***, the sellers could have waited and tested the correctness of their view of the contract by legal process rather than take immediate action. Second, in ***Woodar***, the time for completion was some way off and if Wimpey had refused to complete on this basis their conduct would have amounted to repudiation. Third, in the ***Molena Alpha*** case, the breach was anticipatory but the gap between repudiation and performance was short and thus greater pressure was placed on the charterers. That these differences exist cannot be doubted but in practical terms it leaves the parties, such as the charterers and Woodar, in an impossible position of having to make a qualitative decision as to whether a repudiation is based on a bona fide mistake as to rights contained in the contract, as in ***Woodar***, or whether it is based on a decision by the other party not to carry on with the performance of the contract. On such a view it might be better to confine the decision in ***Woodar*** to the circumstances of that particular case.

A further hazard in this context can be seen in the case of ***Vitol SA* v *Norelf Ltd* (*The Santa Clara*)**.

Vitol SA v *Norelf Ltd (The Santa Clara)* [1996] 3 All ER 193

The facts of the case were that there was a contract for the sale of a cargo of propane to be shipped from Houston at a price of $400 per tonne. The contract provided that a bill of lading had to be tendered by the seller immediately after the loading of the cargo. Prior to the loading on 8 March the buyer sent a telex to the seller stating that they were repudiating

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the contract and rejecting the goods. This was held by the arbitrator to be a wrongful anticipatory breach that amounted to a repudiatory breach. Following the telex the seller did not attempt to perform the contract. A few days later the seller resold the cargo for $180 per tonne. On 9 August the seller sent a letter to the buyer claiming the difference between the contract price and the resale price. The arbitrator found for the seller by deciding that the buyer's wrongful repudiation had been accepted as ending the contract by the seller not taking steps to perform the contract. The buyer appealed to the High Court.

In the High Court Phillips J found that there was no reason why an acceptance of an anticipatory breach by one party could not arise either by words or conduct, provided these made it clear that the innocent party was responding to the repudiation by treating the contract as at an end. The court considered that while it might be more difficult to indicate acceptance of the repudiation solely on the basis of conduct, it was possible for this to arise if an innocent party did something completely incompatible with their own performance, or by simply not performing their own contractual obligations. Phillips J considered that there was an analogy to be drawn here with offer and acceptance in the formation of a contract.

The buyer appealed to the Court of Appeal which held that an innocent party's election to accept a repudiation by the other party must be clear and unequivocal. The court thus held that mere non-performance of the contract by the innocent party after the repudiation could not amount to a clear acceptance of the repudiation. The reason for this is that, while it is possible that a failure to perform one's obligations may amount to acceptance of the repudiation, it is also possible that this is simply evidence of indecision or inadvertence by the innocent party. Further, the inaction could also be evidence of the innocent party merely being confused as to what their rights under the contract are. In other words, the court, also drawing on the offer and acceptance analogy, was stating that silence cannot amount to acceptance, either of an offer or of a repudiation.

The decision of the Court of Appeal raised serious implications with respect to implied acceptance of repudiation, since the decision did not go further and explain the practical results of the decision on the parties, other than that the buyer was not required to pay the damages awarded by the arbitrator. If, however, one accepted that the decision was correct and that acceptance of a repudiation has to be clear and unequivocal, then why was the letter of 9 August not treated as an implied but unequivocal acceptance of the repudiation? If such a letter is not sufficient, then it would seem that hardly anything less than express acceptance will suffice. A possible answer as to why the letter was not considered sufficient may lie in the fact that this amounted to an unreasonable delay in communicating the acceptance of the repudiation. The analogy with offer and acceptance becomes extremely tenuous in this context. It seems peculiar to argue that if one delays in accepting a repudiation the contract can still be regarded as subsisting!

Other difficulties lie with the decision of the Court of Appeal; for instance, if the implied repudiation is regarded as equivocal and therefore ineffective then surely the resale by the seller must itself amount to repudiation of the contract. The question then arises, who can sue whom? If the seller fails to deliver the goods on the contract date they are presumably liable for breach of a primary obligation under the contract. There would appear to be nothing to stop the buyer from renouncing their earlier statement (i.e. his anticipatory breach) indicating that they do not intend to proceed with the contract and from treating the contract as still subsisting. The buyer would then be free to sue the seller for breach, but if this were to be correct there is no doubt that it could apply

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in other situations where one party's breach amounts to repudiation of the contract. It could apply, for instance, where a party is in breach of a condition or where the breach is such that it would substantially deprive the innocent party (i.e. the seller in the present case) of the benefits they would receive under the contract, or where in fact the party's actions amount to an actual breach of contract by virtue of their repudiation of the contract.

It can be seen that very substantial practical difficulties arise from the Court of Appeal decision and no doubt there was a sigh of relief when the seller appealed to the House of Lords, who reversed the decision of the Court of Appeal. Their Lordships, Lord Nolan giving the leading judgment, found that as a matter of law mere failure to perform a contractual obligation was capable of amounting to acceptance of an anticipatory repudiation by an aggrieved party (the seller), depending on the particular circumstances of the case and the contractual relationship entered into. The inference drawn by the arbitrator that the seller had elected to treat the contract as at an end and the communication of it by the failure to tender the bill of lading, which was a precondition to payment, was a question of fact that remained within the sole and exclusive jurisdiction of the arbitrator. The act of acceptance of the repudiation requires no particular form. All that is necessary is for the communication or the aggrieved party's conduct to be an unequivocal and clear indication of his election to treat the contract as at an end. Nor does the indication have to come from the aggrieved party personally; all that is required is for the election to come to the repudiating party's attention, whether by an agent, authorised or unauthorised, or some other third party.

Lord Nolan rejected the analogy of offer and acceptance put forward by Nourse LJ in the Court of Appeal. While it is true, as we have already seen, that an offer cannot be accepted by silence, there are exceptions to this rule – for instance in unilateral contracts where the need for communication of acceptance is impliedly waived by the offeror.

A difficult question regarding repudiation arises in relation to contracts for the sale of goods where delivery is made by instalments, each instalment being paid for separately. Whether a failure to make or pay for an instalment amounts to repudiation largely depends on the terms of the contract and the circumstances in which the failure arises. In ***Maple Flock Co. Ltd*** v ***Universal Furniture Producers (Wembley) Ltd*** [1934] 1 KB 148 it was stated by Lord Hewart in the Court of Appeal that:

> the main tests to be considered . . . are, first, the ratio quantitatively which the breach bears to the contract as a whole, and secondly, the degree of probability or improbability that such a breach will be repeated.

The principle contained in ***Maple Flock*** seems also to have been adopted in ***Decro-Wall International SA*** v ***Practitioners in Marketing Ltd*** [1971] 2 All ER 216 in that not just any breach of contract can be regarded as repudiation, but only those which deprive the injured party of a substantial benefit of what it was intended they should receive under the contract. In the case the defendants were sole dealers for the plaintiffs in the United Kingdom, but as they were short of working capital they were often late in paying for goods received from the plaintiffs. This caused inconvenience to the plaintiffs in that they had to pay interest to the bank when payments were not made promptly, though there was never any question that they would ultimately not be paid. On the face of things the Court of Appeal found that such a situation would almost certainly continue but found that the delays in payment could not amount to repudiation since they were not sufficiently serious as to bring the whole contract to an end. Buckley LJ suggested that the test to be applied was whether:

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> the consequences of the breach be such that it would be unfair to the injured party to hold him to the contract and leave him to the remedy in damages as and when a breach or breaches may occur? If this would be so, then repudiation has taken place.

The process was affirmed in the House of Lords in ***Afovos Shipping Co. SA*** v ***Pagnan and Lli, The Afovos*** [1983] 1 All ER 449 where it was stated that the treatment of an anticipatory breach as repudiation could arise only if the breach related to a primary obligation or a fundamental breach.

The effects of breach

The right to affirm the contract

Where a party to a contract is in breach of a primary obligation or where the party is guilty of conduct that amounts to repudiation then this will not bring about the automatic termination of the contract, and the innocent party is free to treat the contract as still subsisting. Where such a situation applies in a contract for the sale of goods the seller remains liable to deliver the goods in accordance with the contract, while the buyer remains liable to accept delivery and pay for the goods. Both parties also retain their right to sue on the contract.

In a situation where there has been an anticipatory breach of contract and the innocent party elects to affirm the contract, they are still required to perform their own obligations under the contract, but face the danger that, should they subsequently become guilty of a breach of contract, the other party may escape liability. This point was discussed in the following case.

Fercometal SARL v *Mediterranean Shipping Co. SA, The Simona* [1989] AC 788

A charterparty was entered into in June 1982 whereby the shipowner agreed to take a cargo of steel coils from Durban to Bilbao. The charterparty contained an 'expected readiness to load' clause which entitled the charterers to cancel the charterparty should the ship not be ready to load on or before 9 July. On 2 July the shipowners asked for an extension to the expected readiness-to-load date as they wanted to load another cargo first and this meant that the ship would not be ready until 13 July. On receiving this request the charterers immediately cancelled the charterparty and chartered another vessel. The shipowners did not accept the repudiation and on 5 July gave notice to the charterers that the ship would be ready to load on 8 July. When the vessel subsequently arrived in Durban on that date, the shipowners gave notice that the ship was now ready to load. In fact this was not the case so the charterers rejected the notice and proceeded to load the cargo on to the second vessel. The shipowners brought an action for deadfreight.

In the arbitration proceedings that followed, the arbitrator upheld the shipowners' claim on the basis that the wrongful repudiation of the charterers relieved the shipowners from complying with their own obligations. The effect was that the shipowners' failure to tender the ship ready to load on time did not prevent them from recovering damages for wrongful repudiation by the charterers. On appeal this decision was set aside, though on further appeal to the Court of Appeal it was held that the unaccepted wrongful repudiation of the charterers did not prevent them from cancelling the contract when the shipowners failed to tender the vessel ready to load on 9 July.

The shipowners subsequently appealed to the House of Lords. Their Lordships confirmed the position that where a party wrongfully repudiated a contract, the innocent party could elect to affirm or treat the contract as discharged, subject to the criteria already

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discussed. If they elected to affirm the contract they were obliged to comply with their own contractual obligations under the contract. If an innocent party subsequently failed to comply with those obligations then the repudiating party could escape from their liability for wrongful repudiation. The shipowners in question having affirmed the contract were subsequently in breach of contract themselves by not tendering the vessel ready to load on 9 July and thus remained bound by the cancellation clause in the charterparty which was exercised by the charterers when the ship arrived late in Durban. The shipowners' appeal was consequently dismissed.

A further danger with affirmation lies in the possibility that a frustrating event may occur after the innocent party has affirmed the contract. Frustration will be dealt with more fully in Chapter 15 but basically it amounts to an external event that renders the contract impossible. The effect of frustration is automatic and radical in that it brings the contract to an end so that both parties are excused from further performance of the contract. Where an innocent party has decided to affirm a contract and there is an anticipatory breach, frustration will destroy the rights of that party to sue for the breach when the date of performance on the contract arrives. The point is well illustrated by the case of ***Avery* v *Bowden*** (1855) 5 E & B 714 where a ship was chartered to sail to the Russian Baltic port of Odessa and to take a cargo from the charterer's agent within 45 days. On the ship's arrival the agent stated that he could not provide a cargo and told the plaintiff to take the ship away. The plaintiff kept the ship at the port and repeatedly over the period in question asked the agent for a cargo and was in turn advised to take the ship away from the port. Before the 45-day period expired the Crimean War broke out and this rendered Odessa an enemy port and as a result the contract became frustrated. The effect of this was that the plaintiff lost the rights to sue for breach of contract since the frustrating event had destroyed the contract he had affirmed, together with his rights under it.

Once the innocent party has elected to affirm, or for that matter to treat the contract as discharged, the party cannot retract this election. In ***Panchaud Frères SA* v *Établissements General Grain Co***. [1970] 1 Lloyd's Rep 53 it was held that affirmation is really a species of waiver that results in an innocent party being estopped from altering his election.

The fact that an innocent party can treat the contract as still subsisting and affirm their obligations under it so that they can go on to complete their obligations cannot be denied. In some circumstances, however, such a proposition is very unfair to the other party despite the fact that they were originally the offending party. The unfairness results from the fact that, in affirming the contract, the innocent party is entitled to continue to perform their obligations under the contract, thereby increasing their losses. When the date of performance arrives they can, despite having been told by the other party that they do not intend to perform the contract, use these losses as the basis of a claim for damages against the offending party.

White and Carter (Councils) Ltd v *McGregor* [1962] AC 413

The appellants were suppliers of litter bins to local authorities, although the bins were paid for not by the local authorities but by businesses who had advertisements displayed on the bins. The respondents, who were proprietors of a garage, agreed to pay for advertisements on the bins for three years but on the same day that they entered into agreement they

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decided not to proceed and informed the appellants to that effect. The appellants refused to accept the cancellation (repudiation) and affirmed the contract even though they had at that stage taken no steps towards carrying out the contract. For the three years they prepared advertising plates, attached them to bins and displayed them throughout the locality agreed, making no attempt to mitigate their losses. At the end of the three-year period they sued for the entire contract price. It was held by a majority of the House of Lords that they were entitled to the contract price.

The decision is clearly unsatisfactory and all the judges considered that the appellants should not be allowed to succeed in such a claim, though none could find or develop a test which allowed the general rule relating to affirmation while qualifying its application in such a context. Lord Reid suggested that a plaintiff should not be allowed to affirm the contract and continue with it unless they could show that they had a legitimate interest, financial or otherwise, in performing the contract rather than claiming damages. Lord Reid stated:

> It may well be that, if it can be shown that a person has no legitimate interest, financial or otherwise, in performing the contract rather than claiming damages, he ought not to be allowed to saddle the other with an additional burden with no benefit to himself. If a party has no interest to enforce a stipulation, he cannot in general enforce it: so that it might be said that, if a party has no interest to insist on a particular remedy, he ought not to be allowed to insist on it. And just as a party is not allowed to enforce a penalty, so he ought not to be allowed to penalise the other party by taking one course when another is equally advantageous to him.

The decision in ***White and Carter*** has been heavily criticised but it would seem that Lord Reid's approach has now been accepted and indeed judicially approved of in a number of cases such as ***Attica Sea Carriers Corporation*** v ***Ferrostaal Poseidon Bulk Reederei GmbH (The Puerto Buitrago)*** [1976] 1 Lloyd's Rep 250 and ***Clea Shipping Corporation*** v ***Bulk Oil International Ltd, The Alaskan Trader (No 2)*** [1984] 1 All ER 129 and that this will be the stance taken in future cases. It does, however, create a dilemma for the innocent party in that if they affirm but can show no legitimate interest then they will not be able to claim the full damages available – and that position is clearly fair. On the other hand, if they wrongly consider that there is an absence of a legitimate interest and decide to treat the contract as discharged, so that they can sue for their losses immediately, they may well find themselves in breach of contract should they be unable to justify that stance in accordance with the rules discussed on pp. 377–82 above.

Clearly some refinement of the rules is required but this has not been forthcoming, although the courts have shown ingenuity in avoiding the principle in ***White and Carter***.

In ***Hounslow Borough Council*** v ***Twickenham Garden Developments Ltd***, the court considered that it was not just a question of the innocent party demonstrating that he had a legitimate interest in completing the contract but also the contract had to be capable of being completed without the co-operation of the other party.

Hounslow Borough Council v *Twickenham Garden Developments Ltd* [1971] Ch 233

The facts of the case were that Twickenham Garden Developments (TGD) was instructed to carry out some work for Hounslow Borough Council (HBC) on some land owned by the council. HBC purported to cancel the contract under a clause contained in the contract.

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TGD disputed whether HBC was entitled to cancel the contract in this way and continued to work on HBC's land. HBC sought an injunction to prevent TGD from trespassing on its land. TGD sought to rely on the principle in ***White and Carter***, arguing that it was entitled to complete the contract. HBC argued that this case should be distinguished from ***White and Carter*** on the grounds that in that case the appellants had been able to go ahead and complete the contract without any co-operation from the other party. In this case, however, TGD required the co-operation of HBC, i.e. to allow TGD to go on to the land.

The court granted the injunction, stating that the principle in ***White and Carter*** only applied where the contract could be completed without the co-operation of the other party and that the innocent party had a legitimate interest in completing the contract. Neither of these requirements was present in this case.

Cases where, having elected not to accept a repudiation of the contract, an innocent party will be prevented from enforcing his contractual right to keep the contract in force and sue for the contract price, namely where damages would be an adequate remedy and where the election to keep the contract alive would be 'wholly unreasonable', remain a fairly limited category. The case of ***Reichman*** v ***Beveridge*** [2006] EWCA Civ 1659 illustrates that the principles in ***White and Carter*** are still appropriate to landlord and tenant situations.

Reichman v *Beveridge* [2006] EWCA Civ 1659

The facts of the case were that two tenants took a lease on office premises for a five-year term from January 2000 at a yearly rent of £23,101 payable quarterly in advance. They practised there as solicitors until February 2003, when they quit the premises, having no further use for them. In January 2004 the landlords began proceedings to recover rent arrears totalling £23,101 with VAT of £4,026.76. The tenants claimed in their defence that the landlords had failed to take steps to mitigate their loss by failing to instruct agents to market the premises, failing to accept an offer from a prospective tenant who wanted to take an assignment of the lease or a new lease and failing to accept an offer to negotiate a payment for the surrender of the lease. On the trial of a preliminary issue that defence was rejected by the district judge, whose decision was affirmed by the judge on the appeal of one of the tenants. The tenants then appealed to the Court of Appeal.

The Court of Appeal dismissed the appeal. The basis of the tenants' argument was that it was, following Lord Reid's *dicta* in ***White and Carter***, wholly unreasonable for the landlord to elect to affirm the contract following an anticipatory breach by the tenant and that damages would be an adequate remedy; furthermore the landlord did not have a legitimate interest to protect in affirming the contract. The court considered that it was not clear if the landlord was acting unreasonably in not taking their own steps to find a new tenant, rather than leaving it to the tenants to find a new one, or indeed in rejecting a proposal by the tenants. The Court of Appeal also considered that damages may not be an adequate remedy. The reason of the court was that, despite the contractual nature of the lease, where a tenant had abandoned the lease and failed to pay rent and other sums, if the landlords had re-let the premises they may not have received the loss of the future rent if they could only re-let the premises at a lower rent than that available under the lease. The basis behind this argument was that there was no authority in English law for the ability of a landlord to recover *future* rent, thus if the landlords had terminated the lease and then re-let at the lower rent they were then not able to recover damages to

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compensate for the loss of the rent. On the other hand, if the market value for the rent had been the same or higher and the tenants had taken steps to find their own assignee or tenant and the landlords had refused to accept that assignee or new tenant then the tenants would have had a statutory remedy under the Landlord and Tenant Act 1985. On this basis the Court of Appeal considered that the landlords were not acting reasonably in not terminating the lease. The Court of Appeal considered that the principle in ***White and Carter*** that allowed the innocent party to affirm the contract and claim damages with no duty to mitigate was a limited one, given the acceptance of Lord Reid's qualifications; but it was a wholly justified principle in the context of landlord and tenant law.

Before leaving this aspect of the effects of breach it should be borne in mind that the burden of preventing the innocent party from claiming the election to repudiate or affirm the contract lies on the party breaking the contract, as indicated in ***Ocean Marine Navigation Ltd* v *Koch Carbon Inc. (The Dynamic)*** [2003] 2 Lloyd's Rep 693.

A further limit on affirmation is that in certain contracts confirmation of the contract is only possible with the co-operation of the other party. If such co-operation is not forthcoming then clearly affirmation will not be possible. Such a situation often arises in contracts of employment. If an employer wrongfully dismisses an employee, that employee cannot claim that they are ready and willing to work but being prevented from doing so by the employer and that the employer is liable for all losses of wages from the date of the dismissal. The employee's only remedy is to sue immediately for damages.

The right to treat the contract as discharged

The innocent party has the right to elect to accept the repudiation as discharging the contract with the result that all their future obligations under the contract come to an end, as do the obligations of the guilty party, though here his obligation to pay damages arises by operation of law, as stated in ***Moschi* v *Lep Air Services Ltd*** [1973] AC 331. It should also be noted that, just as in affirmation above, once the election to accept the repudiation has been made, it is not possible to retract it.

One refinement on the above principle arose in the case of ***Stocznia Gdynia SA* v *Gearbulk Holdings Ltd*** [2009] EWCA Civ 75, where it was alleged that where there was a contractual right to terminate a contract the innocent party was precluded from terminating the contract at common law and further could not recover damages for loss of bargain. The facts of the case were that the appellant purchaser (G) had entered into contracts with S for the construction of three vessels. In fact, none of the vessels were delivered. Article 10 of the contracts provided for the price to be reduced by way of liquidated damages for delay in delivery and specified deficiencies and provided that G had the right to terminate the contract if there was a major breach by S of its obligation to proceed with construction of the vessel. On any such termination S had to repay any sums previously paid, with interest. Whilst some work had commenced with regard to the first vessel this work had in fact stopped and therefore G wrote to S terminating the contract in respect of that vessel. G then exercised its right under art 10 to recover the first instalment of the price which it had paid on signing the contract. G later took similar steps to terminate the contracts for the other two ships and to recover the first instalments for those as well. G further claimed that it was entitled to recover damages for the loss of its bargain. S said that because G had exercised its contractual right to terminate its remedy was limited to recovery of the instalments only in accordance with the contract. An arbitrator held that S had repudiated the contracts and that the contract

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terms did not exclude G's rights at common law. He also rejected an argument that G had affirmed the contracts. On appeal the judge held that the contract terms were not an exclusive code preventing any claim for damages, but that G was precluded from claiming damages at common law for the repudiation of the contracts because it had affirmed the contracts by virtue of having claimed the instalments under the contract. S submitted that art 10 contained a complete contractual code which precluded any right to treat the contract as repudiated at common law or claim damages for loss of bargain at common law.

The Court of Appeal held that art 10 in the contract did not displace the right to treat the contract as repudiated. The primary purpose of that provision was to provide an agreed measure of compensation for breaches of contract by way of delay in delivery and deficiencies in capacity and performance which, although important, did not go to the root of the contract. However, the parties had also agreed that there was a point at which the delay or deficiency was so serious that G should be entitled to terminate the contract. The court considered that the parties had to be taken as having agreed that it was at that point the breach was a serious breach and one that went to the root of the contract. In those circumstances G had the right to terminate the contract with the usual consequences and it would be wrong to treat the right to terminate in accordance with the terms of the contract as different from the right to treat the contract as discharged by reason of repudiation at common law. The court further considered that art 10 did not exclude the right to recover damages for loss of bargain in the event of termination by G. It was stated that a person who exercised a contractual right of termination which arose on the other party's breach was not inevitably prevented from treating the contract as discharged and recovering damages for the loss of his bargain. The exercise by G of its right to recover the instalments of the contract price under art 10 was not to be taken as an election on G's part to affirm the contract and there was no inconsistency in recovering instalments of the price under art 10 and recovering damages for loss of bargain at common law.

Once the innocent party has decided to accept the repudiatory breach, that party is entitled to recover for the loss of the benefit that the performance would have brought. The loss of those benefits accrues at the time of the repudiation. It is not open to the repudiating party to seek to reduce the damages on the basis of some subsequent act of the innocent party that might reduce the overall benefit that would have accrued. The point can be seen in the case of ***Chiemgauer Membran Und Zeltbau GmbH (formerly Koch Hightex GmbH)* v *New Millennium Experience Co. Ltd (formerly Millennium Central Ltd) (No 2)*** (2001) *The Times*, 16 January. Strictly speaking the case does not concern a repudiatory breach since the claimant had a contractual right to terminate the contract; however, the principle can nevertheless still be seen.

In July 1997 the claimant (Koch) was awarded the contract to construct the roof for the Millennium Dome. The contract permitted the defendant, the New Millennium Experience Co. Ltd (NMEC), to terminate the contract without cause provided it paid compensation calculated in accordance with a term of the contract. This term permitted Koch to claim damages for 'direct loss and/or damage'. In August 1997 NMEC exercised its right to terminate the contract without cause and subsequently Koch filed for bankruptcy under German law in August 1998. In 1999 the Court of Appeal granted Koch judgment in respect of NMEC's liability under the contract but did so without expressing any interpretation as to the meaning of the compensation clause. Koch then applied to the Chancery Division in order to find out whether: first, the expression 'direct loss and/or damage' allowed it to claim for loss of profits; and, second, whether in assessing Koch's

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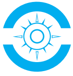
claim the court was obliged to assume that Koch would have been able to perform the contract had it not been terminated by NMEC, notwithstanding that Koch had subsequently become insolvent.



It was held that the term 'direct loss and/or damage' had a clear and established meaning in that it equated with the first limb of ***Hadley* v *Baxendale*** (1854) 9 Exch 341 (see p. 441 et seq.). In other words, Koch could claim for losses which arose naturally according to the usual course of things from the breach of contract. The loss of ordinary profits suffered by Koch fell squarely within this definition. It was, however, contended by NMEC that the damages should be reduced or extinguished since it was likely that Koch would have become insolvent anyway in the course of carrying out the business. On this basis Koch would have made either no profits or profits at a reduced rate as a result and that this should be taken into account when assessing the level of damages to be awarded. The court considered that this case was analogous to the situation where an innocent party accepted a defendant's repudiatory breach. In this situation the repudiating party is precluded from alleging that the innocent party would not have been able to perform the contract. The innocent party is entitled to any benefits the contract would bring on the basis that those benefits had been lost because of the breach of contract by the repudiating party. A repudiating party cannot rely on some intervening act, such as the insolvency of the innocent party, to reduce or even extinguish the right to damages. This right arose and accrued to the innocent party, Koch, as soon as the repudiating party, NMEC, repudiated the contract.

The decision to accept the repudiation and treat the contract as discharged is not one to be taken lightly since, as we have seen in cases such as ***Woodar***, ***Molena Alpha***, and so on, if the repudiation does not amount to a breach of a primary obligation then there is no right to treat the contract as discharged, with the result that the innocent party themself may be held to be in breach of contract.

What is the effect where an innocent party is entitled to refuse performance of their contractual obligations but gives the wrong reason for this refusal, albeit that they do have a justifiable reason? In ***Glencore Grain Rotterdam BV* v *Lebanese Organisation for International Commerce*** [1997] 4 All ER 514, it was held that in such circumstances an innocent party does not deprive themself of the right to refuse performance. Furthermore, it is irrelevant whether they are aware or not that they have a justifiable reason at the time of their refusal.

This principle is, however, subject to two qualifications. First, it will not apply if the justification, known or unknown, by the innocent party could have been put right. Second, the principle does not apply if the innocent party makes some unequivocal representation to the contrary, and this is acted upon by the other party, so that it would be unjust or unfair for the innocent party to rely on their strict contractual right. The representation could take the form of a promise or some other conduct that indicates that the contract is being affirmed, as seen in ***Panchaud Frères SA* v *Établissements General Grain Co*.** [1970] 1 Lloyd's Rep 53. The affirmation could take the form of a waiver, though in that case Lord Denning expressed it as an estoppel by conduct. He stated: 'The basis of it is that a man has so conducted himself that it would be unfair or unjust to allow him to depart from a particular state of affairs which another has taken to be settled or correct.' Later, in ***V Berg & Son Ltd* v *Vanden Avenne-Izegem PVBA*** [1977] 1 Lloyd's Rep 499, Lord Denning referred to ***Panchaud Frères*** 'as a case where there was a waiver by one person of his strict right – or an estoppel – whatever you like to call it – whereby a person cannot go back on something he has done'. Whether estoppel, waiver or some other conduct, the second qualification to the principle set out

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in ***Glencore Grain*** must amount to an unequivocal representation, by conduct or otherwise, which was acted upon by the other party.

The loss of the right to treat the contract as discharged

In contracts for the sale of goods by the Sale of Goods Act 1979, s 11(4) the buyer loses the right to repudiate the contract once they have accepted the goods. But what constitutes acceptance? This is defined in the Act as when the buyer intimates to the seller that they have accepted them (s 35(1)). If the goods have been delivered to the buyer, any act of the buyer that is inconsistent with the seller's ownership once the buyer has had the opportunity to examine the goods to ensure conformity with the contract or, in the case of a sale by sample, by comparing the bulk with the sample (s 35(2)), will suffice. The buyer is deemed to have accepted the goods when after the lapse of a reasonable time they retain the goods without intimating to the seller that they have rejected them (s 35(4)). In determining what is a reasonable time the Act states that one of the factors to be taken into account is whether the buyer has had the opportunity to examine the goods for the purposes set out in s 35(2) (*see* above). Further, the buyer is not deemed to have accepted the goods merely because they ask for, or agree to, their repair (s 35(6)(a)) or have the goods delivered to a sub-buyer/third party (s 35(6)(b)). Similarly, accepting delivery of part of the goods whilst at the same time claiming an entitlement to reject the rest does not amount to acceptance.

The operation of these principles can be seen in the case of ***Clegg* v *Ollie Andersson (t/a Nordic Marine)*** [2003] 2 Lloyd's Rep 32 (CA) where the defendants had contracted to purchase a new yacht from the claimants. When the yacht was delivered in August 2002 the yacht's keel was found to be substantially heavier than the manufacturer's specification. The parties entered into a protracted round of correspondence between August 2000 and March 2001 in which the effects of the overweight keel were discussed, the potential safety repercussions and the means of remedying the defect. In March the defendant purchasers informed the seller that they were entitled to reject the yacht on the basis that there was a breach of the implied condition under the Sale of Goods Act 1979, s 14(2), in that the yacht was not of satisfactory quality. The sellers rejected the condition that the goods were not of satisfactory quality and further alleged that the buyers had lost their right to reject the goods under s 11(4) since they had intimated acceptance within the provisions of s 35(1) or, in any event, had left it too late to reject within the provisions of s 35(4).

At first instance the judge agreed with the sellers that the goods were of satisfactory quality and that the buyers had lost their right to reject by virtue of the operation of s 35(1) and (4). The buyers appealed.

In the Court of Appeal the court held that the test to determine what was satisfactory quality was whether a reasonable person would think the goods satisfactory taking into account their description, price and all other relevant circumstances. On the facts the court considered that a reasonable person would not consider the yacht to be of satisfactory quality because of the overweight keel, the adverse effect it had on the safety of the yacht and the fact that the work required to remedy the defect was more than what could be considered minimal remedial work. The buyers had therefore established a breach of s 14(2) and their right to reject the yacht by virtue of s 11(4); but had they lost this right by virtue of the operation of s 35(1) and/or s 35(4)? The Court of Appeal thought they had not, stating that time taken to ascertain the effect of any modification or repair was a relevant matter in determining the question of fact that arose in s 35(4). The court also stated that in any event s 35(6) states that a buyer does not accept the

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goods simply by asking for or agreeing to a repair. The court stated that it followed that a buyer did not lose his right to reject by seeking information that would enable him or her to make an informed choice between acceptance, rejection or cure. Once the sellers had supplied the information required to the buyers, the buyers had taken only three weeks to inform the sellers that they were exercising their right to reject, which was not an unreasonable amount of time. The buyers were therefore entitled to the return of their purchase price and compensation for consequential losses.

The decision in this case also overturned the heavily criticised earlier decision of ***Bernstein* v *Pamson Motors (Golders Green) Ltd*** [1987] 2 All ER 220 where a subjective test had been applied by Rougier J where he said of s 35:

> That section seems to me to be directed solely to what is a reasonable practical interval in commercial terms between a buyer receiving the goods and his ability to send them back, taking into consideration from his point of view the nature of the goods and their function, and from the point of view of the seller the commercial desirability of being able to close his ledger reasonably soon after the transaction was complete. The complexity of the intended function of the goods is clearly of prime consideration here. What is a reasonable time in relation to a bicycle would hardly suffice for a nuclear submarine.

In situations outside the sale of goods the loss of the right to repudiate may arise by way of a **waiver**. It is considered that for a party to waive a right to rescind they must know of their rights in that respect in the first place. This is because essentially a waiver is a type of election and as such requires knowledge. This view is supported by the case of ***Peyman* v *Lanjani*** [1985] Ch 457 where the defendant entered into a contract for the assignment of a lease that was subject to a covenant that the lease was not to be assigned without the consent of the landlord. This consent was obtained from the landlord by way of a fraudulent misrepresentation, though the plaintiff played no part in the deception. The plaintiff, despite consulting his solicitors, was not aware that he had a right to rescind the contract and therefore, also on the advice of his solicitors, paid £10,000 to complete the transaction and went into possession. Later he consulted new solicitors who advised him that because of the defendant's deception the plaintiff's title was defective and that he had a right to rescind the contract. The defendant argued that the plaintiff had waived his right to rescind by paying the £10,000 and going into possession. The Court of Appeal held that a person would not lose the right to rescind merely by being aware of the facts that give rise to the right to rescind; they also had to be aware of the right to rescind itself. Since he was not aware of this right he was not deemed to have waived his rights in this respect and could rescind the contract.

Summary

Performance

- A contract must be performed strictly in accordance with its terms otherwise the innocent party can claim damages or repudiate the contract (***Re Moore & Co.* v *Landauer & Co.***; ***Arcos Ltd* v *E A Ronaasen & Son***).
- Consumers can still reject for a breach of condition – s 13 SGA.
- Non-consumers cannot reject for a breach of condition where the breach is so slight that it would be unreasonable for the buyer to reject the goods, subject to contrary intention either express or implied in the contract – s 15A.

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- 'Entire' contracts – a person's contractual obligations are conditional on the other party performing his side of the contract completely and entirely (***Cutter* v *Powell***).

Mitigating the strict performance rule

The doctrine of substantial performance

- Occurs where a person makes minor defects when fully performing his side of the bargain.
- Damages – a person who substantially performs his side of the contract can claim the contract price, less an amount by which the value of the contract has been diminished by his breach (e.g. ***Hoenig* v *Isaacs***).

Partial performance

- Occurs where one side partially performs his side of the contract and the other decides to accept the work done rather than reject it. The promisee will be obliged to pay for the work done on a *quantum meruit* basis. The promisee has complete discretion as to whether to accept the partial performance or not.

Tender of performance

- To offer a tender to perform is regarded as equivalent to actual performance.
- The promisee cannot avoid a contract for non-performance where he himself has refused to accept the offer of performance (***Startup* v *Macdonald***).
- The promisor can sue for damages on a *quantum meruit* basis if he has started work but the promisee prevents him completing it (***Planché* v *Colburn***).

Divisible contracts

- Defined as a contract in which partial performance attracts an obligation to provide payment of part of the consideration.

The time of performance

- Time must be made of the essence if a party wishes to terminate the contract, otherwise only damages may be sought (***Raineri* v *Miles***).
- Equity considers time of the essence where:
  1. the parties expressly stipulate that conditions as to time must be strictly complied with; or
  2. the nature of the subject of the contract or the surrounding circumstances show that time should be considered to be of the essence; or
  3. a party who has been subjected to unreasonable delay gives notice to the party in default making time of the essence.
- ***United Scientific Holdings Ltd* v *Burnley Borough Council*** and in ***Bunge Corporation* v *Tradax Export SA***.
- Time not made of essence can become of essence on the giving of reasonable notice (***Charles Rickards Ltd* v *Oppenheim***).
- Before a party gives reasonable notice there must be an unreasonable delay (***British and Commonwealth Holdings plc* v *Quadrex Holdings Inc.***).
- Reasonable notice can be given making time of the essence as soon as the contractual date for performance has passed (***Behzadi* v *Shaftesbury Hotels Ltd***).

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- Where time is of the essence in a contract then any delay will amount to repudiation of the contract (***Union Eagle Ltd* v *Golden Achievement Ltd***).
- Consumer Protection (Distance Selling) Regs 2000, reg 19 – 'unless the parties agree otherwise, contracts must be performed within 30 days, taking effect after the day in which the consumer sent his order to the supplier'.

Breach

- Occurs where a person fails to perform his side of the contract.
- A breach gives rise to a claim for damages, regardless of its severity.

Breach of primary obligation

- The innocent party may treat the contract as discharged where there has been a breach of a primary obligation of the contract.
- A primary obligation is often expressed as a condition.

Repudiation prior to performance of the contract

- Anticipatory breach: occurs when a party either expressly or impliedly, by words or conduct, indicates that he does not intend to honour his obligations under the contract.
  - Express anticipatory breach (***Hochester* v *De La Tour***).
  - Implied repudiatory breach (***Frost* v *Knight***).
- Burden of proof for anticipatory breach is beyond reasonable doubt (***Freeth* v *Barr***; ***Mersey Steel and Iron Co.* v *Naylor Benzon & Co.***).

The effects of breach

The right to affirm the contract

- An innocent party can elect to continue with the contract or to terminate it upon a breach.

The right to treat the contract as discharged

- The innocent party has the right to elect to accept the repudiation as discharging the contract with the result that all his future obligations under the contract come to an end.
- When the acceptance of the repudiation has been made, it is not possible to retract it.

The loss of the right to treat the contract as discharged

- NB: Sale of Goods Act 1979, s 11(4) – the buyer loses the right to repudiate the contract once he has accepted the goods.
- Section 35(1) states acceptance is 'when the buyer intimates to the seller that he has accepted them'.

Further reading

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Beatson, *Anson's Law of Contract*, 28th edn (Oxford University Press, 2002)

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Courtney, 'Termination of a Contract by a Party in Breach' (2008) 3 *Journal of Business Law* 226

Furmston, *Cheshire, Fifoot and Furmston's Law of Contract*, 15th edn (Oxford University Press, 2006)

Liu, 'Inferring Future Breach: Towards a Unifying Test of Anticipatory Breach of Contract' [2007] *Cambridge Law Journal* 574

Treitel, 'Affirmation After Repudiatory Breach' (1998) 114 *Law Quarterly Review* 22

Treitel, *The Law of Contract*, 11th edn (Sweet & Maxwell, 2003)

Visit **www.mylawchamber.co.uk/richards** to access study support resources including sample exam questions with answer guidance, multiple-choice quizzes, flashcards, an online glossary, live weblinks and regular updates to the law, *plus* the Pearson e-Text version of *Law of Contract* which you can search, highlight and personalise with your own notes and bookmarks.

Use Case Navigator to read in full some of the key cases referenced in this chapter with commentary and questions for comprehension:

Hadley* v *Baxendale (1854) 9 Exch 341
Hong Kong Fir Shipping Co. Ltd* v *Kawasaki Kisen Kaisha Ltd [1962] 1 All ER 474

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14

Discharge by agreement

Aims and objectives

After reading this chapter you should be able to:

- Recognise the differences between bilateral and unilateral discharge by agreement.
- Understand the forms of bilateral discharge of a contract.
- Know what is meant by 'accord and satisfaction'.

Introduction

The general rule here is that since contracts are created by agreement then they may be extinguished by agreement. The rule thus stated is simple, but while the parties may agree to extinguish the contract there is always the possibility of one of the parties reneging on the agreement and taking action against the other for breach of contract. It is therefore advisable for the parties to formulate their agreement in terms of a second contract supported by consideration. But if the agreement is contained in a deed then no consideration will be required, regardless of whether the **discharge** is **bilateral** (i.e. where the contract is wholly or partly executory) or **unilateral** (i.e. where the contract is wholly executed by one party, but not by the other). For the most part, however, it is rare for such an agreement to be encompassed within a deed. It is therefore necessary to examine the nature of the consideration needed in the formulation of an agreement which purports to discharge a legally enforceable contract.

While until now **discharge by agreement** has been expressed in terms of bringing the contract to an end, the principles apply not only where the parties are terminating the contract, but also where they are replacing it with a new one or simply varying the terms of the agreement.

Bilateral discharge

Accord and satisfaction

As has already been stated, where both parties have yet to carry out their obligations under the contract, either wholly or partially, then their respective promises must be

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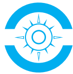
supported by consideration. This situation is often described by lawyers as '**accord and satisfaction**' – which is just mystical legal parlance for describing the need for new consideration to support the discharge agreement. It was explained in ***British Russian Gazette Ltd* v *Associated Newspapers Ltd*** [1933] 2 KB 616 by Scrutton LJ in the following terms:

> Accord and satisfaction is the purchase of a release from an obligation, whether arising under a contract or tort by means of any valuable consideration, not being the actual performance of the obligation itself. The accord is the agreement by which the obligation is discharged. The satisfaction is the consideration which makes the agreement operative.

The 'satisfaction' supplied by the parties must not be something less than what was required under the original contract, as indicated in ***Pinnel's case*** ((1602) 5 Co. Rep 117a), and must amount to sufficient consideration, which was examined in Chapter 3. In this context, however, special attention must be given to the case of ***Williams* v *Roffey Bros & Nicholls (Contractors) Ltd*** [1990] 1 All ER 512 since here a variation of the terms of the contract was enforceable despite the fact that the promise of the contractors was not supported by any consideration supplied by the plaintiffs, but by the contractors obviating a disbenefit that arose because of a further obligation to a third party. Since such consideration falls well short of what is normally regarded as consideration it may be that the law is moving away from such a doctrine, possibly towards a position whereby discharge by agreement will come to rely more on the use of promissory estoppel as a means of enforcing the agreement. The discussions that arise in and out of the case of ***Re Selectmove Ltd*** [1995] 2 All ER 531 should also be considered here.



For more on promissory estoppel refer to Chapter 3.

The form of discharge

Rescission and variation

Very often the problems relating to discharge revolve around the problems that arise because of the formalities required by certain types of contract. Thus it has been seen that certain contracts are required to be under seal, others to be evidenced in writing and yet others to be in writing. The rule here is that where it is intended to bring about the discharge of the contract there is no need to comply with the formalities required at law. The position is different, however, where it is intended not only to discharge the contract but also to substitute a new one since, in this situation, the formalities would have to be complied with, as indicated in ***Morris* v *Baron & Co***. [1918] AC 1.

When a contract is rescinded or varied different effects can arise. The point was considered in ***Compagnie Noga d'Importation et d'Exportation SA* v *Abacha*** [2003] EWCA Civ 1100 where Tuckey LJ stated that the essential difference between rescission and variation is that a contract comes to an end if it is rescinded but continues if it is varied. If the rescinded contract is replaced by a new agreement, even if the terms are the same, new consideration is required and if that is forthcoming there will be sufficiency of consideration to support the new agreement. It follows from this that the case of ***Stilk* v *Myrick*** (1809) 2 Camp 317 has no application since that decision is based upon continuing obligations under a former agreement. Thus if *X* agrees to sell his boat to *Y* for £10,000 and later they agree to tear up the contract or rescind it and replace the contract with one in which *X* agrees to sell the boat to *Y* for £8,000, then clearly there is a valid contract here. There is sufficiency of consideration in that the mutual release and the mutual promises in the new contract will be regarded as sufficient consideration to support the initial release (the rescission) and the new contract. The position is not the

For more on sufficiency of consideration refer to Chapter 3.

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same, however, if *X* and *Y* simply agree to alter the contract so that the price is £8,000 since here there is a possibility that the case of ***Stilk* v *Myrick*** (1809) 2 Camp 317 does have application and there is insufficient consideration to support the variation.

Waivers

The situation above is the position where the parties are entering into an agreement for their mutual advantage, but different considerations apply where the advantage is only to benefit one of the parties. Such a situation is termed a waiver and it normally arises where one party requests an alteration of the terms of the contract and the other party agrees not to insist on strict compliance with the terms of the contract, so, for example, allowing late delivery at the request of the other party. The difference between a waiver and a variation is that in the former no new contract is created; it is simply that one party is agreeing to forgo their strict legal rights. This fact points to the historical basis for the existence of waivers in that it was a method of evading the requirement of evidence in writing under the Statute of Frauds, since no new contract was being created. So desperate were the judges to avoid the effects of the Statute of Frauds that they made no attempt to justify how a purely gratuitous promise could be enforceable.

The enforcement of purely gratuitous promises in waivers still poses a conundrum for lawyers when they are attempting to justify their existence, and it is probably better simply to regard them as a form of promissory estoppel. In truth waivers are slightly wider in application than promissory estoppel, which normally requires the promisee to alter their position in reliance on the promise of the other party; such a requirement is not necessary in waivers.

The modern authority on waivers remains ***Charles Rickards Ltd* v *Oppenheim***.

Charles Rickards Ltd v *Oppenheim* [1950] 1 All ER 420

A chassis for a Rolls-Royce was ordered from the plaintiffs, who later also agreed to build a body for it in 'six to seven months'. At the end of seven months the body had not been completed and the defendant agreed to wait another three months. At the end of this period it was still not ready so the defendant gave notice that if it was not ready within four weeks he would cancel the order. At the end of this period the body was still not ready so the order was cancelled. The Court of Appeal held that he was entitled to do so since, even though he had waived the stipulation as to time of delivery, he had given reasonable notice of his intention to make time of the essence. Lord Denning commented:

> Whether it be called waiver or forbearance on his part, or an agreed variation or substituted performance, does not matter. It is a kind of estoppel. By his conduct he evinced an intention to affect their legal relations. He made, in effect, a promise not to insist on his strict legal rights. That promise was intended to be acted on, and was in fact acted on. He cannot afterwards go back on it.

In fact some authorities distinguish between waivers and promissory estoppel, considering that they are related but separate doctrines that produce the same effects. Such a difference of opinion can be seen in ***Brikom Investments Ltd* v *Carr*** [1979] 2 All ER 753.

Express provision for discharge

The parties may agree either expressly or impliedly in their contract that it will become discharged should certain circumstances arise. A common example would be where the

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parties have agreed that the operation of some condition subsequent will have the effect of discharging the contract.

Unilateral discharge

Unilateral discharge usually arises where one party has fully performed their obligations under the contract, the other party having yet to do so. The situation may arise, therefore, that the first party agrees to release the other from any obligations that are yet to be performed. The problem with this type of discharge is that it is purely gratuitous and unenforceable, unless it is made by deed.

Summary

This chapter deals with the discharge of contracts by agreement. The general rule here is that since contracts are created by agreement they may be extinguished by agreement.

Bilateral discharge

Accord and satisfaction

- Where both parties have yet to carry out their obligations under the contract, either wholly or partially, then their respective promises to discharge the contract must be supported by consideration.
- The 'satisfaction' supplied by the parties must:
  (i) not be something less than what was required under the original contract (***Pinnel's case***) and
  (ii) must amount to sufficient consideration.
- NB: The effect of ***Williams*** v ***Roffey Bros & Nicholls (Contractors) Ltd.***

The forms of discharge

Rescission and variation

- No formalities required to discharge the contract.
- NB: Formalities are required where a contract is to be discharged and a new one put in place (***Morris*** v ***Baron & Co***.).

Waivers

- Occur where one party requests an alteration of the terms of the contract and the other party agrees not to insist on strict compliance with the terms of the contract.

Express provision for discharge

- The parties may agree either expressly or impliedly in their contract that it will become discharged should certain circumstances arise.

Unilateral discharge

- Occurs where one party has performed his obligations under the contract, the other party having yet to do so.

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Further reading

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Furmston, *Cheshire, Fifoot and Furmston's Law of Contract*, 15th edn (Oxford University Press, 2006)

Treitel, *The Law of Contract*, 11th edn (Sweet & Maxwell, 2003)

Visit **www.mylawchamber.co.uk/richards** to access study support resources including sample exam questions with answer guidance, multiple-choice quizzes, flashcards, an online glossary, live weblinks and regular updates to the law, *plus* the Pearson e-Text version of *Law of Contract* which you can search, highlight and personalise with your own notes and bookmarks.

Use Case Navigator to read in full the key case referenced in this chapter with commentary and questions for comprehension:

Williams* v *Roffey Bros & Nicholls (Contractors) Ltd [1991] 1 QB1

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15 Discharge by frustration

Aims and objectives

After reading this chapter you should be able to:

- Understand what is meant by frustration in the discharge of a contract.
- Know the modern development of the doctrine.
- Understand that the modern test is based on a radical change of obligations under a contract and be able to distinguish this from a radical change in circumstances.
- Know and apply the different applications of the doctrine.
- Identify the factors that affect the operation of the doctrine.
- Explain the legal efects of the doctrine both at common law and under the Law Reform (FrustratedCon tracts)Ac t 1943.

Introduction

It has already been seen in relation to the discharge of contracts by performance that the overriding principle is that compliance with the terms of a contract is strict. This principle, however, would be grossly unfair if a promisor becomes liable for breach of contract because they are prevented from performing their side of a bargain by the occurrence of some unforeseeable event that is beyond their control. In such circumstances the law provides the promisor with the excuse that the contract has become frustrated.

Frustration is really an expression indicating that the contract, once entered into, has subsequently become impossible to perform, as opposed to the doctrine of initial impossibility in relation to mistake as discussed in Chapter 10. The effect of frustration being proved is dramatic and radical, in that it brings about the immediate and automatic end to the contract, releasing the parties from the need to perform their obligations under it.

Originally supervening events that were beyond the control of either party had no effect on the obligations of the parties to perform their side of the contract, as we see in the case of ***Paradine* v *Jane*** (1647) Aleyn 26. Once the doctrine began to emerge, however, such was its radical impact on the contract that the courts strove to confine it within narrow limits. This confinement of the doctrine operated at two levels. First, the courts would only allow frustration to be used as a defence to an action for breach of

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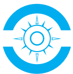
contract where the supervening event destroyed a fundamental assumption on which the contract was based. Second, the courts recognised that contracts themselves could provide for the consequences of the occurrence of such an event. The second point gave rise to so-called ***force majeure* clauses** that businessmen commonly began to draft into their contracts in order to restrict the effects of a frustrating event.

The development of the modern doctrine

Just as businesspeople could insert in their contracts express provisions dealing with frustrating events, the courts were empowered to imply terms into contracts, as we have already seen in Chapter 7. In the nineteenth century the principles of freedom of contract and equality of bargaining power were very much in vogue, with the result that the courts were most reluctant to imply terms into contracts, though they could be persuaded to do so where the gravity of their failure to intervene would produce serious consequences. It should be recalled, however, that this intervention was not made on the basis of judicial intervention but on the fiction that they were giving effect to the unexpressed wishes or intentions of the parties.

The ability of the courts to imply terms into contracts produced the breakthrough that was needed in order to develop the modern doctrine of frustration. The case which produced this result was ***Taylor* v *Caldwell***.



Taylor v *Caldwell* (1863) 3 B & S 826

In this case the defendant agreed to hire a music hall to the plaintiff. After the contract was made, but prior to the day of the first concert, a fire broke out, completely destroying the music hall. By this time the plaintiffs had made extensive arrangements with regard to the productions they intended to perform. The loss of the music hall meant that their concerts had to be cancelled, resulting in substantial financial loss to the plaintiffs. The contract contained no express provisions dealing with this eventuality so the plaintiffs sued for non-performance of the contract in order to recover their losses. The defendants pleaded the destruction of the music hall through no fault of their own as a defence.

The court upheld the defence of the defendants, deciding that the principle contained in ***Paradine* v *Jane*** was confined to positive contracts. The contract in ***Taylor* v *Caldwell*** was found not to be a positive contract, where performance was guaranteed, but one that was subject to an implied condition that the hall would continue to exist until performance was due. Thus Blackburn J stated the position to be:

> that, in contracts in which performance depends on the continued existence of a given person or thing, a condition is implied that the impossibility of performance arising from the perishing of the person or thing shall excuse the performance. In none of these cases is the promise in words other than positive, nor is there any express stipulation that the destruction of the person or thing shall excuse the performance; but that excuse is by law implied, because from the nature of the contract it is apparent that the parties contracted on the basis of the continued existence of the particular person or chattel.

From this basis the doctrine of frustration began to expand, though it always relied on the basis of an implied term because of the continued fiction of equality of bargaining power. Eventually the implied term became almost as fictitious as the principle it sought to avoid, so wide was its area of application.

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The fictitious nature of the implied term was discussed in ***Davis Contractors Ltd* v *Fareham UDC*** [1956] 2 All ER 145, in which both Lord Reid and Lord Radcliffe expressed dissatisfaction with the concept. Lord Radcliffe in particular thought that it was clearly illogical to imply a term into a contract. He stated:

> there is something of a logical difficulty in seeing how the parties could even impliedly have provided for something which, *ex hypothesi*, they neither expected nor foresaw.

The falsehood of the implied term concept is clearly exposed here, since in such circumstances it would be impossible to apply that other peculiar fiction in this area – the officious bystander test – since this relies, as expressed in ***Shirlaw* v *Southern Foundries (1926) Ltd*** [1939] 2 KB 206, on the parties reacting with an 'Oh, of course' to the suggestion that a particular term be contained in the contract. If the parties could not possibly have expected or foreseen the implied term expressed in ***Taylor* v *Caldwell***, then it stands to reason they cannot fall within the officious bystander test.

For more on the 'officious bystander' test refer to Chapter 7.

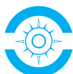
This obvious inconsistency led both Lord Reid and Lord Radcliffe to find for some other basis for a doctrine of frustration. Lord Reid expressed this basis in the following terms:

> It appears to me that frustration depends, at least in most cases, not on adding any implied term but on the true construction of the terms which are, in the contract, read in the light of the nature of the contract and of the relevant surrounding circumstances when the contract was made.

Lord Radcliffe stated this position more fully:

> So, perhaps it would be simpler to say at the outset that frustration occurs whenever the law recognises that, without default of either party, a contractual obligation has become incapable of being performed because the circumstances in which performance is called for would render it a thing radically different from that which was undertaken by the contract.

Thus both Lord Reid and Lord Radcliffe stepped outside the concept of the implied term perpetuated by ***Taylor* v *Caldwell*** and found that the modern doctrine of frustration should be based on an objective rule within the law of contract that arose independently of the intentions of the parties, as formulated in cases such as ***Shirlaw* v *Southern Foundries Ltd***. It may, of course, still be possible to base the application of frustration on an implied term today, but here it will arise as a term implied by law, an application of which was seen in ***Liverpool City Council* v *Irwin*** in Chapter 7, where the intentions of the parties also have no relevance. Lord Wilberforce in ***National Carriers Ltd* v *Panalpina (Northern) Ltd*** [1981] AC 675 was most reluctant to repudiate the continued existence of the implied term basis, preferring to think of it as having merged into the modern test and remaining almost dormant until the circumstances require its use.



The modern test is often expressed as a 'radical change in obligations' or a 'construction' test. The court is required to construe the contract in the light of its nature and surrounding circumstances so that the obligations of the parties can be determined. Once this has been done the court is then able to assess whether the obligations of the parties have changed because of the subsequent supervening events.

It should be noted carefully that it is not a radical change in circumstances that triggers the operation of the doctrine of frustration but a radical change in the obligations of the parties under the terms of the contract as construed by the court. As Lord Radcliffe pointed out in the ***Davis Contractors*** case:

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> it is 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.

Similarly, Lord Simon, in the ***National Carriers Ltd*** case, stated the test to be:

> Frustration of a contract takes place when there supervenes an event (without default of either party and for which the contract makes no sufficient provision) which so significantly changes the nature (not merely the expense or onerousness) of the outstanding contractual rights and/or obligations from what the parties could reasonably have contemplated at the time of its execution that it would be unjust to hold them to the literal sense of its stipulations in the new circumstances; in such a case the law declares both parties to be discharged from further performance.

Before we see how the doctrine of frustration has been applied in various types of situation, it should be noted that the test amounts to a question of law, not fact, even though the issue of fact heavily overlays the considerations of the court.

Applications of the doctrine of frustration

It is not possible to discuss all the circumstances in which the doctrine of frustration applies since these are obviously innumerable, but it is possible to identify certain typical situations which cover most of the situations in which the doctrine has arisen.

Destruction and unavailability of the subject matter of the contract

Clearly this is the most obvious situation, an example of which has already been seen in ***Taylor* v *Caldwell*** above. The death of an individual on whom the execution of the contract depends would present another example.

A similar situation also arises where the subject, though not destroyed, ceases to be available for the purposes of the contract. To a large degree the finding of frustration here revolves around the period of unavailability. If this is only a short time then the courts might well determine that the contract still subsists, such a finding becoming less predictable the longer the period of unavailability. So, for instance, the absence of an artiste from a show for one night because of illness would almost certainly not frustrate the contract, while an absence of several weeks would. It is easy to see here how it is important for the courts to construe the contract in the light of its nature and circumstances before deciding the issue of frustration. In situations like that in the example above, the length of the overall contract balanced against the period of illness is of major consideration by the court. A case displaying a particular problem in this respect is that of ***Condor* v *The Barron Knights Ltd***.

Condor v *The Barron Knights Ltd* [1966] 1 WLR 87

A contract relating to a member of a pop group contemplated that he would be able to work seven evenings a week, should this work be available. The member fell ill and was advised to work only a limited number of nights a week. In fact he ignored this advice since he considered himself sufficiently well to work to the contract, and he did so. The court nevertheless held the contract to be frustrated because it was possible that the member's

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health could have broken down at any time, and therefore it was necessary to employ another musician to be available to take the regular member's place should this event occur. This was, however, impracticable since it meant that the group had to rehearse twice, in order to prepare the reserve member of the group should he be needed.

The unavailability of the subject matter of the contract does not, however, always cause a contract to be frustrated. An example of this can be seen in the case of ***CTI Group Incorporated* v *Transclear SA, The Mary Nour*** [2008] EWCA Civ 856, where the Court of Appeal held that if a supplier decided not to make unascertained goods available for shipment, thereby making performance by the seller of goods to the buyer impossible, this is not of itself sufficient to frustrate the contract. The court's decision was based on the earlier case of ***Blackburn Bobbin Co. Ltd* v *Allen and Sons Ltd*** [1918] 2 KB 467, in which there was a contract whereby the defendants contracted to sell to the claimants Finnish timber. On the outbreak of the First World War, the defendants' source of the timber was cut off. The claimants themselves were not aware that the timber was imported into the United Kingdom and that no stacks were held here. The Court of Appeal held that there was no operable frustrating event since only the seller was concerned about the source of supply. Basically, the seller took the risk of his source of supply being available to perform his contract. These decisions also tie in nicely with the concept that it is not a radical change of circumstances that triggers the doctrine of frustration but a radical change in the obligations of the parties under the terms of the contract, as already examined in ***Davis Contractors Ltd* v *Fareham UDC*** [1956] 2 All ER 145.

It should be noted, however, that in both of these case the contracts consisted of unascertained goods. The position may not be the same if a contract had been for specific goods since in this case the contract would normally have been entered into on the common assumption of the parties that the goods would be available and that this would have been fundamental to the existence of the contract.

Non-occurrence of an event central to the contract

It may happen that while it may be physically possible to carry out the contract, the non-occurrence of an event specified in the contract, on which the contract is based, renders the contract pointless. The question that arises here is whether the non-occurrence renders the object of the contract defeated and thereby frustrated. One has to distinguish here between the situation where the specified event amounts to the object of the contract and that where it amounts merely to the motive for entering into the contract in the first place.

The distinction between object and motive is clearly seen in the so-called 'Coronation cases' of ***Krell* v *Henry*** and ***Herne Bay Steamboat Co.* v *Hutton***.

Krell v *Henry* [1903] 2 KB 740

The plaintiff hired a flat to the defendant for 26 and 27 June 1902. The defendant intended to use the flat in order to watch and celebrate the coronation procession of Edward VII which would pass by the flat. No mention of this purpose was made in the contract. A prepayment of one-third of the rent was made. Due to the sudden illness of the King the coronation procession was cancelled and the defendant refused to pay the balance of the rent owing. It was held that the plaintiff could not recover these moneys since the contract

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had been frustrated by the cancellation of the procession. The court found that the procession and the position of the flat formed the objective of the contract which was thus frustrated and discharged as a result.

Herne Bay Steamboat Co. v *Hutton* [1903] 2 KB 683

The defendant hired a motor launch for 28 and 29 June 1902 for the purpose of seeing the coronation naval review of the fleet at Spithead and allowing the passengers themselves the opportunity of touring the fleet. Again the review was cancelled because of the King's illness, though the fleet remained at Spithead. It was held that the defendant was bound by the contract which had not been frustrated by the cancellation of the review. The coronation review was held not to be the object of the contract but merely the motive for the hiring of the motor launch on these dates. The court based its decision on two grounds. First, it was still possible for the tour of the fleet to take place and, second, since the defendant intended to charge the passengers for the trip it was his venture and therefore he should bear the risks inherent in the venture.

Inability to comply with specified manner of performance

In commercial contracts it is common for the contract to require a party to carry out the terms of the contract in a particular manner, and if it should become impossible to comply with that specified manner then the contract will be frustrated. A distinction is made between mandatory stipulations and those which merely express an expected manner of performance. In the latter any supervening events that occur and prevent such an expected manner of performance rarely have the effect of rendering the contract frustrated.

Thus in 1956 and 1967 the closing of the Suez Canal meant that ships had to be diverted around the Cape of Good Hope in order to reach India and the Far East. This diversion obviously meant that extra costs were incurred by the shipping companies, which therefore sought to have their contracts set aside for frustration in order that they could renegotiate their freight contracts. In a number of cases, like that of ***Tsakiroglou & Co. Ltd*** v ***Noblee Thorl GmbH*** [1962] AC 93 and ***The Eugenia*** [1964] 1 All ER 161, the courts held that the contracts were not frustrated since, while the shipowners had contemplated moving their ships through the Suez Canal when pricing their freight rates, such a manner of performance of the contract was not stipulated within the contract. The fact that their costs had increased substantially over what had been contemplated did not help the shipowners since, if we recollect the words of Lord Radcliffe in the ***Davis*** case, 'it is not hardship or inconvenience or material loss itself which calls the principle of frustration into play'.

Unavailability

It is clear that a delay in performing the contract caused by some supervening event may also frustrate the contract. Cases that arose out of the Gulf War between Iran and Iraq (1980–8) produce an example, where ships became trapped in the Gulf by virtue of hostilities there. Of course the degree of delay is important but in cases like those of ***The Evia*** [1983] 1 AC 736, ***The Agathon*** [1982] 2 Lloyd's Rep 211, ***The Wenjiang (No 2)*** [1983] 1 Lloyd's Rep 400 and ***Finelvet AG*** v ***Vinava Shipping Co. Ltd***, the ships were confined for such long periods that the contracts were found to be frustrated.

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Finelvet AG v *Vinava Shipping Co. Ltd* [1983] 2 All ER 658

The ship was a time-chartered ship which became trapped on 22 September 1980. However, the court upheld the decision of the arbitrator to find that the contract was frustrated, not on this date, but on 24 November 1980. The reasoning was that at the earlier date expert opinion considered that the war would be quickly won by Iraq, thereby reducing the period of confinement. At the time of the later date the expert opinion had changed to that of anticipating a protracted war, which clearly resulted in the contract being frustrated. The courts thus have to balance the length of time of the charter with the temporary unavailability of the vessel caused by the frustrating event. In the case of ***Pioneer Shipping Ltd* v *BTP Tioxide Ltd, The Nema*** [1981] 2 All ER 1030, a time charter envisaged that during a nine-month period the vessel would be able to make six or seven voyages. In fact a strike at the port where the ship was being loaded meant that the number of voyages within the contract period was reduced to two. It was held that the contract was frustrated since the degree to which the contract was capable of performance was inordinately small compared to that contracted for. Lord Wright stated the position:

> If there is a reasonable probability from the nature of the interruption that it will be of an indefinite duration, they ought to be free to turn their assets, their plant and equipment and their business operations into activities which are open to them, and to be free from commitments which are struck with sterility for an uncertain future period.

One difficulty with frustration in such instances is when can one treat the contract as discharged? The delay or unavailability of the subject matter might be for a short period or a long period, but of course one does not know which. In such a situation it is possible for the courts to wait and see in order to determine the possible length of unavailability, either as a matter of fact or as a matter of inference by reference to all the circumstances surrounding the contract and the frustrating event, as we saw in the ***Finelvet*** case above.

Supervening illegality

It occasionally happens that once a contract has been entered into, the law, quite independently, may move to the position that the performance of contracts of the type entered into is illegal. The position here was simply and cogently put by Lord Macmillan in ***Denny, Mott and Dickson Ltd* v *James B Fraser & Co. Ltd*** [1944] 1 All ER 678. He stated: 'It is plain that a contract to do what it has become illegal to do cannot be legally enforceable.' Thus if a contract is made to ship goods to a country and it subsequently becomes illegal to import such goods then the contract becomes frustrated.

The problem of frustration in leases

The particular problem that arises with frustration in leases is that when a tenant takes a lease over property they are acquiring an estate in land that persists even if the building rented is completely destroyed by, for instance, fire or bomb damage or is completely demolished by a heavy goods vehicle. The logic is correct since, while the layperson may think in terms of renting a house, flat, warehouse or factory, the lawyer knows that one is actually leasing the land, the rent that is paid reflecting the length of the lease, the type of property and its position and location. The result is that even if the building is completely destroyed, one still has to pay the rent *on the land* leased, regardless of the fact

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that it merely comprises a burnt-out shell or a hole in the ground. Evidence of this state of affairs lies in the fact that when one purchases a house, for instance, it is well established that the purchaser should take out building insurance from the time the contracts are signed and exchanged, since the risk in the property passes to them at that point. Is it possible, however, to claim that the lease has been frustrated by the occurrence of such an event?

Cricklewood Property & Investment Trust Ltd v *Leighton's Investment Trust Ltd* [1945] AC 221

In this case, a plot of land was let in 1936 to the lessees for 99 years in order that they could build shops on the property. Before the lessees could begin construction the war broke out and the government subsequently passed regulations restricting such development. The effect was that the lessees could not build the shops they had covenanted to do and they thus claimed that the lease was frustrated. The House of Lords held that the doctrine of frustration did not apply, basing their decision in terms more appropriate to unavailability, as outlined above, in that the restrictions would only delay building for a comparatively short period when balanced against the full extent of the 99-year lease. Their Lordships were of divided opinions as to whether frustration could ever apply to leases. Lord Simon and Lord Wright considered it could, but only in the rather extreme circumstance where the land is engulfed by the sea. Lord Russell and Lord Goddard considered that frustration could never apply, while Lord Porter declined to express an opinion.

The position not to allow frustration in leases is, however, more than just a little illogical since if one rents a property for a particular purpose then surely if that purpose becomes impossible the doctrine should apply. Certainly frustration does exist in the case of a contractual licence to hold land since it was fully accepted in the case of ***Krell* v *Henry***, where the contract to rent a room for the coronation procession was held to be frustrated when the procession was cancelled. From here the argument can be taken to the point that the law would have to make a distinction between a legal lease and an equitable lease. The latter takes effect as a contract to grant a lease under the doctrine of ***Walsh* v *Lonsdale*** (1882) 21 ChD 9, and it could therefore be discharged by frustration, while a legal lease could not be.

The issue relating to frustration and leases would seem to be now decided by the case of ***National Carriers Ltd* v *Panalpina (Northern) Ltd*** [1981] AC 675 where the House of Lords decided that frustration could apply to leases. They expressed the view, however, that its occurrence would be rare and probably confined to the situation where there was a joint intention that the property was to be released for a particular purpose, and that the purpose had become impossible because of events beyond the control of the parties. Lord Wilberforce stated:

> if the argument is to have reality, it must be possible to say that frustration of leases cannot occur because in any event the tenant will have that which he bargained for, namely, the leasehold estate. Certainly this may be so in many cases . . . But there may also be cases where this is not so. A man may desire possession and use of land or buildings for, and only for, some purpose in view and mutually contemplated. Why is it an answer, when he claims that this purpose is 'frustrated' to say that he has an estate if that estate is unusable and unsaleable? In such a case the lease, or the conferring of an estate, is a subsidiary means to an end, not an aim or end of itself.

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The result in the case, however, was that a lease for a warehouse which had four and a half years to run was not frustrated by a street closure order that prevented the warehouse from being used for 18 months.

Factors affecting the operation of the doctrine

Self-induced frustration

It has been seen that the basis of frustration lies in the fact that it amounts to a supervening event that is beyond the control of the parties to the contract. It follows therefore that if the event arises out of the actions of a party to the contract then the doctrine cannot be relied on.

Maritime National Fish Ltd v *Ocean Trawlers Ltd* [1935] AC 524

In this leading case, the appellants chartered a trawler from the respondents. The trawler was fitted with a type of net called an 'otter trawl', the use of which was illegal without a licence from the Canadian government, both the parties being aware of this fact. The appellants had four other trawlers all fitted with the same type of net. They applied for five licences but in fact were awarded only three. They had to stipulate to which trawlers the licences applied. The appellants nominated three of their own trawlers and then claimed that their charter of the trawler belonging to the respondents was discharged for frustration on the basis that no licence was forthcoming for that vessel. It was held, by the Privy Council, that their claim would fail since they could have nominated the vessel in question to have one of the licences but had declined to do so. The result was that the appellants had control of the supervening event and therefore frustration could not be relied upon as discharging the contract. Their claim was thus rejected.

The question of choice that arose in the case above with regard to the supervening event was again considered by the Court of Appeal in ***J Lauritzen AS*** **v** ***Wijsmuller BV***.

J Lauritzen AS v *Wijsmuller BV* [1990] 1 Lloyd's Rep 1

In this case the plaintiffs needed to transport a drilling rig from Japan to Rotterdam. The defendant possessed two specialist transportation systems capable of performing this task, *Super Servant One* and *Super Servant Two*. The contract was open as regards which vessel could be used, though the choice of vessel rested with the defendants. In fact, although they did not mention this to the plaintiffs at the time, the defendants intended to use *Super Servant Two* for the task and allocated other tasks to the sister ship. *Super Servant Two* sank some six months before the contract was to be performed. The defendants claimed that the contract was frustrated. The plaintiffs contested this application, stating that the contract would still have been capable of being carried out but for the decision of the defendants to allocate *Super Servant One* to other tasks. The supervening event thus lay in the hands of the defendants. The Court of Appeal held that the contract was not frustrated since the loss of a vessel to the contract was due to the actions of the defendants, even if they were neither negligent nor in breach of contract.

Where the supervening event arises because of the negligent actions of one of the parties then again frustration will not be deemed to have arisen. To take an example,

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if the music hall fire in ***Taylor* v *Caldwell*** had arisen because of a negligent act by the owners, then they could not have pleaded frustration and would have been liable for breach of contract. Negligent actions per se will not prevent frustration from arising since the onus of proving the existence of frustration lies on the party seeking to rely on the doctrine as a means of discharging their contractual obligations.

Frustration expressly provided for in the contract

The parties may make provision for what is to happen should a particular supervening contingency occur. These clauses are the so-called *force majeure* clauses mentioned earlier. If the clause, as a matter of construction, deals with the event that has occurred, then the courts will not deem that the contract has been frustrated. The clause must be capable of dealing with any form that the contingency may take, no matter how serious, otherwise it will not prevent the operation of the doctrine of frustration. In ***Jackson* v *Union Marine Insurance Co. Ltd*** (1874) LR 10 CP 125, a ship was chartered to sail 'with all possible despatch' from Liverpool to Newport to pick up a cargo and then to proceed to San Francisco 'dangers and accidents of navigation excepted'. The ship ran aground one day out from Liverpool. The repairs took eight months to complete, during which time the charterers repudiated the contract. It was held that despite the *force majeure* clause the contract was still frustrated. Undoubtedly the clause took account of the contingency that had occurred but it was not designed to cover damages and delay of such an extensive nature. It was considered that if the contract had been upheld and a voyage to San Francisco had taken place the venture would have been entirely different commercially.

The legal effects of the doctrine of frustration

The general rule

In Chapter 13 it was seen that where there is a breach of contract the injured party has to elect whether to treat the contract as discharged by the breach or not. Such discretion does not arise in the case of discharge by frustration since, as was pointed out by the House of Lords in ***Hirji Mulji* v *Cheong Yue Steamship Co.*** [1926] AC 497, the effect of frustration is to bring about the automatic termination of all obligations incurred under the contract. In turn the effect of automatic dissolution of the contract at common law is to produce fundamental and often harsh repercussions on the parties to the contract.

The effect of frustration at common law

The effect of frustration at common law was that from the date of the supervening event the parties were released from all future contractual obligations. Any obligations that had already arisen under the contract had to be performed. This position is well illustrated by the case of ***Chandler* v *Webster***.

Chandler v *Webster* [1904] 1 KB 493

In this case the defendant agreed to let a room to the plaintiff for £141 for the purpose of viewing the coronation procession. The cost of the hire was payable immediately but in fact the plaintiff paid only £100 in advance. Before he paid the balance the procession was

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cancelled and the contract frustrated as a result. It was held that the plaintiff could not recover the £100 but additionally he was also liable to pay the balance since the obligation to pay this had already accrued prior to the supervening event. Counsel argued that he could recover the £100 in quasi-contract (*see* Chapter 18, below) in that there had been a total failure of consideration. The Court of Appeal, however, held that this line of argument could not be sustained since the effect of frustration was not to discharge the contract *ab initio* but only from the time of the supervening event, and there was no *total* failure of consideration.

It is useful to compare the effects of frustration in the ***Chandler*** case with the case of ***Krell* v *Henry*** since in the latter case the obligation to pay had not accrued at the time of the supervening event. The result here was that the defendant hirer of the room was not obliged to pay anything – all his future obligations ceased to exist at the time of cancellation.

The decision in the ***Chandler*** case that the 'loss lies where it falls' clearly could produce extremely harsh consequences for the parties. The position was no less satisfactory for the reason that the effects on the parties were completely unpredictable and it was largely a matter of luck as to whether one walked away from the situation unscathed or not. The decision was, however, overruled by the House of Lords in ***Fibrosa Spolka Akcyjna* v *Fairbairn Lawson Combe Barbour Ltd***.

Fibrosa Spolka Akcyjna v *Fairbairn Lawson Combe Barbour Ltd* [1943] AC 32

In this case the appellants ordered some machinery from the respondents for delivery to their factory in Poland, paying £1,000 in advance by virtue of the terms of the contract. In 1939 Germany invaded Poland and the contract became frustrated. The London agent for the appellants asked for the return of their £1,000 but the respondents refused on the basis that a substantial amount of time and money had already been expended on the order.

Clearly on the basis of the ***Chandler*** case the £1,000 would have been irrecoverable, but the House of Lords allowed the claim, which of necessity was based in quasi-contract since the contract had ceased to exist by virtue of the supervening event. The House of Lords decided that there had been a total failure of consideration, overruling the ***Chandler*** decision. The appellants had not received anything under the contract they had bargained for and could thus recover the moneys they had paid.

In fact the decision is really no less unsatisfactory than that of the ***Chandler*** case, perhaps even more so in some circumstances. Parties in the position of the respondents could, just as in the case itself, have incurred considerable expenditure in preparing the subject matter of the contract only to find that they would receive no recompense for the time and money put into fulfilling the order. To add insult to injury they might also be left with a product that was so specialised as to be unsaleable to anyone else. Such a sale would have provided them with some degree of return on the energy expended on the contract. Indeed it is very likely because of these last two points that the deposit was charged in the first place so as to underwrite the expenses to be incurred in preparing the subject matter of the contract. In truth the House of Lords had merely shipped the burden of the effects of frustration from one party to the other. The continued unsatisfactory nature of the law led to the passing of the Law Reform (Frustrated Contracts) Act 1943.

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Law Reform (Frustrated Contracts) Act 1943

The operation of this Act is confined to circumstances where a contract is frustrated, although it has no effect on the decision as to whether the contract has been frustrated or not but merely deals with the consequences of frustration. The Act seeks to regulate, first, the recovery of moneys paid or payable under the contract; second, compensation payable for expenses incurred in the performance of the contract; third, the financial readjustment of the parties where one has received a valuable benefit under the contract in the absence of any prepayment.

Recovery of money paid

The position here is enacted by s 1(2) as follows:

> All sums paid or payable to any party in pursuance of the contract before the time when the parties were so discharged (in this Act referred to as 'the time of discharge') shall, in the case of sums so paid, be recoverable from him as money received by him for the use of the party by whom the sums were paid, and, in the case of sums payable, cease to be so payable.
>
> Provided that, if the party to whom the sums were so paid or so payable incurred expenses before the time of discharge in, or for the purpose of, the performance of the contract, the court may, if it considers it just to do so having regard to all the circumstances of the case, allow him to retain or, as the case may be, recover the whole or any part of the sums so paid or payable, not being an amount in excess of the expenses so incurred.

Two effects are immediately discernible from the provision. First, the decision in ***Fibrosa*** is confirmed in that moneys paid are recoverable despite the absence of a total failure of consideration; at the same time any moneys that are owed cease to be payable. Second, the provision regulates the position of the payee, that is, the respondents in the ***Fibrosa*** case, since the court now has a discretionary power to award them a sum in respect of any expenses incurred by the payee in the performance of the contract prior to the discharge of the contract. It should be noted that the payee will not get their expenses but only what the court considers to be a just sum having regard to the circumstances of the case, and in any event this will be no more than their actual expenses. An application of these principles can be seen in ***Gamerco SA* v *ICM/Fair Warning (Agency) Ltd*** [1995] 1 WLR 1226, where it was stated that where a contract is frustrated a plaintiff is entitled to recover payments made in advance by virtue of s 1(2), although the proviso gives the court a wide discretion to make a deduction to offset the defendant's expenses incurred prior to the time of discharge, or for the performance of the contract. It was stated that the court is not obliged to incline towards total retention by a defendant of the sums paid, nor is the court obliged to consider that the loss be equally divided between the parties.

Financial readjustment where a valuable benefit is conferred

The position here is governed by s 1(3) as follows:

> 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 –

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(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.

BP Exploration Co. (Libya) Ltd v *Hunt (No 2)* [1979] 1 WLR 783 (decision affirmed by the House of Lords [1983] 2 AC 352)

This is the leading case on the operation of s 1(3). The facts of the case were that there was a contract between BP and Hunt for the exploration and, ultimately, the exploitation of an oil concession in Libya that was held by Hunt. BP's part of the contract was that they were to get a half-share in the concession, but that they were to provide the finance and conduct the exploration work, though their expenses would be recoverable at a rate of three-eighths of Hunt's share should oil be found until 125 per cent of their initial expenses had been recouped. In fact a large oil field was discovered and in 1967 it came on stream. In 1971 Libya expropriated Hunt's concession with the result that the contract between BP and Hunt became frustrated. At this point BP had recovered only a proportion of their expenses and thus brought an action based on s 1(3) of the 1943 Act.

Robert Goff J decided that in the method of assessing the claim under s 1(3) regard had to be paid, first, to identifying and valuing any benefit obtained and, second, to assessing what would be a just sum. In accordance with s 1(3) this sum could not exceed the valuation placed on the valuable benefit. Goff J stated that the valuable benefit should not be assessed on what had been paid out by BP in the exploration work but on the benefit received by Hunt. Hunt's benefit amounted to the value by which his concession had been enhanced but this had to be reduced, because of the effect of s 1(3)(b), by the diminution to the value of the concession caused by the expropriation. On this basis the valuable benefit obtained by Hunt amounted to the value of the oil he had received plus the amount of compensation awarded to him by the Libyan government for the expropriation. The court, however, took into account that half of this benefit was attributable to BP's efforts, and thus the valuable benefit obtained by Hunt amounted to $85 million.

Turning to the question of assessing what would be a just sum, Goff J decided that this should be calculated on the basis of what BP had actually spent on developing the concession, namely, $87 million, plus any moneys paid to Hunt, that is, $10 million, less expenses actually recovered, that is, $62 million. On this basis the just sum was $35 million and it was this figure that was recoverable by BP in full, since it did not exceed the figure for the assessment of the valuable benefit, which by s 1(3) would otherwise have restricted the amount recoverable for the just sum.

That the provision goes some way towards correcting the inequities that existed prior to the Act cannot be doubted, but the Act itself contains defects. The subsection allows recovery only where a party has received a valuable benefit which has been obtained 'before the time of discharge'. Thus, if the expropriation had taken place prior to any financial reward arising from the concession, for instance in the form of profits from oil, BP could not have recovered anything under s 1(3) since there would have been no valuable benefit. That this is the effect of s 1(3) is not open to doubt, but very serious flaws appear in Goff J's reasoning where a party receives a valuable benefit but this is destroyed by the frustrating event. Such a situation did not arise in the ***BP*** v ***Hunt*** case since the valuable benefit had already accrued to Hunt at the time of the expropriation.

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If, however, one takes a case such as ***Appleby* v *Myers*** (1867) LR 2 CP 651 the defect becomes quickly apparent. In this case the plaintiffs had contracted to install machinery in the defendant's factory, and the defendant was to pay when the installation was complete. When some of the machinery had been installed a fire broke out, completely destroying the factory and the machinery. It was held that the contract had been frustrated. If the plaintiffs attempted to sue under s 1(2) they would receive nothing since no money was payable at the time of the frustrating event and all that they could hope to recover would be an amount for expenses.

If the plaintiff had attempted to claim under s 1(3) in respect of a valuable benefit being obtained by the defendant, he would be met by the argument that the frustrating event had destroyed this and therefore no valuable benefit accrued to the defendant in respect of which a just sum may have been recoverable in the discretion of the court. This is the position adopted by Goff J in his interpretation of s 1(3)(b). His view was that if 'the effect . . . of the circumstances giving rise to frustration of the contract' (s 1(3)(b)) was to destroy the valuable benefit then nothing could be recovered for this. This interpretation has been widely criticised both by academic lawyers in the United Kingdom and judicially in a number of Commonwealth decisions and it is certainly wrong. A cursory glance at s 1(3) indicates that the court has to assess the level of the valuable benefit before the frustrating event, that is, 'where any party . . . obtained a valuable benefit . . . before the time of the discharge'. Furthermore, s 1(3)(b) itself clearly indicates that the valuable benefit must first be assessed and then the court must consider the effect of the frustrating event, that is, 'the effect, in relation to the said benefit, of the circumstances giving rise to frustration'. The interpretation given by Goff J here is unnecessarily restrictive and it may be that his approach has been to regard the Act not as an attempt to apportion losses but as an attempt to prevent undue enrichment – and this was certainly not the original aim of the Act. Unfortunately the decision has been affirmed by the House of Lords, subject to one or two minor adjustments, and thus one will have to wait until their Lordships have the opportunity of reviewing the position in which ***BP* v *Hunt*** has placed the law.

A summary of the impact of the Law Reform (Frustrated Contracts) Act 1943

Effects of Section 1(2)	
Money paid ⟶	Recoverable
Money payable ⟶	Ceases to be payable
Expenses incurred in the performance of the contract may be recovered at the discretion of the Court	
Effects of Section 1(3)	
Any benefits obtained may have to be paid for – the court has discretion to award a 'Just Sum'. In the exercise of discretion the court will consider: (a) Whether benefited party has incurred expenditure to obtain benefit. (b) Whether the benefit has been reduced by the frustrating event.	
BP Exploration Co. (Libya) Ltd* v *Hunt (No 2) [1979] 1 WLR 783; [1983] 2 AC 352	

Contracts falling outside the Act

Certain contracts fall outside the ambit of the Act. Thus s 2(3) allows the parties to contract out of its provisions where they have made express provisions regarding the effect of a frustrating event on the contract.

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By virtue of s 2(4) the Act does not apply to those parts of a severable contract that have been wholly performed prior to the frustrating event. For example, if there is a contract for the installation of two machines, payment being effected when each machine is installed, and a fire breaks out that completely destroys the factory, the Act will not apply in respect of the machine that is installed and paid for. In respect of the second, partially installed machine the Act will apply and the plaintiff may succeed if the other party receives a valuable benefit, if any, in recovering a just sum for that benefit in the discretion of the court.

By s 2(5)(a) and (b) the provisions of the Act do not apply to any charterparty (except a time charterparty), carriage of goods by sea or any contract of insurance. The apparent reason for these exceptions is that they are largely concerned with the apportionment of risk themselves and should therefore lie outside the Act.

By s 2(5)(c), contracts falling within s 7 of the Sale of Goods Act 1893 (now s 7 of the Sale of Goods Act 1979), which renders void any agreement to sell specific goods whereby, without any fault on the part of the seller or buyer, the goods perish before the risks pass to the buyer, are excluded from the provisions of the 1943 Act. This exclusion is more general and does not relate only to s 7 since s 2(5)(c) also states that 'any other contract for the sale, or for the sale and delivery, of specific goods, whereby the contract is frustrated by reason of the fact that the goods have perished' is also excluded.

Summary

- Frustration is really an expression indicating that the contract, once entered into, has subsequently become impossible to perform.
- The doctrine operated at two levels:
  - the courts would only allow frustration to be used as a defence;
  - the courts recognised that contracts themselves could provide for the consequences of the occurrence of such an event (*force majeure* clauses).

The development of the modern doctrine

- Historically the courts imply terms developing the modern doctrine of frustration, e.g. destruction of a music hall (***Taylor* v *Caldwell***).
- The fictitious nature of the implied term was discussed in ***Davis Contractors Ltd* v *Fareham UDC***. NB: The officious bystander test (***Shirlaw* v *Southern Foundries (1926) Ltd***).
- The test is a question of law, not fact, even though the issue of fact heavily overlays the considerations of the court.

Applications of the doctrine of frustration

Destruction and unavailability of the subject matter of the contract

Inability to comply with specified manner of performance

Unavailability

Supervening illegality

The problem of frustration in leases

- Equitable lease takes effect as a contract to grant a lease under the doctrine of ***Walsh* v *Lonsdale*** and it could therefore be discharged by frustration.

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Factors affecting the operation of the doctrine

Self-induced frustration

- Frustration does not apply to an event arising out of the actions of one party to the contract.
- Negligent actions of a party will not give rise to frustration.

Frustration expressly provided for in the contract

- The parties may make provision for what is to happen should a particular supervening contingency occur (*force majeure* clauses).
- The clause must be capable of dealing with any form that the contingency may take, no matter how serious, otherwise it will not prevent the operation of the doctrine of frustration (***Jackson* v *Union Marine Insurance Co. Ltd***).

The legal effects of frustration

- Frustration will terminate a contract automatically (***Hirji Mulji* v *Cheong Yue Steamship Co.***).

The effect of frustration at common law

- From the date of the supervening event the parties are released from all future contractual obligations.
- Any obligations that had already arisen under the contract had to be performed and traditionally any loss lies where it falls (***Chandler* v *Webster***).
- NB: ***Fibrosa Spolka Akcyjna* v *Fairbairn Lawson Combe Barbour Ltd*** overruled ***Chandler***, allowing the recovery of moneys where there had been a total failure of consideration.

Law Reform (Frustrated Contracts) Act 1943

- The Act seeks to regulate:
  - recovery of moneys paid or payable under the contract (s 1(2));
  - compensation payable for expenses incurred in the performance of the contract (s 1(2));
  - financial readjustment of the parties where one has received a valuable benefit under the contract in the absence of any prepayment (s 1(3) – ***BP* v *Hunt***).

Further reading

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Visit **www.mylawchamber.co.uk/richards** to access study support resources including sample exam questions with answer guidance, multiple-choice quizzes, flashcards, an online glossary, live weblinks and regular updates to the law, *plus* the Pearson e-Text version of *Law of Contract* which you can search, highlight and personalise with your own notes and bookmarks.

Use Case Navigator to read in full some of the key cases referenced in this chapter with commentary and questions for comprehension:

Liverpool City Council* v *Irwin and another [1976] 2 All ER 39
Taylor* v *Caldwell (1863) 3 B & S 826

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Part 5

Remedies for breach of contract

16 The common law remedy of damages
17 Equitable remedies and limitation of actions
18 Quasi-contract and the law of restitution

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16 The common law remedy of damages

Aims and objectives

After reading this chapter you should be able to:

- Understand the basis on which damages for breach of contract are awarded and what is meant by restitutionary loss and actions for an agreed sum.
- Know the difference between value and cost of cure in assessing damages as a remedy.
- Know and understand the limitations that apply to the availability of damages, particularly the rule regarding remoteness of damages.
- Explain the need for parties to mitigate their losses when seeking damages and the effects of contributory negligence on their claim.
- Explain how and to what extent loss for speculative damages and non-pecuniary losses are recoverable.

Introduction

For more on equitable remedies refer to Chapter 17.

So far in our analysis of the doctrines, principles and rules that bind the law of contract we have talked in terms of enforcing contracts. In fact the notion of enforcement is somewhat erroneous since at common law the only remedy is damages or compensation for the breach of contract. Of course, the result may be the same in monetary terms but this can be far removed from the notion of forcing compliance with the terms of the contract. It is true that a party to a contract can enforce compliance via decrees of specific performance and injunctions, but these are equitable remedies available only at the discretion of the court, while damages at common law are available as of right. Nor are damages limited to circumstances where a party to the contract suffers loss because of the breach. As we have already seen, liability in breach of contract is strict and a party may claim damages, albeit only nominal damages, despite the fact that they have suffered no loss.

While a person may recover damages even where they have suffered no loss, it has to be said that the majority of claims will be in circumstances where substantial loss has been suffered. The injured party cannot recover for all loss since a causal link must be shown to exist between the loss suffered and the breach of contract. Even where this causal link exists an individual will not in any event be compelled to pay for all loss, since the losses

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must not be 'too remote' from the consequences of the breach. The limitations on the availability of damages for breach of contract, together with **causation** and remoteness, will form the second part of the analysis of the common law remedy of damages. The third part of this analysis will be concerned with how the damages are measured in terms of quantum (amount). Initially, however, we need to make an assessment of the basis on which the courts award damages for breach.

Assessment of the basis on which damages are awarded

General principles

As has been indicated already, the basis of an award of damages is to compensate the injured party for the breach of contract. The underlying and fundamental principle here, as stated in ***Robinson* v *Harman*** (1848) 1 Ex 855, is to place the injured party in the same position they would have been in had the contract been carried out, insofar as money is able to do this. The injured party is thus claiming damages for the gains they could have reasonably expected from the execution of the contract. They are thus claiming for loss of bargain or loss of profits. Such damages are often referred to as an '**expectation loss**'.

Alternatively the injured party may decide not to claim for loss of bargain/loss of profits but for the expenses incurred because of a reliance on the contract being performed. This is often referred to as 'reliance loss'. The circumstances in which a party claims reliance loss may arise where the profits that they hope will materialise from the contract are too speculative or uncertain. In such circumstances the injured party may find it simpler and safer to claim any expenses incurred in performance of the contract. An example of such an instance can be seen in the following case.

Anglia Television Ltd v *Reed* [1972] 1 QB 60

The defendant, an actor, had entered into a contract with the plaintiffs to produce a film. At the last moment the defendant withdrew from the contract with the result that the plaintiffs had to abandon the whole project. They decided not to sue for expectation losses since these clearly would be purely speculative, but for loss of expenses, or reliance losses, in respect of moneys expended hiring other actors, finding locations and engaging scriptwriters. The court allowed the claim for these items of expenditure.

The ***Anglia Television*** case is also authority for the fact that the courts will not allow the injured party to claim for both expectation and reliance loss. Thus Lord Denning MR stated:

> It seems to me that a plaintiff in such a case as this has an election: he can either claim for his loss of profits; or for wasted expenditure. But he must elect between them. He cannot claim both. If he has not suffered any loss of profits – or if he cannot prove what his profits would have been – he can claim in the alternative the expenditure which has been thrown away, that is, wasted, by reason of the breach. That is shown by ***Cullinane* v *British 'Rema' Manufacturing Co. Ltd***.

The '***Rema***' case [1954] 1 QB 292 indicates that to claim both reliance loss and expectation would in effect be to compensate the plaintiff twice for the same loss. However, this

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requires qualification since such a state of affairs only exists if the expectation loss consists of gross profits which will include expenditure on the contract. There would seem to be no objection to a plaintiff claiming reliance loss and expectation loss where the latter consists of a claim for net profits. Unfortunately Lord Denning did not clarify this situation. The position has since been clarified in ***Western Web Offset Printers Ltd* v *Independent Media Ltd***.

Western Web Offset Printers Ltd v *Independent Media Ltd* (1995) *The Times*, 10 October

The defendant wrongfully repudiated a contract under which the plaintiff was to print 48 issues of a weekly newspaper. The only issue in the case arose as to the correct measure of damages. The plaintiff claimed £176,903 as representing the gross profit having deducted direct expenses such as paper and ink. It was argued by the defendant that the plaintiff was only entitled to net profit deducting, in addition to direct expenses, appropriate proportions of the plaintiff's labour costs and overheads. This produced a total of £38,245. The judge at first instance accepted the defendant's calculations and the plaintiff appealed.

The Court of Appeal allowed the plaintiff's appeal. It stated that the correct approach was that the loss of bargain principle should be applied. The question to be asked was, 'What loss had been caused to the plaintiff by the breach of contract?' It was noted by the court that the plaintiff had been unable to find replacement work for the loss of the contract and had thus not been able to mitigate his loss. This failure, however, was not his own fault but a result of the economic recession. The court decided that the plaintiff's 'profit and expenditure account was depreciated by the loss, not just of the notional net profit, but the availability of £176,903 to help defray its existing and inevitable overheads'. The plaintiff was therefore entitled to damages amounting to £176,903.

While the plaintiff generally can choose whether to claim expectation loss or reliance loss, this choice may nevertheless be imposed by the court in certain situations. For instance, the courts look very warily on claims for reliance loss where the plaintiff has made a 'bad bargain', in that there would normally have been no profits made from the contract – because the return on the contract might not even have covered the expenses incurred, either wholly or partly.

Thus in ***C & P Haulage* v *Middleton*** [1983] 3 All ER 94 the court held that in the circumstances of this case there would be no recovery for reliance losses. It would clearly be wrong, though, to prevent a person from recovering for reliance loss simply on the basis that no profits were made on the contract. The court stated that reliance loss could be recovered provided that the losses claimed arose from the breach of contract and that it was anticipated that the return on the contract would have meant, under normal circumstances, that the expenditure on the contract would have been recovered. On the other hand, if it is shown that the wasted expenditure would have arisen whether or not the contract had been broken then the courts will disallow the claim for those losses.

The burden of proof in relation to the last matter is important since it was stated in ***CCC Films (London) Ltd* v *Impact Quadrant Films Ltd*** [1984] 3 All ER 298 that the onus of proof is not on the plaintiff to show that their reliance losses would be at least as much as their expected profits. Such a burden of proof would be almost impossible to sustain. The onus is on the defendant to show that the plaintiff would not have recovered their wasted expenditure even if the terms of the contract had been fully complied with.

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A second situation where a plaintiff will be prevented from exercising the choice of expectation or reliance loss arises where the court itself considers that the claim for expectation loss is too speculative. An example of such a move by the courts occurred in ***McRae* v *Commonwealth Disposals Commission*** (1951) 84 CLR 377, where the court considered that the claim for loss of profits was incapable of calculation since there was nothing in the contract to indicate the size of the tanker in question nor the approximate quantity of oil on board. The court decided that only a claim for reliance loss would be entertained.

Restitutionary loss

It is worth noting at this point that so far we have been concerned with compensation for loss of bargain or expenses incurred. However, it is also possible to claim for the recovery of a benefit received by the defendant from the unperformed contract. Such claims are based in restitution and are discussed more fully in Chapter 18 under quasi-contracts. Claims in restitution are conceptually different from those for damages for breach of contract since the aim is to place both the parties in the same position that they were in *before* the contract had been entered into, that is, as if the contract had not been made. It should be noted that restitution is not the same as claims for reliance loss either since, while the intention in the latter is to compensate for losses sustained before the contract was entered into, it is only intended to return the plaintiff to the pre-contract position and not the defendant, and the latter may be left in a significantly worse position than before. Restitution, therefore, does not amount to compensation at all but a method of returning both parties to the pre-contract status quo so as to prevent a party from being unjustly enriched from the breach. In other words, the damages are used here to prevent a defendant from benefiting from the breach by making a profit. The defendant therefore will be required to '*account for profits*' to the claimant.

By now it can be seen that damages are not intended to be punitive in nature, which is to penalise a guilty defendant for any gains they may have received by way of the breach of contract. There is no concept in English law of assessing the mental state of the defendant so that compensation is payable for a deliberate breach of contract. Traditionally therefore the innocent party can recover only their actual losses and if a defendant made a profit from the breach the claimant would not be able to recover such profits. This traditional position can be seen in the following case.

Surrey County Council v *Bredero Homes Ltd* [1993] 3 All ER 705

In this case, the council had sold land to the defendant property developer. The contract required the developer to develop the land on the terms of the planning permission to build 72 houses. Once the transaction had been completed the developer obtained new planning permission that allowed the defendant to build an additional five houses on the site. This was a deliberate and calculated breach of the contract of sale to develop the site only in accordance with the terms of the original planning permission granted by the council.

The council sued for breach of contract, claiming damages for the breach. The amount of the damages claimed was the sum the council would have required the developer to pay in order to be released from the condition in the contract. It was held that the council could recover only nominal damages since it had not sustained any losses from the breach of the contract. The fact that the defendants themselves made extra profits from their deliberate breach of contract was of no consequence.

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This traditional position was criticised by the Law Commission in its Consultation Paper No 132, *Aggravated, Exemplary and Restitutionary Damages*, 1993, where it suggested that damages should be available if a defendant obtains a benefit from some deliberate wrongdoing capable of being restrained by way of injunction. Steyn LJ in ***Bredero Homes*** considered this to be completely unsatisfactory since injunctions were 'wholly different' from an award of damages and were discretionary in nature, whilst damages are available as of right for breach of contract. It is nevertheless argued that restitutionary damages calculated by reference to the contract breaker's profit would go a long way towards preventing deliberate breaches of contract.

Certainly this was a factor in the Court of Appeal awarding an order of specific performance in ***Co-operative Insurance Society Ltd* v *Argyll Stores (Holdings) Ltd*** [1996] 3 WLR 27 (CA), in circumstances that normally precluded such an order being given. The facts of the case and the ultimate House of Lords decision are dealt with more fully in Chapter 17, below, but the Court of Appeal decided that the breach of contract by the defendant could only be described as 'wanton and unreasonable' and 'gross commercial cynicism'. Since restitutionary damages were not available the Court of Appeal made an order of specific performance instead, stating that damages could not adequately compensate the plaintiff. Lord Hoffmann in the House of Lords rejected this approach, stating that the nature of the defendant's conduct was irrelevant and that specific performance in the circumstances required the constant supervision of the court, which precluded such an award, and thereby overturned the decision of the Court of Appeal.

On this basis it seemed that English law was a long way from seeing the introduction of restitutionary damages for breach of contract. As already stated, Steyn LJ in ***Bredero Homes*** strongly disapproved of any moves towards such a development. He stated:

> The introduction of restitutionary remedies to deprive cynical contract breakers of the fruits of their breaches of contract will lead to greater uncertainty in the assessment of damages in commercial and consumer disputes. It is of paramount importance that the way in which disputes are likely to be resolved by the courts must be readily predictable. Given the premise that the aggrieved party has suffered no loss, is such a dramatic extension of restitutionary remedies justified in order to confer a windfall in each case on the aggrieved party? I think not . . . The recognition of the proposed extension will in my view not serve the public interest.

In some situations, however, the exploitation of a breach of contract is so cynical that a remedy is called for in that it would deter future breaches of contract. Such a remedy would revolve around the possibility of compelling the defendant to surrender their gain. Such an approach is a very different concept from the classical compensatory nature of damages for breach of contract and is clearly a break from the traditional approach.

An early authority for such an approach, however, can be seen in the case of ***Wrotham Park Estate Co. Ltd* v *Parkside Homes Ltd***.

Wrotham Park Estate Co. Ltd v *Parkside Homes Ltd* [1974] 1 WLR 798

A developer acquired land that was subject to a restrictive covenant that had been imposed for the benefit of an adjoining estate and in breach of that covenant built houses on it. An injunction was sought by the estate owners but their application was unsuccessful. They were, however, awarded damages that were based upon the profits the defendant made from the breach of covenant. The damages were assessed on the basis of what the plaintiffs could have expected to gain in agreeing to relax the restrictive covenants. The award may

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be regarded as being in lieu of damages as permitted under the Supreme Court Act 1981, s 50 (*see* Chapter 17). Certainly this was the interpretation placed on this award by the Court of Appeal in ***Bredero Homes***, although this was not available to the Court of Appeal in that case since one of the precursors to such an award is that the plaintiff must have applied for either injunctive relief or specific performance and such equitable relief had not been applied for in that case. Aside from that difficulty the Court of Appeal expressed reluctance to move towards a principle of restitutionary damages in the law of contract. This reluctance was in turn based on principle in that the award of damages is to compensate for loss and since the council had not suffered loss there was no entitlement to compensation.

The award of damages in lieu of equitable relief argument has, however, one fundamental drawback in that it was established in ***Johnson* v *Agnew*** [1980] AC 367 that the measure of damages in such circumstances is calculated on the same basis as in the common law; in the case of breach of contract this is to put the claimant in the same position he or she would have been in had the contract been completed. This position is limited in one respect, however, in that the damages claimed in lieu of the equitable relief must relate to the same breach and this could not apply where there is no right to damages at common law, such as where an injunction or specific performance is claimed for a future breach of contract, as held in ***Jagger* v *Sawyer*** [1995] 1 WLR 269. This position may demonstrate the true difference between ***Bredero Homes*** and ***Wrotham Park*** in that in the former there was no possibility of a future breach occurring since the defendants had by then disposed of all the houses and therefore there was no possibility of injunctive relief being granted. This was not the position, however, in ***Wrotham Park***.

The position regarding restitutionary damages for breach of contract was considered again in ***Attorney-General* v *Blake***.

Attorney-General v *Blake* [2001] 1 AC 268

In this case Blake was a member of the intelligence services who passed secret information to secret agents belonging to the Soviet Union. This was not only in breach of his contract of employment but also an offence under the Official Secrets Act 1911. He was subsequently convicted of espionage and sentenced to 42 years in prison. He then escaped from prison and fled to Russia where 20 years later he entered into a contract with an English publisher for the publication of his autobiography. The information he was to release in his book was no longer secret when he completed the manuscript and had it published. The disclosure, however, amounted to a further offence under the Official Secrets Act 1911 and breach of his contract of employment. The Crown of course suffered no material loss from the breach for which damages representing compensation could ordinarily have been awarded. The usual remedy in such a situation would be to restrain the breach by way of an injunction. Such a remedy should have been sought before the publication of the autobiography and this was not done; further, it was doubted whether such a remedy would have been effective in any event.

The House of Lords held by a majority that where damages were not sufficient and that injunctive relief or specific performance was unavailable, the court could 'exceptionally' exercise its discretion in requiring the defendant to account to the plaintiff for the benefits he was to receive from his breach of contract, the damages being measured with reference to the benefits received by the defendant from the breach of the plaintiff's contract. This development was partly founded on the notion that the court has discretion to award damages

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in lieu of injunctive relief or specific performance where the contract is of a type for which such equitable relief is unavailable. Lord Nicholls, however, went further than this and considered that equity always had discretion to require a wrongdoer to account for profits made from breaches that have already occurred. There is an interplay here between injunctions and an account for profits in that the injunction restrains future breaches and the wrongdoer is then required to account for the profits made so that the two complement each other. Furthermore the account for profit arose even if the plaintiff has not suffered any financial loss or was otherwise disadvantaged. The position is closely aligned to actions for breach of trust or breach of fiduciary duty where both trustees and fiduciaries are required to account for any profits made from their duties irrespective of their honesty or culpability. An example of this can be seen in the case of ***Boardman* v *Phipps*** [1967] 2 AC 46; [1966] 3 WLR 1009. The issue, however, is when does the discretion arise and when does it become exercisable?

Lord Nicholls stated that the circumstances in which the remedy to account for profits may arise is uncertain, although he considered it would only be granted in 'exceptional circumstances . . . no fixed rules can be prescribed'. He considered the criteria on which the discretion to order an account for profits may be exercised. He stated that a 'court will have regard to all the circumstances, including the subject matter of the contract, the purpose of the contractual provision which has been breached, the circumstances in which the breach occurred, the consequences of the breach and the circumstances in which relief is being sought'. He went on to state that 'a useful general guide, although not exhaustive, is whether the plaintiff had a legitimate interest in preventing the defendant's profit making activity and, hence, depriving him of his profit'.

An account for profits is an exceptional remedy and Lord Nicholls attempted to indicate circumstances in which such a remedy would not be appropriate. In this he concurred with the judgment of Woolf MR in the Court of Appeal who suggested three circumstances in which a departure from the normal rules of damages would not be appropriate. These are: 'the fact that the breach was cynical and deliberate; the fact that the breach enabled the defendant to enter into a more profitable contract elsewhere; and the fact that by entering into a new and more profitable contract the defendant put it out of his power to perform his contract with the plaintiff'.

Lord Woolf did, however, identify two cases in which restitutionary damages would be appropriate where compensatory damages would not apply. The first category was that of 'skimped performance', where the defendant fails to provide the full extent of services they were contracted to provide. Lord Nicholls did not think this fell within the remedy of an *account for profits* since this was capable of being remedied by a part-refund of the price, which would be the normal outcome for an action for breach of contract. The second category suggested by Lord Woolf was where a defendant obtained a profit by doing the very thing they had contracted not to do. Lord Nicholls also rejected this as an appropriate category on the basis that it was too wide to fit into the very exceptional situation that arose in the ***Blake*** case. He considered that to include all breaches of negative stipulations within a contract took the remedy to account for profits for breach of contract into the mainstream of contractual remedies and a liability to account is anything but that. Of course it would be useful if it could apply, for instance, in cases such as ***Ruxley Electronics*** (*see* below, p. 431) where there was an issue of finding a remedy that was reasonable in that it provided a balance between the loss suffered by a plaintiff and the need for the defendant to pay damages that were not excessive. Here

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a remedy requiring the defendant to account for the saving he had made by way of 'skimped performance' would certainly provide for a remedy that was fair between the respective parties. The remedy of an account must remain an exceptional one, but in those very exceptional cases it is necessary in order to produce a just response. As Lord Nicholls stated (with Lords Goff, Browne-Wilkinson and Steyn concurring):

> When, exceptionally, a just response to a breach of contract so requires, the court should be able to grant the discretionary remedy of requiring the defendant to account to the plaintiff for the benefits he has received from his breach of contract. In the same way as a plaintiff's interest in performance may make it just and equitable for the court to make an order for specific performance or grant an injunction, so the plaintiff's interest in performance may make it just and equitable that the defendant should retain no benefit from his breach of contract.

Not surprisingly, lawyers have jumped at the vagueness of the principles set out by Lord Nicholls and have attempted to bring cases within the discretionary jurisdiction of the court to order an account for profits. Clearly the circumstances in which restitutionary damages in the form of an account for profits arise is extremely uncertain and very limited.

Following the case of ***Blake*** was that of ***Esso Petroleum Co. Ltd*** **v** ***Niad*** [2001] All ER 324, in which Niad owned a petrol station and entered into a price agreement with Esso for the supply of petrol. The purpose of the agreement was to provide support for a particular pricing regime to enable Esso to sell petrol at lower prices and remain competitive with the supermarkets. Niad charged higher prices to its customers than had been agreed, which meant that Esso provided a price support which Niad was not entitled to. Niad was, therefore, in breach of its agreement with Esso.

It was held by Morritt VC that Esso was entitled to an account of the profits Niad received by way of overcharging on the price of petrol beyond that agreed with Esso. Morritt VC applied the decision in ***Blake*** in that he considered that compensatory damages were inadequate because Esso could not establish what sales had been lost due to the actions of Niad. Niad's breach undermines the 'price watch' scheme and, therefore, Esso was justified in preventing Niad from acquiring the profits from its breach. Thus Esso succeeded in claiming gain-based damages, or restitutionary damages, based on the ***Blake*** principle that compensatory damages were inadequate and that there was a legitimate interest to protect. On this basis, the court made an award that stripped Niad of the profits it had made.

Why are compensatory damages inadequate? In order to claim these types of damages, one has to establish a causal link between the breach and the loss. Esso could not establish that the lost sales were the result of Niad's failure to implement the 'price watch' scheme. In such a situation Esso would only be able to claim nominal damages for the breach itself on a compensatory basis. But the only way in which the actual loss could be compensated was on a restitutionary basis giving rise to damages based on the gains made by Niad – i.e. compensation for unjust enrichment or an account for profits.

A recent case demonstrating this is that of ***Experience Hendrix LLC*** **v** ***PPX Enterprises Inc.*** [2003] EWCA Civ 323, [2003] 1 All ER 830 in which there was a breach of a negative stipulation regarding the use of certain licences appertaining to the music of Jimi Hendrix. An injunction was granted as regards future breaches but the claimant wanted to claim damages for previous breaches even though there was no loss attributable to those breaches. The claimant therefore attempted to claim an account for profits on the basis of ***Blake***. Mance LJ in the Court of Appeal stated that the circumstances in ***Blake*** were exceptional in that the case involved employment in a national security agency in which 'secret

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information was the lifeblood, its disclosure being a criminal offence . . . Blake had furthermore committed deliberate and repeated breaches causing untold damage . . . although the argument that Blake was a fiduciary was not pursued beyond first instance, the contractual undertaking he had given was "closely akin to a fiduciary obligation, where an account of profits is a standard remedy in the event of breach".'

The court held that on the facts the case of ***Experience Hendrix*** was not sufficiently exceptional in that it did not involve national security; nor was there any breach of a fiduciary obligation. Whilst the claimant had a legitimate interest to protect in preventing the profit-making activity of the defendant the circumstances were not exceptional within the ***Blake*** criteria. The Court of Appeal in coming to this conclusion clearly had in mind the dangers of importing such a remedy into a commercial context, particularly as the court held that the defendant should pay the claimant a sum that was quantified on the basis of the cost of buying out the negative stipulation from the claimant. This accorded with the approach taken in ***Wrotham Park*** and since the claimant had a remedy in this form it was unnecessary to allow the principles set out in ***Blake*** to evolve into such a scenario.

Neither is the ***Niad*** case exceptional. There was, of course, evidence of a deliberate breach, but there are no issues concerning national security or a contractual relationship which was 'closely akin to a fiduciary obligation'. What appears to be occurring in the judgments is confusion between the different assessment of the damages in ***Wrotham Park*** and ***Blake***. Both the remedies in these cases are gain-based on restitutionary damages; however, the way in which the damages are calculated is different. In ***Wrotham Park*** the damages are based on the cost to the defendant of buying out the benefit of the claimant's negative condition/covenant in the contract, referred to by some writers as 'transfer reversing' damages. In ***Blake*** the damages are gain-based on the principle of disgorgement, which requires the defendant to hand back profits improperly received in circumstances akin to a breach of fiduciary obligation.

In ***Lane* v *O'Brien Homes Ltd*** [2004] EWHC 303 there was a sale of land for residential purposes. The sale was subject to a collateral contract (as opposed to a restrictive covenant) that no more than three houses were to be built on the land. There was planning permission for this number. Several months after the sale, O'Brien obtained planning permission to build four houses on the land. Mrs Lane applied for an injunction to restrain the development in that it involved the building of four houses, not three. She was refused the injunction, although she was awarded £150,000 damages, based on the hypothetical price that O'Brien would have had to pay Mrs Lane in order to be released from the collateral contract. O'Brien then appealed.

It was held that the appeal would be dismissed in that the assessment of the damages had been correctly assessed in line with the ***Wrotham Park*** case. O'Brien's argument was that, since Mrs Lane had suffered no loss by the building of the fourth house, she was not entitled to any damages – there was no expectation loss. On the facts, though, the court found that Mrs Lane had suffered a loss – her right to charge O'Brien for the release from the collateral contract. Since Mrs Lane would have been prepared to negotiate a release from the collateral contract, she had lost her opportunity to bargain. This factor distinguishes the case from the ***Wrotham Park*** decision where it was clear that the estate owners would not have entered into negotiations over the relaxation of the restriction covenant. Nevertheless, the criteria in ***Blake*** were fulfilled in that the damages were inadequate and Mrs Lane had a legitimate interest to protect. The assessment of damages based on 'transfer reversing' damages as a restitutionary remedy was correct. The more controversial aspect of the decision, however, was the fact that these

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damages were described as damages for loss of opportunity to bargain, which are compensatory and not restitutionary.

The decisions in ***Wrotham Park*** and ***Blake*** were also considered in ***WWF World Wide Fund for Nature*** v ***World Wrestling Federation Entertainment*** [2006] EWHC 184.

WWF World Wide Fund for Nature v *World Wrestling Federation Entertainment* [2006] EWHC 184

In the case a dispute arose from the World Wrestling Federation's ('F') use of the initials 'WWF' in connection with its activities. Those initials had been long used by the World Wide Fund for Nature ('N'). In 1994 the parties had entered into an agreement to compromise litigation and regulate the future use of the WWF initials. The agreement did not give N an exclusive right to the initials; however, it did substantially restrict F's use of the initials. N brought proceedings, alleging that F had broken the agreement, and claimed damages. Subsequently N sought to amend its claim so that it could claim for an account of profits on the basis of ***Blake***. Whilst it obtained summary judgment, it was refused an application for an account of profits. The basis behind this decision was that there was nothing of an 'exceptional character', which was a fundamental requirement for a claim on the principles set out in that case. Some years later N brought a further claim for damages, this time based on ***Wrotham Park*** in that the damages should be measured by reference to the sum that N might reasonably have demanded from F for relaxing its rights under the agreement. In deciding the preliminary issue Smith J held that damages based on this principle were recoverable. F appealed on two points: first, the remedy sought by N was either the same as or juridically similar to the relief refused by Jacob J in the original hearing and therefore was ***res judicata***. The basis of this point was that both the account of profits under ***Blake*** and the damages based on ***Wrotham Park*** were both gain-based forms of relief. Second, N's attempt to claim damages based on ***Wrotham Park*** at this stage was an abuse of process since it had not entered such a plea in the earlier proceedings.

In the trial of the preliminary issue Smith J provided a thorough and comprehensive review of the authorities surrounding the issue of restitutionary damages in the law of contract. Smith J considered that the basis of the damages in ***Wrotham Park*** was of a compensatory nature, which is not the case. This is based on the fiction that ***Wrotham Park*** is concerned with a lost opportunity of the claimant to profit from giving up the negative covenant in the contract. The fallacy in this argument is revealed when it becomes clear that the claimants never intended to relax the covenant and, therefore, no such opportunity was ever contemplated. Furthermore, the concept of the 'lost opportunity to bargain' principle was firmly rejected in ***Experience Hendrix*** and ***Surrey CC*** v ***Bredero***.

The Court of Appeal [2007] EWCA Civ 286, [2008] 1 All ER 74, allowed the appeal on the second ground and considered that N could and should have raised the claim for damages on the ***Wrotham Park*** principle when it sought to amend its claim for an account of the profits. To raise such a claim at this point in time was an abuse of process in that it had asked the earlier court to decide the issue on the basis that there would be no claim for damages based on the ***Wrotham Park*** principle. Essentially N was therefore attempting to re-establish such a claim in later proceedings when it had decided that a claim based on the ***Wrotham Park*** principle was unsustainable at the earlier hearing. Chadwick LJ considered that to allow the claim would be 'inconsistent with the underlying interest that there should be finality in litigation'. With respect, this is incorrect since the difference between ***Wrotham Park*** damages and an account of profits was not established until later in ***Experience Hendrix***. Essentially the court was attempting to read back this difference

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to the time when N was seeking leave to amend its claim. Furthermore the parameters and nature of ***Wrotham Park*** damages were uncertain at that time and one could therefore well understand why N did not raise this claim at that time.

With regards to the first ground of appeal the court affirmed the principles established in ***Experience Hendrix*** in that where there was a claim by a covenantee (N) for damages against a covenantor (F), who had acted in breach of a restrictive covenant, a court could award an amount assessed on the sum the court considered it would have been reasonable for the covenantor to pay and the covenantee to accept for a hypothetical release from the covenant immediately before the breach. In the light of ***Experience Hendrix*** the court considered that it was settled that where a covenantee claimed for an injunction and damages against a covenantor for breach of a restrictive covenant it could, in addition to awarding an injunction for future breaches, also award damages for past breaches even though the covenantee had not suffered any financial loss. The sum awarded was to be assessed on the basis (a) that the hypothetical release would have taken effect from the date immediately before the covenantor was first in breach; and (b) that the hypothetical release should be for the period ending with the date on which the injunction to restrain future breaches took effect.

The court went on, however, and stated that the damages being awarded under this process were not 'gain based' damages but compensatory damages. Having said this, the court then accepted F's contention that the award of damages under ***Wrotham Park*** was juridically similar to an account for profits. This is highly questionable. In ***Blake*** the award for account of profits is emphatically not compensatory and patently of a restitutionary nature in that they are gain based to prevent a defendant benefiting from a breach of contract in circumstances where the claimant suffers no loss per se, where, as Lord Nicholls stated 'it [is] just and equitable that the defendant should retain no benefit from his breach of contract'. The damages awarded in ***Niad*** were also based on the same premise that compensatory damages were inadequate and that there was a legitimate interest to protect, leading the court to strip Niad of the profits it had made – clearly 'gain based' damages. The reasoning of the court appears to ignore the fact that an account for profits lies within equity on a restitutionary basis and is applied in many circumstances where a claimant does not suffer loss. ***Boardman* v *Phipps*** [1967] 2 AC 46 is a prime example of this, where a trustee was held to be accountable for profits gained from his position of trustee. The trustee had acted openly but nevertheless was required to hand his 'gains' over. The beneficiaries had suffered no loss from the trustee's breach.

There is a further contradiction within the judgment. If an account for profits is, according to Chadwick LJ, compensatory and this was refused by Jacob J, why are damages under ***Wrotham Park*** allowable if they also are compensatory? One answer lies in the fact that an account is 'gains based' and ***Wrotham Park*** compensatory. If one examines the ***Wrotham Park*** case, though it can be seen that the remedy in that case is also 'gains based', the Court of Appeal expressed reluctance in introducing restitution remedies into the law of contract. It would seem, therefore, that both account for profits and ***Wrotham Park*** damages are both founded in restitution as 'gains-based' remedies. With respect, neither are based in compensation. The lack of clarity in this judgment unfortunately requires resolving in another case at another time.

Actions for an agreed sum

Before we embark on an analysis of the specific issues that may arise in assessing the basis on which damages are awarded, a distinction has to be drawn between actions for damages and actions for an agreed sum. The latter commonly arise where the contract provides

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that an agreed sum is payable in return for some performance under the contract by the other party, such as the sale of goods for a fixed price. Actions to recover the agreed price or sum are very different from actions for damages in two respects. First, such actions take the form of specific relief, though without the restrictions normally found in actions for decrees of specific performance. Second, not only does the remedy differ in nature from damages, but it also differs in respect of the limitations imposed upon its award. Such actions are truly speaking actions in debt, since a precise known sum is being claimed. The result is that claims for such sums are not subject to the limitations of remoteness, mitigation of loss and so on that are frequently imposed on awards of damages.

Difference in value and cost of cure

While damages for reliance losses or restitution are fairly readily quantifiable, this is not necessarily the case when trying to quantify damages for loss of bargain, that is, restoring the plaintiff to the same position he would have been in had the contract been performed. In assessing the damages here one of two methods may be adopted: they will be assessed either on a 'difference in value' basis or on a 'cost of cure' basis. Choosing between these two methods in itself is not as straightforward as it may appear.

In contracts for the sale of goods there is generally no problem, since where the goods are not of the correct quality, for instance, the prima facie rule is that damages are assessed on the difference in value basis, that is, 'the difference between the value of the goods . . . and the value they would have had' if the quality of the goods had been in accordance with the contract, as stated in the Sale of Goods Act 1979, s 53(3). The approach here is based on the principle that the buyer can resell the goods they received and add the proceeds to the damages awarded so that they can then go out and purchase goods of the correct quality. The buyer would then be in the same position as if the contract had been performed, which of course is the general principle set out in ***Robinson* v *Harman*** (1848) 1 Ex 855. The prima facie nature of this rule, however, has to be emphasised and it may be displaced if a defect in the goods can be removed at a reasonable cost.

Other factors may also displace the principle contained in s 53(3). In ***Bence Graphics International Ltd* v *Fasson UK Ltd*** [1997] 3 WLR 205 (CA), the defendants were suppliers of vinyl film, which was used to manufacture identification numbers for bulk containers. The plaintiffs printed words or numbers on the film so it could be applied to the containers. The plaintiff used the film to manufacture decals for Sea Containers Ltd and it was an implied term that the film would survive in good legible condition for at least five years. In fact the film started to degrade well within this period, with the result that several customers of Sea Containers complained about the poor labelling on the containers. The plaintiffs claimed the whole purchase price or alternatively for an indemnity against all claims from their customers. At the time of the claim the plaintiffs had retained some £22,000 of unused defective vinyl, but had not themselves had a claim brought against them by their own customers.

Section 53(2) of the Sale of Goods Act 1979 provides that:

> The measure of damages for breach of warranty is the estimated loss directly and naturally resulting, in the ordinary course of events, from the breach of warranty.

Section 53(4) also provides:

> The fact that the buyer has set up the breach of warranty in diminution or extinction of the price does not prevent him from maintaining an action for the same breach of warranty if he has suffered further damage.

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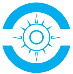
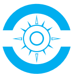


For more on the decision in *Hedley* v *Baxendale* see page 441.

These two subsections lay down basic principles for remoteness of damage in terms that are very similar to those used in ***Hadley* v *Baxendale*** (1854) 9 Exch 341 and which will be discussed more fully in the context of remoteness later on. It is, however, sufficient to state at this juncture that the rule in ***Hadley* v *Baxendale*** allows only for the recovery of true loss and neither more nor less. At first instance, however, the judge applied s 53(3) and found that the correct measure of damages was the difference between the value of the goods at the time of delivery and the value they would have had if they had complied with the warranty. In the Court of Appeal, however, it was decided that the correct measure of the damages was the actual losses suffered by the buyer. It was clear that both parties, at the time of entering into the contract, would have contemplated that the plaintiff would have wished to pass on to the defendants claims for damages from its own dissatisfied customers. The parties, in other words, must have contemplated that any latent defect in the vinyl film, either at the time of delivery or at the time the buyer converted it into decals, might when discovered later expose the buyer to claims for damages which he may wish to pass back to the defendant seller.

Where the contract is for building work the prima facie rule is that damages are assessed on a 'cost of cure' or reinstatement basis, that is, the builder will be liable for the costs of putting the defects right or completing the contract. Thus in ***East Ham Borough Council* v *Bernard Sunley Ltd*** [1965] 3 All ER 619 (HL), a contractor was held to be liable to replace stone panels that fell off the side of a building owing to defective fixing.



Such an approach was also suggested in ***Ruxley Electronics and Construction Ltd* v *Forsyth; Laddingford Enclosures Ltd* v *Forsyth***, although the case again demonstrates the prima facie nature of the rules on the assessment of loss of bargain.

Ruxley Electronics and Construction Ltd v *Forsyth; Laddingford Enclosures Ltd* v *Forsyth* [1995] 3 All ER 268 (HL)

The facts of the case were that the defendant (the owner) entered into a contract with two plaintiff companies for the construction and enclosure of a swimming pool in his garden for a price of £70,178. The contract expressly provided that the maximum depth of the pool was to be 7ft 6in. When the work was completed the owner observed that the maximum depth was only 6ft 9in. Further, where people had hoped to dive in, the depth was only 6ft. The owner had paid various sums in advance but owed £39,072. The builders sued for this amount and the owner counter-claimed for breach of contract. While it was accepted that there had been a breach of contract, the judge at first instance found that the value of the pool had not been diminished by the breach and that the pool as constructed was safe to dive into. He found that the only method of curing the defect was to demolish the existing pool and construct a new one. He considered that the cost of rebuilding was wholly disproportionate to the disadvantage of having a pool of a depth shallower than that contracted for. The judge ordered that the owner should pay £40,777 to the builders. The judge, however, considered that the owner was entitled to £2,500 damages for loss of amenity.

The owner appealed, contending that the judge should have awarded damages for the breach or deducted a sum from the contract price to reflect the need for the pool to be reconstructed to the depth specified in the contract. The Court of Appeal allowed the appeal, finding that it was reasonable to award damages to take into account the cost of replacing the pool in order to make good the breach of contract, despite the fact that the pool was still usable and that the breach had not diminished the value of the pool. The plaintiffs appealed to the House of Lords, where their Lordships upheld the findings of the judge at first instance and reversed the decision of the Court of Appeal.

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In deciding which measure of damages should be applied the House of Lords considered three aspects. First, the question of reasonableness in the context of reinstatement; second, the question as to the relevance of whether the owner intended to use any damages to rebuild the swimming pool if damages were awarded; and, third, the award of damages for loss of amenity, which is more fully discussed at p. 460 below.

With regard to the first aspect the court took the view that it was unreasonable for the owner to insist on the reconstruction of the swimming pool in order to make good the breach, the reason being that the expense of the reconstruction work would be out of all proportion to the benefit obtained. In such cases their Lordships found a plaintiff would be limited to the difference in value between what he had contracted for and what he had actually received. Lord Jauncey reiterated the general principle that damages were to compensate for an established loss and not to provide a gratuitous benefit, so that the reasonableness of the award is directly referable to the loss sustained. He stated that while reinstatement might be a starting point for the assessment of damages, this was subject to the qualification that it must be reasonable, having regard to the loss sustained. Thus if a plaintiff has suffered no loss then they may be awarded only nominal damages. Lord Lloyd considered that this principle also accords with the overall requirement that a plaintiff should mitigate any loss, that is, a plaintiff should take reasonable steps to reduce their losses, as stated by Viscount Haldane in ***British Westinghouse Electric and Manufacturing Co. Ltd*** v ***Underground Electric Railways Co. of London Ltd*** [1912] AC 673.

In applying the above criteria to the two means of assessing damages for loss of bargain, Lord Lloyd stated that if the cost of reinstatement is less than the difference in value, the measure of damages would be the cost of reinstatement. Claiming the difference in value in such circumstances would mean that a plaintiff is failing to mitigate the loss. Lord Lloyd, however, considered that the requirement of reasonableness went further than simply the duty to mitigate. He affirmed the principle set out by Steyn LJ in ***Darlington Borough Council*** v ***Wiltshier Northern Ltd*** [1995] 1 WLR 68, where he stated:

> in the case of a building contract, the prima facie rule is cost of cure, i.e. the cost of remedying the defect. . . . But where the cost of remedying the defects involves expense out of all proportion to the benefit which could accrue from it, the court is entitled to adopt the alternative measure of the difference of the value of the works.

The problem in the ***Ruxley*** case, however, was that if the proper measure of damages is the difference in value and that the diminution in value is nil, then should the court not revert to an award based on the cost of reinstatement? Lord Lloyd considered that an injustice that arises by way of making an award of too little is not counterbalanced by a court making an award of too much: 'that cannot make reasonable what . . . has been found to be unreasonable'.

It was further argued in the case that this was not a commercial contract but a contract for a personal preference and that the test of what was reasonable had to have regard to those personal preferences. Lord Lloyd considered that this was correct but that such preferences could not be elevated into a separate category of damages with its own special rules. Personal preferences were to be regarded as simply another factor to be taken into account, but only where the cost of reinstatement is not unreasonable. Where the cost of reinstatement is unreasonable, as in the ***Ruxley*** case, a plaintiff is not entitled to have their personal preferences satisfied. Lord Lloyd considered that a plaintiff could be compensated for loss of disappointed expectations and did not consider that the law of damages was so inflexible that it could not compensate in these circumstances.

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He quoted from the case of ***G W Atkins Ltd* v *Scott*** (1980) 7 Const LJ 215 where Sir David Cairns in the Court of Appeal stated:

> There are many circumstances where a judge has nothing but his commonsense to guide him in fixing the quantum of damages, for instance, for pain and suffering, for the loss of pleasurable activities or for inconvenience of one kind or another.

Lord Lloyd considered that personal preference could give rise to a modest award for loss of amenity and that this amounted to another exception to the rule in ***Addis* v *Gramophone Co. Ltd*** [1909] AC 488, which will be discussed more fully later. He therefore affirmed the decision of the judge at first instance to make an award of £2,500 on this basis.

So far the question of reasonableness in the context of reinstatement has largely been confined to building contracts; however, the principles apply in a wider context. A plaintiff can only be placed in the same position as if the contract had been performed if it is reasonable for him to be so. The principles can also be seen in ***Sealace Shipping Co. Ltd* v *Oceanvoice Ltd, The Alecos M*** [1991] 1 Lloyd's Rep 120.

The court also considered the relevance of whether the owner, if he was awarded damages, would actually spend the damages on rebuilding the pool. Lord Lloyd stated that while the courts were not normally concerned as to what a plaintiff does with his damages, the question of the intention to rebuild was not irrelevant to the question of reasonableness in relation to the measure of damages to be awarded. He referred to Megarry VC in ***Tito* v *Waddell (No 2)*** [1977] 3 All ER 129 in which he stated:

> if the plaintiff has suffered little or no monetary loss in the reduction in value of his land, and has no intention of applying any damages towards carrying out the work contracted for, or its equivalent, I cannot see why he should recover the cost of doing the work which will never be done. It would be a mere pretence to say that this cost was a loss and so should be recoverable as damages.

Thus the absence of a desire to spend the damages on rebuilding or otherwise remedying the breach can undermine the reasonableness of a claim for such damages. In the ***Ruxley*** case itself the owner undertook to spend any damages he would receive on rebuilding the pool; however, Lord Lloyd considered that this did not affect the principle. A plaintiff cannot create a loss where no loss existed simply to punish the defendant for a breach of contract.

The ***Ruxley*** case is important in that it restates that the general principle in the assessment of damages is that it is based on the loss which the injured party has suffered. The injured party must not be overcompensated since this is just as much an injustice as if he were insufficiently compensated. The fact that the owner had received a usable pool meant that he would be overcompensated if he received the cost of rebuilding it. On the other hand, he had not received what he had contracted for and thus the award of £2,500 for loss of amenity was undoubtedly a fair award, though this was not contested in the House of Lords. The decision is also a good indicator of the position that the courts will not shy away from making an assessment simply because it is difficult to do so and gives an indication that further exceptions to the rule in ***Addis* v *Gramophone Co. Ltd*** may emerge where the courts find this expedient.

For more on the rule in the ***Addis* v *Gramophone Co. Ltd*** case and the exceptions to it, see page 458.

The assessment of damages by reference to the market

An area where expectation losses are commonly claimed arises out of contracts for the sale of goods. The assessment of damages here depends on whether the seller is in

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breach of contract for non-delivery or whether it is the buyer who is in breach for non-acceptance of the goods delivered. In either case the measure of damages is dependent on the difference between the contract price and the price of the goods in the market at the time of the breach of contract.

Breach caused by non-delivery

Such a breach will occur where the seller refuses or neglects to deliver the goods to the buyer. In such a case the buyer is expected to mitigate this loss by going into the market-place and buying goods of a similar nature, the damages being the difference between the contract price and market price, assuming that the buyer has had to pay more for the goods, otherwise they are only entitled to nominal damages. Thus the Sale of Goods Act 1979, s 51(3) states:

> Where there is an available market for the goods in question the measure of damages is *prima facie* to be ascertained by the difference between the contract price and the market or current price of the goods at the time or times when they ought to have been delivered or (if no time was fixed) at the time of refusal to deliver.

This measure, however, will change somewhat where the buyer has contracted to resell the goods and this resale is within the contemplation of the seller (*see* the rule in ***Hadley* v *Baxendale***, below). If there is no available marketplace then the resale price is taken as the market price and the measure of damages will thus be the difference between the contract price and the resale price, as was held in ***Patrick* v *Russo-British Grain Export Co.*** [1927] 2 KB 535. If there is an available marketplace then the damages remain the same as stated in s 51(3), that is, the difference between the contract price and the market price, whether or not the resale was within the contemplation of the seller, as was held in ***Williams* v *Reynolds*** (1865) 6 B & S 495.

Where the delivery is late but is nevertheless accepted by the buyer the damages have to be assessed on a different basis entirely since here the buyer's complaint is that he will only be able to resell them at a lower price than that prevailing at the time the goods should have been delivered. In such an instance the measure of damages is the difference between the market value of the goods when they ought to have been delivered and the market value when they were actually delivered. Nevertheless it was held in ***Wertheim* v *Chicoutimi Pulp Co. Ltd*** [1911] AC 301 that this rule will be displaced if the goods were resold at more than their market value at the time of delivery. Here the measure of damage will be the difference between the market price at the time fixed for delivery and the price for which the goods are resold. By way of illustration, if the market price of the goods was £20 per ton at the time fixed for delivery and £9 per ton at the time of actual delivery, then prima facie the loss is £11 per ton. If, however, the buyer was able to resell the goods for £15 per ton, then according to the ***Wertheim*** case the measure of damages should be £5 per ton, since otherwise, according to the court, the buyers would make a profit out of the breach. The decision has been heavily criticised (see, for instance, Treitel).

Breach caused by non-acceptance

Such a breach occurs where the buyer refuses or neglects to accept delivery of the goods. In a private sale the seller can recover from the buyer the difference between the value of the goods still in their possession and the agreed sale price, subject of course to their duty to take reasonable steps to mitigate the loss by attempting to sell them elsewhere. This position can be seen in the Sale of Goods Act 1979, s 50(3) which states:

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> Where there is an available market for the goods in question the measure of damages is *prima facie* to be ascertained by the difference between the contract price and the market or current price at the time or times when the goods ought to have been accepted or (if no time was fixed for acceptance) at the time of refusal to accept.

The situation is not quite so simple where the seller is a dealer. It is true that the dealer has to take reasonable steps to mitigate the loss, just as in a private sale, so that where there is an available market the loss is the difference between the contract price and the market price. The problem, however, may be that there is no difference between the contract price and the market price so that the claim will be for the loss of profits from the sale. The ability of the seller to recover such loss of profit depends, however, on the supply and demand for the goods in question.

Thompson Ltd v *Robinson (Gunmakers) Ltd* [1955] Ch 177

In this case, there was a contract for the sale of a new Vanguard car but the defendants refused to accept delivery. The defendants contested that the plaintiff dealers were only entitled to nominal damages given that there was no difference between the contract price and the market price. The plaintiffs, however, claimed their loss of profits since they maintained that given that the supply of such vehicles exceeded demand, they had sold one car less than they would normally have been able to do. It was held that the plaintiffs were entitled to their loss of profits, the judge finding that since s 50(3) was only a prima facie rule it could be displaced in such circumstances. On the other hand, in ***Charter* v *Sullivan*** [1957] 2 QB 117 it was held that only nominal damages could be claimed where demand exceeds supply since there the dealer, being able to sell all that he could get his hands on, had suffered no loss.

The situations described above tend to arise where there is a fixed retail price for the goods, and it may be that in the competitive market that exists today the rule in s 50(3) may be a more appropriate means of measuring the loss. Certainly the above rules do not apply to second-hand goods which do not have a fixed retail price. Such goods are unique and a failure to accept does not give rise to a claim for loss of profits here. The seller must again take reasonable steps to mitigate the loss by going into the marketplace, should a market be available; and if they sell the goods at the same or a higher price they can recover no damages from the first buyer, as held in ***Lazenby Garages Ltd* v *Wright*** [1976] 1 WLR 459. If the seller can sell only at a diminished price then the damages are the difference between the contract price and the market price as provided in s 50(3).

It should be noted that if the buyer delays in accepting the goods then by the Sale of Goods Act 1979, s 38, the seller can recover any losses resulting from that delay, together with a reasonable charge for the care and custody of the goods.

'Available market'

The expression 'available market' in s 50(3) and s 51(3) appears to have no precise definition. Various rather unconvincing attempts have been made over the years to define the expression. In ***Shearson Lehman Hutton Inc.* v *Maclaine Watson & Co. Ltd (No 2)*** [1990] 3 All ER 723 it was suggested that (in the case of a breach by the buyer) a market arises where the seller actually offers the goods for sale and there is a buyer who offers a fair price on the day. Alternatively there will be a market where the seller does not actually offer the goods for sale but where, nevertheless, it can be shown that there are

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sufficient dealers potentially in touch with one another to evince the existence of a market. Presumably a market arises on a similar basis where it is the seller who is in breach.

The question of time in assessing an award of damages

Damages are usually assessed as at the time the contract has been broken and this principle is evidenced by both s 50(3) and s 51(3) of the Sale of Goods Act 1979, above. This principle is only a presumption and is largely based on the fact that a plaintiff's obligation to take reasonable steps to mitigate their loss assumes that they will act immediately. In ***Johnson* v *Agnew*** [1980] AC 367, however, it was stated that the plaintiff does not have to take such immediate action where it is reasonable for them to take some other course of action, such as attempting to persuade the defendant to carry out their side of the bargain or to seek confirmation from the defendant that they do intend to perform. Thus Lord Wilberforce stated:

> The general principle for the assessment of damages is compensatory, i.e. that the innocent party is to be placed, so far as money can do so, in the same position as if the contract had been performed. Where the contract is one of sale, this principle normally leads to assessment of damages as at the date of the breach, a principle recognised and embodied in s 51 of the Sale of Goods Act 1893. But this is not an absolute rule; if to follow it would give rise to injustice, the court has power to fix such other date as may be appropriate in the circumstances.
>
> In cases where a breach of a contract for sale has occurred, and the innocent party reasonably continues to try to have the contract completed, it would appear to me more logical and just rather than to tie him to the date of the original breach, to assess damages as at the date when (otherwise than by his default) the contract is lost.

On this basis it would seem that the courts fully intend to give themselves substantial discretion as to the time when the assessment of damages should be made. This discretion was used in ***Gardline Shipping Ltd* v *Dyson and McCarthy*** (1998) (unreported). It was stated, applying ***County Personnel (Employment Agency) Ltd* v *Alan R Pulver & Co.*** [1987] 1 WLR 916 (as approved by ***Smith New Court Ltd* v *Scrimgeour Vickers Ltd*** [1996] 4 All ER 769), that whilst the general principle usually meant that the assessment of damages would be as at the date of the breach, this was not an absolute rule. The principle may be relaxed not only to prevent injustice to the defendant, but also to prevent injustice to the plaintiff as held in ***Kennedy* v *Van Emden*** (1997) 74 P & CR 19.

Affirmation of the time of breach rule has also occurred in the case of ***Golden Strait Corporation* v *Nippon Yusen Kubishka Kaisha (The Golden Victory)*** [2007] UKHL 12 (HL).

Golden Strait Corporation v *Nippon Yusen Kubishka Kaisha (The Golden Victory)* [2007] UKHL 12 (HL)

The facts of the case were that the shipowner, the Golden Strait Corporation ('GS'), had chartered a ship to Nippon ('N') by way of a period time charterparty dated 10 July 1998. The earliest contractual date for termination of the contract was 6 December 2005. Clause 33 of the charterparty provided that if war should break out between certain countries, named as including the USA, the United Kingdom and Iraq, both GS and N would be entitled to cancel the charter. N repudiated the charter on 14 December 2001 by redelivering the ship to GS and three days later GS accepted the repudiation. By the time the consideration

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for the damages for the breach came to arbitration the second Gulf War had broken out. This event would have entitled N to cancel the charter had it still been current. At the time of the outbreak of the war there was an available market for ships such as the ***Golden Victory***. The arbitrator decided that the outbreak of war in March 2003 placed a limit on the damages that could be awarded in that no damages were capable of being recovered after that date.

It fell before the House of Lords to decide, where damages for an accepted repudiation of a contract were claimed, in what circumstances could the party in breach of the contract rely on subsequent events to show that the contractual rights lost by the anticipatory breach would have been less valuable, or even valueless, by virtue of those events. GS contended that since there was an available market, loss was measured at the date of acceptance of the repudiation and that such loss was measured as the difference between the contract rate and the market rate for chartering a substitute ship for the balance of the charter period. GS also argued that events subsequent to that date were irrelevant and that in commercial agreements the overriding consideration was certainty. N, however, argued that whilst the normal assessment of damages is at the date of the breach this was not an absolute rule and that the available market rule required an innocent party to mitigate his loss. Clearly any condition within a contract that would bring the contract to an end on the occurrence of a specific event always created an element of uncertainty and therefore damages had to be assessed on a causation basis.

A majority of the House of Lords dismissed the appeal by GS, stating that the outbreak of war contingency within the contract had to be taken into account when assessing the damages. The fundamental principle governing the measure of damages for breach of contract was to compensate the victim and put him in the same position as he would have been had the contract been performed, so far as damages could accomplish that. Usually the assessment of damages at the date of the breach achieves that result but it was for the courts to find a solution that most fairly compensates the party suffering the loss. If the contract would have terminated earlier because of a particular event, the chance of that event occurring had to be taken into account. Thus if it was certain that the terminating event would occur, the damages had to be assessed on that basis. The reasoning behind this is that the charterparty in the case had made provision (Clause 33) for the termination of the contract on the happening of a certain event, the outbreak of war. The benefit that GS was deprived of by the breach was the right to receive the hire rate during the currency of the charterparty. The occurrence of the event terminated those rights and therefore GS could not claim damages for the whole of the charterparty. To decide otherwise would have meant that GS would have received more compensation than they would have been deprived of. The House of Lords, however, recognised that the principle as stated was subject to exceptions and should not be applied mechanistically. The principle may be overridden if to do so would be to provide a more accurate measure of compensation. The majority recognised that whilst certainty in commercial contracts was important, this did not take precedence over principles of law.

Lords Bingham and Walker gave dissenting judgments in this case and both considered that the value of the charterparty lost on the date of repudiation was one with four years to run and that GS should be compensated to that extent considering that certainty and predictability in contracts should not be overridden and that such a principle was a long-established one in commercial contracts. The outbreak of war was no more than a possibility and therefore they considered that at the time of the breach the contract had

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four years to run. Thus they considered that the damages should be assessed on the full term of the contract.

There is, however, one firm exception to the normal date of breach rule. This arises when a party is claiming damages in lieu of a decree of specific performance under the Chancery Amendment Act 1858 (otherwise known as the Lord Cairns Act). Here damages are assessed as at the date of the judgment, though it should be noted here that the damages claimed are not damages at common law.

The effect of tax on the assessment of damages

The principle that damages are merely designed to compensate the plaintiff for their actual losses means that their liability in respect of tax has to be taken into account.

British Transport Commission v *Gourley* [1956] AC 185

In this case there was a claim for loss of earnings that arose from personal injuries caused by negligence. The plaintiff was awarded a sum of £37,720 which represented the claim relating to loss of gross earnings. It was held by the House of Lords that the damages had to be reduced by the amount the plaintiff would have had to pay in tax in respect of that sum. Consequently the plaintiff was awarded a sum of £6,695 representing net income.

The rule in ***Gourley*'s** case establishes that damages will be reduced to take into account taxation only if two criteria are met:

1 the damages must represent taxable income or gains; *and*

2 the damages themselves are not taxable by HM Revenue & Customs.

As a general guide the following are not taxable by HM Revenue & Customs:

1 Compensation for personal injuries. Clearly these will not generally attract the application of the rule as they do not represent taxable income or gains. Thus if the hirer of a taxi successfully claims in contract for personal injuries sustained by the taxi owner's failure to take reasonable care and is awarded £100,000, then these damages would be payable in full. Similarly, if a person suffers emotional distress from a ruined holiday or wrongful demotion then the awards here will both be payable in full since neither of these awards represents income.

2 Compensation for loss of office up to £30,000. The effect of the Income and Corporation Taxes Act 1988, s 148 is that the first £30,000 of any payment for loss of office, redundancy or wrongful dismissal is tax free. Any balance paid in excess of that amount is added to the recipient's income for the year and taxed at the appropriate income tax rate(s). It follows that damages for loss of office etc. up to £30,000 do not represent taxable income or gains and should be paid to the claimant in full. As damages over and above £30,000 will be taxed by HM Revenue & Customs, they should be paid to the claimant in full to avoid the possibility of double taxation. The effect is to achieve Parliament's intention by ensuring that the claimant receives the first £30,000 tax free and the excess is then taxed by HM Revenue & Customs. Thus if *A* has a fixed-term contract of employment for one year for which they are to be paid £70,000 per annum and *A* is subsequently, in breach of contract, dismissed after six months, *A* may well successfully claim £35,000 compensation for the breach. In such a case the court will pay the first £30,000 in full to take into account s 148, whilst the remaining £5,000 will be paid in full and left to be taxed by HM Revenue & Customs itself.

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Income and capital receipts of a trade, profession, office or employment (subject to the above) are taxed by HM Revenue & Customs and therefore fall outside the ***Gourley*** rule. Thus if *X*, a motor dealer, successfully sues a customer for loss of profit on the sale caused by the customer acting in breach of contract, *X* will receive the damages in full since they effectively represent a receipt of the trade. The damages will then be added to *X*'s gross income and duly taxed by HM Revenue & Customs. Similarly if *R* contracts to buy certain goods from *S* for £1,000 and subsequently *S* fails to deliver in breach of contract so that *R* has to buy similar goods which cost him £1,500, then *R* may claim the £500 extra expense as damages. It is suggested that *R* will be awarded this amount in full since here the amount does not represent income but increased expenditure for an asset from which *R* might have made a profit eventually.

While the logic of ***Gourley*** may be correct it has been criticised in its operation since it treats damages awarded for loss of earnings arising out of personal injuries as taxable income.

Beach v *Reed Corrugated Cases Ltd* [1956] 2 All ER 652

In this case, it was estimated that an employee who had been wrongfully dismissed would have received £58,000 by way of salary over the next ten years. In fact the plaintiff had a large personal fortune and therefore his damages were reduced by reference to his tax liability in respect of both earnings and the personal fortune, despite the fact that the fortune might of course vary over that period. The plaintiff was eventually awarded £18,000, though Pilcher J admitted that this was no more than a rough estimation.

It would seem much more sensible for the courts to award the gross sum to the plaintiff and then allow them to make the necessary arrangements with regard to tax with HM Revenue & Customs. Whilst the principle in ***Gourley*** was considered in 1958 by the Law Reform Committee, 7th Report (1958) Cmnd 501, no recommendations arose out of the discussions. In the meantime it might be more convenient for the courts to follow the decision in ***Shove*** **v** ***Downs Surgical plc*** [1984] 1 All ER 7 where Sheen J estimated the plaintiff's net loss of income after deduction of tax and to this he added an amount equivalent to income tax. A further way round the rule is to treat awards of damages for loss of earnings as loss of earning capacity since such damages are treated for tax purposes as representing losses to a capital asset and they do not attract income tax. As the law stands at the moment, however, it is possible for a defendant to rely on totally extraneous matters, such as private income, as in the ***Beach*** case, to reduce the damages payable by themself, a result that is hardly just.

Limitations on the availability of damages

Causation

In order to claim damages the plaintiff must show that there is a causal link between the losses sustained and the breach of contract. The problem here is that circumstances might arise whereby a breach of contract occurs but the defendant argues that the level of loss sustained by the plaintiff has resulted, not from the breach of contract, but from some other intervening state of affairs.

It was stated in ***Galoo Ltd and Others*** **v** ***Bright Grahame Murray*** [1994] 1 All ER 16 that the nature of the causation necessary to establish liability for breach of contract

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(or in tort) was one of the most difficult areas of law. The Court of Appeal said that it was clear that if a breach of contract by a defendant was to entitle a plaintiff to claim damages, it must first be found to be the dominant cause of the loss. In considering whether a breach of contract was the cause of the loss or merely the occasion for the loss, a court had to arrive at that decision on the basis of common sense.

It may be the case that the loss is caused by the very nature of the contract itself so that it is this factor that results in the loss rather than the breach of contract itself.

C & P Haulage v *Middleton* [1983] 3 All ER 94

In this case the plaintiff hired a garage on a six-monthly contract basis for use in his business. During the operation of one such contract he decided to equip the garage to meet his own particular needs. The garage owner then, in breach of contract, terminated the contract ten weeks early and the plaintiff sued to recover his expenses in equipping the garage. It was held that his action would fail since the garage owner could legitimately have terminated the contract ten weeks later whereupon the plaintiff would have sustained his losses in any event. Clearly it was not the breach that had caused the loss but the nature of the contract he had entered into, although the breach meant that he suffered his losses somewhat earlier than was intended.

These matters were also discussed in ***Young* v *Purdy*** (1995) *The Times*, 7 November, where Leggatt LJ in the Court of Appeal stated that the commonsense test set out in the ***Galoo*** case was an uncertain guide in deciding whether a particular breach of duty resulted in the loss being caused. The breach of duty may be the actual cause of the loss or it may be merely an occurrence without which no loss would have been sustained, with the result that no damages would be awarded, as can be seen in the ***C & P Haulage*** decision.

A further situation which may break the causal link between the breach of contract and the losses suffered occurs where the loss results partly from a breach of contract and also from the intervening acts of a third party. In such circumstances the party who is in breach of contract will continue to be liable provided the actions of the third party are, on the balance of probabilities, foreseeable. Thus in ***Stansbie* v *Troman*** [1948] 2 KB 48 a painter was engaged to decorate some premises. On completion he left the house unlocked so that thieves were able to enter and burgle the premises. He was held to be liable for the value of the goods stolen since it was reasonably foreseeable that such an event might occur and that he should have guarded against the possibility by securing the premises. A case that contrasts with this position and is referred to extensively by Treitel is ***Weld-Blundell* v *Stephens***.

Weld-Blundell v *Stephens* [1920] AC 956

In this case an accountant was employed to conduct an investigation into the affairs of a company. The plaintiff wrote a letter to the accountant in which he libelled a number of directors of the company in question. The letter was then negligently left in one of the company's offices by the accountant's partner and when found by a manager it was handed to the directors concerned. The directors subsequently brought an action in defamation and secured damages from the plaintiff who, in turn, brought an action against the accountant for breach of contract. The claim was dismissed by the House of Lords on the basis that the action in libel did not result from the breach of contract but from the unforeseeable actions of the manager.

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While this case illustrates the point in question the basis for the decision has to be questionable since it is clear that the accountant owed the plaintiff a duty of confidentiality. Similarly, the actions of the manager are reasonably foreseeable since any employee is bound to disclose information that may be damaging to his employer's interests. Even though this reasoning would appear wrong the case is probably correctly decided on the basis that the action in defamation was in any event independent of the contract, although it resulted from the accountant's breach of contract in the first place.

Remoteness of damages

Having established that there is a causal link between the breach and the losses sustained by the plaintiff it must not nevertheless be assumed that the defendant will be liable for all losses arising out of the breach. The defendant will be liable only for losses that arise from the consequences of the breach and which can be said to be within the contemplation of the parties at the time of contracting, other losses being regarded as 'too remote'. The case that forms the basis of the modern law as regards remoteness is that of ***Hadley* v *Baxendale***.

Hadley v *Baxendale* (1854) 9 Exch 341

The plaintiffs' mill had ceased working because of a broken crankshaft. As there was no spare shaft the broken one had to be sent to the manufacturer for use as a pattern for a new one. To this end the plaintiffs engaged the defendant carriers to transport the shaft to the manufacturers. The defendants were told what the item was, a broken shaft from a particular mill, and that the plaintiffs were the proprietors of the mill. The defendants were negligent in their delivery of the shaft and their negligence resulted in the operation of the mill being shut down for longer than would have been ordinarily necessary had there been no delay in the transit of the shaft. The plaintiffs sued for their increased loss of profits caused by the delay. In his judgment Alderson B produced what has since become known as the rule in ***Hadley* v *Baxendale***:

> Where two parties have made a contract which one of them has broken, the damages which the other party ought to receive in respect of such a breach of contract should be such as may fairly and reasonably be considered either arising naturally, i.e. according to the usual course of things, from such breach of contract itself, or such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it.

It can be seen that the rule in fact has two limbs to it. Some authorities consider that there are two rules but this interpretation has largely been discounted today in favour of the notion of one rule with two limbs. The result is that there is a single test as regards the liability for damages for breach of contract based on a reasonable foresight test, and that the level of liability varies depending on the degree of knowledge that the party in breach has or is assumed to have. The effect is that the more remote the damage becomes the greater the degree of knowledge required of the guilty party. It can be seen that the two limbs represent two extremes, one dealing with normal (natural) loss, the other with abnormal (exceptional) losses. The two limbs thus comprise damage:

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1 'arising naturally, i.e. according to the usual course of things, from such breach of contract itself'. This limb covers damage that is an inevitable consequence of the breach and which the defendant should have contemplated as arising from the breach, that is, the defendant is deemed to have imputed notice of this type of damage since it is a normal consequence of the breach;
2 'such as may reasonably be supposed to have been in the contemplation of both the parties, at the time they made the contract, as the probable result of the breach of it'. This limb covers losses which would not normally be in the contemplation of the defendant as likely to result from the breach, but which they may nevertheless be liable for if they had actual knowledge of those consequences when they entered into the contract. The type of loss dealt with by this limb is special or abnormal loss.

Translating the rule into the facts of ***Hadley* v *Baxendale*** the court decided that the loss of profits could not be regarded as a normal loss since such loss was not an inevitable consequence of the delay, as the mill owners could well have had a spare shaft which would have prevented any loss from occurring. If the loss of profits was not a normal loss in the contemplation of the parties as being an inevitable consequence of the breach, then it must have amounted to a 'special loss'. Could the plaintiffs succeed here? The court again decided that they could not since this type of loss required actual knowledge on the part of the carriers that their delay would result in such losses being incurred. Since the carriers were not given actual knowledge of this potential consequence by the plaintiffs they could not be held liable for that consequence.

The rule in ***Hadley* v *Baxendale*** was given substantial airing by Asquith LJ in ***Victoria Laundry (Windsor) Ltd* v *Newman Industries Ltd*.**

Victoria Laundry (Windsor) Ltd v *Newman Industries Ltd* [1949] 2 KB 528

The facts of the case were that the plaintiffs, hoping to expand their business, bought a second-hand boiler from the defendants. At the time of contracting the boiler had yet to be dismantled but in carrying out that operation the defendants damaged it. The result of this was that it arrived at the plaintiffs 22 weeks late. The delay meant that the plaintiffs failed to reap the extra profits the new boiler would have produced. These were assessed at £16 per week. The plaintiffs also lost a lucrative dyeing contract with the Ministry of Supply, the damages for the loss of profits here being assessed at £262 per week. The plaintiffs sued for breach of contract. It was held that the plaintiffs could recover the £16 per week. The loss of profits here clearly fell within the first limb, being normal losses which the defendants must have known, at the time of entering into the contract, that the plaintiffs would sustain by their failure to deliver the boiler on time. The claim in respect of the £262 per week failed. This item was a special or abnormal loss for which the defendants would be liable only if they had actual knowledge of the possibility that such loss might occur at the time of entering into the contract. Since the plaintiffs had not told or otherwise informed the defendants of the lucrative dyeing contract, the defendants had no actual knowledge of such potential loss and were not therefore liable for this item.

It was stated earlier that the two limbs of the rule represent two extremes and it thus remains to be decided how one determines liability for loss which is something more than a natural loss and yet falls short of a special loss, actual knowledge of which has been given to the defendant. Asquith LJ considered that the liability for loss here depended on a reasonable foreseeability test. Thus he stated:

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> In cases of breach of contract the aggrieved party is only entitled to recover such part of the loss actually resulting as was at the time of the contract reasonably foreseeable as likely to result from the breach . . . In order to make the contract-breaker liable under either rule it is not necessary that he should actually have asked himself what loss is liable to result from a breach . . . It suffices that, if he had considered the question, he would, as a reasonable man, have concluded that the loss in question was liable to result . . . Nor, finally, to make the particular loss recoverable, need it be proved that on a given state of knowledge, the defendant could, as a reasonable man, foresee that a breach must necessarily result in that loss. It is enough if he could foresee it was likely so to result. It is enough . . . if the loss (or some factor without which it would not have occurred) is a 'serious possibility' or a 'real danger'. For short, we have used the word 'liable' to result. Possibly the colloquialism 'on the cards' indicates the shade of meaning with some approach to accuracy.

The result of the above was that Asquith LJ seemed to suggest that the test of remoteness in contract was the same as the test applied in tort. This approach was subject to sharp rebuke from their Lordships in ***Koufos* v *Czarnikow Ltd, The Heron II*** [1969] 1 AC 350. They considered that it was insufficient merely to show reasonable foreseeability of the loss. Lord Reid, in particular, considered that the question of liability turned on whether:

> on the information available to the defendant when the contract was made, he should, or the reasonable man in his position would, have realised that such loss was sufficiently likely to result from the breach of contract to make it proper to hold that the loss flowed naturally from the breach of contract or that loss of that kind should have been within his contemplation.

Lord Reid thus for the most part confined liability to that of loss arising naturally from the breach or loss that should have been within contemplation, that is, special loss. He considered that loss that fell within these two extremes would only occur 'in a minority of cases' and that such loss was not recoverable.

Lord Reid went on to distinguish between foreseeability in tort and foreseeability in contract. He considered that reasonable foreseeability in tort imposed a wider liability and allowed for recovery of the most unusual losses – provided that they were reasonably foreseeable. In contract, however, he considered the situation was different since the parties were free to protect themselves in respect of unusual or special losses by specifically drawing the attention of the other party to that particular risk, thereby placing it within the contemplation of that individual.

The other judges within the House of Lords produced various ways of explaining the difference in the foreseeability test in contract and in tort, though these attempts were largely spurious exercises in semantics which failed to explain the difference adequately, although four of the five members of the House considered the 'on the cards' expression of Asquith LJ to be inappropriate.

The decisions in the ***Victoria Laundry*** and ***Heron II*** cases were extensively considered in the Court of Appeal in ***H Parsons (Livestock) Ltd* v *Uttley Ingham***.

H Parsons (Livestock) Ltd v *Uttley Ingham* [1978] 1 All ER 525

In this case there was a contract for the sale and installation of an animal feed hopper which was to have a ventilated top. During transit to the site the ventilation hatch had been sealed and when installation was completed the defendants forgot to open the hatch. The result was that some of the feed went mouldy and caused a rare intestinal disease to break out amongst the plaintiff's pigs, killing 254 of them. At first instance the plaintiff lost his claim for the loss of the pigs since the judge considered that such loss was not within the contemplation of the parties. The Court of Appeal reversed this decision.

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Lord Scarman took a diametrically opposing view to that of the House of Lords in the ***Heron II*** case and was supported by Orr LJ. He stated that there was no difference between the test of remoteness in contract and that in tort. He stated that, in any event, whether it be in contract or in tort, the test of remoteness depended, not on the contemplation of the degree of injury, but simply on proof that the loss could reasonably have been anticipated. He stated that if the defendants had merely manufactured the defective hopper which had then been sold to a retailer, who, in turn, had resold it to the plaintiffs, then the action of the plaintiffs would have been in tort against the manufacturer. The test of remoteness here would have been based on a reasonable foreseeability test based in tort and clearly there was no reason why this should be any different from the test that should exist in contract. The arguments of Lord Scarman make a great deal of sense and certainly make for a simpler application of the law.

Lord Denning adopted a different solution to the problem, differentiating between economic loss, such as loss of profits, as occurred in ***Victoria Laundry*** and ***Heron II***, and physical loss, which occurred in the ***H Parsons*** case. He considered that the stricter test proposed by Lord Reid was appropriate where the loss amounted to economic loss, and to some degree this view has some credence since, as pointed out by Lord Reid himself, the parties can provide for such occurrence specifically within the contract itself. In respect of physical loss, that is, personal injury or damage to property, Lord Denning considered that the test of remoteness in contract should be the same as that found in tort. In such an instance the defendant is liable for any loss which they ought reasonably to be able to foresee at the time of the breach as being a possible consequence of the breach, no matter how slight that possibility. The view of Lord Denning undoubtedly reconciles the particular problems of cases like ***H Parsons*** with those encountered in ***Victoria Laundry*** and ***Heron II*** but it is unattractively unwieldy and has no authoritative support.

The discussions that took place in the Court of Appeal in ***H Parsons*** clearly stand in the shadow of the decision in ***Heron II***. For the moment at least the reasoning of Lord Reid that liability for special loss arises only where that loss is contemplated must persist. It has one advantage in that the strictness of the rule should encourage parties to a contract to provide information as regards the possible extent of their losses, though it is clearly inappropriate in cases such as ***H Parsons***.

In ***Jackson* v *Royal Bank of Scotland plc*** [2005] UKHL 3; [2005] 2 All ER 71, the House of Lords confirmed that the rule of remoteness of damages in contract was governed by that which was contemplated by the parties at the commencement of the breach of the contract. The logic in making this distinction between remoteness in contract as from tort is sound. In the law of contract parties enter into their obligations from the time of contracting and therefore it is assumed that any breach of the contractual terms arises from the inception of the contract. Thus, on entering into a contract, if a party wishes to know what his liability is for breaking it that party can be advised accordingly from a simple examination of the contract. This is not the case in tort. One cannot foresee the consequences of a tortious act until the act itself occurs and it is only at this time that one can assess the likely liability.

A recent application of the rule in ***Hadley* v *Baxendale*** can be seen in the Scottish case of ***Balfour Beatty Construction (Scotland) Ltd* v *Scottish Power plc*** (1995) 71 BLR 20 where Balfour Beatty were the main contractors for the construction of a section of the Edinburgh bypass and its associated structures. In order to carry out the project it was necessary to build a concrete production plant to provide for a continuous pour of concrete. The defendants contracted to provide a temporary supply of electricity to the plant. During construction the electricity supply was interrupted which caused a break in the continuous

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pour process. As a result of this an aqueduct could not be constructed according to the civil engineering specifications and therefore had to be demolished and rebuilt. The plaintiffs sought to recover the costs of the demolition and reconstruction from the defendants.

The House of Lords held that the loss was too remote. It applied the principles in ***Hadley* v *Baxendale*** (the rule also operates in Scots law), i.e. whether the loss was of the type that might reasonably have been contemplated by the defendants at the time of the contract as a consequence of the breach. Their Lordships found there was no evidence that the defendants were aware of the need for a continuous pour process. They considered that it had always to be a question of fact what one contracting party was presumed to know about the business activities of the other. Jauncey LJ considered that there was no general rule to the effect that in all the circumstances contracting parties were presumed to have reasonable knowledge of the course of business conducted by each other, finding support for this view in the ***Heron II*** case. However, the simpler the activity, the more likely could it be inferred that the parties had a reasonable knowledge of each other's business activities. On the other hand, if one party was involved in complex manufacturing or construction processes, there was no reason why a supplier of a product to be used in those processes should be aware of the details of all the techniques to be used in the process and thus be aware of the effect of a failure or deficiency in the product supplied.

Transfield Shipping Inc. v *Mercator Shipping Inc. (The Achilleas)* [2008] UKHL 48; [2008] 3 WLR 345

In this case the House of Lords reviewed the operation of the first arm of the rule in ***Hadley* v *Baxendale***. The facts of the case were that Mercator Shipping ('M'), the shipowner, had chartered a ship to Transfield Shipping ('T'), for a period of five to seven months, to end no later than midnight on 2 May 2004. T notified M that the ship would be back no later. M therefore contracted to let the ship to new charterers for a period of about four to six months, promising that they could have the ship no later than 8 May 2004. The agreed price of hire was $39,500 a day. The ship was delayed on its last voyage and M did not get it back until 11 May 2004. The new charterers agreed to take the ship, but by then the market had fallen sharply and they would only take it at a reduced price of $31,500 a day. The dispute went before the arbitrators on the basis of whether T was liable to pay only for the use of the ship for the number of days that it was late at the market rate then prevailing or whether, as M had argued, T was liable to pay the difference between what M would have got from the new charter had the ship been returned in time and what it in fact got. The arbitrators, by a majority, adopted the latter approach. They concluded that the loss on the new charter fell within the first rule in ***Hadley* v *Baxendale*** as arising 'naturally, i.e. according to the usual course of things, from such breach of contract itself'. It fell within that rule because it was damage 'of a kind which the [charterer], when he made the contract, ought to have realised was not unlikely to result from a breach of contract caused by delay in redelivery'. A dissenting arbitrator did not deny that T would have known that M would be very likely to enter into a following fixture (or charter) during the course of the charter and that late delivery might cause that fixture to be lost. However, he concluded that a reasonable man in T's position would not have understood that he was assuming liability for the risk of the type of loss in question. He stated that the general understanding in the shipping market was that liability was restricted to the difference between the market rate and the charter rate for the overrun period and that 'any departure from this rule [is] likely to give rise to a real risk of serious commercial uncertainty which the industry as a whole would regard as undesirable'. The appellant charterer (T) appealed against the decision to the Court of Appeal, which upheld the decision by the arbitrators. The appellant charterer then appealed to the House of Lords, which allowed the appeal.

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The House of Lords considered that, in accepting M's submission that what mattered was whether the type of loss claimed was foreseeable, the majority arbitrators had applied too crude a test, and it was an error of law to adopt it. The common basis on which the parties had contracted was essential to the rule in ***Hadley* v *Baxendale*** as a whole. In ***Heron II*** their Lordships had in mind that it was not simply a question of probability but also of what the contracting parties had to be taken to have had in mind, having regard to the nature and object of their business transaction. What mattered was whether it was the common intention of reasonable parties to a charterparty of this sort that in the event of a relatively short delay in redelivery that an extraordinary loss, measured over the whole term of the renewed fixture, was, in the words of Lord Reid in ***Heron II***, 'sufficiently likely to result from the breach of contract to make it proper to hold that the loss flowed naturally from the breach or that loss of that kind should have been within [the defaulting party's] contemplation'. The court considered that would not have been the common intention of reasonable contracting parties and it was contrary to the principle stated in ***Victoria Laundry (Windsor)* v *Newman Industries***, as reaffirmed in ***Heron II***, to suppose that the parties were contracting on the basis that T would be liable for any loss, however large, occasioned by a delay in redelivery in circumstances where it had no knowledge of, or control over, the new fixture entered into by M.

The House of Lords was clearly of the opinion that the rule in ***Hadley* v *Baxendale*** is more than simply a principle that 'remoteness of damages in contract is determined by . . . what at the time of the contract was reasonably foreseeable' (Lord Hope). In order to arrive at the losses for which the charterer was liable one has to consider not just the question of foreseeability but also whether the losses are of a 'type' or 'kind' which the charterer ought fairly to be taken to have accepted responsibility for. Thus whilst the losses suffered by M are foreseeable in the sense that T must have known that M would have suffered loss by the charter overrun, T would not have reasonably contemplated the losses sustained by M – a reasonable man in T's position would not have understood that he was assuming liability for the risk of the type of loss in question. As Lord Hoffmann stated:

> It is generally accepted that a contracting party will be liable for damages for losses which are unforeseeably large, if loss of that type or kind fell within one or other of the rules in ***Hadley* v *Baxendale*** . . . But . . . a party may not be liable for foreseeable losses because they are not of a type or kind for which he can be treated as having assumed responsibility. What is the basis for deciding whether loss is of the same type or a different type? It is not a question of Platonist metaphysics. The distinction must rest upon some principle of the law of contract. In my opinion the only rational basis for the distinction is that it reflects what would have [been] reasonable [as] regarded by the contracting party as significant for the purpose of the risk he was undertaking.

The claim of M in this case was a novel one, there being no previously reported case dealing specifically with this issue. Previous cases had always assumed that the measure of damages for late delivery was the difference between the charter rate and the market rate. None of the previous authorities had dealt with the possibility of damages for the loss of a following charter. In arriving at his judgment Lord Hoffmann relied heavily on the cases of ***Banque Bruxelles Lambert SA* v *Eagle Star Insurance Co. Ltd (sub nom South Australia Asset Management Corporation* v *York Montague Ltd)*** [1997] AC 191. In that case the question had arisen as to whether a valuer, who (in breach of an implied term to exercise reasonable care and skill) had negligently misinformed his client, a bank, that property to be used as security for a loan was worth significantly more than its true

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market value, was liable not only for the losses attributable for the deficient security but also further losses attributable to the fall in the property market. The House of Lords considered that he should not be so liable on the basis that a term implied by law that imposes a duty of care on the valuer could only render him liable to the extent that the lender, the bank, does not obtain less than he was reasonably entitled to expect, nor extending the liability of the valuer to the extent that it is more than he could reasonably have thought he was undertaking. The effect of this was to exclude the liability for the fall in the property market despite the fact that those losses were foreseeable in the sense of being 'not unlikely' to arise. Those losses were therefore 'outside of the scope of liability which the parties would have reasonably considered that the valuer was undertaking' (*per* Lord Hoffmann).

Lord Hoffmann also referred to the judgment of Goff J in ***Satef-Huttenes Albertus Spa* v *Paloma Tercera Shipping Co. SA (The Pegase)*** [1981] Lloyd's Rep 175 in which he stated that the test was:

> . . . have the facts in question come to the defendant's knowledge in such circumstances that a reasonable person in the shoes of the defendant would, if he had considered the matter at the time of making the contract, have contemplated that, in the event of a breach by him, such facts were to be taken into account when considering his responsibility for loss suffered by the plaintiff as a result of such a breach.

This position was also adopted in the later Court of Appeal case of ***Mulvenna* v *Royal Bank of Scotland plc*** [2003] EWCA Civ 1112 in which a property developer sought to recover loss of profits that he hoped to make from a development to be financed by the bank and which he lost by the actions of the bank in withdrawing from the loan agreement. In that case the Court of Appeal held that even if the bank knew the purpose for which the funds were to be required and that it was foreseeable that the claimant developer would suffer loss of profit if he did not receive them, the damages were not recoverable.

In this case Sir Anthony Evans provided a useful insight into why the loss of profits were not recoverable and reconciled the decision in terms of the judgments contained in ***South Australia*** and ***The Pegase*** cases. He thus stated:

> The authorities to which we were referred . . . demonstrate that the concept of reasonable foreseeability is not a complete guide to the circumstances in which damages are recoverable as a matter of law. Even if the loss was reasonably foreseeable as a consequence of the breach of duty in question (or of contract, for the same principles apply), it may nevertheless be regarded as 'too remote a consequence' or not a consequence at all, and the damages claim is disallowed. In effect, the chain of consequences is cut off as a matter of law, either because it is regarded as unreasonable to impose liability for that consequence of the breach (***The Pegase*** [1981] Lloyd's Rep 175, Robert Goff J), or because the scope of the duty is limited so as to exclude it (***Banque Bruxelles Lambert SA* v *Eagle Star Insurance*** [1997] AC 191), or because as a matter of commonsense the breach cannot be said to have caused the loss, although it may have provided the opportunity for it to occur . . .

Sir Anthony Evans therefore provides us with three reasons why the damages in each of the cases were irrecoverable. It would appear that even if losses could be regarded as reasonably foreseeable they are still not recoverable since the losses were not of the type or kind for which a contracting party at the time the contract was entered into could have contemplated assuming responsibility. Essentially in the ***Mulvenna*** case

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one may argue that the losses claimed for were too speculative. Clearly the bank could not have predicted being liable for such loss of profits – even if such profits were made. Building developments often make losses and clearly it could not be in the contemplation of the bank when agreeing to a development loan that they could be liable for loss of profits that may or may not arise. As Sir Anthony Evans indicates, 'as a matter of commonsense the breach cannot be said to have caused the loss'. Equally, damages may not be recoverable if the level of loss is unpredictable in the sense that whilst the losses may be reasonably foreseeable, they were 'outside of the scope of liability which the parties would have reasonably considered that the valuer was undertaking', as in ***South Australia***. It is suggested that this is the essence behind the decision in ***Transfield***. Would the decision in ***Transfield*** have been different if the second charterer on not receiving the ship on time had repudiated their contract with M? Would T have been liable for the losses sustained by M from the loss of that contract? Presumably this would have been reasonably foreseeable and in the contemplation of the parties as a likely result of an overrun on the charter and, subject to mitigation of loss by M, damages would be recoverable in such an instance.

One final point on the question of remoteness is that once the kind of damage brought about by the breach of contract is found to be within the reasonable contemplation of the parties, whichever branch of the rule in ***Hadley* v *Baxendale*** applies, the fact that the results are far more serious than could be reasonably contemplated is immaterial, as held in ***Vacwell Engineering Co. Ltd* v *BDH Chemicals Ltd*** [1971] 1 QB 111n and affirmed in ***Brown* v *KMR Services Ltd*** [1995] 4 All ER 598.

Mitigation of loss

It has been seen how the basic concept of damages in contract, that is, to place the plaintiff in the same position they would have been in had the contract been carried out, is subject to the test of remoteness. However, the basic concept is also limited by the notion of **mitigation of loss**. Mitigation essentially means that a plaintiff will not be able to claim for losses which could have been avoided by the taking of reasonable steps to reduce those losses once the plaintiff has elected to treat the contract as at an end.

The principle may be seen in the context of a fixed-term contract of employment, say, for two years. If the employee is wrongfully dismissed four months into the contract, they cannot sit back and do nothing for the balance of the two years and then claim the full salary for the period of the contract. They must attempt to reduce the loss as far as can be expected of a reasonable person. They should, as held in ***Brace* v *Calder*** [1895] 2 QB 253, attempt to take up other employment, thereby reducing the losses. As stated by Haldane LC in ***British Westinghouse Electric and Manufacturing Co. Ltd* v *Underground Electric Railways Co. of London Ltd***:

> I think that there are certain broad principles, which are quite well settled. The first is that, as far as possible, he who has proved a breach of a bargain to supply what he contracted to get is to be placed as far as money can do it, in as good a situation as if the contract had been performed. The fundamental basis is thus compensation for pecuniary loss naturally flowing from the breach; but this first principle is qualified by a second, which imposes on a plaintiff the duty of taking all reasonable steps to mitigate the loss consequent on the breach, and debars him from claiming in respect of any part of the damage which is due to his neglect to take such steps.

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British Westinghouse Electric and Manufacturing Co. Ltd v *Underground Electric Railways Co. of London Ltd* [1912] AC 673

The facts of this case were that the appellants, Westinghouse, had contracted to supply turbines to the respondents. The respondents laid down that the turbines had to meet certain specifications. While the appellants built and delivered the turbines they never met the specifications required by the contract. In due course the respondents had to replace the turbines with those produced by a different manufacturer. The new turbines were highly efficient, so much so that they quickly paid for themselves. Nevertheless the respondents sued for the cost of purchasing and installing the new turbines. It was held that they could not do so. The respondents were required to mitigate their losses and this they had done, but so efficiently as to eliminate the costs of replacing the original turbines, and therefore nothing could be recovered as regards these losses. They were entitled, however, to compensation for the losses sustained while the inefficient turbines were being used.

Whether a plaintiff has taken reasonable steps to reduce their losses is a question of fact, the question revolving around whether the plaintiff has done everything a reasonable person might be expected to do in the ordinary course of business. From this it can be seen that the plaintiff is not obliged to embark upon a difficult course of action in order to mitigate any losses. Thus it was held in ***Pilkington* v *Wood*** [1953] 2 Ch 770 that the plaintiff was not obliged to embark upon difficult and complicated litigation. Similarly, in ***Selvanayagam* v *University of the West Indies*** [1983] 1 WLR 585 it was held that the plaintiff was not required to undergo an operation which carried a risk of post-operative complications in order to mitigate the loss. According to ***Payzu Ltd* v *Saunders*** [1919] 2 KB 581 the burden rests on the defendant to prove that the plaintiff has not taken reasonable steps to mitigate any losses. In this context it should be noted that provided the plaintiff's attempts to mitigate are reasonable at the time, it is irrelevant if they are subsequently found to be inefficient, as stated in ***Gebruder Metel Mann GmbH & Co. KG* v *NBR (London) Ltd*** [1984] 1 Lloyd's Rep 614.

The rules on mitigation present particular problems in relation to anticipatory breach since there is no duty to mitigate while the plaintiff treats the contract as still subsisting, as may be seen in the case of ***White and Carter (Councils) Ltd* v *McGregor*** [1962] AC 413. In this context, however, the attempts to restrict this rule as stated in ***The Alaskan Trader*** [1984] 1 All ER 129 should also be noted carefully (both cases being discussed in Chapter 13). Thus the duty to mitigate in anticipatory breach arises only where the plaintiff elects to treat the contract as at an end.

There are two final points on mitigation. First, there is no duty on the plaintiff to mitigate. A plaintiff is only under a duty to take reasonable steps to mitigate the loss, and if the plaintiff chooses to take no steps it simply means that they will fail to be compensated for those losses which they could have avoided by the taking of reasonable steps. Second, there is no duty on an agent to mitigate their loss for the purpose of calculating their indemnity under reg 17 of the Commercial Agents (Council Directive) Regulations 1993, as held in ***Moore* v *Piretta PTA Ltd*** [1999] 1 All ER 174.

Contributory negligence

The apparent overlap between contract and tort in relation to the test of remoteness also arises in this fourth limitation on the availability of damages, contributory negligence. The limitation of contributory negligence on an award of damages in tort has been

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recognised for some time, initially as a complete defence to an action and latterly, since the Law Reform (Contributory Negligence) Act 1945, as a means of reducing the amount of damages that might be recovered. The question arises as to whether such a doctrine will apply equally to contract as to tort, given the different criteria by which damages are assessed in the two areas and the fact that the law of contract imposes strict liability.

The answer to the question appears to lie within ss 1(1) and 4 of the 1945 Act. Section 1(1) states:

> (1) Where any person suffers damage as the result partly of his own fault and partly of the fault of any other person or persons, a claim in respect of that damage shall not be defeated by reason of the fault of the person suffering the damage, but the damages recoverable in respect thereof shall be reduced to such extent as the court thinks just and equitable having regard to the claimant's share in the responsibility for the damage.

For liability in contract to fall within this provision it would be necessary to show that it falls within the concept of 'fault' as expressed in s 1. 'Fault' is defined in s 4, which is the interpretation section of the Act. It states:

> 'Fault' means negligence, breach of statutory duty or other act or omission which gives rise to a liability in tort or would, apart from this Act, give rise to the defence of a contributory negligence.

In deciding whether liability in contract falls within the latter part of this provision Hobhouse J in ***Forsikringsaktieselskapet Vesta*** v ***Butcher*** [1986] 2 All ER 488 (affirmed by the Court of Appeal [1989] 1 All ER 404) identified three possibilities: first, the defendant is in breach of their strict obligations under the contract; second, the defendant is in breach of a duty to take reasonable care which is laid down in a contract, though there is no corresponding duty in tort – for example, such a duty may arise in a contract for services; third, the defendant is in breach of a duty of care arising out of liability both in contract and in tort.

It was held in the ***Butcher*** case that the 1945 Act would apply only in regard to the third classification, thus allowing contributory negligence to have a bearing on the overall assessment of damages. Apparently the reason is that the defendant's liability in contract could also arise separately and independently within an action in negligence, in which, of course, the 1945 Act would apply. This position was also affirmed in ***Barclays Bank plc*** v ***Fairclough Building Ltd*** [1995] 1 All ER 289 (CA).

In ***AB Marintrans*** v ***Comet Shipping Co. Ltd*** [1985] 3 All ER 442 and ***Basildon District Council*** v ***J E Lesser (Properties) Ltd*** [1985] 1 All ER 20, it was stated that the 1945 Act did not apply to the first possibility since s 4 clearly placed 'fault' in the context of a claim in tort, thereby specifically excluding liability arising in contract solely from the provisions of s 1. With regard to the second possibility, Neil LJ in the ***Comet Shipping*** case considered that the 1945 Act applies only where the breach complained of involves a breach of a duty in tort. This view thus also excludes this category from the provisions of the 1945 Act. This reasoning is also propounded by O'Connor LJ in the ***Butcher*** case.

Gran Gelato Ltd v *Richcliff (Group) Ltd* [1992] 1 All ER 865

This case considered whether contributory negligence should operate to reduce an award of damages made under an action for breach of the Misrepresentation Act 1967, s 2(1). The facts of the case were that the defendant had given the plaintiff an underlease for ten years in 1984. The head lease contained a break clause which was exercisable on the giving of

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12 months' notice, expiring on or after June 1989. Neither Gran Gelato nor its solicitors was aware of this restriction. In reply to an inquiry, the defendant's solicitors had stated that there were no such rights in the head lease that would affect the tenant's enjoyment of the property 'to the lessor's knowledge'. In 1988 the lessor of the head lease exercised the break clause in order to redevelop the property. The plaintiff brought an action for misrepresentation and for negligent misstatement. The defendant claimed that the plaintiff was contributory negligent in not asking for and examining the head lease. The plaintiff argued that the Law Reform (Contributory Negligence) Act 1945, s 1, did not apply to a claim for damages under s 2(1) of the 1967 Act. It was held that the 1945 Act applied to both the claim under s 2(1) and that for negligent misstatement at common law. It was also stated that this would be the case if a claim was framed under s 2(1) alone, otherwise plaintiffs could avoid apportionment by bringing a claim under the Misrepresentation Act 1967. Nicholls VC considered that 'fault' within the 1945 Act was wide enough to encompass the 1967 Act. On the facts, however, it was decided that it was not just and equitable to make a reduction in damages.

For more on fraudulent misrepresentation refer to Chapter 9.

It should be noted that in ***Alliance & Leicester Building Society* v *Edgestop Ltd*** [1994] 2 All ER 38, Mummery J considered that contributory negligence has no application in the case of fraudulent misrepresentation. This decision clearly distinguishes the decision in ***Gran Gelato*** and may be considered as affirming the decision of Lord Jessel MR in ***Redgrave* v *Hurd*** (1881) 20 ChD 1 (*see* p. 238) in which he stated: 'Nothing can be plainer, I take it, on the authorities in equity than that the effect of false representation is not got rid of on the ground that the person to whom it was made has been guilty of negligence.' But is it correct to place so much store in this decision? After all, contributory negligence is widely accepted as being applicable to negligent misstatements following the 1945 Act today. It is arguable that a person who has the opportunity of investigating the representations made to them, for example, by having accounts audited, should be regarded as being contributory negligent if they fail to do so. Furthermore, Lord Jessel MR makes no reference specifically to fraud. It thus appears to be somewhat dubious to use ***Redgrave* v *Hurd*** as expounding a principle that contributory negligence could be used in the case of fraudulent misrepresentation, although the circumstances in which this may arise must be very limited. One should also note the wording of s 4 of the 1945 Act, 'negligence, breach of statutory duty or other act or omission which gives rise to a liability in tort'. This does not preclude contributory negligence in fraud – the tort of deceit; quite the contrary, it states it can apply to 'liability in tort' in the generic sense of the expression.

The Law Commission proposed in Law Commission Working Paper No 114 that the 1945 Act should apply to a breach of the strict contractual duty, although this proposal has not found favour, probably because of the need to balance the interests of the parties within the contract, particularly with regard to the equality of their bargaining power.

In 1993 the Law Commission published its report *Contributory Negligence as a Defence in Contract* (Law Com. No 219). The Law Commission recommended that the possibility of apportionment should be rejected where there was liability for breach of a strict contractual obligation. It was stated that the reason for this conclusion related to a consideration of the position before a plaintiff is aware, or must be taken to be aware, of the defendant's breach of contract. If the defendant commits himself to a strict obligation regardless of fault (as arises in contract), then a plaintiff should be able to rely on the

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defendant fulfilling his obligations and should not have to take precautions against the possibility that a breach might occur. The Law Commission thus affirmed the present law and, while it considered that the rules on mitigation of loss were not a substitute for apportionment for contributory negligence, they nevertheless prevented the plaintiff from acting unreasonably once they became aware of the loss or the defendant's breach.

The Law Commission considered, however, that where a plaintiff suffered damage partly as a result of their own failure to take reasonable care for the protection of themself or their interests and partly as a result of the defendant's breach of a contractual duty to take reasonable care or exercise reasonable skill, apportionment should be allowed in respect of the plaintiff's damages. It was stated that whether a duty of reasonable care is classified as contractual or tortious does not affect the content of the duty and the Law Commission considered that the availability for apportionment should not depend on how the duty to take reasonable care is classified.

The report (which also contains a draft Bill) defines contributory negligence as a 'plaintiff's failure to take reasonable care for the protection of himself or his interests' (clause 1(1)(b) of the draft Bill). The criteria for apportionment would be the same as in the 1945 Act, i.e. the plaintiff's damages would be reduced by the amount the court thinks 'just and equitable having regard to the plaintiff's share in the responsibility for the damage' (clause 1(1) of the draft Bill). While the Law Commission allowed for the parties to contract out of contributory negligence as a defence (clause 1(2)), it also stated that, if a contract made provision for liquidated damages in the event of a breach, this amount would not be subject to a reduction on the grounds of the plaintiff's contributory negligence (clause 1(2)). The Law Commission also made it clear that anything done or omitted to be done by the plaintiff prior to entering into the contract would be disregarded for the purposes of assessing whether the damages should be reduced for contributory negligence (clause 1(3)).

As the law stands, it may nevertheless still be possible, by the use of the common law rule, to raise contributory negligence as a means of defeating a plaintiff's claim altogether. The effect of contributory negligence here, however, is to break the chain of causation and it is rather different conceptually since the basis here is that the plaintiff was solely responsible for their injury or loss, as was held in ***Quinn* v *Burch Bros (Builders) Ltd*** [1966] 2 QB 370.

Contractual provisions relating to the limitation of damages

It has been clearly demonstrated in this work that it was in the nineteenth century first and foremost that a philosophy of freedom of contract was established. Embedded in this philosophy was not only the freedom to enter into and negotiate the terms of contract, but also the right of the parties to determine the levels of compensation payable in the event of a breach. The courts therefore readily surrendered their right to make awards to the will of the parties themselves as expressed within the terms of the contract. There were substantial advantages to the judicial process by the adoption of this approach, such as savings in time and expense. Despite the adoption of this position by the courts there was no question of their completely abrogating their jurisdiction as regards awards of damages. The courts were not so naive as to think that freedom of contract and equality of bargaining power represented the same thing and would step in to regulate awards of damages despite the terms of the agreement. The regulatory nature of the courts may be encountered in two broad areas: first, in the area of **penalties**; and, second, in the regulation of **deposits** and **forfeiture clauses**.

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Liquidated damages and penalties

The parties may decide to make a genuine pre-estimate of the losses they may encounter should the other party be in breach of contract and then agree that certain sums will be payable if such an event occurs. Where the sums payable are a genuine pre-estimate of loss then the courts will support claims for such sums, despite the fact that the actual losses may be more or less than the actual loss sustained by the breach. The sums agreed to be payable by the parties in these circumstances are termed 'liquidated damages'.

In some contracts, however, the sums agreed by the parties to be payable are not based on a genuine pre-estimate of the losses the parties may encounter should a breach occur. These sums are usually excessive in relation to the maximum possible losses the parties may sustain in such circumstances. Such sums, rather than being 'liquidated damages' and amounting to compensation, are termed 'penalties' and are placed in the contract as a punitive measure to hold a party *in terrorem* of (as a warning against) breaking the terms of the contract. The courts will not award sums which are considered to be penalties and will substitute a sum representing the actual losses sustained to a party by reason of the breach.

Dunlop Pneumatic Tyre Co. Ltd v *New Garage and Motor Co. Ltd* [1915] AC 79

The basis on which the courts decide whether a pre-estimated sum is a penalty or not was laid down by Lord Dunedin in this case as follows:

1. A sum will be a penalty if it is extravagant having regard to the maximum possible loss that may be sustained by the breach.
2. If the contract imposes a liability on a party to pay a sum of money and failure to do so results in that party incurring liability to pay a larger sum, then the latter will be regarded as a penalty. In such cases it is possible to measure fairly precisely what the loss will be, and thus the liability to pay the larger sum must of necessity clearly be a penalty.
3. If a single sum is payable upon the occurrence of one or several breaches of the contract, some being serious, some being minor, then that sum will raise the presumption of its being a penalty.

This presumption is weakened if it is almost impossible to prove the actual losses that may result from the various breaches, although the fact that an accurate pre-estimation of loss is not possible will not prevent a sum from being a penalty. Thus in the ***Dunlop*** case itself there was a contract entered into for the supply and purchase of tyres. The agreement was said to be a 'Price Maintenance Agreement' under which the defendants were not to sell the tyres below certain prices, not to sell to persons on a 'black' list, not to exhibit or export the tyres without consent and, lastly, not to tamper with certain marks on the tyres. The defendants had to pay £5 by way of liquidated damages for every tyre cover or tube sold or offered in breach of the agreement. The defendants sold a tyre below the plaintiff's current list price, and he claimed the £5 damages. The court held that the sum amounted to liquidated damages, the reason being that, while the sum involved was disproportionate to the loss sustained, the motive behind the agreement was to prevent a price war, as this would have damaged Dunlop's selling organisation. The motive behind this clause therefore was not to hold the defendants *in terrorem* of breaking the agreement, but to maintain balance within the industry. From Dunlop's point of view this would amount to a genuine pre-estimate of their possible indirect losses.

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A rather more straightforward approach to differentiating between a liquidated damages clause and a penalty can be seen in ***Lordsvale Finance plc* v *Bank of Zambia*** [1996] QB 752 where Coleman J stated:

> Whether a provision is to be treated as a penalty is a matter of construction to be resolved by asking whether at the time the contract was entered into the predominant contractual function was to deter a party from breaking the contract or to compensate the innocent party for breach. That the contractual function is deterrence rather than compensatory can be deduced by comparing the amount that would be payable on breach with the loss that might be sustained if breach occurred.

This approach was approved of by Mance LJ in ***Cine Bes Film Cilik ve Yapimcilik* v *United International Pictures*** [2003] EWCA 1669 considering it was a more accessible paraphrase of the concept of penalty rather than relying on statements such as *'in terrorem'*. In ***Murray* v *Leisureplay plc*** [2005] EWCA Civ 963 Lord Arden stated that the courts are not confined to the terms of the agreement in determining whether a term is a penalty or not and it was stated that the court may look at the inherent circumstances of the contract to be judged at the time the contract was entered into such as the bargaining power of the parties.

It was held in ***Robophone Facilities Ltd* v *Blank*** [1966] 1 WLR 1428 that the burden of proving whether a sum is a penalty lies on the party from whom the sum is being recovered. The mere fact that a clause is described in the contract as being either a 'liquidated damages' clause or a 'penalty' clause is not conclusive. Thus in ***Cellulose Acetate Silk Co. Ltd* v *Widnes Foundry (1925) Ltd*** [1933] AC 20 a pre-estimated sum of £20 per week which was payable on late performance was described in the contract as a penalty. In fact the amount was not excessive with regard to the actual losses that would be sustained by late performance and was thus awarded, despite the designation given to the term.

It is not possible for the parties simply to agree to a term of contract that an amount payable on termination of a contract is a reasonable pre-estimate. In ***Duffen* v *FRA BO SpA*** (1998) *The Times*, 15 June, an agent terminated his agreement following a breach by his principal. He claimed £100,000 by way of a liquidated damages clause within the agreement. This stated: 'upon termination of the agency agreement by the agent . . . the principal shall immediately become liable to the agent for and shall pay to the agent forthwith the sum of £100,000 by way of liquidated damages which sum is agreed by the parties to be a reasonable pre-estimate of the loss and damage which the agent will suffer on termination of this agreement'. At first instance the judge considered that this was not a penalty and awarded the agent £100,000. The principal appealed to the Court of Appeal, which allowed the appeal. The court considered that the clause could not have been a genuine advance estimate of the loss that the agent might suffer on the occasion of a breach by his principal. The agent was therefore confined to claiming damages based on ordinary common law principles, though he could augment these damages by bringing a claim under the Commercial Agents (Council Directive) Regulations 1993. The court followed the much earlier case of ***Elphinstone* v *Monkland Iron & Coal Co.*** (1886) 11 App Cas 332, in that the fact that the clause actually stated that the sum of £100,000 was agreed to be a genuine pre-estimate was not conclusive, albeit that it might be persuasive. The Court of Appeal considered other factors had to be taken into account – for instance, the sum did not take into account the length of time the contract had to run. Thus if there was only a short period of time before the contract was to expire the sum of £100,000 would be excessive. The amount payable under such a clause consequently had no regard to the possible losses the agent might sustain and thus could be described as 'extravagant'. This

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position was further reinforced by the fact that the Court of Appeal on examining the contract found that it set out reasons which allowed the agent to terminate the agreement. Several of these reasons were regarded as trivial. The court considered that a sum of £100,000 was a penalty when the contract could be concluded on such trivial grounds.

The case of ***Philips Hong Kong Ltd*** v ***Attorney-General of Hong Kong*** (1993) 9 Const LJ 202 appears to advocate a rather more flexible approach than that laid down in ***Dunlop Pneumatic Tyre Co. Ltd*** v ***New Garage and Motor Co***. In that case Lord Dunedin stated:

> The question whether a sum stipulated is penalty or liquidated damages is a question of construction to be decided upon the terms and inherent circumstances of each particular contract, judged of as at the time of the contract not at the time of the breach.

While on this basis the clause has to be viewed objectively, the ***Philips*** case suggests that a court can examine what actually happened in the case to decide whether or not the clause represents a penalty or liquidated damages, since it allows an assessment to be made of what the parties expected the losses to be when the contract was made. This would allow a court to disregard a liquidated damages clause which in the particular circumstances of the case provides for a disproportionate sum in relation to the actual losses suffered, if the facts showed that the parties did not intend the clause to apply in those circumstances. This would therefore allow such clauses to stand, whereas previously, following the ***Dunlop*** case, they would have been entirely severed from the contract. It may be that this flexible approach is confined to commercial contracts, as in the ***Philips*** case, since the court considered that such contracts (and clauses) are entered into by businesspeople at arm's length who should normally be bound by what they have agreed. Such an approach would accord with the comments of Lord Roskill in ***Export Credits Guarantee Department*** v ***Universal Oil Products Co.*** [1983] 2 All ER 205. This approach to penalty clauses in commercial contracts has been subsequently approved of in several cases, for instance, ***Lordsvale Finance plc*** v ***Bank of Zambia*** [1996] QB 752; ***Euro London Appointments Ltd*** v ***Claessens International Ltd*** [2006] 2 Lloyd's Rep 436; ***M & J Polymers Ltd*** v ***Imerys Minerals Ltd*** [2008] 1 Lloyd's Rep 541; ***Steria Ltd*** v ***Sigma Wireless Communications Ltd*** [2008] BLR 79; and ***McAlpine Capital Projects Ltd*** v ***Tilebox Ltd*** [2005] BLR 271 where Jackson J stated:

> Because the rule about penalties is an anomaly within the law of contract, the courts are predisposed, where possible, to uphold contractual terms which fix the level of damages for breach. This predisposition is even stronger in the case of commercial contracts freely entered into between parties of comparable bargaining power.

Whilst the distinction between a pre-estimate of damages and a penalty often lies at the heart of this area of law one has to be aware that this does not cover all the possibilities. Thus in ***Lordsvale Finance plc*** v ***Bank of Zambia*** [1996] QB 752 Coleman J stated:

> There would . . . seem to be no reason in principle why a contractual provison the effect of which was to increase the consideration payable under an executory contract upon the happening of a default should be struck down as a penalty if the increase could in the circumstances be explained as commercially justifiable, provided always that its dominant purpose was not to deter the other party from breach.

This approach was also approved of by Mance LJ in the ***Cine Bes Cilik*** case, stating that there are 'clauses which may operate on breach, but which fall into neither category, and they may be commercially justifiable'.

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It should be noted that the rules regarding penalties and liquidated damages are only applicable where there has been a breach of contract. Where a sum becomes payable because of the occurrence of some other event the above rules have no application, leaving the stronger of the two parties in a position to apply and enforce what would otherwise amount to a penalty. In ***Export Credits Guarantee Department* v *Universal Oil Products Co.***, Lord Roskill explained the reasoning for the principle in the following way:

> My Lords, one purpose, perhaps the main purpose, of the law relating to penalty clauses is to prevent a plaintiff recovering a sum of money in respect of a breach committed by a defendant which bears little or no relationship to the loss actually suffered by the plaintiffs as a result of the breach by the defendants. But it is not and never has been for the courts to relieve a party from the consequences of what may, in the event, prove to be an onerous or possibly even imprudent commercial bargain.

While the rule is easy to understand when placed in such a context, nevertheless in practical terms it is perverse and illogical since it is likely that the defendant will find it cheaper to breach the contract than to labour on under harsh and onerous conditions. In ***Jobson* v *Johnson*** this rule does not seem to have been followed.

Jobson v *Johnson* [1989] 1 All ER 621

The facts of the case are fairly complex but basically there was a contract for the purchase of shares, the purchase moneys to be paid in seven instalments, including the initial payment. One clause in the contract stated that should the defendant default on any instalment then he would be required to re-transfer the shares back to the vendor, or his assignee, at a price substantially lower than the value of the shares or the amounts he might have paid in instalments. It was held that the reduced price payable, while clearly within the contract, was nevertheless a penalty. The court therefore refused specific performance of the re-transfer clause unless measures were taken to make adjustment for the amounts already paid in previous instalments. Patently, the court seems to have ignored the rule contained in the ***Universal Oil Products*** case and its predecessors.

Deposits and forfeiture clauses

Deposits are essentially the converse of penalties in that they are payable before a breach occurs, rather than after as in the case of a penalty. Deposits are normally regarded as a part-satisfaction of the contract price which may be retained should the purchaser fail to perform his side of the bargain.

Forfeiture clauses normally arise where there is a purchase of goods by instalments and the contract provides that should the purchaser default on any instalment then he must surrender the goods, at the same time forfeiting any instalments already paid. Both deposits and forfeiture clauses are regarded as guarantees that the contract will be performed.

The normal rule in relation to deposits is that if the money has been paid and the party to whom it is paid breaks the contract, then the payer may recover the deposit either for breach of contract or in quasi-contract. Deposit moneys payable in the future usually cease to be payable.

For more on quasi-contracts refer to Chapter 18.

Where the person who has paid the deposit is in breach of contract then one must distinguish between sums paid as a deposit and those which amount merely to prepayments made on account. As regards the latter, it has been held in ***Dies* v *British and International Mining and Finance Corporation*** [1939] 1 KB 724 that in a contract of sale

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the advance payments on account can be recovered, subject to any rights of set-off possessed by the seller in respect of actual losses. In ***Hyundai Heavy Industries Co. Ltd*** **v** ***Papadopoulos*** [1980] 2 All ER 29, the House of Lords held that such advance payments could not be recovered. The apparent reason for the distinction is that in the latter case the prepayment on the shipbuilding contract was regarded as an unconditional payment for the work that had already been completed, while generally in contracts of sale prepayments are conditional on performance taking place subsequent to the prepayment. The position was stated by Kerr LJ in ***Rover International Ltd*** **v** ***Cannon Film Sales Ltd (No 3)*** [1989] 3 All ER 423 as:

> The question is whether there was any consideration in the nature of part performance for which the instalment was payable, as in the ***Hyundai Heavy Industries*** case, or whether the instalment was payable in advance of any performance which was required from the party in default.

There does not appear to be any reason why a shipbuilding contract (as in the ***Hyundai*** case) should be different from any other type of contract of sale. *Cheshire, Fifoot and Furmston* (2006) suggests that the distinction can be justified in three ways: first, the ***Dies*** case is wrong; second, shipbuilding contracts should be viewed differently from other contracts of sale; and, third, more convincingly, it is suggested that distinction lies in the fact that in ***Dies*** there was a total failure of consideration but that this was not the case in ***Hyundai***.

Where a person who has paid money is in breach of contract, the deposit or prepayment may be made subject to a right of forfeiture. In such circumstances the payee is entitled to keep all of the deposit despite the fact that his losses may be less than the amount of deposit paid, as stated in ***Howe*** **v** ***Smith*** (1884) 27 ChD 89. It should also be noted that if the deposit is payable but so far unforthcoming, the innocent party can (it has been held in ***Damon Cia Naviera SA*** **v** ***Hapag-Lloyd International SA, The Blankenstein*** [1985] 1 All ER 475) take action to recover the deposit. The same principles have also been held to apply to money paid as a prepayment.

It may be noticed that the effect of a payee being able to keep a deposit which in fact exceeds their losses is not very different from the effect of a penalty. Despite the similarity there is no, or little, relief available in cases of forfeiture which corresponds to that already seen in relation to penalties. Such relief as does exist tends to arise in specialist contracts, as in the termination of hire purchase and conditional sale agreements under the Consumer Credit Act 1974, s 100, or in contracts for the sale of land under the Law of Property Act 1925, s 49(2). The latter provides:

> Where the court refuses to grant specific performance of the contract, or any action for the return of a deposit, the court may, if it thinks fit, order the repayment of the deposit.

The question arises, however, as to whether relief against forfeiture can be given outside these rather specialist areas. In equity the court will normally grant relief where the payer is overdue in the payment of instalments. Relief here normally takes the form of extending the time for payment, though occasionally the court may order the repayment of moneys paid. Relief here is dependent on the buyer being ready and willing to pay an instalment or the balance of moneys owed within a period fixed by the court, as stated in ***Starside Properties Ltd*** **v** ***Mustapha*** [1974] 2 All ER 567.

In ***Stockloser*** **v** ***Johnson*** [1954] 1 All ER 630 Lord Denning and Lord Somervell considered that there existed a more general equitable principle that gave relief against forfeiture. This principle, they thought, arose where the sum to be forfeited by reason of

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the forfeiture was out of all proportion to the losses sustained by the innocent party, in other words that the clause was penal in character and that it was unconscionable for that party to retain the moneys paid. Lord Romer, however, took a far more restrictive view and considered that equity could intervene in this way only if the seller had acted in a fraudulent or unconscionable manner.

The view of Lord Romer is the one that seems to have gained prevalence in recent cases. In ***Scandinavian Trading Tanker Co. AB* v *Flota Petrolera Ecuatoriana, The Scaptrade*** [1983] 2 AC 694, the House of Lords held that relief against forfeiture could not be invoked by a time charterer of a ship where he had failed to pay the hire instalments on time in order to prevent the shipowner withdrawing the ship from the charterparty. The reason given was that such relief would not be granted where specific performance would not be granted and it would not normally be given in the case of a time charter, since damages are an adequate remedy where there has been a breach of such a contract. The effect of relief against forfeiture here would be tantamount to a decree of specific performance. From this it follows from the decision of the House of Lords that relief against forfeiture is available only where proprietary or possessory rights are being forfeited. In ***The Scaptrade*** they clearly were not, since a time charter was regarded as merely a contract for the use of a ship, that is, a contract for services. This position has recently been affirmed in ***Sport International Bussum BS* v *Inter-Footwear Ltd*** [1984] 2 All ER 321, though in ***BICC plc* v *Bundy Corporation*** [1985] 1 All ER 417 the Court of Appeal considered that such relief could extend to proprietary and possessory rights in goods, rather than being confined to contracts for the sale of land as envisaged by Lord Diplock in ***The Scaptrade***.

One further point in relation to relief from forfeiture needs to be made in that it is only available in respect of prepayments subject to a forfeiture clause, *not* deposits, despite the fact that the distinction between the two, as already seen, is non-existent.

Speculative damages and damages for non-pecuniary losses

The fact that damages cannot be accurately assessed is in no way a bar to the recovery of compensation, provided that they do not fall foul of the rules regarding remoteness. A clear example of this can be seen in the following case.

Chaplin v *Hicks* [1911] 2 KB 786

The plaintiff, who had entered a beauty contest and won the earlier stages, was prevented from competing in the final stages of the contest contrary to the terms of the contract. It was held that she could claim damages for the loss of opportunity caused by the defendant's breach of contract.

While damages are available for losses which are clearly speculative it is equally clear that damages are not available as a punitive measure, being purely compensatory. Nevertheless, damages are not confined to financial loss, though it is true that in most of the cases discussed so far the actions revolve around commercial contracts in which such losses provide the main cause of the actions. Despite the fact that damages are not confined to financial loss the law is not as flexible as might first be supposed, since for many years the principle was that physical inconvenience had to arise from the breach and not simply mental distress, as affirmed in the case of ***Addis* v *Gramophone Co. Ltd*** [1909] AC 488, where loss of reputation caused by the abrupt dismissal of the plaintiff was held to be irrecoverable.

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In recent years a number of cases have arisen that have undermined the principle and allowed damages for mental distress and anxiety to be claimed. This position developed out of the case of ***Jarvis* v *Swans Tours Ltd*** [1973] 1 QB 233 and was affirmed in ***Jackson* v *Horizon Holidays Ltd*** [1975] 1 WLR 1468.

In both cases the plaintiffs suffered considerable disappointment as to the quality of the holidays they had bought, which did not live up to their expectations based on the holiday brochures of the respective tour companies. In both cases the courts decided that damages for disappointment, mental anxiety and distress could be compensated. In the ***Jarvis*** case Lord Denning stated:

> What is the right way of assessing damages? It has often been said that on a breach of contract damages cannot be given for mental distress . . . I think those limitations are out of date. In a proper case damages for mental distress can be recovered in contract, just as damages for shock can be recovered in tort. One such case is a contract for a holiday, or any other contract to provide entertainment and enjoyment. If the contracting party breaks his contract, damages can be given for the disappointment, the distress, the upset and frustration caused by the breach. I know it is difficult to assess in terms of money, but it is no more difficult than the assessment which the courts have to make every day in personal injury cases for loss of amenities.

The ***Jarvis*** and ***Jackson*** cases produced a considerable widening of the scope for awarding damages for mental distress caused by the breach of contract. Thus in ***Cox* v *Phillips Industries Ltd*** [1976] 3 All ER 161 an employee was able to recover damages for distress and anxiety caused by his wrongful demotion, the judge distinguishing it from the ***Addis*** case on the basis that the decision there arose out of a dismissal, though why this is any the less distressing remains something of a mystery. Clearly, where the contract is of a personal nature it can be expected that there will be some degree of anxiety and distress if a breach of contract occurs. However, the principle soon expanded to cover other areas. In ***Perry* v *Sidney Phillips & Son (a firm)*** [1982] 3 All ER 705, for example, damages were awarded for the mental distress caused by the failure of a negligent surveyor to discover major structural defects in a dwelling house.

In recent years there has been a movement in the courts towards a considerable tightening up of awards of damages for such types of losses. Thus in ***Shove* v *Downs Surgical plc*** [1984] 1 All ER 7, the decision in ***Addis*** was reaffirmed and Sheen J found that damages for mental distress caused by wrongful dismissal were irrecoverable. More importantly in ***Bliss* v *South East Thames Regional Health Authority*** [1985] IRLR 308, the Court of Appeal reversed the decision at first instance that the mental distress and anxiety caused by the suspension of an orthopaedic surgeon for refusing to submit to an examination by a psychiatrist was recoverable. The decision substantially overruled the ***Cox*** case and also reaffirmed ***Addis***. In the course of their judgments, the members of the Court of Appeal confined liability for damages for mental distress to facts such as those seen in the ***Jarvis*** and ***Jackson*** cases, where the provision of comfort, pleasure or 'peace of mind' was a central feature of the contract, or, indeed, where the relief of discomfort played such a prominent role in the contract. This decision received affirmation in ***Hayes* v *James and Charles Dodd (a firm)*** [1990] 2 All ER 815 where Staughton LJ stated that damages could not be recovered for the distress that might result from a breach of a commercial contract. In relation to the 'peace of mind' criterion discussed in ***Bliss***, Lord Staughton stated:

> it might be that the class was wider than that. But it should not include any case where the object of the contract was not comfort or pleasure or the relief of discomfort, but simply carrying on a commercial contract with a view to profit.

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In ***Watts* v *Morrow*** [1991] 1 WLR 1421 Lord Bingham reiterated the principle that damages are not generally recoverable for 'any distress, frustration, anxiety, displeasure, vexation, tension or aggravation' caused by the breach, even though the parties contemplated that a breach would cause the parties to suffer such 'distress', etc. The reason for this is that such non-pecuniary or non-physical harm presents difficulties of measurement and proof. As the Law Commission stated in its paper *Aggravated, Exemplary and Restitutionary Damages* (1993) (Law Com. No 132), there is 'no standard measure of assessment by reference to which the harm can be converted into monetary form'.

The ***Watts*** case, however, produced two exceptions to the general rule as set out above. Lord Bingham stated further:

> But the rule is not absolute. Where the very object of a contract is to provide pleasure, relaxation, peace of mind or freedom from molestation, damages will be awarded if the fruit of the contract is not provided or if the contrary result is procured instead . . . A contract to survey the condition of a house for a prospective purchaser does not, however, fall within this exceptional category. In damages not falling within this exceptional category, damages are in my view recoverable for physical inconvenience and discomfort caused by the breach and mental suffering directly related to that inconvenience and discomfort.

Thus, damages for **non-pecuniary loss** may be awarded where the object of the contract was for pleasure or where physical inconvenience flowed from the breach of contract. The first exception equates largely to the situations which occurred in the ***Jarvis*** and ***Jackson*** cases, though here there is a subtle tightening of the exception in that the 'very object' of the contract must be to provide pleasure, etc. rather than where it is simply a central feature of the contract.

For more on the *Ruxley Electronics* case, see page 431.

The application of the first exception can be seen in the decision of the House of Lords in ***Ruxley Electronics and Construction Ltd* v *Forsyth*; *Laddingford Enclosures Ltd* v *Forsyth*** [1995] 3 All ER 268 where it was stated that the exceptions to the rule in the ***Addis*** case are not closed. Lord Lloyd considered the first instance decision to award the plaintiff £2,500 for loss of amenity because of the swimming pool being built shallower than the depth stated in the contract, thereby precluding the ability of users to dive into the pool. He concurred with the judge that the contract was one 'for the provision of a pleasurable amenity', the loss of which was compensatable. Lord Lloyd was of the opinion that the decision to make an award was a simple extension of the principle in the ***Jarvis*** and ***Jackson*** cases rather than another exception to the ***Addis*** case.

Lord Lloyd, however, went a little further and considered the situation where damages for loss of amenity were not available, that is, the majority of cases. He gave an example of where a house is built that does not conform to some minor specification in the contract, for instance, where there is a difference in level between two rooms requiring a step. In this situation if there is no measurable difference in the value of the house contracted for and that received, and the cost of reinstatement is prohibitive, then no damages would be available. He questioned whether there was any reason why a court should not compensate the buyer for his disappointed expectations:

> Is the law of damages so inflexible . . . that it cannot find some middle ground in such a case?

Lord Lloyd referred to Sir David Cairns' judgment in ***G W Atkins Ltd* v *Scott*** (1980) 7 Const LJ 215 where he stated:

> There are many circumstances where a judge has nothing but his commonsense to guide him in fixing the quantum of damages, for instance, for pain and suffering, for the loss of pleasurable activities or for inconvenience of one kind or another.

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Lord Lloyd considered this could amount to an alternative basis for an award of damages for loss of amenity where the exceptions to the principle in the ***Addis*** case may not apply. Whether or not this approach will find general favour is open to speculation; however, in ***Alexander*** **v** ***Rolls-Royce Motor Cars*** (1995) *The Times*, 4 May (CA) and ***Knutt*** **v** ***Bolton*** (1995) 45 Con LR 127 (CA) it was stated that damages for disappointment would not be awarded where the contract was a commercial one or where pleasurable amenity was not the main purpose of the contract.

The position as regards whether the 'very object' of the contract is flexible enough to include contracts where the pleasure is merely an important feature of the contract was considered by the House of Lords in the case of ***Farley*** **v** ***Skinner***.

Farley v *Skinner* [2001] 4 All ER 801

The facts of the case were that Mr Farley wanted to buy an idyllic house set in the Sussex countryside. He had hoped to retire to the house and was looking for a peaceful location. He was therefore concerned that the house did not lie on the flight path to Gatwick airport 15 miles away. If this was the case he would not have proceeded with the purchase. He employed a surveyor to conduct a survey of the house and to investigate specifically if the property was on the flight path or not. The surveyor's report stated that he considered it 'unlikely that the property will suffer greatly from such noise'. The surveyor negligently failed to notice, however, that the house was situated close to a navigation beacon. This meant that at busy times aircraft were 'stacked up' around the beacon until given clearance to land. In reliance on the surveyor's report Mr Farley purchased the property for £420,000 and then spent another £125,000 renovating the property. On moving into the house Mr Farley found that the house was badly affected by aircraft noise. He did not, however, wish to move from the house having spent such a large amount of money renovating it and decided to 'make the best of a bad job'. He sued the surveyor for damages.

At first instance the judge found that Mr Farley had not suffered any pecuniary loss on the basis that the price paid for the house already reflected the level of aircraft noise. The judge, however, awarded Mr Farley £10,000 as compensation for his discomfort. The surveyor appealed and the Court of Appeal, by majority, allowed the appeal against the award. The court considered that the case fell outside the two exceptions stated by Lord Bingham in ***Watts*** **v** ***Morrow*** since, first, the facts did not support an action for an award arising out of physical inconvenience. Second, the case was outside the category where the 'very object of the contract [was] to provide pleasure, relaxation, peace of mind'. Mr Farley then appealed to the House of Lords.

Their Lordships allowed his appeal, stating that it did not matter that the object of the contract was not to provide 'pleasure, relaxation, peace of mind' provided this was an important part of the contract and that the surveyor had been specifically requested to report on the issue of aircraft noise. Their Lordships thus reinterpreted the first exception as set out in ***Watts*** **v** ***Morrow***, moving it back in line with the ***Jarvis*** and ***Jackson*** cases. Lord Steyn in particular disagreed with the 'very object of the contract' criterion interpretation. He considered it was sufficient if a 'major or important object of the contract is to give pleasure, relaxation or peace of mind'. He considered it to be wrong to allow a party to a contract to recover damages if the contract had merely been to report on aircraft noise (i.e. the 'very object of the contract') but not where that issue was part of a wider contract in relation to the structure of the house as well (i.e. an important part of the contract).

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Farley* v *Skinner is authority that the exception is now based on whether 'it is sufficient if a major or important object of the contract is to give pleasure, relaxation or peace of mind'. It should be noted that a surveyor's general or standard contract would not suffice here. The important issue is that the surveyor was specifically instructed to investigate the matter of aircraft noise. This exception cannot, however, apply to commercial contracts as stated by Lord Staughton above. The reason for this is that such contracts are contracts for profit and pecuniary loss has to be proved in such cases. Thus ***Farley* v *Skinner*** recognises that consumer contracts are generally not those for profits and that consumers enter into contracts for other motives that are not measurable in terms of pecuniary loss.

Their Lordships also examined the second exception and, indeed, some considered that Mr Farley's case fell within this exception as well. It was considered that 'physical inconvenience' should be given a broader interpretation and that it could encompass the effects of aircraft noise since this could 'be regarded as having a physical effect on him'.

Farley* v *Skinner thus represents a significant step forward in allowing claims for damages with respect to non-pecuniary losses and provides a realistic interpretation of the two exceptions to the principle set out in ***Addis***.

Summary

- Damages may be:
  (i) Liquidated: where the parties have agreed the damage as a genuine pre-estimate of loss.
  (ii) Unliquidated: where no amount has been fixed and the court decides.

Assessment of the basis on which damages are awarded

General principles

- An injured party to be in the same position he would have been in had the contract been carried out, insofar as money is able to do this (***Robinson* v *Harman***).
- The injured party can claim damages for loss of bargain/profits and expenses.
- Damages are not intended to be punitive but compensatory.

Difference in value and cost of cure

- In assessing the damages one of two methods may be adopted:
  (i) a 'difference in value' basis, or
  (ii) a 'cost of cure' basis.
- Mitigation of loss:
  - No loss = nominal damages.
  - A plaintiff should mitigate his loss by taking reasonable steps to reduce it (***British Westinghouse Electric and Manufacturing Co. Ltd* v *Underground Electric Railways Co. of London Ltd***).

The assessment of damages by reference to the market

- Depends on whether:
  (i) the seller is in breach of contract for non-delivery, or
  (ii) the buyer is in breach for non-acceptance of the goods delivered.

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'Available market'

- No precise definition of 'available market'.
- A market arises where the seller actually offers the goods for sale (***Shearson Lehman Hutton Inc.*** **v** ***Maclaine Watson & Co. Ltd (No 2)***).

The question of time in assessing an award of damages

- The general principle for the assessment of damages is compensatory.
- Damages are usually assessed as at the time the contract has been broken.
- The principle may be relaxed to prevent injustice (***Kennedy*** **v** ***Van Emden***).

Limitations on the availability of damages

Causation

- To claim damages a causal link between the losses sustained and the breach of contract must be shown (***Young*** **v** ***Purdy***; ***C & P Haulage***).
- Break of the causal link between the breach of contract and the losses suffered occurs where the loss results partly from a breach of contract and also from the intervening acts of a third party (***Stansbie*** **v** ***Troman***; contrast with ***Weld-Blundell*** **v** ***Stephens***).

Remoteness of damages

- The defendant will be liable only for losses that arise from the consequences of the breach and which can be said to be within the contemplation of the parties at the time of contracting.
- Damages under ***Hadley*** **v** ***Baxendale***:
  1. Loss 'arising naturally, i.e. according to the usual course of things, from such breach of contract itself . . .'
  2. Loss 'such as may reasonably be supposed to have been in the contemplation of both the parties, at the time they made the contract, as the probable result of the breach of it'.
     - Introduction of reasonable foreseeability to damages (***Victoria Laundry (Windsor) Ltd*** **v** ***Newman Industries Ltd***).
     - ***Koufos*** **v** ***Czarnikow Ltd, The Heron II***. Remoteness in contract was not the same as the test applied in tort.

Mitigation of loss

- Plaintiffs will not be able to claim for losses which he could have avoided by the taking of reasonable steps.
- Reasonable steps to mitigate losses is a question of fact.

Contributory negligence

- Law Reform (Contributory Negligence) Act 1945 reduces the amount of damages that might be recovered if fault is proved.

Contractual provisions relating to the limitation of damages

- The parties can agree the amount of damages to be paid on a stipulated event.
- The courts will still regulate agreements regarding (i) penalty clauses and (ii) the regulation of deposits and forfeiture clauses.

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Liquidated damages and penalties

- Courts support claims where the parties make a genuine attempt to pre-estimate the loss if there is a breach.
- Damages payable from genuine pre-estimates of loss are termed 'liquidated damages'.
- The courts will not award sums which are considered to be penalties.
- Penalty clauses v pre-estimate of loss clauses: How to identify the difference: ***Dunlop Pneumatic Tyre Co. Ltd*** v ***New Garage and Motor Co. Ltd***.

Deposits and forfeiture clauses

- Deposits are payable before a breach occurs and deposits are normally regarded as a part consideration which may be retained should the purchaser fail to perform his side of the bargain.
- Forfeiture clauses normally arise where there is a purchase of goods by instalments and the contract provides that should the purchaser default on any instalment then he must surrender the goods, at the same time forfeiting any instalments already paid.

Speculative damages and damages for non-pecuniary losses

- Inaccurately assessed damages do not bar the recovery of compensation, subject to remoteness (***Chaplin*** v ***Hicks***).
- Damages are not confined to financial loss – physical inconvenience had to arise from the breach and not simply mental distress (***Addis*** v ***Gramophone Co. Ltd***).
- Holidays – damages for disappointment, mental anxiety and distress could be compensated (***Jarvis*** v ***Swans Tours Ltd***; ***Jackson*** v ***Horizon Holidays Ltd***).

Further reading

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Visit **www.mylawchamber.co.uk/richards** to access study support resources including sample exam questions with answer guidance, multiple-choice quizzes, flashcards, an online glossary, live weblinks and regular updates to the law, *plus* the Pearson e-Text version of *Law of Contract* which you can search, highlight and personalise with your own notes and bookmarks.

Use Case Navigator to read in full some of the key cases referenced in this chapter with commentary and questions for comprehension:

Hadley* v *Baxendale (1854) 9 Exch 341
Ruxley Electronics and Construction Ltd* v *Forsyth; Laddingford Enclosures Ltd* v *Forsyth [1995] 3 All ER 268 (HL)

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17 Equitable remedies and limitation of actions

Aims and objectives

After reading this chapter you should be able to:

- Know the different effects of orders for specific performance and injunctions as remedies for breach of contract.
- Explain the nature of the remedies.
- Explain the factors a court may take into account when making an order for specific performance and awarding injunction.
- Discuss the different periods imposed by the Limitation Act 1980 that limit the opportunity for the injured party to take action for breach of contract.

Equitable remedies

Specific performance

The nature of the remedy

Specific performance is an order of the court which compels a defendant to carry out their obligations under a contract in accordance with the terms and conditions set out in the contract. Failure to comply with the order will render the defendant liable to criminal proceedings for contempt of court. The remedy is normally used to enforce positive obligations, negative ones being restrained with the use of a prohibitory injunction.

Specific performance is a remedy *in personam* and can be ordered even where the subject matter of the contract is outside the jurisdiction, provided the party subject to the order is within the jurisdiction. The remedy is awarded at the discretion of the court and it should be noted that it is only sparingly awarded, where the court considers it just and equitable to do so. The award will not be given, for instance, where its effect would be to cause hardship amounting to injustice to either party or an interested third party, as was held in ***Patel*** v ***Ali***.

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Patel v *Ali* [1984] Ch 283

In this case the vendor and her husband were the co-owners of a house which they had entered into a contract to sell in 1979. Completion was delayed by reason of the husband's bankruptcy. In addition the vendor contracted bone cancer which resulted in her having to have a leg amputated. These events also corresponded with the birth of their second and third children. The purchaser applied for, and was awarded, an order of specific performance, but the vendor appealed on the grounds of hardship. The vendor spoke little English and had to rely on friends and relatives for help. The effect of the decree would thus be to expose her to undue hardship. The court held that in an appropriate case relief could be given against specific performance where hardship arose once the contract had been entered into, even if the hardship itself was not related specifically to the subject matter and not caused by the plaintiff. The court decided that damages should be awarded instead of specific performance as the latter would amount to injustice, given the level of hardship that would be inflicted on the vendor.

While an application for an award of specific performance will usually be made where a breach of contract has occurred, a breach is not an essential requirement for the application of an award. The award of the order is based on the existence of a contract, together with circumstances rendering it just and equitable to make an award, as stated in ***Hasham*** **v** ***Zenab*** [1960] AC 316, where an order of specific performance was given before the contractual date for completion since the defendant was in anticipatory breach of contract.

The award of an order of specific performance is not an arbitrary one and various factors might influence a court in the granting of the order.

Factors to be considered in making an order for specific performance

1. Damages must not be an adequate remedy

If damages are an adequate remedy then an order of specific performance will not be awarded (the same principle also applying to the award of injunctions). The reason for this is that the remedies of the courts of chancery arose out of the inadequacy of the award of damages at common law. In the vast majority of contracts damages provide an adequate remedy, as, for example, in contracts for the sale of goods, where compensation will generally allow a purchaser to buy the goods elsewhere. In contracts for the sale of land, however, an order of specific performance will normally be awarded since, on just and equitable grounds, a simple award of damages would defeat the reasonable aspirations and expectations of the vendor.

Specific performance will be awarded for contracts for the sale of goods, however, where the goods in question are unique. A contract for the purchase of a valuable antique or painting clearly would not be compensated by damages since there is no or little prospect of a buyer being able to go into the marketplace to purchase a similar item. This factor is another reason why contracts for the sale of land lend themselves readily to the award of such a remedy. Even in these circumstances the court will not make an order where the award would produce an injustice to the defendant. The principle is illustrated by the case of ***Wroth*** **v** ***Tyler***.

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Wroth v *Tyler* [1974] Ch 30

In this case a husband, who was the owner of a matrimonial home, entered into a contract to sell the property with vacant possession. Before completion could take place his wife, who did not want to move, registered her right of occupation under the Matrimonial Homes Act 1967 (now 1983) as a Class F landcharge against the property, and this action had the effect of placing an encumbrance on the ability of the husband to give vacant possession. The husband withdrew from the contract and the purchaser sued for an order of specific performance.

It was held by Megarry J that the purchaser should fail in his action since to compel the husband to carry out his obligation he would have had to apply to the court to terminate the wife's right of occupation. In order to do this the husband would have had to embark on difficult and uncertain litigation against his own wife, which was clearly undesirable given the fact that they were still living together. Even if he was successful in such an action, the court's decision to remove the right of occupation was in any event discretionary. Further, if the court awarded specific performance subject to the wife's right of occupation this would have entailed the purchaser in obtaining an order of eviction against the husband and his daughter, thereby resulting in the break-up of the family.

Contracts to pay money do not usually attract an order for specific performance since damages are normally an adequate remedy here. In certain circumstances the use of such an order can be justified where there is a contract under which money has to be paid to a third party. The case of ***Beswick* v *Beswick*** [1968] AC 58 (the facts of which are given in Chapter 19) is an obvious and extremely good illustration of the use of specific performance in such circumstances. An award of damages to Peter Beswick's estate would have been nominal since the contract to pay the annuity in question to his widow resulted in no loss to his estate, while the annuity payable to himself ceased on his death. The most appropriate remedy, therefore, was a decree of specific performance in order to compel the defendant to comply with his obligations under the contract to the third party.

2. The requirement of mutuality

The general principle is that specific performance will not be awarded unless the order is available to both parties, that is, availability of the award is mutual. Thus in ***Flight* v *Bolland*** (1828) 4 Russ 298 an application for specific performance by a minor failed since the award would not have been available against the minor by the other party because of the incapacity of the applicant. The Landlord and Tenant Act 1985, s 17, provides an exception to the rule requiring mutuality. It states that the court can make an order of specific performance in respect of a landlord's covenant to keep the premises in a good state of repair despite rules of equity restricting the award of the order 'whether based on mutuality or otherwise'.

One problem that has arisen in the past with respect to mutuality is the time at which mutuality should be present between the parties. It was suggested by Fry in *Specific Performance* (1921) that there had to be mutuality between the parties at the time an enforcement contract had been entered into. Ames, however, in *Lectures on Legal History* (1913) pointed to several exceptions to this rule, stating that the rule should be expressed as:

> Equity will not compel specific performance by a defendant if, after performance, the common law remedy of damages would be his sole security for the performance of the plaintiff's side of the contract.

The rule, however, was subject to extensive review in the case of ***Price* v *Strange***.

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Price v *Strange* [1978] Ch 337

The facts of the case were that the defendant had contracted to grant a sublease to the plaintiff, provided the plaintiff did some external and internal repairs to the premises. The plaintiff did the internal repairs but, though he was ready and willing to do the external repairs, he was unable to do so because the defendant had by then done them herself at her own expense. The defendant repudiated the contract and the plaintiff claimed for an order of specific performance. At first instance the application failed since the availability of the remedy was not mutual at the date of the contract because the defendant could not have compelled the plaintiff to carry out the repairs. The decision was reversed on appeal to the Court of Appeal. Goff LJ stated that the principle of mutuality is:

> that one judges the defence of mutuality on the facts and circumstances as they exist at the hearing, albeit in the light of the whole contract of the parties in relation to the subject-matter, and in the absence of any other disqualifying circumstances, the court will grant specific performance if it can be done without injustice or unfairness to the defendant.

It should be noted that the rule regarding the need for mutuality is one which affects the discretion of the court to award specific performance. The rule does not affect the jurisdiction of the court to award damages in lieu of specific performance under the Chancery Amendment Act 1858, which will be dealt with later.

3. The exercise of discretion

As already stated, the exercise of discretion is not an arbitrary one but is exercised within certain broad parameters in order to promote justice between the parties. Should the exercise of the discretion result in injustice being wrought upon an individual then the order of specific performance will not be given. The notion that governs this aspect of the exercise of discretion is sometimes expressed in the equitable maxim, ‘he who seeks equity must do equity’, or rather more graphically, ‘he who comes to equity must come with clean hands’.

It has been seen how hardship can prevent the exercise of equitable discretion to give an order for specific performance, and the same is also true of mistake and misrepresentation. It should be noted, however, that a defendant cannot resist the granting of an order simply because they made a mistake. As a general rule the defendant will be held to their bargain, unless they can prove that this would lead to injustice. In ***Webster* v *Cecil*** (1861) 30 Beav 62 the vendor offered to sell some property to the purchaser for £2,250 but mistakenly wrote £1,250. The purchaser, who was aware of the mistake, immediately accepted the offer. The vendor on realising his mistake gave notice of it to the purchaser. It was held that in the circumstances he could not be compelled to carry on with the sale.

The rules relating to time in relation to performance of a contract have been fully discussed in Chapter 13. There it was seen that the rule in equity is that time is not of the essence in a contract and that therefore a plaintiff can obtain specific performance, despite the fact that he has not carried out his obligations under the contract at the time specified in the contract. Where, however, the parties have agreed that time will be of the essence then specific performance will not be awarded if the elements relating to time have not been met by the plaintiff. This principle applies even if time was only made of the essence by the service of notice during the ambit of the contract. Even where time is not of the essence specific performance may still be lost since the rule that ‘delay defeats

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equity' (the **doctrine of laches**) may apply. Unreasonable delay, then, may defeat an application for equitable relief, including specific performance, but what is unreasonable depends substantially on the subject matter of the contract. At one time it was considered that specific performance had to be applied for within 12 months. However, in ***Lazard Bros & Co. Ltd* v *Fairfield Properties (Mayfair) Ltd*** (1977) 121 SJ 793, Megarry VC stated that specific performance should not be regarded as a prize to be awarded to the zealous and denied to the indolent. In that case a delay of over two years was held not to be a bar to the award of an order.

The exercise of the discretion to award specific performance is not given where the contract demands a personal service or work, for instance, in contracts of employment. The reason is that the order would require the constant supervision of the court, as was held in ***Ryan* v *Mutual Tontine Westminster Chambers Association*** [1893] 1 Ch 116 where the landlord of a flat agreed that he would appoint a porter who would be in constant attendance to maintain the common areas of the building, collect mail, and so on. The porter appointed also worked as a chef at a nearby club and was thus constantly absent. The plaintiff's action for specific performance failed since the exercise of the order would require the constant supervision of the court. It should also be noted that the courts are reluctant to order specific performance in personal contracts since as a matter of public policy it is considered undesirable to force a person to carry out obligations with another against his will.

A modern example of the refusal of the courts to grant specific performance where the order requires the constant supervision of the court is in the House of Lords decision in ***Co-operative Insurance Ltd* v *Argyll Stores (Holdings) Ltd***.

Co-operative Insurance Ltd v *Argyll Stores (Holdings) Ltd* [1997] 2 WLR 898

The facts of the case were that the plaintiffs granted the defendants a lease of a unit in a shopping centre for a term of 35 years from 1979 to operate a Safeway supermarket. The supermarket was the largest retail outlet in the centre and its presence was likely to have a substantial impact on the success of the centre and the other retail outlets as a whole. The lease contained a covenant that the defendants undertook to keep the supermarket open for retail trade during the usual hours of business in the locality.

In 1995 the supermarket was running at a loss and the defendants resolved to close it. The plaintiffs attempted to persuade them to keep the supermarket open, but when these efforts failed an order for specific performance was sought.

It was held at first instance that the application should be refused and that damages only would be awarded. The plaintiffs were successful on their appeal to the Court of Appeal, which considered that the order should be made on two grounds. First, the Court of Appeal considered that damages would not be an adequate remedy since it would be difficult to quantify the loss that flowed from the breach. Second, the Court of Appeal considered the breach to be cynical and unreasonable. The defendants appealed to the House of Lords which reversed the Court of Appeal's decision, stating that it had long been settled practice that the courts do not award specific performance of covenants to carry on business or to continue trading. Lord Hoffmann stated, in accordance with orthodox practice, that an order in such circumstances was undesirable because it required the constant supervision of the court. Further, he stated that the only way to enforce compliance if such an order was made was to initiate criminal proceedings for contempt of court. He considered such proceedings to be inappropriate in a commercial contract requiring a party to continue trading.

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Lord Hoffmann was prepared to accept that an order of specific performance could be made in exceptional cases where a one-off result was required: for instance, where a landlord required a tenant to comply with a covenant to repair premises under a lease, since here compliance was easy to achieve. It is not clear, however, whether it will always be so easy to make a distinction between an award of specific performance to achieve a stated result as in this case, and an award to ensure a continued compliance with a covenant to carry on a business or trading. Further, it is questionable whether Lord Hoffmann's reasoning ignores the reality of the situation in that the order of specific performance is a commercial gambit to ensure that adequate levels of compensation should be paid. It should be noted that damages would normally be assessed on the loss of rent to the landlord, whilst the landlord would be seeking not just those losses but also the wider losses that might arise from the withdrawal of an 'anchor' tenant from the shopping centre. An order for specific performance would be a useful lever in securing damages for such losses from the defendants that would not otherwise be recoverable. Lord Hoffmann might have been better relying on the imprecise nature of the covenant as a reason for his refusal rather than tying the strings of the discretionary bag so tightly as to prevent the courts from adopting a flexible approach to the award of such orders.

The Court of Appeal considered the deliberate cynical conduct of the defendants to be an important issue in their award of specific performance. Lord Hoffmann rejected this argument and considered that all the defendants had done was to make a commercial decision to shut down a loss-making site and nothing else could be read into this decision.

4. 'Equity will not assist a volunteer'

In ***Penn* v *Lord Baltimore*** (1750) 1 Ves Sen 444, Lord Hardwicke declared that 'the court never decrees specifically without a consideration'. The requirement of consideration is a fundamental requirement for the granting of an order for specific performance, whether or not the contract is a simple one or one that is made under seal by deed.

Injunctions

The nature of the remedy

A further way in which a contract may be enforced is by the use of an **injunction**, which can be either prohibitory or mandatory in its application. A prohibitory injunction in the law of contract is used only to restrain a breach of a negative undertaking, for instance where the defendant has broken an agreement not to carry on a particular trade, as in ***Nordenfelt* v *Maxim Nordenfelt Guns and Ammunition Co. Ltd*** [1894] AC 535.

For more on contracts in restraint of trade refer to Chapter 12.

A mandatory injunction is an order to the defendant to do some positive act, such as demolishing a building, and is thus restorative in its nature. As a general rule such injunctions arise out of tortious acts rather than contractual ones, where specific performance is used. This type of injunction is quite uncommon and is not usually issued where damages are an adequate remedy or where the injunction would require the constant supervision of the court. Generally speaking, if a mandatory injunction should be claimed in a contractual situation, it will be subject to very similar limitations to those imposed on applications for specific performance.

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Limitations on the use of prohibitory injunctions

The rule that damages must be shown to be inadequate before equitable relief will be granted does not apply to prohibitory (sometimes called 'ordinary') injunctions. That is not to suppose that the courts will allow this difference to be used in order to allow a plaintiff to gain a benefit that he would not ordinarily be entitled to claim in an application for specific performance. The courts will thus grant the injunction only where there is an express stipulation in the contract that the defendant should not do a particular act. Thus in ***Lumley* v *Wagner*** (1852) 1 De GM & G 604 the defendant agreed to sing at the plaintiff's theatre over a particular period. She eventually abandoned the contract and took engagements to sing elsewhere. It was held that the plaintiff could have an injunction restraining the defendant from singing anywhere else. The negative nature of the injunction should be noted in the case, since the court could not compel the defendant to work solely for the plaintiff, though it could prevent her from working for anyone else.

The decision in ***Lumley* v *Wagner*** was followed in the case of ***Warner Bros Inc.* v *Nelson*** [1937] 1 KB 209 where the actress Bette Davis was restrained from working for anyone but the plaintiffs. Both cases have been criticised as being tantamount to forcing the defendants to work for the respective plaintiffs, an effect which in personal contracts has always been ruled against in the granting of equitable relief. Indeed, in the case of ***Page One Records Ltd* v *Britton*** [1968] 1 WLR 157 the courts refused to grant an injunction which would have had the effect of compelling the defendant, representing The Troggs pop group, to engage the plaintiffs as their agents and managers or to wind up the group. This approach was also followed in ***Nichols Advanced Vehicle Systems Inc.* v *De Angelis*** (unreported, 21 December 1979) where Oliver J considered the proper approach was that taken in the ***Page One Records*** case, unless the period of the contract was very short, as in ***Lumley* v *Wagner***.

Lastly, it should be stated that there are no restrictions on a court granting a prohibitory injunction to prevent an employee from breaking particular terms in his contract of employment. Examples of the use of an injunction in these circumstances are ***Lansing Linde Ltd* v *Kerr*** [1991] 1 All ER 418 and ***Lawrence David Ltd* v *Ashton*** [1991] 1 All ER 385 where prohibitory injunctions were used to prevent employees from disclosing the confidential information of their employers to a business rival.

Damages in lieu of specific performance and injunction

The Chancery Amendment Act 1858 gave the court of chancery the opportunity to grant damages in lieu of specific performance or injunction. It is possible for the court to grant damages in addition to these orders, provided the plaintiff can show that they have suffered some special loss or damage.

The position with respect to these types of damages is now governed by the Supreme Court Act 1981, s 50. It should be noted that the damages that arise here are discretionary and that the discretion arises only where the contract is of a type for which an injunction or an order for specific performance is not available. Where the contract is of such a type then the court may exercise its discretion to award damages despite the fact that an injunction or an order for specific performance would not be given because of some discretionary reason, for example the lack of mutuality. In order for the court to exercise its discretion, however, the plaintiff must have applied for either an injunction or an order for specific performance.

The measure of damages under the Act is calculated on the same basis as those at common law, as held by Lord Wilberforce in ***Johnson* v *Agnew*** [1980] AC 367.

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Limitation of actions

Limitation Act 1980

While equity could exercise its discretion not to grant relief under the doctrine of laches, where a plaintiff unreasonably delayed in applying to the court, the common law developed no such rule, although stale actions were discouraged as a matter of policy.

The Limitation Act 1980 has laid down a framework of periods within which actions must be brought or be debarred. In actions for breach of contract the following periods are laid down by the Act.

Actions founded on a simple contract

Here the action must be commenced within six years from the date on which the cause of the action accrued, by virtue of s 5. In contract the cause of action accrues from the time of the breach, rather than from the time any damage occurs, as in actions for negligence. Where the action can be framed in either contract or tort, or both, there may thus be a procedural advantage in framing the action in terms of a tortious claim.

Where the breach gives rise to personal injuries then s 11 of the Act provides that the limitation period is reduced to three years from the date on which the cause of action accrued.

Actions founded on a speciality contract

By s 8(1) an action upon a speciality contract shall not be brought after the expiration of 12 years from the date on which the cause of action accrued.

Action for an account

By s 23 an **action for an account** shall not be brought after the expiration of any time limit which is applicable to the claim which is the basis of the duty to account, that is, six years in relation to breach of contract.

The suspension of the 1980 Act by virtue of disabilities

If the plaintiff is under a disability, for example is a minor or of unsound mind, when the cause of action accrued then the limitation period does not begin to run until the disability has ceased to operate, by virtue of s 28(1). It should be noted that by s 28(2), if time under the limitation period had already started to run, then any subsequent disability has no effect on the running of time for the purposes of calculating the limitation period.

Postponement of the limitation period in cases of fraud or mistake

The position here is governed by s 32(1) of the 1980 Act which provides:

> where in the case of any action for which a period of limitation is prescribed by this Act, either –
>
> (a) the action is based upon the fraud of the defendant; or
> (b) any fact relevant to the plaintiff's right of action has been deliberately concealed from him by the defendant; or
> (c) the action is for relief from the consequences of a mistake;

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> the period of limitation shall not begin to run until the plaintiff has discovered the fraud, concealment or mistake (as the case may be) or could with reasonable diligence have discovered it.

Extension of the limitation period by acknowledgement or part-payment

It is provided by s 29(5) that:

> Where any right of action has accrued to recover –
>
> (a) any debt or other liquidated pecuniary claim . . . and the person liable or accountable therefor acknowledges the claim or makes any payment in respect thereof, the right shall be deemed to have accrued on and not before the date of the acknowledgement or the last payment.

The result of the above provision is that if a person owes a debt to another then, every time the debtor makes a part-payment of the debt or acknowledges the debt, the limitation period begins to run afresh from the date of each part-payment or acknowledgement of the debt. By s 29(7), however, once the debt is statute-barred then the right of action cannot be revived by any acknowledgement or part-payment. An effective acknowledgement must be made in writing signed by the debtor, or their agent, and made to the other party or their agent by virtue of s 30.

Summary

Equitable remedies

Specific performance

The nature of the remedy

- Specific performance is an order of the court which compels a defendant to carry out his obligations under a contract.
- The defendant is liable to criminal proceedings for contempt of court if he fails to comply.
- Specific performance is used to enforce positive obligations.
- Negative obligations are restrained with a prohibitory injunction.
- Specific performance is an equitable remedy.
- Specific performance is not used if it causes hardship to a party or third party (***Patel* v *Ali***).
- The courts will not order specific performance in personal service contracts.

Factors to be considered in making an order for specific performance

- *Damages must not be an adequate remedy*: if damages are an adequate remedy then an order of specific performance will not be awarded.
- *The requirement of mutuality*: specific performance is generally not awarded unless the order is available to both parties (***Flight* v *Bolland***).

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Injunctions

The nature of the remedy

- Injunctions can be either prohibitory or mandatory.
- Prohibitory injunctions restrain a breach of a negative undertaking (***Nordenfelt* v *Maxim Nordenfelt Guns and Ammunition Co. Ltd***).
- Mandatory injunction – order to the defendant to do some positive act.

Limitations on the use of prohibitory injunctions

- The rule that damages must be shown to be inadequate before equitable relief will be granted *does not* apply to prohibitory injunctions.

Damages in lieu of specific performance and injunction

- Governed by the Supreme Court Act 1981, s 50.
- Damages that arise here are discretionary.
- Discretion arises only where the contract is of a type for which an injunction or an order for specific performance is not available.
- For the court to exercise its discretion the plaintiff must have applied for either an injunction or an order for specific performance.

Limitations of actions

Limitation Act 1980

- The Act provides periods in which actions must be brought or be debarred.

Actions founded on a simple contract – s 5

- Six years from the date on which the cause of the action accrued for a breach of contract.

Actions founded on a speciality contract – s 8(1)

- An action upon a speciality contract shall not be brought after the expiration of 12 years from the date on which the cause of action accrued.

Action for an account – s 23

- No claim to be brought ouside the time limit.

Postponement of the limitation period in cases of fraud or mistake – s 32(1)

- Limitation begins to run when the fraud is discovered.

Further reading

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18 Quasi-contract and the law of restitution

Aims and objectives

After reading this chapter you should be able to:

- Understand the nature of quasi-contracts and the broader body of law known as the 'law of restitution'.
- Understand the nature of actions to recover moneys paid where there has been a total and partial failure of consideration.
- Know how a partial failure of consideration is converted into a total failure of consideration and how moneys can be recovered in a void contract.
- Know how money paid under a mistake of law can be recovered.
- Understand the nature of *quantum meruit* claims and how *quantum meruit* can be used withina c ontract.

Introduction

The doctrine of quasi-contract lies within a broader area of law known as the **law of restitution**. Historically actions based in quasi-contract arose individually, though they possessed a common procedure within the now defunct forms of action. Nevertheless, it was always considered that there was some linking element between the cases which broadly fell into the category now known as quasi-contract. Eventually Lord Mansfield in ***Moses* v *Macferlan*** (1760) 2 Burr 1005 expressed the common link as being one of unjust advantage. In explaining the basis for an action for money had and received he stated that:

> This kind of equitable action, to recover back money, which ought not in justice to be kept, is very beneficial, and therefore much encouraged. It lies only for money which, *ex aequo et bono*, the defendant ought to refund: It does not lie for money paid by the plaintiff, which is claimed by him as payable in point of honour and honesty, although it could not have been recovered from him by any course of law; as in payment of a debt barred by the Statute of Limitations, or contracted during his infancy or to the extent of principal and legal interest upon a usurious contract, or for money fairly lost at play: because in all these cases, the defendant may retain it with safe conscience, though by positive law he was debarred

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> from recovering. But it lies for money paid by mistake; or upon a consideration which happens to fail; or for money got through imposition, (express or implied); or extortion; or oppression; or an undue advantage taken of the plaintiff's situation, contrary to laws made for the protection of persons under those circumstances. *In one word, the gist of this kind of action is, that the defendant, upon the circumstances of the case, is obliged by the ties of natural justice and equity to refund the money*. (emphasis added)

Lord Mansfield saw this action as one which arose independently of an action in either contract or tort, arising as an obligation imposed by the law on the basis of natural justice. This approach did not find favour after the abolition of the forms of action, with the passing of the Common Law Procedure Act 1852, for two reasons. First, there developed a hardening of the categories into which legal obligations fell, those not being tortious of necessity being contractual, and vice versa. The result was that quasi-contractual obligations, being clearly not tortious, had to come within the law of contract. Second, since such obligations fell within the law of contract their existence within this category had to be justified in legal terms, especially as the tendency of nineteenth-century judges was to reject such nebulous concepts of natural justice. The result was that the existence of quasi-contractual obligations was justified in terms of contracts implied by law.

The implied contract approach has been subject to fierce criticism and largely rejected today in favour of a doctrine based on unjust enrichment which does not depend on the existence of a contract. In truth quasi-contract, and the wider concept of restitution, now exists as a subject in its own right, forming the middle ground between the narrow concept of the law of contract and the wide concept of the law of obligations. Thus Lord Wright in ***Fibrosa Spolka Akcyjna* v *Fairbairn Lawson Combe Barbour Ltd*** [1943] AC 32 stated:

> It is clear that any civilised system of law is bound to provide remedies for cases of what has been called unjust enrichment or unjust benefit, that is to prevent a man from retaining the money of or some benefit derived from, another which is against conscience that he should keep. Such remedies in English law are generically different from remedies in contract and tort, and are now recognised to fall within the third category of the common law which has been called quasi-contract or restitution.

The broad parameters in which the courts will grant relief for unjust enrichment have been set out by Jones in *Goff and Jones*: *The Law of Restitution* (2002). It is stated that the principle requires three factors to be present: first, that the defendant has been enriched by some benefit given to him; second, that the enrichment has been acquired at the expense of the plaintiff; and, third, that the retention of the benefit by the defendant would be unfair or unjust.

Whilst claims in quasi-contract cover myriad situations, making it difficult to classify the instances in which the remedy arises, we will conduct our study of the subject by analysing actions to recover money paid, actions for payments made under a mistake of law and claims in *quantum meruit*. Such an analysis will not cover all the situations in which restitution arises, but it will cover the use of the remedy as it arises within the law of contract.

Actions to recover moneys paid

An action will lie in quasi-contract to recover moneys paid either under a contract or purported contract where there has either been a total failure of consideration or where the moneys have been paid under a void contract.

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Total failure of consideration

Generally

A party may recover moneys paid in anticipation that the other will perform their contractual obligations in circumstances where there has been a total failure of consideration, that is, where they have received nothing that they bargained for, even where the other party is not in breach of contract. Thus any moneys paid in advance in a contract that is subsequently frustrated, for instance, may be recovered in circumstances where there has been a total failure of consideration. The ***Fibrosa*** case (as discussed in Chapter 15) is a typical example of the operation of quasi-contract in such a situation, where a buyer was able to recover moneys paid in advance for a contract that subsequently became impossible for the seller to carry out due to the outbreak of war. Since the buyer received no benefit from the contract there was deemed to be a total failure of consideration and it was clearly a case where the seller would have been unjustly enriched had he retained those moneys.

Consideration in this context refers, usually, to the performance of a promise, rather than the promise itself. This distinction is important since while (as already seen in Chapter 3 in the analysis of consideration) it is possible for an exchange of promises to amount to consideration, this definition is not appropriate in this context. Clearly if a promise could amount to a consideration then there will rarely, if ever, be a total failure of consideration. The position was explained by Lord Simon in the ***Fibrosa*** case as:

> In the law relating to the formation of contract, the promise to do a thing may often be the consideration, but when one is considering the law of failure of consideration and of the quasi-contractual right to recover money on that ground, it is, generally speaking, not the promise which is referred to as consideration, but the performance of the promise. The money was paid to secure performance and, if performance fails, the inducement which brought about payment is not fulfilled. If this were not so, there could never be any recovery of money, for failure of consideration, by the payer of the money in return for a promise of future performance.

As Lord Simon indicates, it is not always the case that quasi-contract requires an absence of performance of a promise, since it may be that the promise itself may form the basis of the consideration. Treitel gives the example of a contract of insurance where the insured bargains for the promise of the insurer with the result that if their property is destroyed by some hazard other than that insured against, they cannot recover their premiums on the basis of a total failure of consideration since they have already enjoyed the benefit of the insurer's promise. Treitel points out that such premiums could only be recovered should the property insured be destroyed before the insurer adopts the risk via the contract. This point is also illustrated in the following case.

Stocznia Gdanska SA v *Latvian Shipping Co.* [1998] 1 WLR 574 (HL)

A shipyard entered into a contract to design, build and deliver a vessel to the buyers. The design and construction formed part of the consideration. The contract was subsequently rescinded by the shipyard before the ownership in the vessel passed to the buyers. It was held that the shipyard was able to refute the claim by the buyers that they were able to recover an instalment of the contract price on the grounds of failure of consideration. The test for failure of consideration did not depend on whether the promisee (the buyer) had or had not received anything under the contract, but on whether the promisor had performed any part of the contract for which the payment was due.

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Partial failure of consideration

The rule here is that if a promisee has received part of the consideration due to them under the contract then they are unable to recover moneys paid in advance, as held in ***Whincup* v *Hughes*** (1871) LR 6 CP 78 where the plaintiff paid a watchmaker a premium of £24 to apprentice his son to him for six years. After one year the watchmaker died, though it was held that the plaintiff could not recover his money since the failure of the consideration was only partial. It should be noted, however, that the circumstances in this case would now be covered by the Law Reform (Frustrated Contracts) Act 1943, s 1(2), as a sum 'paid . . . in pursuance of the contract before the time when the parties were so discharged'.

Where there is a partial failure of consideration caused by a party failing wholly to perform their side of the bargain then the usual remedy is to sue for damages for breach of contract. The reason for the rule apparently is that the courts baulk at attempts to apportion the amounts due in relation to the partial performance of the contract. This rule, however, is not an absolute one and where apportionment is easy, as in the case of a divisible contract, or where the moneys paid can be divided up on a pro rata basis in relation to the performance of the contract, then partial restitution may be allowed.

Converting a partial failure into a total failure of consideration

In certain circumstances it may be possible to convert a partial failure into a total failure of consideration by the promisee returning such benefits as they have already acquired under the partial performance of the contract. Such a situation may occur where the promisee has a right to rescind the contract because the performance itself is either partial or defective. The result of the act of rescission is to produce a total failure of consideration. Such a situation arises where there has been a breach of condition which is discovered only when the goods are delivered. The breach of condition may arise either through a term of the contract or by virtue of a condition implied by statute. Thus if a purchaser pays in advance for an item in a catalogue which, when delivered, does not correspond with the description in the catalogue, then the purchaser can quite clearly rescind the contract under s 13 of the Sale of Goods Act 1979 and claim back the purchase moneys on the basis of a total failure of consideration.

For more on implied terms see Chapter 7.

Rescission depends, however, on *restitutio in integrum* and where this is not possible then clearly there can be no total failure of consideration. Thus, for example, where there is a contract to rebuild a dilapidated vintage car that has been partially completed, it would probably not be possible for rescission to take place and the failure of performance could only remain as a partial one. The only alternative for the promisee here would be to sue for damages. One should, however, note that the principle of *restitutio in integrum* will not apply where the reason for the impossibility of rescision arises because of the very defect for which the right to rescind emanates in the first place.

Rowland v *Divall* [1923] 2 KB 500

The plaintiff bought a car from the defendant and used it for some four months. The plaintiff then discovered that the defendant was not the owner of the car and had no right or authority to sell it. The plaintiff sued to recover the price and succeeded. He was entitled to treat the contract as discharged as there had been a total failure of consideration. Lord Atkin stated:

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> There has been a total failure of consideration, that is to say, the buyer has not got any part of that for which he paid the purchase money. He paid the money in order that he might get the property and he has not got it.

It was clear from the case that the defendant could not claim that the plaintiff had derived some consideration from the contract in that the plaintiff had used the car or that the car was not worth as much at the time of rescission because of depreciation. The plaintiff had paid the price to acquire ownership, which he had not got and it was from this defect that his right to rescind arose. The use of the car in this context was totally irrelevant to the contract for the sale of the vehicle.

In certain circumstances the use of the benefit under the contract by the promisee may, despite the above decision in ***Rowland* v *Divall***, prevent the failure of consideration from being total.

Hunt v *Silk* (1804) 5 East 449

A contract for a lease provided that the landlord should carry out certain repairs, that immediate possession was to be given, that the lease be executed within ten days of the agreement and that on execution the tenant would pay the landlord £10. The tenant duly went into possession and paid the £10 in advance and prior to the lease being executed. In fact the landlord failed to carry out the repairs or execute the lease within the ten-day stipulation, and as a result the tenant vacated the premises and claimed his £10 on the basis of a total failure of consideration. The court applied the strict rule that a person receiving part of the benefit he contracted for under the contract cannot recover his moneys in quasi-contract. The tenant had occupied the premises, albeit for a short period of time, and thus he could not recover his £10, though, of course, he might have been able to claim damages for breach of contract and thus the decision is probably correct and proper in such circumstances.

In truth the ***Rowland* v *Divall*** case is a means of mitigating the rule as applied in ***Hunt* v *Silk***. Its application in this way can result in great harshness simply because a party has received a benefit, no matter how slight. Nevertheless, the principle in ***Rowland* v *Divall*** can itself produce great unfairness.

Butterworth v *Kingsway Motors Ltd* [1954] 1 WLR 1286

A person who was buying a car on hire purchase, and thus had no title to the car, sold it before all the instalments had been paid. The car was then bought and sold by several persons until it was eventually sold by the defendant to the plaintiff for £1,275. The plaintiff used the car for 12 months before being told by the finance company that the car belonged to them but that he could acquire the title by paying off the final amount owing on the hire purchase agreement, a sum of £175, otherwise they would want the car returned to them. The plaintiff claimed the return of his £1,275 even though the car was now worth only £800 due to a slump in the second-hand car market. Further, eight days after the plaintiff heard from the finance company and after he had claimed the return of the £1,275 the original hirer paid off the final instalment so that the title to the vehicle should have 'fed' to the plaintiff. The court nevertheless allowed the plaintiff the full £1,275 despite the fact that the court considered his claim had little merit.

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The case represents an unfair and illegitimate extension of the ***Rowland* v *Divall*** case, and has led to substantial criticism of the ***Divall*** case itself. Nevertheless, there is nothing wrong with the principle within it if it were to be confined to dealers who are making the purchase in order to resell the item in question and who therefore require good title. In the case of the consumer, however, it would seem that the better principle is to be found in ***Hunt* v *Silk***, since the consumer will generally be able to maintain an action for damages for breach of contract.

Recovering moneys paid in a void contract

The basic rule here is that money paid under a void contract is recoverable, though this rule is not an absolute one and depends largely on the reason for the contract being held to be void. Thus it has been seen in the consideration of illegal contracts above that the effects can vary considerably. Suffice it to say that in cases where the contract is void for mistake then it is possible to recover moneys paid under such a contract.

Actions for payments made under a mistake of law

Until recently the general rule of English law was that money paid under a mistake of law, or as to the legal effect of the circumstances on which money was paid, but on a full understanding or knowledge of the facts, was irrecoverable. The rule dates back many years, though it was affirmed in 1996 in the case of ***Westdeutsche Landesbank Girozentrale* v *Islington London Borough Council*** [1996] AC 669. Despite its long pedigree the rule has been the subject of heavy criticism primarily because it allows a payee to retain moneys paid to him which would have not been so paid but for the payer's mistake of law. Further, the rule that money paid under a mistake of law was not recoverable became unpredictable, indeed often capricious, as the lines of distinction between mistakes of fact and mistakes of law became blurred.

For more on mistakes of law refer to Chapter 10.

By the early 1990s the rule that money paid under a mistake of law was irrecoverable began to be challenged in several Commonwealth jurisdictions. In 1994 the Law Comission (Law Com. No 227 (1994)) recommended that the rule should be abolished. In 1998 the House of Lords in the case of ***Kleinwort Benson* v *Lincoln City Council*** [1999] 2 AC 349 essentially did just that and declared that the rule would no longer form a part of English law.

The background to the ***Kleinwort Benson*** case was that at this time local authorities in England and Wales were subject to 'rate-capping' by the central government. It was in order to avoid the effects of rate-capping that several local authorities, Lincoln City Council included, became involved in transactions known as 'loan-swaps'. Under such a scheme Kleinwort Benson paid a substantial amount of money to Lincoln City Council, believing such loan-swap arrangements to be legal and valid. In 1992, however, in ***Hazell* v *Hammersmith and Fulham London Borough Council*** [1992] 2 AC 1, the House of Lords held that such loan-swap schemes were *ultra vires* the local authorities and as a result were void.

Following the ***Hazell*** case, Kleinwort Benson claimed for the recovery of the money it had paid to the local authority under the void contract. The problem it faced was that some of the payments had been made more than six years previously and therefore the claim for restitution for mistake was statute-barred as being outside the limitation period. Kleinwort Benson, however, attempted to rely on s 32(1)(c) of the Limitation Act 1980, which provides that time does not begin to run for limitation purposes until the mistake has been

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discovered. Kleinwort contested that the mistake was not known until the decision in the ***Hazell*** case and until that case no one was aware that such schemes were void. Thus Kleinwort alleged that time only began to run from the date of this decision and as such it was entitled to bring an action in restitution to recover the money paid under the void contract. The judge at first instance rejected the claim on the basis that a restitutionary claim was unsustainable where the payment of money had been made under a mistake of law. Kleinwort appealed and the judge invoked the leapfrog procedure under the Administration of Justice Act 1969, s 12, so that the case went directly to the House of Lords.

In the House of Lords their Lordships were unanimous in deciding that the rule that money paid under a mistake of law was irrecoverable should be abolished. There was disagreement, however, as to whether the change should be brought about judicially, given that the existing rule was an embedded principle of English law. The majority clearly indicated that the rule that a payment could be recovered by way of restitution on the grounds of a mistake of law could be implemented by judicial decision. The minority of the House of Lords, whilst they considered that the present rule ought to be overturned, did not consider that the mistake in the case was a mistake of law at all. On this basis they did not consider it appropriate to abolish a rule if it meant that the payment in the case would then become recoverable.

What then are the principles governing the recovery of money under a mistake of law? Broadly, the principles are similar to those found in cases of mistake of fact: Was there a mistake? Did the mistake cause the payment to be made? Did the payee have a right to the money paid to them? The Council in the case argued that the bank had not made a mistake of law because at the time the payment was made it was considered that 'loan-swap' arrangements were lawful. Such arrangements only became illegal and void following the decision in the ***Hazell*** case. The Council argued that on this basis there was no mistake of law at the time the arrangement was entered into. The bank for its part concurred with this view but argued that at the time the arrangement was entered into the law was not settled and that this therefore allowed a mistake of law to arise that, in turn, allowed for restitution to be made.

Thus both the Council and the bank agreed that in establishing a mistake of law it was necessary to examine the law at the time of the contract. The point of difference lay in whether the law could be considered to be settled at that time. If it was not, as alleged by the bank, then a mistake of law could arise. The decision of the majority of the House of Lords, however, went a great deal further than this. Their Lordships considered that whether the law was settled at the time of the payment was irrelevant. Further, they stated that it did not matter if the law was changed after the payment had been made and that this would also give rise to a mistake of law.

This last point is astounding since it means that if a person entered into a contract and made a payment to another, say in 1980, if there is a later decision in 2000 that overturns a principle of law which the parties had assumed to be settled law, then recovery of the payment by way of restitution is possible! Just a look at many of the situations that arise within this book where decisions of earlier cases have been overturned by the Court of Appeal or the House of Lords will give an idea of the implications of this decision. It is of course a founding principle of the common law and the notion of judicial precedent that they are based on a declaratory theory. The underlying principle in this theory, which every student of law knows, is that it declares the previous law to be erroneous and that the corrected law applies retrospectively. The basis behind this is that the newly declared law is what the law has always been and therefore the parties must have contracted under a mistake of law.

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The problem that arises from this in the context of restitution under a mistake of law, as declared by the House of Lords, is that it is expecting every party to a contract to be vested with a crystal ball. Decisions to enter into a contract based upon a legal authority that has long been considered to be an absolute statement of the law, which is then subsequently overturned, must invariably give rise to a mistake of law.

Both the dissenting judges, Lord Browne-Wilkinson and Lord Lloyd, expressed surprise at the logic set out above and recognised immediately the profound effects the majority decision would have. Both considered that if the law was regarded as settled when the payment was made, but that position changed as a result of a later decision, then the payment was not made under a mistake of law. Thus Lord Lloyd stated:

> If it is right that the House of Lords can change the law by overruling a previous decision of the Court of Appeal, it must follow that a person relying on the old law was under no mistake of law at the time, and cannot claim to have been under a mistake post facto because the law is subsequently changed.

Similarly, Lord Browne-Wilkinson was equally unequivocal. He stated:

> although the decision in ***Hazell***'s case is retrospective in its effect, retrospection cannot falsify history: if at the date of each payment it was settled law that local authorities had capacity to enter into swap contracts, Kleinwort were not labouring under a mistake of law at that date. The subsequent decision in ***Hazell***'s case could not create a mistake where none existed at the relevant time.

Unfortunately, the Limitation Act 1980, s 32(1)(c), does not help provide a solution to the dilemma created by the decision of the House of Lords in ***Kleinwort Benson***. The Act is quite clear in stating that time does not begin to run until the mistake is discovered, and in the situation in ***Kleinwort Benson*** this is at the time of the overruling decision. Perhaps the solution to the problem could nevertheless be found by Parliament taking the initiative and amending s 32(1)(c) in order to prevent recovery of payments in these circumstances. Some degree of caution is required here, since amending the provision so that time begins to run from the time the contract is entered into, as opposed to the discovery of the mistake, will probably have the effect of preventing bona fide claims under mistakes of fact from being brought.

The decision in ***Kleinwort Benson*** is undoubtedly a landmark decision, but it is considered that it is unlikely to survive in its present form. There is no doubt that defences to the application of the principle will emerge over time; indeed Lord Goff specifically stated that such defences will undoubtedly develop in future cases. One such defence is quickly apparent in that the payee will not be required to pay money if the payee has already spent the money, provided that the money was received in good faith in the first place. Such a defence is more likely to be raised where there is a long period of time between the payment of the money and the overruling precedent. It should be noted, however, that for this defence to apply the burden of proof would be on the payee to justify the retention of the money.

For more on illegal contracts see Chapter 12.

On the issue of defences Lord Goff considered that English law contained no principle to the effect that a contract that was fully performed rendered any money paid irrecoverable. He stated that it would be incorrect to allow an *ultra vires* contract to stand merely because the contract had been fully performed. To do otherwise would be to validate a contract that was contrary to public policy on the basis that it was illegal and void.

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It is also no defence for the mistaken party to claim that they honestly believed that they were entitled to retain the money paid. The House of Lords considered that such a defence would be too wide and would effectively preclude the other party from recovering money paid under a mistake of law.

One further limitation on the right of the payer to recover money paid under a mistake of law arises where the law is changed by legislation as opposed to a judicial decision. The reason for this is that in this situation there is no mistake of law at the time the payment was made. This position may be different, however, if the legislation enacted is retrospective in operation.

The decision in ***Kleinwort Benson*** can throw up some quite bizarre results. It has been established that where a person makes a payment on the basis of a judicial decision and believes the transaction to be valid, they may recover that payment if a later decision overrules that earlier one. But what about the losing party in the case that forms the earlier decision, could they claim in restitution for any money not recovered by them? Lord Hope in ***Kleinwort Benson*** emphatically declared that such a party could not so recover since they had not paid any money under a mistake of law but because the court had ordered them not to do so. An example of the application of the principles in ***Kleinwort Benson*** can be seen in ***Nurdin and Peacock plc* v *D B Ramsden and Co. Ltd (No 2)***.

Nurdin and Peacock plc v *D B Ramsden and Co. Ltd (No 2)* [1999] 1 All ER 941

In this case a dispute arose out of a 25-year lease which provided for an annual rent of £207,000, an extra rent of £59,000 for years 4 and 5 and a rent review in 1995 at the end of year 5. No review took place and accordingly the rent, as per the terms of the lease, should have reverted to the sum of £207,000. Between November 1995 and February 1997 the claimant paid all the sums demanded. In April 1997 after reading the terms of the lease the claimant informed the defendant that it would pay only the lower amount and stated that it intended to set off the overpayments against future rent. Subsequently the claimant sought legal advice. The solicitors advised the claimant to continue paying the higher amount without set-off until the dispute had been resolved through arbitration or court proceedings. Furthermore the solicitors advised the claimant that if it were successful in these proceedings it would be entitled to a full refund of the excess. As a result of this advice the claimant paid rent in May 1997 at the higher rate. The claimant then sought to recover all the overpayments including that made in May 1997. The problem, however, was that the May payment was made by the claimant when it was not acting under a mistake that the higher sum was payable. On this basis the claimant had no legal right to recover the overpayment since it was aware that the payments had not been due. Nevertheless the claimant contended that it was entitled to recover the May payment. The defendant contested the claim stating that the money paid under a mistake of law could only be recovered if the payer had mistakenly believed that it was liable to make the payment.

It was held that where a claimant sought to recover money under a mistake of law, it was not required to prove that it had mistakenly believed it was liable to make the payment. It had to show that it would not have made the payment but for the mistake, that the mistake was directly related to the overpayment and/or it was connected to the relationship between the payer and the payee.

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Claims in *quantum meruit*

A *quantum meruit* claim is defined by Beatson, *Anson's Law of Contract* (2002, p. 649), as a claim arising 'where goods are supplied or services rendered by one person to another in circumstances which entitle him to be recompensed by that other by receiving a reasonable price or remuneration'.

Quantum meruit claims arise in two situations.

Restitutionary *quantum meruit* actions

Very often the contract will contain express terms setting out what remuneration is payable on the occurrence of certain events. In such circumstances the court has no option but to award such sums. However, it may occur that the remuneration expressly provided for does not become payable because the contract has ceased to exist.

Lord Greer in ***Craven-Ellis* v *Cannons Ltd*** [1936] 2 KB 403 explained the nature of restitutionary *quantum meruit* as:

> an interference which a rule of law imposes on the parties where work has been done or goods have been delivered under what purports to be a binding contract but is not so in fact.

In such circumstances restitutionary *quantum meruit* actions will arise independently of the existence of any promise or agreement. The circumstances in which such *quantum meruit* awards are made may be as follows.

Void contracts

An example of such a case can be seen in ***Craven-Ellis* v *Cannons Ltd*** itself.

Craven-Ellis v *Cannons Ltd* [1936] 2 KB 403

Here the plaintiff was employed as the managing director of the defendant company. By virtue of the articles of association of the company the plaintiff was required to take qualification shares within two months of taking office, failure to do so rendering him unable to act. The plaintiff failed to take up the shares but, nevertheless, the company executed an agreement under seal in which it agreed to pay the plaintiff. In fact, the resolution of the directors to affix the company's seal to the agreement was invalid, which rendered the agreement void. The plaintiff's action to recover the promised remuneration in contract must, of course, have failed since the contract was void. He could, however, succeed in *quantum meruit* for services already rendered.

Frustrated contracts

For more on the doctrine of frustration and the effects of the Law Reform (Frustrated Contracts) Act 1943 refer to Chapter 15.

Where a contract becomes frustrated then by virtue of s 1(3) of the Law Reform (Frustrated Contracts) Act 1943 a party is able to recover such sums as the court considers just where the other party has a valuable benefit conferred on them. Clearly this would appear to be a statutory-based type of *quantum meruit*. The rule would also apply outside the 1943 Act where work is done after the frustrating event and still carries on, with the result that it may be said that the plaintiff's actions are voluntary. The effect of this will be to deny them a claim in *quantum meruit*, though it is, of course, possible that a new contract will be implied, giving them a right to damages for breach of contract.

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Contracts discharged by breach

Where a contract has been broken so that the innocent party can elect to treat the contract and their obligations under it as discharged, the innocent party can elect to claim in *quantum meruit* for work done rather than to sue in damages for breach of contract. It should be noted that it is only the innocent party who may claim in *quantum meruit*. The remedy is not available to those in default. Second, the breach must entitle the innocent party to treat the contract as discharged.

The use of *quantum meruit* is particularly useful in such circumstances where the actions of the party in default allow the other party to treat the contract as discharged halfway through them performing the obligations under the contract. It is clear that the innocent party could not claim the sum fixed for completing the work since it has not been completed, but *quantum meruit* allows them to claim for the reasonable value of the work actually completed. An example of *quantum meruit* in such circumstances can be seen in ***Planché* v *Colburn*** (1831) 8 Bing 14, where the defendants were in the process of compiling a series of books to be entitled *The Juvenile Library*. They engaged the plaintiff to write a book on medieval costume and armour. When the plaintiff had written several chapters the series was cancelled. It was held that he was entitled to refuse the publisher's offer to publish the book separately and claim in *quantum meruit* for work completed on the book.

Services rendered in contemplation of a contract

It sometimes occurs that a party undertakes work on the basis that a formal contract will be entered into at some future time. If the contemplated contract fails to materialise then the party that has undertaken the work may claim in *quantum meruit* for the work done, as seen in the case of ***British Steel Corporation* v *Cleveland Bridge and Engineering Co. Ltd*** [1984] 1 All ER 504 where construction work had begun in contemplation of a contract that never materialised. Here the plaintiffs, on ceasing further performance, could claim on a *quantum meruit* basis for work carried out. This position was also affirmed in the case of ***Whittle Movers Ltd* v *Hollywood Express Ltd*** [2009] EWCA Civ 1189. The cases of ***G Percy Trentham Ltd* v *Archital Luxfer*** [1993] 1 Lloyd's Rep 25 and ***RTS Flexible Systems Ltd* v *Molkerei Alois Muller Gmbh & Co KG (UK Production)*** [2010] UKSC 14 should be noted since they suggest that a broader approach to the finding for a contract should be taken, particularly where the whole or part of it is executed, and this may mean that there will be less need to rely on quasi-contract in these circumstances. The decisions in these cases were fully discussed in Chapter 2.

The use of *quantum meruit* within a contract

Quantum meruit may arise within a contract in two situations.

Where part-performance has been accepted

Where a party in breach of contract has only partly performed the contract and the other party elects to accept that performance, then they will be required to pay for that part-performance on a *quantum meruit* basis. By accepting the partial performance the innocent party implies that they will pay a reasonable sum for such performance. The same rules also apply where the party in default completes the contract in a manner different from that contemplated by the parties originally and where the innocent party accepts such performance. It should be noted that *quantum meruit* will *not* apply where

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the innocent party has no option to accept either part-performance or performance in a manner different from the original contract.

Where there is an implied agreement to pay

It may be that the parties have entered into a contract but have failed to include provision for payment within the contract. In such a situation the law implies on a *quantum meruit* basis that a reasonable sum will be payable. In contracts for the sale of goods the Sale of Goods Act 1979, s 8(2), provides that when goods are bought and sold without an express agreement as to price, then the buyer must pay a reasonable price, thus giving statutory authority to the rule in such contracts. A similar provision is also contained in the Supply of Goods and Services Act 1982, s 15.

Summary

- The doctrine of quasi-contract lies within a broader area of law known as the law of restitution.
- The broad parameters in which the courts will grant relief for unjust enrichment have been set out by Jones in *Goff and Jones*: *The Law of Restitution* (2002):
  (i) The defendant has been enriched by some benefit given to him.
  (ii) The enrichment has been acquired at the expense of the plaintiff.
  (iii) The retention of the benefit by the defendant would be unfair or unjust.

Actions to recover moneys paid

- An action will lie in quasi-contract to recover moneys paid either under a contract or purported contract where there has either been a total failure of consideration or where the moneys have been paid under a void contract.

Actions for payments made under a mistake of law

- Until recently, the general rule of English law was that money paid under a mistake of law, or as to the legal effect of the circumstances on which money was paid, but on a full understanding or knowledge of the facts, was irrecoverable (***Westdeutsche Landesbank Girozentrale*** v ***Islington London Borough Council***).
- The rule that money paid under a mistake of law was irrecoverable was abolished (***Kleinwort Benson*** v ***Lincoln City Council***).
- What then are the principles governing the recovery of money under a mistake of law?
  (i) Was there a mistake?
  (ii) Did the mistake cause the payment to be made?
  (iii) Did the payee have a right to the money paid to him?

Claims in quantum meruit

- Defined as a claim arising 'where goods are supplied or services rendered by one person to another in circumstances which entitle him to be recompensed by that other by receiving a reasonable price or remuneration', Beatson, *Anson's Law of Contract* (2002).

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Part 6

The rights and liabilities of third parties to the contract

19 Privity of contract
20 Agency
21 Assignment of contractual rights

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19 Privity of contract

Aims and objectives

After reading this chapter you should be able to:

- Understand what is meant by privity of contract and the effects of the doctrine of privity of contract.
- Explain how the doctrine of privity can be avoided by way of actions in tort.
- Know and explain the exceptions to the privity rule thereby allowing third parties to claim under a contract.
- Know and explain the exceptions to the privity rule that allow obligations to be imposed on third parties whether in relation to land or personal property.
- Understand the need for and how third parties may be protected by exemption clauses in a contract.
- Know the effects of the Contracts (Rights of Third Parties) Act 1999.

The general rule

The rule in English law is that only the parties to the contract may enforce the contract against each other, even if the contract was entered into with the sole intention of benefiting or imposing liabilities on a third party. The rule was confirmed as being part of English law in the nineteenth century. However, the modern authority for the rule is said to be the decision of the House of Lords in ***Dunlop Pneumatic Tyre Co. Ltd*** v ***Selfridge & Co. Ltd*** [1915] AC 847 where Viscount Haldane LC stated:

> My Lords, in the law of England certain principles are fundamental. One is that only a person who is a party to a contract can sue on it. Our law knows nothing of a *jus quaesitum tertio* arising by way of contract. Such a right may be conferred by way of property, as, for example, under a trust, but it cannot be conferred on a stranger to a contract as a right to enforce the contract *in personam*. A second principle is that if a person with whom a contract not under a seal has been made is to be able to enforce it consideration must have been given by him to the promisor or to some other person at the promisor's request.

It can be seen that the rule relating to privity is closely interlinked with the rule that consideration must move from the promisee. It is sometimes stated that the rule that

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only a party to a contract can sue on it is a different way of stating the above rule relating to consideration, and vice versa. This is not the case and both aspects are required to be shown in order to allow a person to sue on the contract. Very often when the rule relating to consideration arises it is assumed that there was an intention to include a person as party to the contract. If one translates this into the case of ***Tweddle* v *Atkinson*** (1861) 1 B & S 393, the facts of which were discussed in Chapter 3, it can be seen that even if the husband had furnished consideration for the promises of his father and father-in-law he would still not have been able to enforce the contract since the terms of the contract were not addressed to him; there was no intention to make the husband a party to the contract.

For more on the principle that consideration must move from the promisee see Chapter 3.

The precise reasons for the presence of the rule are somewhat unclear and over the years several different theories have emerged that have attempted to explain its existence. For instance, it is considered that to impose contractual liability on a person without their consent and in an arbitrary manner strikes at the liberty of the individual. Similarly, it is considered unjust to allow a person to sue on a contract which cannot be enforced against themself. Lastly, it is considered that gratuitous beneficiaries of a simple contract should not be entitled to enforce the contract. It may be that there is a vestige of an equitable principle in the latter point in that it is inequitable for a person who had nothing to be able to gain a benefit that is accruing to them only by way of the goodwill of the parties to the contract.

Whatever the reasons for the existence of the rule, it is now confirmed as part of the law though, as we shall see later, not without substantial criticism. The application of the rule can be seen in the following cases.

Dunlop Pneumatic Tyre Co. Ltd v *Selfridge & Co. Ltd* [1915] AC 847

The appellants sold tyres to a distributor on the basis that he would not resell them below the appellants' list price and that if the distributor sold the tyres to a trade buyer, the distributor would ensure that the trade buyer would also have the price restriction clause imposed on him. The distributor sold the tyres to Selfridge & Co. and imposed the price restriction clause in the contract and provided that Selfridge would pay £5 to Dunlop in respect of each tyre sold in breach of the price restriction clause. Selfridge sold the tyres to customers below Dunlop's list price and were sued by them in respect of each transgression and an injunction was issued restraining Selfridge from further sales of tyres below the list price. It was held that their action would fail since Dunlop had provided no consideration for Selfridge's promise. Privity of contract did not arise between Selfridge and Dunlop.

Beswick v *Beswick* [1968] AC 58

Peter Beswick sold his coal business to his nephew who agreed to pay £6 10s a week to Peter for the rest of his life. He further agreed that in the event of Peter predeceasing his wife, the nephew would pay the widow £5 per week for the rest of her life. On Peter's death the nephew made only one payment to the widow and refused to make any further payments. The widow sued but did so in two capacities: first, in her personal capacity as widow and beneficiary of the contract; and, second, as administratrix of her husband's estate. It was held that in respect of her personal capacity her action would fail as she was not a party to the contract and had not supplied any consideration under it. In her capacity as personal representative of Peter's estate she was successful since here she represented Peter's personal capacity rather than her own, such as it was.

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The effect of the doctrine of privity of contract

The basic effect

Where *A* and *B* contract with the intention that *C* will be the object benefiting from the contract then *C* will be unable to sue on the contract despite the intentions of the parties, as seen in ***Tweddle* v *Atkinson***. The only way in which *C* can have the contract enforced is by seeking the assistance of a promisee. Lord Denning considered in ***Beswick* v *Beswick*** that the third party could compel a promisee to bring the action by starting the action himself and then conjoining the promisee as co-defendant. This process was rejected by the Court of Appeal who took a traditional stance in relation to the doctrine.

The basic position as regards third parties has a particular effect in relation to consumer protection. It was seen in Chapter 7 that in contracts for the sale of goods, for instance, the parties enjoy the benefit of certain implied conditions, such as the implied condition as to satisfactory quality. If the third party receives the goods other than by way of entering into a consumer contract then they will be unable to benefit from the implied conditions and warranties imposed by the Sale of Goods Act 1979. Thus if *C* above receives the goods by way of a birthday present and they prove not to be of satisfactory quality then *C* has no right of action against the seller since *C* is not a party to the contract. Again, *C*'s only hope is to enlist the help of the purchaser of the gift. Contracts for the benefit of third parties do not affect the validity of the contract as regards the parties to the contract, who may take action to enforce it in the usual way. Such action may, however, affect the position of the third party.

Actions against the promisor for damages

It is clear that a third party cannot enforce the contract against the parties to the contract. While it may be possible for the third party to persuade a party to the contract to enforce the contract, that party can recover damages only in respect of their own loss, unless they, or the third party, can bring the claim within one of the exceptions to the rule. Further, the losses recoverable by the promisee are likely to be nothing more than nominal damages. This problem can be seen in the case of ***Beswick* v *Beswick*** since if the widow as administratrix had sued for damages in respect of the breach of contract as it affected Peter Beswick's estate, the amount of the damages would have been purely nominal given that the payments to Peter ceased on his death.

Even if the party to the contract can recover damages for losses incurred by the third party, there is always the problem of the third party recovering those damages from the promisee. Unless there is a contract between them, there would appear to be no legal basis for such a claim.

Jackson v *Horizon Holidays Ltd* [1975] 3 All ER 92

In this case a husband booked a holiday for himself, his wife and his two children. His original booking proved to be unavailable and a substitute was found. The holiday proved to be a disaster and fell far short of what had been promised. The company admitted liability for breach of contract but appealed on the basis of the £1,100 damages awarded by the judge at first instance, since this figure was only just short of the full cost of the holiday. Lord Denning agreed that as regards the husband's losses alone the award was excessive, but that the assessment was correct as regards the loss sustained by the family as a whole.

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He considered that a promisee, as a matter of general principle, was entitled to recover damages on behalf of third parties who were beneficiaries of the contract entered into by the promisee and that the third parties could, in turn, compel the promisee to hand over to them such proportion of the damages as represented their losses. The other members of the court upheld the award but did not openly support Lord Denning's proposition.

Undoubtedly the decision of Lord Denning represented a substantial inroad into the doctrine of the privity of contract, but was one that was comparatively short-lived.

Woodar Investment Development Ltd v *Wimpey Construction (UK) Ltd* [1980] 1 All ER 571

The vendors had contracted to sell land to the purchasers for £850,000 for themselves and £150,000 in respect of a third party. A dispute arose between the purchasers and the vendors who brought an action for breach of contract, claiming not only the £850,000 owed to themselves but also the £150,000 owed to the third party. The House of Lords decided that the purchasers were not liable for breach of contract. Their Lordships agreed that even if the purchasers had been liable then the vendors would not have succeeded in their claim in respect of the £150,000 since this was due, not to themselves, but to a third party. The vendors had not, in other words, suffered any loss in relation to the £150,000. The House of Lords stated that the principle stated by Lord Denning was not of general application but confined to a situation where a trust arose. Nevertheless, their Lordships considered that the decision in ***Jackson* v *Horizon Holidays Ltd*** was a correct one, albeit based on erroneous reasoning. Unfortunately, while a number of their Lordships were highly critical of the doctrine of privity of contract they were not prepared to present a legal rule that would allow parties to a contract to sue on behalf of a third party. Lord Wilberforce considered that the *Jackson* case was a special one that called for 'special treatment'. He stated:

> I am not prepared to dissent from the actual decision in ***Jackson***. It may be supported either as a broad decision on the measure of damages or possibly an example of a type of contract, examples of which are persons contracting for family holidays, ordering meals in restaurants for a party, hiring a taxi for a group, calling for special treatments. As I suggested in ***New Zealand Shipping Co. Ltd* v *A. M. Satterthwaite & Co. Ltd***, there are many situations of daily life which do not fit neatly into conceptual analysis, but which require some flexibility in the law of contract. *Jackson*'s case may well be one.

The decision in ***Woodar*** is not entirely satisfactory since rather than provide an answer to the problem of whether a party can sue on behalf of a third party and whether the third party can subsequently recover their share of the losses from the promisee, it tends to pose a problem as to when such a claim is sustainable. At the moment it can only be said that such a principle exists where a promisee, for instance, stands in a fiduciary relationship to the third party.

A footnote has to be added to the case of ***Jackson* v *Horizon Holidays*** and the doubtful reasoning within it in the form of the Package Travel, Package Holidays and Package Tours Regulations 1992. These Regulations make an organiser or retailer of package holidays liable to consumers, including third party beneficiaries, for the proper performance of their obligations under the contract. The Regulations only apply to 'package' holidays or travel as defined in reg 2(1). The effect of the regulation is to put the decision on a more substantial footing, giving third parties specific rights outside of the Contracts

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(Rights of Third Parties) Act 1999. However, ***Jackson* v *Horizon Holidays*** and the 1999 Act will continue to apply where a holiday falls outside the definition of a package holiday.

The promisee and specific performance

It was seen in ***Beswick* v *Beswick*** earlier that an action for damages by the widow as administratrix would result in only nominal damages being awarded. The claim here would be a representative action on behalf of the estate to recover any sums owed to Peter Beswick by the nephew under the contract. Since none were owed and the weekly payments to Peter were to cease on his death, the damages would only reflect a technical breach of contract. The real loss arising from the breach would be to the widow herself but, as we have already noted, as third party she could not claim in respect of this loss. The court, however, found that the widow in her capacity of administratrix could enforce the contract between the nephew and Peter Beswick by way of a decree of specific performance. The effect of the decree was to ensure that the widow in her personal capacity received the payments due to her under the contract.

The use of specific performance to enforce an undertaking in respect of a third party is not, however, without difficulties. The facts of the case were particularly beneficial to the widow in ***Beswick* v *Beswick*** because she had dual roles. Ordinarily the position of personal representative might reside in completely different hands from that of the third party, the result of which would be to leave the third party with the problem of persuading the personal representative to adopt the action. Further, it should be borne in mind that specific performance as an equitable remedy is a discretionary remedy.

Undertakings where the promisor promises not to sue the third party

There may arise a term in the contract between the promisee and the promisor, whereby the promisor undertakes either expressly or impliedly not to sue a third party. If the promisor reneges on the undertaking there is nothing the third party can do to restrain the action brought by the promisor since they are not a party to the contract. In such a case the promisee can obtain a stay of proceedings on the basis of the breach of the contractual undertaking by the promisor.

The obtaining of the stay of proceedings is not always a straightforward exercise. In ***Gore* v *Van Der Lann*** [1967] 2 QB 31 it was held that the grant of a stay of proceedings was dependent on the promisee being able to show that he had an interest to protect by enforcing the undertaking against the promisor.

Snelling v *John Snelling Ltd* [1973] QB 87

In this case the need to prove an interest worthy of protection by the promisee was ignored by the court. In the case the plaintiff, together with his two brothers, were directors and creditors of the family company. Arguments arose between the brothers who therefore agreed that should any one of them resign then that individual would forfeit all moneys owed to him by the company. Despite the agreement, which was meant to put an end to the arguments, the plaintiff resigned. The plaintiff then brought an action for the debt owed to him by the company. The plaintiff's brothers were cited as co-defendants in the action against the company. The brothers counter-claimed on the basis that the brother by resigning had forfeited his rights in respect of the debts owed to him by the company. As a

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third party the company could not rely on the agreement in order to avoid the debt so the brothers sought a declaration that the agreement bound the plaintiff and that his action ought to be stayed. It was held by Ormrod J that the brothers should be entitled to have the action stayed as between themselves and the plaintiff. He further held that the brothers could have the action stayed against the plaintiff as regards the company also. The judge considered that the most convenient way of dealing with this situation was to dismiss the action against the company.

Clearly the ***Snelling*** case runs contrary to the principles contained in the ***Van Der Lann*** case. Treitel considers that the decision is consistent with the ***Beswick*** case and submits that in such a situation the most appropriate remedy is either a decree of specific performance or an injunction.

Total failure of consideration

Where the parties have entered into a contract for the benefit of a third party under which the promisee has paid money to the promisor, then, if the promisor has completely and totally failed to carry out their part of the contract, for example by delivering goods to the third party, the promisee can recover the moneys paid on the basis of a total failure of consideration under quasi-contract.

For more on quasi-contracts refer to Chapter 18.

Avoiding the doctrine of privity of contract

Actions in tort

The law of torts, in particular the law of negligence, has developed to give relief to third parties in certain circumstances. Thus if *X* has been given a present that has been manufactured or produced in a negligent manner so that *C* is injured or otherwise suffers loss, then *X* will have a right of action against the negligent person, as seen in ***Donoghue* v *Stevenson*** [1932] AC 562. Very often the action for negligence will lie against the manufacturer and thus avoids the contracting parties altogether. This is not necessarily the case, however, since if, for instance, the defect in the goods arises because the seller has stored the goods in a negligent manner then the action will lie against them rather than against the manufacturer or the wholesaler. Thus in ***Donoghue* v *Stevenson*** the consumer of the adulterated ginger beer did not have to rely on the support of the purchaser in an action against the seller but could take direct action against the manufacturer.

The principle in ***Donoghue* v *Stevenson*** can also be seen in the case of ***Junior Books Ltd* v *Veitchi Co. Ltd*** [1983] 1 AC 520 where the plaintiffs entered into a contract with *X* to build a warehouse. *X* employed the defendants as subcontractors for the flooring work. The defendants allegedly did this work in a negligent manner. Normally the plaintiffs would have sued *X* who, in turn, would have sued the defendants. The House of Lords held, however, that on the facts there was no reason why the plaintiffs, despite the fact that they would not suffer injury or damage as a result of the actions of the defendants, could not maintain the action against them. It is unclear why the plaintiffs took such a course of action but the case created some disquiet and the decision has been subsequently confined to the facts of the particular case. In the case of ***D & F Estates Ltd* v *Church Commissioners for England*** [1989] AC 177 the court made it clear that it

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would be unlikely that a plaintiff could maintain an action against a subcontractor in the future. The change of attitude probably also reflects a feeling that to allow such actions as a matter of general policy would be likely to result in a formulation of a principle that every breach of contract could arise as an action in tort where the breach had arisen as a result of the negligence of the defendant.

The use of negligence by third parties has also been curtailed to some degree by the ruling that pure economic loss cannot be claimed in an action. Since physical injury or damage is less likely to occur in a contract, the ruling places some limitations on the use of tort as a means of securing a remedy and avoiding the doctrine.

Collateral contracts

The rule of privity of contract can be avoided by the finding of a collateral contract between the third party and the promisor, who may enforce the contract for and against each other. Such contracts must comply with the normal rule of contract and each party must, as a result, provide consideration. The principle of collateral contract can be seen in the case of ***Shanklin Pier Ltd*** **v** ***Detel Products Ltd***.

Shanklin Pier Ltd v *Detel Products Ltd* [1951] 2 KB 854

The plaintiffs employed contractors to repair and repaint their pier. The plaintiffs specified in the contract with the contractors that they had to use the paint manufactured by the defendants, since they had been persuaded by the defendants that the paint would last seven years despite the harsh conditions to which it would be exposed. The contractors purchased the paint from the defendants but it soon became apparent that it did not match the specification represented by the defendants to the plaintiffs. In fact the paint only lasted three months and approximately £4,000 had to be spent remedying the defects. The problem for the plaintiffs was that, since the contract for the purchase of the paint was between the contractors and the defendants, they were third parties and clearly could not recover on the basis of that contract. The court, however, found that there was a collateral contract between the plaintiffs and the defendants and that the defendants were liable to pay damages for breach of the collateral contract. One problem faced by the court was that of finding consideration for the contract. The court held that the plaintiffs had provided consideration for the defendants' undertaking as to the longevity of the paint by entering into a contract with the contractors, in which they had stipulated that the defendants' paint had to be used.

Exceptions to the doctrine of privity of contract

The doctrine of privity of contract has often been subject to sharp criticism, in particular by Lord Denning who considered it to be an outmoded nineteenth-century concept. The doctrine nevertheless continues to form part of the modern law, though it exists as a doctrine that is by no means absolute since the courts and Parliament have seen fit from time to time to create exceptions to the rule. One of the great problems of completely abolishing the rule is that while there is general agreement that third parties should be allowed to take action to enforce benefits due to them under a contract, the same is not true when the converse arises – where the parties to a contract wish to impose liabilities on a third party.

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Exceptions allowing a third party to claim under a contract

Statutory exceptions

1. Road Traffic Act 1988

The driver of a motor vehicle is obliged to take out a policy of insurance to cover possible claims by persons suffering injury by virtue of the actions of the driver of the vehicle. The Act permits an injured third party to make a direct claim against the insurance company despite the fact that he is not a party to the contract, by virtue of s 148(7).

2. Married Women's Property Act 1882

By virtue of s 11 of this Act a husband can take out a policy of insurance on his own life for the benefit of his wife and children (and vice versa). The effect of this provision is that when the husband dies the proceeds of the policy are held on trust for the wife and the children. The result of this is that the proceeds do not fall into the estate of the husband and are thus outside the application of inheritance tax. If the insurance company does not pay out on the policy the wife and/or the children may take direct action against the company.

3. Companies Act 2006

By virtue of s 33 (formerly Companies Act 1985, s 14) the provisions of a company's constitution bind the company and its members to the same extent as if there were covenants between the company and its shareholders and between the shareholders *inter se*. The result is that an individual shareholder can sue another shareholder on the basis of the contract contained in the memorandum and articles of association.

4. Bills of Exchange Act 1882

Negotiable instruments provide an important exception to the privity of contract rule since the debt on the face of the instrument is enforceable not only by the original party to the transaction but by anyone to whom the debt is negotiated and who is deemed to be a 'holder in due course'. By virtue of s 38(2) the holder in due course may take action not only against the original debtor on the instrument if they fail to pay, but also against any other previous signatories of the instrument who have had the debt negotiated to them. In order for the holder in due course to be able to enforce the instrument in this way, the instrument must be in a deliverable state which means that, if the instrument is made out to a named individual *X*, or 'to *X* or order', the instrument must be endorsed on to the third party by *X*. Where the instrument is not made out to a named individual but to the 'bearer' then the instrument is said to be a 'bearer bill' which is in a deliverable state and may be negotiated on without the need for endorsement.

Agency

For more on agency, refer to Chapter 20.

The principle in agency is that 'he who does an act through another does it himself'. Thus if *A* contracts with *B* on behalf of *C* then the contract that results is between *B* and *C*.

Assignment

This will be dealt with in greater detail in Chapter 21.

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Trusts

If property is given to a person (the **trustee**) on trust for another (the beneficiary), then the former is the legal owner of the property, while the latter is said to be the equitable owner of the property. A trustee is in a fiduciary relationship to the beneficiary and this results in the trustee being under a duty to protect the property appertaining to the **trust**. Such a duty extends to the trustee taking action against a third party to the trust who is in breach of obligation to the trust. Where the trustee fails to take action the beneficiary can require the trustee to do so or alternatively have an action against the third party themself, at the same time joining the trustee into the action as co-defendant or, if they consent, as co-plaintiff.

The property that may be the subject of the trust can include intangible property, known generically as a **chose in action**, which includes a right to enforce a contractual obligation. Immediately one can see that this allows the possibility of a third party enforcing a contract, if the promisor simply declares that they hold the benefit of the contract on trust for the third party. The principle can be seen in the case of ***Les Affréteurs Réunis SA*** **v** ***Leopold Walford (London) Ltd***.

Les Affréteurs Réunis SA v *Leopold Walford (London) Ltd* [1919] AC 801

Walford, acting as a broker, arranged a charterparty between the owners of a ship and a charterer. The charterparty provided that the shipowners would pay commission owed to Walford by the charterers. The shipowners subsequently refused to pay Walford's commission and so he brought an action for breach of contract as beneficiary under a trust. In such circumstances it was a normal practice of the shipping industry for the charterers to sue as trustees on behalf of brokers and this practice was acknowledged by the shipowners. It was thus possible for a broker to sue in the name of a trustee promisor, namely, the charterers. From that proposition the House of Lords found that the promisor could waive that requirement thus allowing the broker beneficiary to sue in his own name.

Clearly the trust idea could have been used to drive a large hole in the doctrine of privity of contract but this was not to be. The courts limited the application of the principle by imposing the requirement that to create a trust certainty of intention must be shown clearly from the circumstances of the case. Such certainty of intention to create a trust will not be regarded as arising simply where the parties enter into a contract for the benefit of a third party. Thus Lord Greene MR stated in ***Re Schebsman, Official Receiver*** **v** ***Cargo Superintendents (London) Ltd and Schebsman*** [1944] Ch 83:

> It is not legitimate to impute into the contract the idea of a trust when the parties have given no indication that such was their intention.

Similarly, in the same case, Du Parcq LJ stated:

> It is true by the use possibly of unguarded language, a person may create a trust . . . but unless an intention to create a trust is clearly to be collected from the language used and the circumstances of the case, I think that the court ought not to be astute to discover indications of such an intention.

The above comments do not destroy the possibility of the occurrence of a constructive trust at all, but the burden of proving the certainty of intention has the effect of severely curtailing the use of this device.

The notion that a trustee can recover damages to compensate loss suffered by the beneficiaries can only arise if it was known to both parties to the contract that one of

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them was contracting as a trustee. Thus in ***Rolls-Royce Power Engineering plc* v *Ricardo Consulting Engineers Ltd*** [2003] EWHC 2871 (TCC) it was held that, where a subsidiary had contracted with the defendant on behalf of its parent company, the subsidiary would not be able to claim damages as a trustee. This is because the defendant was not aware at the time of the contract, nor had any reason to know, that the parent company had a direct interest in the contracts. This principle follows from Lord Clyde's judgment in ***Panatown Ltd* v *Alfred McAlpine Construction Ltd*** [2000] 4 All ER 97, where he stated that the recovery of damages in such circumstances can only arise where the claimant 'expressly enters a contract as a trustee or agent'.

The rule in *Dunlop* v *Lambert*

In many respects the expression 'rule' here is somewhat of a misnomer since the case in fact provides an exception to the general principle of English law that a person cannot recover substantial compensation for breach of contract where he has suffered no loss. Thus the exception in ***Dunlop* v *Lambert*** [1839] 6 Cl & F 600, which has been affirmed in ***The Albazero*** [1977] AC 774, provides a remedy where no other remedy would be available for a breach of contract in circumstances where the contracting parties contemplated that a breach by one was likely to cause loss to an identified or identifiable stranger to the contract. The purpose therefore was to prevent a claim for damages from falling into a legal 'black hole'.

The rule has been applied more recently in the House of Lords in the joint appeals of ***Linden Gardens Trust Ltd* v *Lenesta Sludge Disposals Ltd*; *St Martin's Property Corporation Ltd* v *Sir Robert McAlpine Ltd*** [1994] 1 AC 85, where the so-called 'black hole' can be easily identified. Thus it arises in cases such as the ***St Martin's*** case where *A* enters into a contract with *B* for the erection of a building by *B* on land owned by *C*. If the building proves defective, who has the remedy against *B* – *A* or *C*? An application of the general rule provides that *A* can only recover damages for the losses sustained by *A*. It may be argued though that since *A* does not own the land or the building, no loss has been suffered and therefore *A* cannot recover damages as compensation. *C* as owner of the land and the building clearly suffers damage but, since *C* is not a party to the contract, there is no right of action against *B*. Thus the claim falls into the 'black hole' with neither *A* nor *C* being able to recover damages.

Originally the rule in ***Dunlop* v *Lambert***, as also seen in ***The Albazero***, arose in the context of contracts for the carriage of goods. Thus a consignor of goods could recover damages from a carrier for loss or damage to goods in transit, even if the goods had become the property of the consignee before the loss or damage occurred, and who had not acquired any rights to sue the carrier under the contract of carriage. The effect of the joint appeals in the ***Linden Gardens*** and ***St Martin's*** cases, however, was to extend this principle to building contracts. This meant that an employer could recover substantial damages from a contractor on the basis that the employer had contracted on behalf of the owner of the land. A further modern application of the rule can be seen in ***Darlington Borough Council* v *Wiltshier Northern Ltd***.

Darlington Borough Council v *Wiltshier Northern Ltd* [1995] 1 WLR 68

The Council wished to build a new recreational centre but, to avoid some of the financial constraints, employed Morgan Grenfell (Local Authority Services) Ltd ('MG'). MG entered into contracts for the construction work with the defendants, Wiltshier Northern Ltd ('W'), for the benefit of the Council. A collateral agreement provided for MG to pay W and then the

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Council would reimburse MG, who would assign to the Council all rights which MG had against W.

On completion, serious defects were found to exist which would cost £2 million to remedy. At first instance it was stated that MG had no proprietary interest in the recreational centre and had suffered no loss or damage caused by the defects. The result of this was that MG could only assign rights to nominal damages for breach of contract, rather than a claim for substantial compensation for the defects. The Council was precluded by the rule of privity of contract from claiming the damages it suffered; indeed, it was agreed between the parties that the Council, as assignees of MG, could not recover any damages from W beyond those which MG could have recovered if there had been no assignment.

In the Court of Appeal Dillon LJ stated that damages for breach of contract were merely compensatory and that it remained the law that a third party could not sue for damages on a contract to which they were not a party. He affirmed the decision in ***Woodar Investment Development Ltd*** **v** ***Wimpey Construction (UK) Ltd*** [1980] 1 WLR 277 that a plaintiff could only recover for their own loss and that if a plaintiff entered into a contract with a defendant for the benefit of a third party, who was not a party to the contract, the plaintiff could not recover substantial damages from the defendant for breach of that obligation by the defendant. Dillon LJ, however, stated that it was obvious to W that the centre was being constructed for the Council and that the rule in ***Dunlop*** **v** ***Lambert*** would apply as an exception to the rule that a plaintiff could only recover damages for their own loss. The Council, as assignee, had a valid claim against W for breach of contract and the damages would be assessed on the normal basis as if the Council had employed W. Further, the Court of Appeal held that in any event MG could have recovered from W the losses of the Council, to whom it stood in a fiduciary relationship.

The rule in ***Dunlop*** **v** ***Lambert*** is subject to a proviso set out in the ***The Albazero*** [1977] AC 774. This states that the rule in ***Dunlop*** **v** ***Lambert*** does not apply when the parties to the original contract, the consignor and carrier, contemplated that a separate contract would come into existence between the carrier and the consignees, regulating the liabilities between them. This is because it is envisaged that the consignees would have their own right of action against the carrier. Such a right of action would preclude the consignors from suing the carrier for their own losses and those of the consignees since this would result in the carrier paying out twice.

This view was referred to as the 'narrower ground' in the ***Linden Gardens*** case, in that *A* only had a course of action to recover from *B* the losses suffered by *C*. This gave rise to a second provision in that *A* was liable to account to *C* for the losses *A* had recovered.

Lord Griffiths in the ***Linden Gardens*** case proposed and indeed came to his decision on an entirely different ground – 'the broader ground'. This broader ground states that *A* has a right of action against *B* in their own right and that the damages may be more than nominal damages. This right of action by *A* arises despite the fact that *A* did not own the land at the time of the breach. In other words, by reason of the breach, *A* himself had suffered damage, this being the loss of the value to him of performing the contract to provide *C* with the benefit that *B* had agreed to provide – referred to as the 'performance interest'.

A use of the proviso in ***The Albazero*** as a defence to claim based on the rule in ***Dunlop*** **v** ***Lambert*** occurred in the following case.

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Alfred McAlpine Construction Ltd v *Panatown Ltd* (1998) 88 BLR 67

The facts of the case were that the contractor, McAlpine, was employed by Panatown to design and build a multi-storey car park. Panatown alleged that the building when completed was so seriously defective that it would have to be demolished and rebuilt, and that McAlpine was in breach of contract. Whilst Panatown employed McAlpine it was not the owner of the site; the owner was an associate company, Unex Investment Properties Ltd (UIPL), which was broadly speaking the developer.

On the same day that McAlpine entered into the construction contract with Panatown it also entered into a duty of care deed with UIPL. When Panatown commenced proceedings against McAlpine claiming damages for defective works, McAlpine alleged as a defence that Panatown was not entitled to recover such damages since it was not, and never had been, the owner of the site. The losses claimed by Panatown had not been incurred by Panatown but by UIPL, which was the owner and the developer of the site. On this basis McAlpine claimed that even if the breaches were proved, Panatown could claim only nominal damages since it had suffered only nominal losses. On the other hand, McAlpine also argued that UIPL could not claim damages for the defective works since it was not a party to the construction contract.

At first instance the arbitrator rejected McAlpine's defence, but the official referee on appeal reached the opposite conclusion. Panatown appealed to the Court of Appeal where the issue before the court was whether Panatown could claim substantial damages despite the fact that it was not and never had been the owner of the site.

The Court of Appeal stated that the cases of ***Dunlop* v *Lambert, Linden Gardens Trust Ltd* v *Lenesta Sludge Disposals Ltd; St Martin's Property Corporation Ltd* v *Sir Robert McAlpine Ltd*** and ***Darlington Borough Council* v *Wiltshier Northern Ltd*** were all authorities for the principle that a contracting party (*A*) could recover substantial damages for breach of contract, notwithstanding that the financial loss, which was the measure of damages, was not suffered by *A*. Further, that this right to damages existed despite the fact that the contracting party had no proprietary interest in the property. In other words, the 'broader ground' of entitlement was applied, as set out by Lord Griffiths in the ***Linden Gardens*** and ***St Martin's*** cases, allowing A to recover damages in respect of *A*'s 'performance interest'. The question remained, however, whether the proviso in ***The Albazero*** would prevent the rule in ***Dunlop* v *Lambert*** from applying, thereby precluding the claim of Panatown. In other words, did the fact that contractual rights were given to UIPL in the duty of care deed preclude Panatown's claim to substantial damages?

The court considered that the building contract clearly contemplated that the accounts would be settled between Panatown and McAlpine and that an anomaly would arise if the employer, Panatown, could not claim for the defective work. On the other hand, the duty of care deed was also clearly intended to create a separate right of action by the site/building owner against the contractor if the contractor was in breach of the terms in the duty of care deed. There was no intention within this deed, however, to prevent Panatown from receiving substantial damages for McAlpine's breach of contract.

Clearly this reasoning poses a problem in that there is a risk of a double recovery arising against McAlpine, one by Panatown and one by UIPL. It is this risk that forms the basis of the proviso set out in ***The Albazero***. In the present case the double liability arose from two separate contracts. This is not to say that double liability would occur in reality since the court considered that, given that Panatown could recover substantial damages,

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such damages would be taken into account should UIPL make a separate claim under the duty of care deed.

The problem in the ***Panatown*** case was that there was one factor that was essentially different from the previous ***Linden Gardens*** and ***St Martin's*** cases. In the ***Panatown*** case UIPL had negotiated for and had obtained a direct contractual obligation between itself and McAlpine which was contained in the duty of care deed. This provided that McAlpine would exercise all reasonable skill, care and attention and owed a duty of care in respect of all matters within the scope of its responsibilities under the building contract to UIPL. It was the existence of this duty of care deed that formed the basis of McAlpine's appeal to the House of Lords ([2000] 4 All ER 97).

In the House of Lords it was held that if a contractor (*B*) had been in breach of a contract with an employer (*A*) to construct a building for a third party (*C*), *A* would not be able to recover substantial damages on behalf of *C* if it had been intended that *C* would have a direct cause of action against *B* to the exclusion of any substantial claim by *A*. Lord Browne-Wilkinson considered that the whole contractual matrix of the development envisaged that McAlpine's obligations could be enforced not only by Panatown, but also by UIPL and indeed any successors in title of UIPL.

Lord Browne-Wilkinson considered that the direct cause of action given to UIPL prevented any claim by Panatown on the 'narrower ground'. This is clearly correct since the whole basis of the rule in ***Dunlop* v *Lambert***, as set out in ***The Albazero***, was based on the fact that a remedy was provided to a third party 'where no other would be available to a person sustaining loss which under a national legal system ought to be compensated by the person who caused it'. Thus if the contractual arrangements gave a third party, UIPL, a direct right of action against the wrongdoer, McAlpine, the whole basis for the application of the rule was negated. Further, in such a situation since *C* had a direct right of action against *B*, *A* had no right to recover damages on behalf of *C*.

On 'the broader ground' Lord Browne-Wilkinson affirmed the reasoning of Lord Griffiths in the ***Linden Gardens*** and ***St Martin's*** cases in that *A* had a right of action in their own right for substantial damages with respect to the loss of his 'performance interest', namely 'the failure to provide *C* with the benefit that B had contracted for *C* to receive' or the cost to *A* of providing *C* with the benefit. His Lordship, however, qualified the application of this principle in that he stated that *A* would have no such right if the contract gave *C* a direct cause of action of the type given to UIPL under the duty of care deed. He stated that the critical factor was to establish *A*'s interest in the provision of his service to *C*. He considered that in the ***Panatown*** case the whole contractual scheme was aimed at giving UIPL and its successors a legal remedy against McAlpine for failure to perform the construction with due care. On this basis he considered that Panatown had not suffered any loss to its 'performance interest'. Any physical or pecuniary losses suffered by UIPL could be recovered by UIPL by way of its own cause of action. Whilst UIPL had such a cause of action Panatown had suffered no damage to its performance interest and on this basis the House of Lords distinguished the case from that of the decisions in the ***Linden Gardens*** and ***St Martin's*** cases.

It must be emphasised that the rule in ***Dunlop* v *Lambert*** is limited to situations where damage is caused to property which is transferred to a third party by one of the contracting parties. Whilst the scope of the rule has been extended from contracts for the carriage of goods to contracts generally, it is nevertheless bound by this restriction, at least for the moment. It could not be applied to situations such as that seen in ***Jackson* v *Horizon Holidays***.

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The position seen in the ***Linden Gardens*** case may still arise following the passing of the Contracts (Rights of Third Parties) Act 1999. Section 4 provides that, 'Section 1 does not affect any right of the promisee to enforce any term of the contract'. Thus in a contract between *A* and *B*, *A* will still be able to enforce the contract against *B* even where the Act also gives *C* the right to enforce the contract on one of its terms. Thus on *B*'s failure to perform a contract in favour of *C*, *A* can make any claim for damages, specific relief or an action for an agreed sum that would have been available to them at common law. Thus the Act itself is unlikely to affect the number of situations where *A* can recover damages in respect of a third party's (*C*'s) loss.

Law of Property Act 1925, s 56(1)

This provides:

> A person may take an immediate or other interest in land or other property, or the benefit of any condition, right of entry, covenant or agreement over or respecting land or other property, although he may not be named as a party to the conveyance or other instrument.

In ***Beswick*** **v** ***Beswick*** Lords Denning, Salmon and Danckwerts applied the literal rule to this provision and found that Mrs Beswick was entitled to enforce the contract in her personal capacity. They considered that s 56 formed a general exception to the doctrine of privity of contract. Their arguments revolved around the interpretation of the words 'other property' since s 205(1) of the Law of Property Act 1925 stated, in part:

> (xx) Property includes anything in action and any interest in real or personal property.

Since 'anything in action' or a chose in action, as we have already seen, can amount to a contractual obligation, the Court of Appeal proposed that s 56(1) had abolished the doctrine of privity of contract. The House of Lords rejected this proposition and unanimously held that s 56(1) did not have this effect. They added that s 205(1)(xx) was to be construed in a restrictive way so that it had no application in the law of contract.

Exceptions imposing obligations on a third party

Obligations imposed by way of interests arising in land

1. Obligations arising in leasehold land

Very often in leases the original parties, the landlord and the tenant, undertake to abide by certain conditions or covenants within the lease. These covenants are enforceable between the original parties to the lease since there exists privity of contract. Where the tenant assigns the lease to an assignee, *X*, then the landlord can continue to enforce covenants that are said to 'touch and concern' the land against *X*, as stated in ***Spencer's case*** (1583) 5 Co. Rep 16a. For his part *X* can also enforce such covenants against the landlord. There is said to be privity of estate between *X* and the landlord.

The rules that render *X* liable for breaches of covenant above are also of application where the landlord assigns their reversion to a third party, *Y*, since the original tenant can enforce covenants that have 'reference to the subject matter of the lease' against *Y*, by virtue of s 142 of the Law of Property Act 1925. For their part *Y* can also enforce covenants against the original tenant on the same basis by virtue of s 141. Again between *Y* and the original tenant there is said to exist privity of estate. The same position also applies with respect to *X* and *Y* themselves, both being able to enforce the covenants

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against each other even though they were not parties to the original lease, again by virtue of s 141 and s 142.

The above rules do not apply where the original tenant grants a sublease to a subtenant, *Z*. Although the original tenant can enforce the contracts against *Z* on the basis of privity of contract, neither this nor privity of estate exists between the original landlord or the assignee and *Z*, none of whom can enforce the covenants against each other, unless the covenant is a **restrictive covenant**. The rules regarding restrictive covenants are contained in the decision in ***Tulk* v *Moxhay*** which will be discussed in relation to **freehold land** below.

2. Obligations arising in freehold land

The position in relation to the enforcement of restrictive covenants in both freehold and, in certain circumstances, **leasehold land** is to be found in the rules that arose out of the decision in ***Tulk* v *Moxhay***.

Tulk v *Moxhay* (1848) 2 Ph 774

The facts of the case were that the plaintiff was the owner of a number of plots of land in Leicester Square. The plaintiff sold the gardens to a purchaser who entered a covenant to the effect that he would maintain the status of the gardens and that he would not build on the site. After the land in question had passed through the hands of several purchasers it came into the hands of Moxhay, the defendant. Despite the fact that Moxhay knew of the restrictive nature of the covenant in relation to the land, he nevertheless proposed to build on it. The original party could not, of course, obtain damages against Moxhay at common law for being in breach of the covenant since he was not a party to the contract with Moxhay. Instead the plaintiff sought the equitable remedy of an injunction to restrain Moxhay from building. The court issued the injunction on the basis that to allow the defendant to ignore an obligation of which he had knowledge at the time he purchased the property was contrary to the principles of equity and good conscience.

The case thus established the notion of the restrictive covenant which will be binding, not only on the original parties, but also on the third parties who later acquire the land with knowledge of the restrictive covenant. It should be noted that it is not merely because there is knowledge of a covenant that is of a restrictive nature that the doctrine will apply. In addition the person seeking the injunction (the covenantee) must show that they retained an interest in land adjoining the land being sold which was intended to benefit from the restrictive covenants.

Obligations imposed by way of interests in personal property

The problem that arises here is whether the principle as expressed in relation to covenants in land may be extended to personal property. Thus where the owner of a car agrees to hire it to an individual and then sells the car to a third party, to what extent is the third party bound by the contract of hire, assuming they have knowledge of it when they purchase the car? Is it possible for the hirer to restrain the new owner from using the car in a manner which is inconsistent with the terms of the contract of hire by way of an injunction? The answer seems to be that equity will not assist the hirer in such circumstances. Equity will normally grant an injunction only where, first, damages are inadequate and, second, the property in question is unique. In the example above it is clear that the hirer could be adequately compensated by an award of damages, unless the

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vehicle was unique in some way, such as a Rolls-Royce Silver Ghost which was to be used for a wedding. It is thus somewhat unlikely in the normal course of things that the courts will grant an injunction in such circumstances.

Despite the above it would appear that the courts have attempted to extend the principles seen in ***Tulk* v *Moxhay*** to charterparties, that is, personal property. This development was first seen in the case of ***Lord Strathcona Steamship Co.* v *Dominion Coal Co. Ltd***.

Lord Strathcona Steamship Co. v *Dominion Coal Co. Ltd* [1926] AC 108

In this case the Dominion Coal Co. Ltd had a long-term charterparty of a ship, the *Lord Strathcona*. The owners of the ship sold it and after a series of transactions it came into the hands of the Lord Strathcona Steamship Co., the respondents, who were fully aware of the charterparty at the time of the purchase and in fact specifically agreed with the sellers to abide by it. The respondents later broke the charterparty when they refused to yield up the ship at the start of the charter period. The respondents were sued by the appellants but claimed as a defence that since they were not parties to the original charterparty they were not bound by it. The Privy Council rejected the contentions of the respondents and awarded an injunction restraining them from using the ship in a manner that was inconsistent with the charterparty.

The Privy Council applied the rules as expressed in ***Tulk* v *Moxhay***, finding that the respondents were bound by the charterparty because they had notice of it at the time of purchase. This reasoning, however, has been heavily criticised since the rules in ***Tulk* v *Moxhay*** revolve not only around notice but also around the fact that the person attempting to enforce the restrictive covenant owns adjoining land which it was intended that the restrictive covenant should benefit. No such proprietary interest arose in the ***Lord Strathcona*** case since the charterer merely had a personal right to the use of the ship. This right, rather than simply an action for damages, might be enforced by an injunction where the property in question is unique. There was no indication that the *Lord Strathcona* could be regarded as unique and damages would therefore have amounted to an adequate remedy. There thus appears to be no justification for the decision, especially when a ship only amounts to personal property and is no different from the car in the above example.

In ***Port Line Ltd* v *Ben Line Steamers Ltd*** [1958] 2 QB 146 Lord Diplock considered the ***Lord Strathcona*** case to be wrongly decided and stated that a proprietary interest was an essential element in ***Tulk* v *Moxhay***, an interest that was noticeably absent in the ***Lord Strathcona*** case.

Some judges have supported the decision in the ***Lord Strathcona*** case, notably Browne-Wilkinson J in ***Swiss Bank Corporation* v *Lloyds Bank Ltd*** [1979] Ch 548 who considered that the appellants were bound by the charterparty on the basis that they were constructive trustees of the ship and therefore obliged by equity to comply with their fiduciary obligations to the respondents. Further consideration of this aspect of privity of contract arose in the following case.

Law Debenture Trust Corporation plc v *Ural Caspian Corporation Ltd and Others* [1993] 2 All ER 355

The facts of the case were that the minority shareholders in the first four defendants ('the Russian companies') agreed to sell their shareholdings to Leisure Investments (Overseas) Ltd (LIO Ltd). The Russian companies were in fact English registered companies which had

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traded in Russia prior to the 1917 revolution and whose assets had been confiscated by the Soviet authorities without compensation. The majority shareholding was held by Shell Petroleum Co. Ltd who also agreed to accept the offer by LIO Ltd on condition that, should the Soviet authorities ever decide to pay compensation, that compensation would be applied for the benefit of the existing shareholders. In 1986 each of the Russian companies and LIO Ltd entered into covenants with the plaintiff, Law Debenture Trust Corporation plc, as trustee for the shareholders. The covenants also required the Russian companies to take whatever action was necessary to pursue the compensation claims. Further, the covenants required that, should LIO Ltd decide to dispose of its control of the companies, it would ensure that the transferee also entered into similar covenants. On this basis Shell and the minority shareholders relinquished control of the companies to LIO Ltd.

Later LIO Ltd sold the shares in the Russian companies to Hilldon Ltd but imposed no requirements in the contract that Hilldon should enter into covenants with the plaintiff. Hilldon subsequently sold its shareholdings to Caspian Resources Ltd, again without imposing the requirement that Caspian enter into the covenants with the plaintiff. In the meantime compensation amounting to some £13.2 million was paid to the Russian companies by the Soviet authorities by way of the Foreign Compensation Commission. The Russian companies then refused to pay any of the moneys received to the plaintiff.

The plaintiff subsequently sought damages from the six defendants, alleging that Hilldon (the fifth defendant) had, with knowledge of the agreements between the Russian companies and LIO Ltd, caused LIO Ltd to breach the covenants and that therefore Hilldon was, by virtue of an implied collateral contractual agreement, bound to comply with the covenants. It was also argued that the sixth defendant, Caspian, by purchasing the shares from Hilldon, with the knowledge of the previous agreements, had also caused Hilldon to breach its implied collateral obligation and was, as a result, under an implied collateral obligation itself.

Hilldon and Caspian applied for the plaintiff's statement of claim to be struck out on the basis that it disclosed no reasonable cause of action. The plaintiff then applied to have its original statement of claim amended in order to include an allegation that, since both Hilldon and Caspian took the shares with knowledge of the covenants and LIO Ltd's breach of them, they also took the burden of the covenants and were therefore under either a legal or equitable obligation to perform the covenants and could be compelled to do so by way of a mandatory (positive) injunction. Alternatively, the plaintiff argued that it should receive damages in lieu of the award of an injunction or the shares should be re-transferred to the plaintiff so that the covenants could then be enforced against LIO Ltd.

It was held that the claim against Caspian depended on whether Hilldon was under a contractual duty to the plaintiff which Caspian had caused it to break. The court, however, considered that neither Hilldon nor Caspian was party to a contract with the plaintiff, nor were there any grounds for implying a collateral contract. There was thus no arguable claim against Caspian.

The court also considered the principles set out in ***De Mattos* v *Gibson*** [1843–60] All ER 803, as now set out in the ***Lord Strathcona*** case, as affirmed in the ***Swiss Bank*** case, namely, that where a person acquires property from another, who has entered into a legally binding contract with a third party to use the property for a particular purpose, the person acquiring the property is bound not to use the property in a manner inconsistent with the contract, provided they had full knowledge of the contract when they acquired the property. The court admitted that neither ***Lord Strathcona*** nor ***Swiss Bank*** made it entirely clear when the above principle applied; however, the court decided to

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apply the principle nevertheless. It considered that the difficulty did not lie with the principle itself but with the remedy to be applied. In his judgment Hoffmann J considered that the principle in ***De Mattos* v *Gibson*** only gave rise to a possibility of an award of a prohibitory (negative) injunction, that is to restrain an acquirer of this property from doing acts which are inconsistent with the performance of the contract by the original contracting party. He stated that the principle has never allowed the imposition of a mandatory injunction to compel the acquirer of the property to carry out an obligation to perform covenants imposed on his predecessor. To support his position Hoffmann J referred to Lord Shaw in the ***Lord Strathcona*** case when he stated:

> It has sometimes been considered that ***Tulk* v *Moxhay*** . . . and ***De Mattos* v *Gibson*** . . . carried forward to and laid upon the shoulders of an alienee with notice, the obligations of the alienor, and, therefore, that the former is liable to the covenantee in specific performance as by the law of contract, and under a species of implied privity. This is not so; the remedy is a remedy in equity by way of injunction against acts inconsistent with the covenant, with notice of which the land was acquired.

He pointed out that there was not one case in which the ***De Mattos* v *Gibson*** principle was applied that allowed an award of a mandatory (positive) injunction, a position that was confirmed by Browne-Wilkinson J in the ***Swiss Bank*** case. He also stated that it was this point that prevented the principle in ***De Mattos***, as applied in ***Lord Strathcona***, from being applied in ***Port Line Ltd* v *Ben Line Steamers Ltd*** since there the owner was under a positive obligation to provide the vessel. Injunctive relief, therefore, was only available to prevent the purchaser from doing an inconsistent act, that is, chartering the vessel to someone else; it could not be used to compel a purchaser of the vessel to deliver it up to the charterer. Hoffmann J considered that Diplock J in ***Port Line Ltd*** was wrong in concluding that just because positive injunctive relief was not available, the principle in ***De Mattos***, as applied in ***Lord Strathcona***, was entirely wrong.

As regards the claim that damages could be awarded in lieu of injunctive relief by reason of the Supreme Court Act 1981, s 50, Hoffmann J decided that this claim could not be sustained. He reasoned that damages in these circumstances were a substitution for injunctive relief and that, since this was not available for the reasons already given, so an award of damages under s 50 could not be sustained.

Protecting third parties in exemption clauses

The question that arises here is to what extent third parties can rely on the protection of an exemption clause in a contract made between the promisor and the promisee. The principle can be seen in the following case.

Scruttons Ltd v *Midland Silicones Ltd* [1962] 1 All ER 1

In this case a shipping company had agreed to carry a drum of chemicals for the plaintiffs. The bill of lading limited the shipping company's liability to $500. The shipping company had contracted with the defendant stevedores for the latter to unload the drum, specifically stating that the defendants were to have the benefit of the limitation clause. The plaintiffs were unaware of the contract between the shipping company and the defendants. The drum was damaged to the extent of $1,800 by the negligent acts of the defendants, who were sued for this amount by the plaintiffs. The defendants claimed the protection of the limitation clause contained in the bill of lading.

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It was held by the Court of Appeal and the House of Lords that the defendants should be liable for the full extent of the loss suffered. The courts held that since the defendants were not parties to the bill of lading, they could not rely on its protection. The fact that such clauses were commonplace in the commercial field did not exclude the operation of the privity rules, even in the case of an alleged implied contract between the plaintiffs and the defendants.

While the privity rule was fatal to the claim, Lord Reid stated that a third party could have the benefit of an exemption clause in agency. While this exception to the doctrine of privity will be dealt with in the next chapter, the comments of Lord Reid are worth noting. He stated:

> I can see a possibility of success of the agency argument if (first) the bill of lading makes it clear that the stevedore is intended to be protected by the provisions in it which limit liability, (secondly) the bill of lading makes it clear that the carrier, in addition to contracting for these provisions on his own behalf, is also contracting as agent for the stevedores that these provisions should apply to the stevedore, (thirdly) the carrier has authority from the stevedore to do that, or perhaps later ratification by the stevedore would suffice, and (fourthly) that any difficulties about consideration moving from the stevedore were overcome.

The arguments of the defendants pointing to the existence of an agency thus failed since Lord Reid found that there was nothing in the bill of lading that stated or implied that the parties to it intended the limitation of liability to extend to the defendant stevedores. Lord Reid's statement did not go unnoticed, however, and it led to the development of 'Himalaya' clauses, so called after the name of the ship in ***Adler* v *Dickson*** [1954] 3 All ER 397. A typical Himalaya clause may read as follows:

> Without prejudice to the foregoing, every such servant, agent and subcontractor shall have the benefit of all exceptions, limitations, provisions, conditions and liberties herein benefiting the carrier as if such provisions were expressly made for their benefit, and, in entering into this contract, the carrier, to the extent of these provisions, does so not only on [his] own behalf but also as agent and trustee for such servants, agents and subcontractors [extract from ***The Mahkutai*** [1996] 2 Lloyd's Rep 1].

The remarks of Lord Reid were taken into account in the following case.

New Zealand Shipping Co. Ltd v *A M Satterthwaite & Co. Ltd (The Eurymedon)* [1975] AC 154

There was a contract between a consignor and a carrier to ship drilling equipment to New Zealand. The contract contained an exemption clause exempting the carrier and its servants and agents, including any independent contractors that might be employed by the carrier from time to time, from liability in respect of damage to cargo. In respect of this exclusion it was stated that the 'carrier is acting as agent and all such persons shall to the extent be parties to the contract'. The defendants were employed as stevedores to unload the cargo and they negligently damaged the machinery. They attempted to rely on the exclusion clause in the contract between the consignor and the carrier.

It was held by the Privy Council that the stevedores could rely on the exemption clause. The first three factors set out by Lord Reid were found to be present. The case largely revolved around whether any consideration had been provided by the stevedores since, as

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we saw in Chapter 3 on consideration, the performance of unloading the ship was an existing contractual duty owed to the carrier. It was held that sufficient consideration had been provided by the stevedores since the court found that a promise to perform a duty to the carrier could also amount to consideration for the promise of the consignor.

The decision in ***The Eurymedon*** has since been affirmed in the case of ***Port Jackson Stevedoring Pty Ltd*** **v** ***Salmond and Spraggon Pty (Australia) Ltd, The New York Star*** [1980] 3 All ER 257 where Lord Wilberforce stated that the principle contained in Lord Reid's statement was now of general application. The principle is, however, always subject to the general principles contained in the law of agency. Thus, in ***Southern Water Authority*** **v** ***Carey*** [1985] 2 All ER 1077 the attempt to bring third parties within the scope of the exemption via agency failed on the basis that the third parties (who are the principals in the matter) did not exist when the agent entered into the main contract. The principle in agency by **ratification** is that this type of agency cannot arise without there being an ascertainable **principal** at the time of the contract. Since the third parties, who were subcontractors, could not possibly have been ascertained at the time the main contract was entered into, they could not ratify the acts of the agent and thereby gain the benefit of the exemption clause. The problem of agency arising in such circumstances must clearly point to a major weakness in the use of agency to bring third parties within the ambit of an exemption clause.

The use of so-called Himalaya clauses and the acceptance of the approach set out in ***The Eurymedon*** and ***The New York Star*** as an exception to the privity of contract has to be treated somewhat guardedly. The principles as set out allow third party subcontractors only to take advantage of exclusion clauses contained in the main contract. The principles go no further than that so as to allow third parties to regard the whole contract as applying to them, since some terms can apply only where mutual agreement has taken place.

This position was discussed by Lord Goff in ***The Mahkutai*** [1996] 2 Lloyd's Rep 1, where the owners of a ship attempted to claim the benefit of an exclusive jurisdiction clause through the applicability of a Himalaya clause. It was alleged that the charterers of the ship had contracted as agents for the shipowners. It was stated by Lord Goff that the principles as set out in ***The Eurymedon*** and ***The New York Star*** applied only to exemptions and limitations and they had no application to exclusive jurisdiction clauses. He stated:

> Such a clause can be distinguished from terms such as exceptions and limitations in that it does not benefit only one party, but embodies a mutual agreement under which both parties agree with each other as to the relevant jurisdiction for the resolution of disputes. It is therefore a clause which creates mutual rights and obligations.

The problem in this case was that the Himalaya clause (*see* above) talked of 'exceptions, limitations, provisions, conditions and warranties'. Surely the expression 'provisions' would also encompass an exclusive jurisdiction clause? The Privy Council thought not and the expression was given a restricted interpretation in that it only related to terms inserted in the bill of lading for the charterer's protection. The expression could not extend to terms contained in the contract by mutual agreement.

Undoubtedly Lord Goff's reasoning makes commercial sense since, for instance, if a carrier agrees to take a cargo for the owners to a port in the USA subject to an exclusive jurisdiction clause that all disputes would be subject to English law, the bill of lading

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containing a Himalaya clause, it would clearly be wrong for stevedores in the USA to be able to claim the benefit of the exclusive jurisdiction clause. The stevedores have no connection whatsoever with the jurisdiction chosen by the carrier for the resolution of any disputes. The exclusive jurisdiction clause arises by way of mutual agreement between the carriers and the owners of the cargo and is not intended to benefit anyone else.

The effect of third party actions on contracts

It will have been noticed in Chapter 11 that it is possible for the actions of third parties to affect the validity of a contract between two persons. This very often occurs in the context of a husband and wife relationship where a wife is induced to enter into a contract of guarantee with a bank or some other creditor with respect to her husband's debts. If the wife is induced into the contract by the undue influence, misrepresentation or some other legal wrong of her husband, she will be entitled to rescind the contract. This therefore provides an exception to the rule of privity of contract in that a third party is, by his or her actions, able to affect the legal relationship between two parties to a contract. Previously this exception might have fallen into the category of agency, as already discussed above; however, since ***Barclays Bank plc* v *O'Brien*** [1993] 4 All ER 417, this is no longer possible as the effects of the third party's actions are now based on the doctrine of notice rather than an agency relationship.

Reform of the doctrine of privity of contract

The doctrine of privity of contract has been criticised, not so much with regard to the rule that no one can be made liable on a contract to which they are not a party, which is clearly correct, but for the fact that the rule prevents a third party who has an interest in a contract from enforcing it. Of course, the exceptions to the rule offset some of its major vagaries; nevertheless, it has been agreed that the doctrine ought to be abolished, or at least modified. In 1937 the Law Revision Committee (6th Interim Report, Cmd 5449) recommended that:

> Where a contract by its express terms purports to confer a benefit directly on a third party it shall be enforceable by the third party in his own name subject to any defence that would have been valid between the contracting parties.

No action was taken in response to the call for the abolition of the rule and, as seen above, in the intervening years the courts continued to exercise their imagination in finding means to avoid the rule. However, the Law Commission in its Consultation Paper No 121, *Privity of Contract: Contracts for the Benefit of Third Parties*, 1991, again considered the need for the rule, which it referred to as 'the third party rule'.

The Consultation Paper accepted several pronouncements in decisions in the House of Lords; for instance, the case of ***Murphy* v *Brentwood District Council*** [1991] 1 AC 398 that called for the rule to be reconsidered. The Law Commission agreed with the comments of Viscount Simonds in ***Scruttons Ltd* v *Midland Silicones Ltd*** [1962] AC 446 that reform of the rule should come by legislative enactment, given that the rule is an established principle of law involving complex issues and is already circumscribed by numerous exceptions. Further, the Law Commission considered that simply widening the scope of damages available to a promisee so as to encompass loss suffered by a third party, as in ***Jackson* v *Horizon Holidays***, was an inadequate reform of the law. It took

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the view that the third party here was in the hands of the promisee, who might refuse to act, thereby depriving the third party of compensation. Thus in ***Beswick* v *Beswick***, if the executor had been someone other than Mrs Beswick herself, she might have been without a remedy had the executor declined to act.

In deciding that the third party rule should be the subject of legislative reform, the Law Commission then went on to consider what form this should take. First, it considered whether the contents of any enactment could simply be restricted to extending the exceptions to the third party rule in certain specific instances. This approach was rejected on the basis that the number and variety of exceptions had already produced a complex body of law and that the creation of further exceptions would simply further complicate the position. Second, the Law Commission considered simply abolishing the rule preventing the promisee from recovering the third party's loss in damages. This approach was rejected on the grounds already discussed above. Third, it was considered whether any enactment could provide that no third party be denied enforcement of a contract made for their benefit on the grounds of lack of privity. The Law Commission considered that such a general approach could not address in a satisfactory manner all the situations in which third party rights arise. For instance, the Law Commission considered that the problem of defining the class of third party beneficiaries would not be solved by such a piece of legislation and that it was incorrect to leave this and other complex matters to the judiciary to solve without more complete legislative guidance.

Lastly, the Law Commission considered that reform could take place by means of a full legislative scheme that defined matters such as the rights of contracting parties to modify or terminate the contract, promisor's defences and the types of remedy available to third parties. It considered that this approach had the advantages of clarity and certainty. The Law Commission considered, however, that simply giving third parties the right to enforce contracts made for their benefit would be unacceptably wide in that it would open the floodgates to litigation and leave promisors open to a potentially indeterminate class of third party plaintiffs. In attempting to limit the position of third parties, the Law Commission considered that only allowing them to sue where it was expressly intended they should be able to do so within the contract was not sufficiently wide since it excluded the enforcement of contracts by third parties who, while it was intended that they should benefit, could not do so because there was no express term to this effect. Similarly, the Law Commission found themselves faced with the floodgates argument if third parties could sue merely because they could show that the original parties intended that they should benefit from the contract.

In order to reconcile the problems set out above, the Law Commission recommended that a third party should be able to enforce a contract in which the parties intend that the third party should receive the benefit of the promised performance and also intend to create a legal obligation enforceable by that person. Thus a third party's rights could not be inferred from the fact that they would derive a benefit from the performance of the contract. Similarly, the third party would not be able to sue on a contract that is simply made for their benefit – they would have to show that the parties intended to confer a legally enforceable obligation on them. Whether or not this intention exists is to be derived from the terms of the contract and the surrounding circumstances of the case. Thus it would not be necessary to name the beneficiary or even for the beneficiary to exist at the time the contract is made (as in the case of a pre-incorporation contract), though it has to be said that difficulties in identifying a beneficiary would presumably affect whether the parties to the contract could have intended to confer a legally enforceable obligation on a third party.

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It can be seen immediately that the Law Commission considers that an objective test should be employed in determining the original parties' intentions *vis-à-vis* the ability of a third party to take action on the contract.

Benefits and defences

The Law Commission also considered what benefits would be conferred on third parties under the arrangements set out above. The Law Commission recommended that the rights created would arise only to the extent that the contract itself was valid and would be conditional on the other party performing their obligation under it. Thus a contract that is affected by misrepresentation, lack of formalities (where relevant) or frustration would also limit the rights of a third party. Similarly, if the promisee had failed to perform their own obligations under the contract, then the consequent rights of the third party would also be affected. The Law Commission gave an example here of an insurance policy taken out by a father in favour of his son and stated that the son could clearly not enforce the policy if his father had not paid the premiums due under it.

It was stated that, where rights are created in favour of a third party, that party should have the right not only to receive the promised performance of the contract from the promisor where that is appropriate, but also to pursue any remedies for defective performance of the contract. The Law Commission also considered that the third party would have the right to rely on terms in the contract which restrict or exclude the third party's liability as if the third party were a party to the contract.

With regard to defences, the Law Commission considered that the third party's rights would be subject to the promisor's defences, rights of set-off and counter-claims. The Law Commission, however, was undecided as to whether the promisee should be made a party to an action when the third party seeks to enforce a contract made for their benefit.

Variation and cancellation of contracts

It is clear that parties to a contract are entitled, subject to the provisions of the contract, to vary the terms of the contract or even to cancel it. The Law Commission considered that they should still be entitled to do so where third party rights arise, provided the parties expressly allow for such reservations on the rights of third parties. The Law Commission, however, was undecided as to whether variation or cancellation would be allowed where there was no such express provision. In considering this position the Law Commission examined several possibilities: thus it was considered that variation or cancellation would cease to be available once the third party adopted the contract, either expressly or by conduct; that variation or cancellation would be available until the third party accepted the contract or until they materially altered their position in reliance on the contract.

Creation of duties in third parties

The Law Commission Consultation Paper is centred on the conferment of benefits on third parties. However, the Law Commission also briefly examined the question as to whether parties to a contract could impose liabilities on third parties. It was considered that this should not be allowed except to the extent that the parties to the contract could impose conditions on the enjoyment of any benefits conferred on the third party by the contract. By way of example the Consultation Paper refers to the case of ***Halsall* v *Brizell***

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[1957] Ch 169, in that it states that if a contracting party agrees to allow a third party to use a road across their land on condition that the third party keeps it in repair, the third party becomes subject to an obligation, though one that arises out of their own implied agreement rather than one that is imposed on them by the parties to the contract.

Conclusions

The proposals for reform put forward by the Law Commission answered many of the criticisms of the privity of contract rule, although the proposals themselves do create substantial difficulties in some situations – for instance, in relation to the variation and cancellation of contracts where third party rights arise. The double-intention criteria based on an objective test will tend to blur the point at which third party rights arise and, indeed, if applied to cases such as ***Jackson* v *Horizon Holidays*** may well produce a different result.

Law Commission Report No 242, *Privity of Contract: Contracts for the Benefit of Third Parties* (1996) and the Contracts (Rights of Third Parties) Act 1999

Following on from its Consultation Paper No 121, the Law Commission published its report, which also contained a draft Bill. The report proposed that the principle of privity of contract should no longer apply to prevent third parties from enforcing contracts that are made for their benefit. The draft Bill was introduced into Parliament in 1997 but failed to make the statute book because of the general election of that year. It was subsequently reintroduced into Parliament in December 1998 and, apart from some amendments, seeks to implement the recommendations of the Law Commission report.

The Contracts (Rights of Third Parties) Act 1999 came into force on 11 November 1999. The Act provides a major exception to the privity of contract rule – it is not a wholesale abolition of this rule, which still applies as regards imposing burdens on third parties. The Act only creates an exception to the doctrine of privity in the context of contracts for the benefits of third parties, but even here the reform is not a complete one. The traditional doctrine still applies in some situations. This is confirmed by Law Commission Report No 242 which states:

> it is important to emphasise that, while our proposed reform will give some third parties the right to enforce contracts, there will remain many contracts where a third party stands to benefit and yet will not have a right of enforceability. Our proposed statute carries out a general and wide-ranging exception to the third party rule, but it leaves the rule intact for cases not covered by the Statute.

The Act therefore provides a statutory exception that will apply in addition to the common law exceptions already discussed. This is expressly provided for in s 7(1) which states that 'section 1 does not affect any right or remedy of a third party that exists or is available apart from this Act'. Thus, in contracts that fall outside the Act, the courts will continue to be able to make use of existing legal principles to avoid the application of the doctrine of privity of contract.

The general right of a third party to enforce contractual terms

Section 1(1) of the 1999 Act states:

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> Subject to the provisions of this Act, a person who is not a party to a contract (a 'third party') may in his own right enforce a term of the contract if –
>
> (a) the contract expressly provides that he may, or
> (b) subject to subsection (2), the term purports to confer a benefit on him.

The provision therefore provides two means by which a third party can enforce a contract made for their benefit. The first requires little in the way of explanation but in relation to the second, when will a contract purport to confer a benefit on a third party? It would seem that this question has to be resolved by looking at the whole contract; although s 1(2) provides that the second means will:

> not apply if on a proper construction of the contract it appears that the parties did not intend the term to be enforceable by the third party.

On this basis it would seem that all third parties will be assumed to have the right to enforce the contract and that this right is cut down if, on a true construction of the contract, the contracting parties do not intend a third party to have the right to enforce it. The meaning of 'purports' was considered in the case of ***Prudential Assurance Co. Ltd* v *Ayres*** [2007] 3 All ER 946 where the court examined what was necessary to satisfy the requirements of that provision. The court considered that the expression 'purports' is different from the expression 'express' in s 1(1)(a). Lindsay J stated that the expression is defined as, *inter alia*, 'to bear as its meaning; to express, set forth, state; to mean, imply'. He thus considered that s 1(1)(b) was satisfied 'if, on a true construction of the term in question, its sense had the effect of conferring a benefit on the third party in question'. The court held that there was nothing in s 1(1)(b) which required the benefit on a third party to be the predominant purpose or intent behind the term in question. Conversely neither did s 1(1)(b) contain anything which denied applicability of s 1(1)(b) if the term conferred a benefit on someone other than a third party.

The rights of third parties are further reduced in s 1(3) since this requires that the third party must be expressly identified in the contract 'by name, as a member of a class or as answering a particular description but need not be in existence when the contract is entered into'. Thus the provisions do not give rights to third parties generally, although they establish that the third parties do not have to be in existence when the contract is made. It is therefore possible for the contracting parties to confer enforceable contractual rights on a future spouse, unborn children or companies that have yet to be incorporated.

It should be noted that s 1(3) requires that third parties' rights 'must be expressly identified in the contract by name, as a member of a class or as answering a particular description'. Thus it was held in ***Avraamides* v *Colwill*** [2006] EWCA Civ 1533 that there is no possibility of third party rights becoming available by way of construction or implication under a contract.

The benefits conferred on third parties must arise under a contract and not by any other means, such as a will.

White v *Jones* [1995] 2 AC 207

In this case, a person entered into a contract with his solicitor for him to draft a will. The solicitor failed to deal with the matter expeditiously so that the client died before the will had been drafted. The potential beneficiaries, who failed to gain an interest in the deceased's estate because of the lack of a will, successfully sued the solicitor in tort.

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Clearly they had no right to sue in contract on the basis of existing law of contract principles relating to privity of contract. Would they be able to succeed under the new provisions? The answer appears to be that they would not be able to. The contract between the solicitor and the client did not purport to confer a benefit on the potential beneficiaries as required by s 1(1)(b). In any event, if any benefit had been conferred on the beneficiaries, this would have arisen not from the contract but from the will and would therefore have been outside the ambit of the Act.

A very different perspective emerges if one analyses the case of ***Beswick* v *Beswick*** [1968] AC 58 in the context of the Act. It will be recalled that Mr Beswick's contract with his nephew provided that the nephew should pay an annuity to Mr Beswick's widow on his death. Mrs Beswick would now have the right to sue the nephew personally since he had promised to confer a benefit on her. The nephew could only avoid liability if he could show that there was no intention between himself and his uncle that Mrs Beswick should have the right to enforce the provision in the contract. The fact that Mrs Beswick was specifically named in the contract is not of itself sufficient to confer enforceable rights on her. The contract must expressly confer (s 1(1)(a)) or purport to confer (s 1(1)(b)) benefits on her. The other feature of Mrs Beswick's case was that, unlike in ***White* v *Jones***, her rights emanated from the contract, not from Mr Beswick's will.

To what extent are a third party's rights limited by the terms of the contract? This is dealt with by s 1(4) which states that a third party's right of enforcement is subject to the terms and conditions imposed by the contract. Thus a third party does not have any greater rights than the parties themselves; indeed, it is open to the parties to the contract to place limitations or conditions on the third party's rights of enforcement.

What remedies are available to the third party? This matter is dealt with in s 1(5) which provides that all the substantive remedies available to the person bringing an *action* for breach of contract are equally available to the third party seeking to enforce their rights under s 1(1). The expression 'action' is understood to mean that the third party is only entitled to remedies that a court could award. The third party is not entitled to terminate a contract for a breach since this is essentially a self-help remedy. Also since the section refers to an action for 'breach of contract' it is considered that this means that the third party cannot sue for a remedy under the law of restitution, for instance. The provision goes on to state that 'the rules relating to damages, injunctions, specific performance and other relief shall apply accordingly'. The third party's rights are limited to those they could have enjoyed if they had been a party to the contract. Thus the normal rules of law that govern such an entitlement apply equally to the third party's claim. They must mitigate their losses, they cannot claim for damages which are too remote and subject to other restrictions which apply to the remedy they are claiming. Thus the rules regarding time (the doctrine of laches) in applying for equitable remedies will have equal application. One peculiarity that could arise here is that a third party's rights to an equitable remedy, such as an order for specific performance, would be lost if such an order caused hardship or injustice to another interested third party, as in the case of ***Patel* v *Ali*** (*see* p. 467). Similarly, the equitable rule that 'Equity will not assist a volunteer' will also be limited with the passing of the 1999 Act, though it will not of course be completely devoid of effect since it will continue to apply to third parties who are not within the Act, or where there is a contract that is outside its ambit.

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Section 1(6) provides:

> Where a term of a contract excludes or limits liability in relation to any matter references in this Act to the third party enforcing the term shall be construed as references to his availing himself of the exclusion or limitation.

This provision therefore ensures that the third party can take advantage not just of their positive rights as set out in s 1(5), but also of any exclusion or limitation clauses contained within the contract.

The rights of third parties where the original parties cancel or vary the contract

One question that emerged in Law Commission Report No 242 was whether the proposed reforms limited the rights of the original parties to the contract to exercise their freedom to cancel or vary the terms of the contract. This is of great importance since if the original parties had such unlimited rights, then a third party would not have any rights that they could confidently rely on. Whilst the original parties do still retain general rights to cancel or vary the contract, s 2 places limitations on these rights. Thus s 2(1) provides:

> where a third party has a right under section 1 to enforce a term of the contract, the parties to the contract may not, by agreement, rescind the contract, or vary it in such a way as to extinguish or alter his entitlement under that right, without his consent if –
>
> (a) the third party has communicated his assent to the term to the promisor;
> (b) the promisor is aware that the third party has relied on the term; or
> (c) the promisor can reasonably be expected to have foreseen that the third party would rely on the term and the third party has in fact relied on it.

Section 2(2) provides that the assent referred to in (a) above may be by words or by conduct, although if the assent is sent by post then the postal rules are specifically excluded from operating in that the communication must be 'received by him'. It is possible to limit the effects of s 2(1) by expressly allowing a contract to be cancelled or varied without the consent of the third party. Alternatively the contract may expressly require that the third party's consent is required, but only in cases outside those stated in s 2(1)(a)–(c) above.

One of the difficulties with the general requirement that the consent of a third party is required to cancel or vary the contract arises where the third party cannot be traced or is found to be mentally incapable of giving consent. In such an instance a court may dispense with the need for consent on an application of the parties to the contract (s 2(4)). Similarly, a court may dispense with the need for consent if it cannot reasonably be ascertained whether a third party has in fact relied on the contract under s 2(1)(c) above (s 2(5)). Where a court dispenses with the need for the consent of the third party, it may impose such conditions as it thinks fit, which may include a condition that the parties to the contract pay compensation to the third party.

Defences available to the promisor

A 'promisor' is defined by s 1(7) as the 'party to the contract against whom the term is enforceable by the third party'. Such an individual may have all sorts of defences, set-offs and counter-claims available against an action by a promisee, defined in the Act as 'the party to the contract by whom the term is enforceable against the promisor'. To what

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extent, however, are these defences available to a promisor in an action brought against him by a third party?

Section 3(2) provides:

> The promisor shall have available to him by way of defence or set-off any matter that –
>
> (a) arises from or in connection with the contract and is relevant to the term, and
> (b) would have been available to him by way of defence or set-off if the proceedings had been brought by the promisee.

Thus the promisor has available any defence or set-off which arises from or in connection with the contract and which would have been available if the promisee himself had brought the action. On this basis a void, discharged or unenforceable contract is no more enforceable by a third party than by a promisee. Another example of the application of this provision arises where the promisor (*A*) and the promisee (*B*) enter into a contract whereby *B* will sell goods to *A*, who is to pay the purchase price to the third party (*C*). If *B* is in breach of contract by selling goods that do not meet the correct specification and *C* sues for the price, then *A* is entitled to reduce or extinguish the price payable by reason of the breach of contract. In other words, *A* is able to exercise the same rights as if *B* themself had brought the action.

Section 3(3) provides:

> The promisor shall also have available to him by way of defence or set-off any matter if –
>
> (a) an express term of the contract provides for it to be available to him in proceedings brought by the third party, and
> (b) it would have been available to him by way of defence or set-off if the proceedings had been brought by the promisee.

This rather obscure provision allows an express term to be inserted into the contract that has the effect of making a third party's claim subject to *all* defences and set-offs that the promisor would have had against the promisee, and not just those that arise out of the contract itself. For example, the promisor, *A*, may enter into a contract with *B* (the promisee) for the purchase of a car. It is agreed that *A* will pay the purchase price to the third party, *C*, when *B* transfers his car to *A*. If *B* owes *A* money by reason of some other totally unrelated contract, then they may agree to insert an express term in the contract for the sale of the car that *A* can set off against any claim by *C* the money owed by *B* under the unrelated contract.

Section 3(4) provides:

> The promisor shall also have available to him –
>
> (a) by way of defence or set-off any matter, and
> (b) by way of counterclaim any matter not arising from the contract,
>
> that would have been available to him by way of defence or set-off or, as the case may be, by way of counterclaim against the third party if the third party had been a party to the contract.

This provision is intended to provide that the third party's claim, in addition to being subject to defences and set-offs that the promisor would have had in an action by the promisee, will also be subject to the defences, set-offs and counter-claims (not arising from the contract) that would have been available to the promisor had the third party been a party to the contract. Again, an example can best illustrate how this provision

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might operate. Thus if *A*, the promisor, enters into a contract with *B*, the promisee, to pay £1,000 to *C*, the third party, if *C* already owes *A* £400, then *A* has a right of set-off so that he will only be obliged to pay £600.

The Law Commission was presented with substantial problems with regard to this provision since, if a counter-claim against the third party arose from within the contract, the effect might have been to impose a contractual burden on the third party – something that is outside the objectives of the legislation. This provision is therefore designed to allow the promisor to offset any claim independent of the contract they may have against a third party. This might arise where the promisor was induced into the contract by way of a fraudulent or negligent misrepresentation, duress or undue influence or some other independent counter-claim that may be available against the third party.

For more on these vitiating factors refer to Chapters 9 and 11.

The rights of the promisor that are given to him in s 3(2) and (4) above may be subject to an express term in the contract making the promisor's defences, rights of set-off and counter-claims unavailable to them, by virtue of s 3(5). Third parties also are subject to a limitation under these provisions in that an action may not be brought within the ambit of s 1 if they could not have brought an action if they had been parties to the contract themselves, by virtue of s 3(6).

The Act does not purport to affect the rights of the promisee to enforce any contractual term (s 4); however, the promisor is protected from incurring double liability by virtue of s 5, which provides:

> Where under section 1 a term of the contract is enforceable by a third party, and the promisee has recovered from the promisor a sum in respect of –
>
> (a) the third party's loss in respect of the term, or
> (b) the expense to the promisee of making good to the third party the default of the promisor,
>
> then, in any proceedings brought in reliance on that section by the third party, the court shall reduce any award to the third party to such extent as it thinks appropriate to take account of the sum recovered by the promisee.

In its deliberations the Law Commission refused to make any recommendations as to whether there should be some order of priority as between the actions of the promisee and the third party. Implicitly there is such a priority being made in s 5. There is no corresponding provision that states that where a third party takes action and receives damages, followed by an action by the promisee, the court will reduce any amount awarded to the promisee to take into account a sum recovered by the third party. The Law Commission considered that no problem should arise in this context since if the third party does recover first a promisee would be left with no outstanding corresponding loss. In any event, where a promisor does satisfy the judgment of the third party, no doubt the promisor could raise an equity in the action brought by the promisee that any judgment obtained by the promisee must be met from that given to the third party.

Excluded contracts

Not all contracts are covered by the Act and there are some notable exceptions. Section 6(1) states that s 1 confers no benefits on third parties in the case of a contract contained in a bill of exchange, promissory note or any other negotiable instrument. No benefits are conferred on third parties in the case of any contract binding on a company and its members under s 33 of the Companies Act 2006 (formerly s 14 of the Companies Act 1985).

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Limitations in s 6(3) and (4) are designed to prevent a third party from enforcing a term in a contract of employment against an employee or other worker. Thus a customer of an employer would not be able to enforce a term of a contract of employment against the employee, for instance a confidentiality clause. Enforcement here lies solely with the employer. Similarly, a third party has no rights to enforce a contract for the carriage of goods by sea or a contract for the carriage of goods by road, rail or air, which are subject to the rules of the appropriate transport conventions. However, whilst such contracts are excluded from the Act, in s 6(5) the Act allows third parties to take advantage of a term excluding or limiting their liabilities. Thus the Act allows for the operation of so-called 'Himalaya' clauses so that a carrier of goods will now be able to exclude or limit the liability of their servants, agents and independent contractors employed in the loading and unloading of ships.

For more on exemption clauses refer to Chapter 8.

This provision effectively reverses the decision in ***Scruttons Ltd* v *Midland Silicones Ltd*** and affirms the principles set out in ***The Eurymedon*** and ***The New York Star***. To a limited degree the Act also appears to push the decision in ***Southern Water Authority* v *Carey*** (see p. 512) into a backwater. It will be recalled that the agency principles set out in ***The Eurymedon*** and ***The New York Star*** were held not to apply because the third party principals were unascertainable at the time of the contract. Nowadays this is unnecessary by virtue of s 1(3) provided the third party is named or is a member of a class or answers a particular description.

It should be noticed that s 6(5) does not extend to cases such as ***The Mahkutai*** since, whilst objections to a third party acquiring rights under a contract have been removed, this does not extend to choice of law clauses. The legislation is very specific here in that it only applies to exclusion or limitation clauses.

Other provisions relating to third parties

Section 7(1) provides that 'Section 1 does not affect any right of remedy of a third party that exists or is available apart from this Act'. This provision is intended to preserve all the existing statutory and common law exceptions to the privity of contract rule. Thus a third party will still be able to rely on actions in tort or collateral contract devices in order to take action. Similarly, in appropriate cases they will be able to rely on 'Himalaya' clauses and the law of trusts, where this is applicable. It should be noted that many of the provisions of the 1999 Act, such as ss 2 and 3, apply only where s 1 itself applies and not in any other circumstances.

For more on UCTA 1977 refer to Chapter 8.

Section 7(2) operates to prevent a third party from invoking s 2(2) of the Unfair Contract Terms Act (UCTA) 1977 so as to contest the validity of a clause that seeks to exclude or limit the promisor's liability under the Act to third parties for loss or damage caused by negligence, except where personal injury or death results. Thus a promisor is not restricted in excluding their liability to a third party even where apparently the term may be regarded as unreasonable were it to apply to the promisee.

By s 7(3) the provisions of the Limitation Act 1980 that apply to simple contracts and speciality contracts apply equally to actions brought by a third party, so that their action must be brought within 6 years and 12 years respectively. The limitation periods for such contracts are discussed in more detail at p. 473, above.

Conclusions

The Contracts (Rights of Third Parties) Act 1999 should have a profound effect on decisions of the kind seen in ***Beswick* v *Beswick***, ***Jackson* v *Horizon Holidays***, provided the

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holiday falls outside the Package Travel, Package Holidays and Package Tours Regulations 1992, and ***Woodar Investment Development*** v ***Wimpey***. In ***Beswick*** v ***Beswick*** Mrs Beswick would now be able to sue in her personal capacity and claim damages and specific performance of the contract made between her husband and her nephew for her benefit. In cases like ***Jackson*** v ***Horizon Holidays***, third parties not covered by the 1992 Regulations will have a firmer base on which to found their actions where a holiday company has failed to meet its obligations. This is to be welcomed especially when the decision in ***Jackson*** v ***Horizon Holidays*** was of a questionable nature anyway. There is one proviso to this in that the ability of parties to exclude the provisions of the Act may render it stillborn. It is almost inconceivable that a professionally drafted agreement will allow a third party to retain a right of action or enforcement. The main dangers that arise from the Act come from s 1(1)(b) where a 'term purports to confer a benefit' on a third party since this will expose the promisor to actions from third parties which were not within their contemplation when they entered into the contract. This position is further exacerbated by the fact that the third party need not be specifically named, provided they can be identified by reference to a class or description (s 1(3)), or were in existence at the time of the contract. It is suggested therefore that in most standard-form contracts, the rights of third parties conferred by the Act will invariably be excluded.

In contracts for the carriage of goods by sea and carriage of goods by rail, air and road, where the contract is subject to the rules of the appropriate international transport convention, the Act will make a substantial mark in bringing employees, agents and subcontractors within the ambit of the promisor's exclusion clauses. Thus in cases such as ***Adler*** v ***Dickson***, albeit this was an action for personal injuries, such provisions will have the effect of removing a promisee's alternative right of action against such third parties. In ***Adler*** v ***Dickson*** the plaintiff suffered serious injuries when she fell off a gangplank as she was boarding a ship due to the negligence of the captain and bosun. She found that she could not pursue an action against the shipping company in vicarious liability because of the presence of an exclusion clause. However, she successfully sued the captain and bosun who were not within the ambit of the company's exclusion clause. The effect of the Act would now be to draw the protection of the exclusion clause not just around the company itself but also around its employees, agent and subcontractors, but only in contracts for the carriage of goods. Thus the plaintiff would still have an action for personal injuries against the captain or bosun today, though not if her action was to recover for damage to her goods.

The Act is likely to have an important effect in certain industries. Of particular note here is the construction industry where the use of subcontractors is widespread. Actions such as those seen in ***Alfred McAlpine Construction*** v ***Panatown*** should now be placed on a somewhat simpler footing, provided always that the rights of third parties are not excluded. It may be unlikely that this would arise in such cases since the whole point of the transaction is that one party, the employer, is contracting on behalf of a third party and for their benefit.

The Act opens the way for actions by third parties in situations that were not considered by the Law Commission, such as those where the law implies a contract where certain formalities are not complied with. For instance, in the law of trusts, in order to create an express trust the person creating the trust, the settlor, must do two things. They must make a valid declaration of trust and transfer the property subject to the trust to the trustees. Failure to comply with these formalities prevents the trust from taking effect – it is said to be 'incompletely constituted' and takes effect as a contract to create a trust.

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What happens if the settlor makes a valid declaration of trust but fails or refuses to hand the trust property over to the trustees? The answer to this question lies, first, as to who the contracting parties are. If the contract is made between the settlor and the beneficiaries of the trust, the beneficiaries may either claim damages, based on the value of the trust property, or enforce the contract by way of specific performance. The choice of remedy depends on the type of consideration given by the beneficiaries. However, this is a technical matter that is best left to a wider study of the law of trusts itself. The settlor and beneficiaries are the original parties to the contract so there is no problem regarding privity here. Usually the agreement is made between the settlor and the trustees for the benefit of the beneficiaries. Can the trustees take action on the contract? The answer is yes, but only with regard to the breach as it affects them as *trustees*, not on behalf of the beneficiaries. Any damages awarded would not be based on the trust property but on what fees, if any, the trustees would have been entitled to if the trusts had been properly constituted. Such a sum may be a purely nominal amount. Usually the agreement or promise between the settlor and the trustees arises within a deed of trust and, since equity does not recognise a deed, the trustees are confined to an action for damages only. The trustees cannot obtain an order for specific performance since this is an equitable remedy and therefore not available to them.

Can the beneficiaries compel the trustees to obtain specific performance *on behalf* of the beneficiaries? The courts in several judgments, such as ***Re Pryce*** [1917] 1 ChD 9 and ***Re Kay*** [1939] ChD 329, have always refused such applications. The reasoning in these cases is that the courts will not allow the beneficiaries to compel the trustees to seek specific performance, since this would be allowing the beneficiaries to enforce indirectly what the law would not allow them to enforce directly.

A different position will now arise following the passing of the 1999 Act since such beneficiaries will almost invariably fall within s 1 either because the trust is stated to be expressly for the benefit of the beneficiaries or because the trust purports to confer a benefit on them. Thus the provisions of the Act will have a profound effect on this area of law that was until now very settled. Of course, within the terms of the Act, it is possible to exclude the beneficiaries from being able to take action as benefiting third parties. The document that emerges will no doubt be a strange one in that it is clearly made for the benefit of third party beneficiaries and yet, within its terms, it will deny them the right to enforce the contract.

There is no doubt that the 1999 Act will also have substantial effects in law relating to landlord and tenant. The scenario that arises here concerns a situation where a landlord (*L*) gives a lease (the 'head lease') to a tenant (*T*), who then gives a sublease to a subtenant (*S*). Of course there is privity of contract between *L* and *T* and also between *T* and *S*. Usually the conditions or covenants in the sublease will be the same as those in the head lease. There is no privity of contract between *L* and *S* and therefore if *L* wishes to take action they have first to sue *T* who, in turn, would have to sue *S*. There is an exception to this rule where the covenant that has been broken is a restrictive covenant. The 1999 Act therefore seems to set up a general exception that will allow *L* to take direct action against *S*, provided it can be shown that the sublease is for the benefit of *L*.

There is no doubt that the 1999 Act is important and is set to change the landscape of the law of contract as it relates to the rule of privity of contract. In formal contracts, however, it is highly likely that the provisions will be excluded and therefore its overall effects are going to be substantially limited. In less formal contracts the Act may make substantial inroads into the existing doctrine. Would this apply to consumer-type contracts? For instance, would the buying of a Christmas present for someone now be

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regarded as a contract for the benefit of a third party entitling that person to take action on the contract under the terms implied by the Sale of Goods Act 1979? The answer appears to be clearly in the affirmative. There are, however, provisos that place severe limitations on the scope of the Act in such contracts. First, in s 1(3) of the 1999 Act the third party has to be 'expressly identified in the contract by name, as a member of a class or as answering a particular description'. It is suggested that it may be unusual to do this in these types of contracts, though not beyond the realms of possibility. A more serious limitation, however, arises in s 7(4). This provides that the Act is not to give third parties any additional causes of action under any other statutory provisions. It states that 'a third party shall not . . . be treated as a party to the contract for the purposes of any other Act'. This provision would seem to preclude a third party from relying on the terms implied by the Sale of Goods Act 1979 and any other consumer legislation for that matter. Thus third parties would not be able to bring themselves within s 3 of the Unfair Contract Terms Act 1977, which applies 'as between contracting parties where one of them deals as a consumer or on the other's written standard terms of business'.

The Law Commission originally considered that the rule that consideration must move from the promisee would have to be abolished in order to accommodate the proposed reforms of the privity of contract rule. This move has not been taken on board within this piece of legislation nor was it adopted within the Law Commission's own draft Bill despite the fact there was some concern that it may nullify their proposed reform of the privity of contract rule. It is unclear as to why this has been excluded; presumably because it was considered that the application of the legislation would not be impaired by the continuance of the rule.

Summary

The general rule

- Only the parties to the contract may enforce the contract against each other (***Dunlop Pneumatic Tyre Co. Ltd*** **v** ***Selfridge & Co. Ltd***).
- A third party cannot enforce a contract even if it was made for his benefit (***Tweddle*** **v** ***Atkinson***; NB: ***Beswick*** **v** ***Beswick***).

The effect of the doctrine of privity of contract

The basic effect

- Consumers have no implied statutory rights under SGA 1979 if they are not a party to the contract.

Actions against the promisor for damages

- A third party could persuade the buyer to enforce the contract against the seller but the buyer will only recover damages for his own loss.
- Damages may be recoverable where a trustee acts on behalf of a beneficiary.
- The beneficiary can compel the trustee to hand over to them the proportion of damages that represent their losses (***Jackson*** **v** ***Horizon Holidays Ltd***). ***Woodar Investment Development Ltd*** **v** ***Wimpey Construction (UK) Ltd*** confined ***Jackson*** to a situation where a trust arose.
- Contracts (Rights of Third Parties) Act 1999 allows third parties to sue on a contract.

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Total failure of consideration

- Where the parties have entered into a contract for the benefit of a third party, moneys can be recovered if there is a total failure of consideration by one party.

Avoiding the doctrine of privity of contract

Actions in tort

Collateral contracts

Exceptions to the doctrine of privity of contract

Exceptions allowing a third party to claim under a contract

Statutory exceptions

- Road Traffic Act 1988, s 148(7) – compulsory third party insurance.
- Married Women's Property Act 1882, s 11 – a husband's life assurance for the benefit of his wife and children.
- Companies Act 2006, s 33 (formerly Companies Act 1985, s 14) – memorandum/articles of association form a contract between the company and its shareholders and between the shareholders *inter se*.
- Bills of Exchange Act 1882 – the debt on the face of the instrument is enforceable not only by the original party to the transaction but by anyone to whom the debt is negotiated and who is deemed to be a 'holder in due course'.

Agency

- The principle in agency is that 'he who does an act through another does it himself'.

Trusts

- A trustee can sue a third party on behalf of the beneficiary.
- A beneficiary can sue a third party where the trustee fails to do so (***Les Affréteurs Réunis SA*** **v** ***Leopold Walford (London) Ltd***).

Law of Property Act 1925, s 56(1)

- Does not abolish privity (in ***Beswick*** **v** ***Beswick***).
- Section 205(1)(xx) is restrictive and has no application in the law of contract.

Exceptions imposing obligations on a third party

Obligations imposed by way of interests arising in land

- Obligations arising in leasehold land – ***Spencer's Case***.
- Obligations arising in freehold land – ***Tulk*** **v** ***Moxhay***.

Obligations imposed by way of interests in personal property

- ***Lord Strathcona Steamship Co.*** **v** ***Dominion Coal Co. Ltd.***

Protecting third parties in exemption clauses

- Third parties and reliance of exemption clauses (***Scruttons Ltd*** **v** ***Midland Silicones Ltd***).

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- Third parties can rely on exemption clauses (***New Zealand Shipping Co. Ltd*** v ***A M Satterthwaite & Co. Ltd (The Eurymedon)*** affirmed ***Port Jackson Stevedoring Pty Ltd*** v ***Salmond and Spraggon Pty (Australia) Ltd (The New York Star***), ***Adler*** v ***Dickson***).

The effect of third party actions on contracts

- Contracts (Rights of Third Parties) Act 1999.

The general right of a third party to enforce contractual terms

- Section 1(1) – a third party can enforce a contract made for his benefit, or when a contract confers a benefit on a third party.
- Section 1(3) – requires the third party to be expressly identified in the contract 'by name, as a member of a class or as answering a particular description but need not be in existence when the contract is entered into'.

Further reading

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Agency

Aims and objectives

After reading this chapter you should be able to:

- Know how an agency relationship is created whether by agreement, ostensible authority, usual authority, necessity, presumed agency or ratification.
- Understand the effects of the agency relationship between the principal and a third party.
- Understand the effects of the agency relationship between the principal and the agent.
- Understand the effects of the agency relationship between the agent and a third party.
- Recognise the circumstances in which the agency situation is terminated.
- Know the effects of the Commercial Agents (Council Directive) Regulations 1993 on the agencyr elationship.

Introduction

It was seen in the last chapter that a person cannot, as a general rule, enter into a contract with another so that rights and liabilities are conferred and imposed on a third party. It is, however, possible for a person, an agent, to act on behalf of another, the principal, in order to effect a contractual relationship between the principal and a third party. The latter point is particularly important since it must be emphasised that there is no contractual relationship between the agent and the third party and therefore there is no question of an exception to the doctrine of privity of contract being set up by virtue of the relationship between a principal, the agent and a third party.

Agency is an essential fact of business life, and indeed it is questionable whether business would exist without the doctrine of agency since non-human agencies such as companies, while having a separate personality, could not function without a human representative who acts on behalf of the company. This point also provides an indication of the fact that agency may arise quite independently of some other capacity a person may have in relationship to the principal. Thus an employee is the agent of his employer, a partner is an agent for the partnership, a person may be in a business as an independent contractor acting as a mercantile agent for several companies, and, indeed, a person can be an agent simply because he represents the interests of his principal, who has conferred on him the authority to act on his behalf.

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The creation of the agency relationship

Agency by agreement

Where an agency arises out of an agreement between the principal and the agent then actual authority is said to be conferred on the agent. The actual authority may arise either expressly or impliedly.

Express authority

In general such authority may be given orally or it can simply be reduced to writing. In either case the normal rules of construction as to the terms of the agreement will apply in order to assess the authority of the agent.

In certain circumstances special formalities have to be complied with, thus, in the Law of Property (Miscellaneous Provisions) Act 1989, s 1 stipulates certain requirements where the agency is arising out of the deed. Section 1(5) provides:

> Where a solicitor or licensed conveyancer, or an agent or employee of a solicitor or licensed conveyancer in the course of or in connection with a transaction involving the disposition or creation of an interest in land, purports to deliver an instrument as a deed on behalf of a party to the instruments, it shall be conclusively presumed in favour of a purchaser that he is authorised so to deliver the instrument.

The provision thus has the effect of deregulating the need for an agent to be appointed by deed where they are executing a deed involving the disposition or creation of an interest in land.

Implied authority

1. Generally

Agency may arise from the conduct or relationship of the parties, and indeed may arise despite the absence of an express agreement. In the latter case whether the implied agency exists or not is subject to an objective test. More usually implied authority arises out of an express authority since an agent's authority is not necessarily confined to those matters expressly referred to within the authority. The agent will have implied authority to carry out such acts as are ordinarily incidental to the performance of his duties under the express authority. Thus it was held in ***Mullens* v *Miller*** (1882) 22 ChD 194 that an estate agent has implied authority to make representations and warranties relating to a property when conducting negotiations with a prospective purchaser.

2. Incidental authority

This type of authority arises from the fact that authority may be implied to an agent from a particular trade usage or custom found in a particular marketplace, such as the London Stock Exchange, or arising in a particular trade, profession or business. In these circumstances an agent is clothed with implied authority to perform such acts as are consistent with the trade usage or custom prevailing, provided that they are reasonable. Thus a custom would not bind a principal if it is inconsistent with the relationship that exists between the principal and his agent, as in ***Blackburn* v *Mason*** (1893) 68 LT 510 where a principal instructed a country broker to sell certain shares for him. The broker (agent) sold the shares to a member of the London Stock Exchange. The member alleged that

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there was a custom within the Exchange that a member who owed money to a country broker could set that debt off against the broker in his personal capacity for moneys owed by the broker in respect of previous transactions. It was held that this custom did not bind the principal since it was unreasonable in that it resulted in a conflict of interest with regard to the agent's duties to the principal.

Before we leave incidental authority a word of warning needs to be issued since this type of authority is sometimes described as 'usual' authority. Unfortunately this term is seldom used consistently and some authorities have used it to describe apparent authority, below. In this work it has been used to describe an authority that arises out of the case of ***Watteau* v *Fenwick*** [1893] 1 QB 346, though again some authorities place this decision within the bounds of incidental authority as described above. These approaches all have some degree of integrity but it is hoped that the structure adopted here, as in Treitel (2003), will aid one's understanding of this not particularly easy aspect of the topic.

Apparent authority

Generally

This type of authority, sometimes referred to as '**ostensible**' authority, as well as 'usual' authority, as described above, really forms an application of the doctrine of estoppel. It arises where a principal, whether by words or conduct, creates an implication that the agent is entitled to act on the principal's behalf when in fact no such authority actually exists. An agent acting within this apparent authority will bind the principal to a third party despite the fact that the agent has no actual authority to do so. In other words, the principal has 'held the agent out' as having authority and is therefore estopped from denying this authority in order to avoid liability to a third party. The principle is illustrated by the case of ***Spiro* v *Lintern*** [1973] 1 WLR 1002 where a wife had been asked by her husband to employ an estate agent in order to enable his house to be sold. The estate agents employed found a purchaser and, acting on the instructions of the wife, they signed a contract of sale and handed this to the purchaser. The husband did not authorise the sale but nevertheless when he discovered the facts he took no action whatsoever. When the husband later attempted to deny the existence of a valid contract the court held that his conduct estopped him from sustaining the allegation as regards the non-existence of the contract.

The criteria needed for establishing apparent authority

The basic criteria needed for establishing apparent authority can be seen by reference to the judgment of Slade J in ***Rama Corporation* v *Proved Tin and General Investments Ltd*** [1952] 2 QB 147, where he stated:

> Ostensible or apparent authority which negatives the existence of actual authority is merely a form of estoppel and a party cannot call in aid an estoppel unless three ingredients are present (1) representation, (2) a reliance on that representation and (3) an alteration of his position resulting from such reliance.

1. Representation

While the representation may be either express or implied, it must produce a belief in the third party's mind that it is attributable to the principal rather than being merely the words or conduct of the agent, as held in ***Attorney-General for Ceylon* v *Silva*** [1953] AC 461. In certain situations the fact that apparent authority cannot arise out of the actions of the

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agent themself may present problems. For instance, a company can act only through its agents and on the face of things it would not appear possible for the principal, the company, to set up the representations needed to invest an agent with apparent authority.

Freeman & Lockyer v *Buckhurst Park Properties (Mangal) Ltd* [1964] 2 QB 480

A company had power within its articles of association to appoint a managing director. *X*, with the knowledge and approval of the board of directors, acted as the managing director, although his appointment was never confirmed. *X* entered into a contract on behalf of the company with a firm of architects. The company purported to disclaim liability under the contract on the basis that *X* had no authority to enter such a contract on behalf of the company. It was held that while *X* did not operate with actual authority, he was invested with apparent authority. The Court of Appeal found that the representations needed to support the apparent authority arose out of the actions and knowledge of the board who, while having actual authority themselves, had condoned the actions of *X* and held him out as possessing such authority. The company was thus bound by the contract.

The above circumstances also give rise to the question as to whether an agent, having actual authority, can enlarge the scope of their own authority by way of apparent authority. The House of Lords in ***Armagas Ltd* v *Mundogas SA, The Ocean Frost*** [1986] 2 All ER 385 stated not, since here the representation would arise from the agent themself rather than from the principal.

While the representation can arise by either the intentional or the negligent actions of the principal it must nevertheless clearly present the agent as having authority to act.

2. Reliance on the representation

In order to render the principal liable, the third party must show that they have relied on the representation. It was stated in ***The Ocean Frost*** that constructive notice of the representation is not enough, and that the third party must have actual knowledge of the representation. It follows that if the third party is unaware of the representation, or has actual or constructive knowledge of the fact that the agent does not possess the authority to act, in spite of the representations made by the principal, they will not be able to enforce the contract against the principal, as was held in ***Overbrooke Estates Ltd* v *Glencombe Properties Ltd*** [1974] 1 WLR 1335.

3. Alteration of the third party's position

The third party must have altered their position by relying on the representation. It seems to be unclear whether the third party must have altered their position to their own detriment or not, as in promissory estoppel. Since the situation is more akin to proprietary estoppel than promissory estoppel some commentators consider that the third party has to act to their own detriment.

Usual authority

As indicated earlier, the meaning of the term 'usual authority' has created substantial difficulties since authorities are not consistent in their use of the expression. Some use it to mean implied actual authority, while others use it to describe apparent authority. As has been stated, in this work it is intended to use it in the sense used by Treitel (2003) in order to aid understanding of all the material surrounding the various types of agencies

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already referred to. Treitel uses the expression to describe an authority that binds a principal to a contract entered into by their agent where that agent has no express, implied or apparent authority to act. The type of authority revolves around the decision in ***Watteau* v *Fenwick***.

Watteau v *Fenwick* [1893] 1 QB 346

In this case Fenwick employed Humble as manager of his public house. Humble had been expressly forbidden to purchase cigars on credit, but Humble did so order cigars from Watteau. Watteau himself at the time of contracting was unaware of the existence of Fenwick and, indeed, it was Humble's name that appeared over the door as licensee. Furthermore, the cigars were of the type normally supplied to such premises. It was held that Fenwick was liable since Humble was acting within the usual authority normally possessed by agents acting within that trade.

The decision is striking since, first, it is clear that any restriction placed on an agent by a principal will not bind the third party, unless they are aware of the restriction imposed by the principal. Second, it is clear that there is no question of liability arising under apparent authority since, as has already been seen, there must be a representation to the third party from the principal that the agent has authority to act, when in fact they do not. No such representation was, of course, present in the case.

The decision has been heavily criticised since one must ask why the principal should be liable in circumstances where they have not only not conferred authority on an agent but expressly restricted that authority in respect of purchasing the cigars. Similarly, Watteau had not been misled by any representations made by Fenwick to the effect that Humble had such authority. It is sometimes thought that the decision is wrongly decided, though it may be that the case fulfils a commercial exigency in that it is incorrect that an innocent third party should suffer when a person of business, intent on maximising profits, and in order to avoid liability, relies on the fact that they have not been disclosed by the agent. Such reasoning might well have been in the mind of Wills J when he stated in the case:

> once it has been established that the defendant was the real principal, the ordinary doctrine as to principal and agent applies – that the principal is liable for all acts of the agent which are within the authority usually confided to an agent of that character notwithstanding limitations, as between the principal and the agent, put upon that authority. It is said that it is only so where there has been a holding out of authority . . . But I do not think so. Otherwise, in every case of undisclosed principal, or at least in every case where the fact of there being a principal was undisclosed, the secret limitation of authority would prevail and defeat the action of the person dealing with the agent and then discovering that he was an agent and had a principal.

If this is the reasoning behind the case then it should be borne in mind that the principal does not necessarily suffer loss since they would, of course, have a right of indemnity from the agent themself.

Wills J makes reference to one important limitation on the operation of usual authority, that is, that its existence depends on the class or character of the agent and on the common understanding within the particular trade to which they belong concerning the authority of agents. Usual authority does not therefore operate as a matter of general application and indeed could not operate at all where an agent does not belong to a

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particular trade or belongs to a trade which does not recognise the authority that the third party is attempting to attach to the agent. In ***Daun* v *Simmins*** (1879) 41 LT 783 it was decided that the manager of a tied public house could not have attached to him the usual authority to purchase spirits from anyone he liked. A manager's authority in this particular aspect of the trade was normally restricted, thus preventing usual authority from arising. Here the third party should have been put on notice to inquire into the authority of the manager. Since he did not do so the principal was not liable to the third party.

Wills J also made reference to the undisclosed principal, a doctrine which raises wider issues and which will be dealt with later on. The relationship of ***Watteau* v *Fenwick*** to this doctrine will also be discussed later.

Agency of necessity

The law sometimes confers the authority of an agent on an individual despite the fact that the principal has not consented to the granting of such authority. Such an agency often arises where, as a matter of urgency, a partner enters into a contract on behalf of another and without that other's consent. The use of this type of agency is strictly confined by the courts, which allow such an agency only where there is an existing contractual relationship between the two individuals. Historically the basis for such agency arose out of the merchant shipping business, at a time when communication with one's principal was well-nigh impossible, as in cases like ***Couturier* v *Hastie*** (1856) HL Cas 673. The use of agency of necessity soon developed into areas beyond this specific situation. In ***Great Northern Railway Co.* v *Swaffield*** (1874) LR 9 Ex 132 a horse had been transported by train but on its arrival no one appeared to receive it. The railway company, being bound to take reasonable steps to take off the animal and being unable to contact the defendant, placed it with a livery stable. It was held that the defendant principal was bound to pay the livery fees.

To establish agency of necessity it has to be shown that the agent had been unable to contact the principal in order to obtain instructions on how to act. In ***Springer* v *Great Western Railway*** [1921] 1 KB 257 the plaintiff sent a consignment of tomatoes from the Channel Islands to London. The ship was delayed so that they arrived on the mainland three days late. A further delay of two days arose because of a railway strike so that the consignment could not be unloaded. When at last the consignment was unloaded the tomatoes were found to be bad and the railway company sold the consignment locally. No communication was made to the plaintiff even though this had been possible. It was held that the company were liable since they should have asked for instructions prior to selling the consignment.

It must be shown that the creation of the agency was both an actual and commercial necessity. In ***Prager* v *Blatspiel Stamp and Heacock Ltd*** [1924] 1 KB 566 an agent acting for the principal in 1915 bought a number of fur skins for £1,000. The skins were paid for by the principal but before they could be sent the German forces invaded Romania thus rendering transportation impossible; nor could the agent communicate with the principal. Some two years later the agent sold the skins which by this time had increased in value. It was held that the agent would be liable to the principal in damages since the sale had been completely unnecessary given that the skins, if stored correctly, would not have deteriorated.

Agency of necessity will arise only if the agent has acted in a bona fide manner and in the interests of the parties concerned.

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It should be noted that agency of necessity does not apply simply where a person voluntarily expends money in order to protect some interest of another. The principle is that one cannot compel individuals to take liabilities that have been incurred by others on their behalf while their backs have been turned. There is no contractual relationship here and any claim made would therefore have to fall within the law of restitution rather than agency.

Presumed agency

This type of agency is really a form of implied agency that arises out of cohabitation. It is afforded special status since there are vestiges of agencies of necessity and apparent authority within it. A wife is presumed to have the authority of her husband to pledge his credit for the necessary household items needed to maintain their station in life. The principle is not confined to married couples and will arise in relation to cohabitees. Whilst it has been traditionally based on female cohabitees there appears to be no reason why the principle does not apply equally to male cohabitees pledging the credit of a female cohabitee.

Once cohabitation has ceased the trader, in order to recover moneys in respect of goods supplied on credit, would have to show that a husband, for example, had held his wife out as having authority to pledge his credit. It should be noted that the same considerations as relate to necessaries in minors' contracts apply equally here. Thus the trader would have to show that the goods bought were necessary to the cohabitees' station in life and could only claim a reasonable sum and not necessarily the whole contract price.

For a husband to avoid liability he will have to rebut the presumption that his wife has the authority to act. He may do this by expressly warning tradespersons not to supply his wife with credit, or he may be able to show that the items purchased by the wife were not necessaries, in that she was already adequately supplied with such goods or that the goods in nature or price were extravagant having regard to their station in life or means. Lastly, he may be able to avoid liability by showing that he expressly forbade his wife to pledge his credit. It should be noted, however, that if he has held his wife out as having authority then a private communication to his wife telling her to stop pledging his credit will not be sufficient to exclude his liability.

Ratification

If a duly appointed agent enters into a contract without the authority of their principal or if a person having no authority to act as an agent at all purports to act in such capacity, the principal may, nevertheless, decide to adopt, or ratify, the contract so that they will be bound by it. The act of ratification renders the principal liable as if they had entered into the contract *ab initio* since the principal's authority is said to 'relate back'. The principal will be bound whether the act of the agent is detrimental or beneficial to them and whether the liability arises in contract or in tort.

It has already been seen that only parties to a contract, acting either for themselves or by way of an authorised agent, can sue or be sued on it. Ratification forms an important exception to this rule. Lord MacNaghten in ***Keighley, Maxted & Co.* v *Durant*** [1901] AC 240 stated it to be:

> a wholesome and convenient fiction [whereby] a person ratifying the act of another who without authority has made a contract openly and avowedly on his behalf, is deemed to be, though in fact he was not, a party to the contract.

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The principle of ratification may be stated as follows:

> The agent must contract as agent, for a principal who is in contemplation, and who must also be in existence at the time for such things as the principal can and lawfully may do.

This principle requires further elaboration, however.

The agent must contract as agent

In other words, the agent must purport to act on behalf of a principal. If an agent purports to act on their own behalf then the principal is not capable of ratifying the acts of the agent. The most common example of this is where the agent fails to disclose the existence of the principal. An undisclosed principal cannot ratify the act of an agent. This proposition can be seen in the following case.

Keighley, Maxted & Co. v *Durant* [1901] AC 240

An agent bought corn at a price higher than he was authorised to do. While he intended to purchase on behalf of his principal, he failed to disclose his agency to the seller. The undisclosed principal initially purported to ratify the actions of his agent but in fact refused to accept the corn when it was delivered to him. The seller sued but it was held by the House of Lords that his action should fail. The agent's actions were unauthorised and since the principal was undisclosed at the time of the contract, the principal was incapable of ratifying the actions of the agent.

In the normal course of things an agent would usually name his principal, though he need not go as far as this provided the principal is capable of being identified. Not declaring the agency at all or simply stating that one is contracting as an agent is not sufficient and the act of the agent could not be ratified in such circumstances.

The principal must be in existence

In order for ratification to take place there must have been a competent principal in existence at the time the agent entered the contract. In ***Kelner* v *Baxter*** (1866) LR 2 CP 174 the promoters of a company purchased a quantity of wine on behalf of a company which had not been formed at that time. When the company was formed it purported to ratify the contract entered into by the promoters. It was held that since the company was not in existence at the relevant time ratification was not possible and the contract could not be enforced against the company.

The liability of persons purporting to act on behalf of a company prior to its formation is now governed by the Companies Act 2006, s 51(1), which provides:

> A contract that purports to be made by or on behalf of a company at a time when the company has not been formed has effect, subject to any agreement to the contrary, as one made with the person purporting to act for the company or as agent for it, and he is personally liable on the contract accordingly.

It should be noted that in the case of ***Phonogram Ltd* v *Lane*** [1982] QB 938 it was held that agents signing 'for and on behalf of' a company that had not yet been formed could not escape liability personally on the basis of the clause 'subject to any agreement to the contrary' within the above provision. Exactly what is meant by this expression continues to be unclear. (Note that s 51(1) of the Companies Act 2006 was formerly embodied in the European Communities Act 1972, s 9(2).)

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The principal must be a competent principal

In other words the principal must have had the capacity to enter into the contract at the time the agent did so on his behalf. An enemy alien, for instance, is incapable of entering into a valid contract or ratifying the actions of an agent who has entered into a contract on behalf of the principal.

The actions of the agent must be capable of ratification

It is not possible to ratify contracts which are void *ab initio* though this restriction on ratification does not apply where the contract was merely voidable, since here there is a valid contract until it is repudiated.

Knowledge of material facts

The actions of an agent are capable of being ratified only if the principal was aware of all the material facts.

Ratification *in toto*

The principal cannot choose to ratify some parts of the contract entered into by the agent on their behalf and not others. If the principal elects to ratify then they must ratify the whole agreement *in toto*.

The effects of agency

The effect as between the principal and the third party

Where the principal is disclosed

Where an agent has express, implied or usual authority then the principal may sue and be sued on the contract with the third party. The agent has no further part to play and disappears from the scene, leaving a contract between the principal and the third party. A similar situation also arises where the principal ratifies the actions of the agent, provided the criteria for the ratification are present.

Where the principal is undisclosed

1. Generally

It has been seen in our discussions of ratification that one of its central rules is that the agent must disclose the existence of the principal to the third party at the time they enter the contract, so that the principal is reasonably identifiable, before ratification becomes possible. It was, of course, the absence of this factor that prevented the third party from enforcing the contract against the principal in the ***Keighley, Maxted*** case, despite the fact that the principal initially purported to ratify the contract entered into by his agent.

Into the above situation an anomaly must be introduced – the doctrine of the undisclosed principal. The doctrine, which is peculiar to English law, states that where an agent acting within their express, implied or usual authority makes a contract on behalf of a principal, but does not disclose the existence of the principal to the third party, then, despite that fact, the principal can sue or be sued in respect of the contract. The doctrine forms an exception to the privity of contract rule but, unlike ratification, seems to be completely irreconcilable with that principle.

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In the ***Keighley, Maxted*** case the House of Lords criticised the doctrine and refused to apply it, thus Lord Davey stated:

> [T]he rule which permits an undisclosed principal to sue and be sued on a contract to which he is not a party, though well settled, is itself an anomaly, and to extend it to the case of a person who accepts the benefit of an undisclosed intention of a party to the contract would, in my opinion, be adding another anomaly to the law, and not correcting an anomaly.

Furthermore, Lord MacNaghten refused to allow the principle of ratification to be extended to situations where the agent had not disclosed the existence of the principal. He stated:

> Does the fiction [in respect of privity of contract in relation to ratification] cover the case of a person who makes no avowal at all, but assumes to act for himself and for no one else? . . . it would seem to exclude the case of a person who may intend to act for another, but at the same time keeps his intentions locked up in his own breast; for it cannot be said that a person who so conducts himself does assume to act for anybody but himself . . . But ought the doctrine of ratification to be extended to such a case? On principle I should say certainly not. It is, I think, a well established principle in English law that civil obligations are not to be created by or founded upon undisclosed intentions.

While one can understand Lord MacNaghten's reluctance to extend ratification in that direction, since its principles are now well established, one has to ask why the undisclosed principal should not be bound, as he certainly was in ***Watteau* v *Fenwick***, the facts of which are virtually analogous to those of ***Keighley, Maxted***. Of course, in ***Watteau* v *Fenwick*** there was a finding of usual authority that did not seem to arise in the ***Keighley, Maxted*** case. ***Watteau* v *Fenwick*** was nevertheless considered to be exceptional, given that the agent was expressly forbidden to pledge the credit of Fenwick in relation to the purchase of the cigars. A significant matter in the decision, however, was the fact that a commercial expediency was fulfilled by the decision and this approach seemed to have the support of Wills J. It is this feature that could appear to justify the anomalous existence of the doctrine of the undisclosed principal. Thus in ***Keighley, Maxted***, Lord Lindley stated:

> There is an anomaly in holding one person bound to another of whom he knows nothing and with whom he did not, in fact, intend to contract. But middlemen, through whom contracts are made, are common and useful in business transactions and in the great mass of contracts it is a matter of indifference to either party whether there is an undisclosed principal or not. If he exists it is, to say the least, extremely convenient that he should be able to sue and be sued as a principal and he is only allowed to do so upon terms which exclude injustice.

It would seem that the doctrine of the undisclosed principal also exists as a matter of commercial expediency, even though it runs contrary to the general principle of privity of contract. But how does such a doctrine arise? The doctrine is, it is suggested, similar in nature to that of vicarious liability in tort, since here too the third party may be completely ignorant of the existence of an employer yet may, nevertheless, maintain an action against them. One of the reasons often given as justification for the principle is the fact that the employer is normally better able to bear the loss, a factor which strikes a common accord with the comments made so far.

In conclusion, it may be suggested that while liabilities in respect of usual authority and those arising under the doctrine of the undisclosed principal have developed from

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differing backgrounds, the common theme seems to be based on rendering the principal liable, on the basis that they will be the one who profits from the actions of the agent and thus likely to be better able to compensate the third party in respect of his losses. If this statement represents the true picture, it is suggested that the decision in ***Keighley, Maxted*** is incorrect and that the better solution would have been to find the principal liable and then allow him to claim an indemnity from the agent.

2. Factors preventing the operation of the doctrine

The doctrine of the undisclosed principal will not apply where the terms of the contract are inconsistent with the agency, as in ***Humble* v *Hunter*** (1848) 12 QB 310, where an agent entered into a contract for the charter of a ship in his own name and describing himself as 'owner'. It was held that this raised a sufficient inference that there was no principal, so that the principal was found not to be liable on the contract.

The doctrine will not apply where there is an express provision in the contract that the agent is to be the sole principal. The effect of such a provision renders the whole question of agency incompatible with the contract. The doctrine will not apply where the personal qualities of the principal – for instance, the identity of the principal – are such as to be of importance to the third party. One case illustrating this point is that of ***Said* v *Butt***.

Said v *Butt* [1920] 3 KB 497

In this case the plaintiff, a theatre critic, wanted to go to the first night of a particular play. He knew that the management of the theatre would not sell him a ticket since there had been differences between them in the past regarding his critical comments on their productions. The plaintiff employed a friend to purchase a ticket for him without disclosing his name. When the plaintiff was then refused admission he sued the theatre for breach of contract. It was held that his action would fail since the theatre had specifically reserved first night seats for special persons and therefore the personality element was considered to be an important and fundamental factor. The principle would seem to be that an undisclosed principal cannot enforce a contract if they are aware that the third party would not normally agree to contract with them. It should nevertheless be borne in mind that the basic rule, as stated in ***Dyster* v *Randall & Sons*** [1926] Ch 932, is that simply because a third party does not want to contract with the principal, this does not prevent a valid and binding contract from coming into existence.

If the third party decides to sue the agent, then the fact that the agent could not personally comply with the terms of the contract is not a bar to the action being brought. This misnomer often arises because of the principle of *nemo dat quod non habet*, 'one cannot give what one has not got'. This rule arises in relation to the passing of title or ownership, as seen in unilateral mistake as to identity. There is, however, nothing to prevent a person from entering into a contract to sell something they do not own or even possess, albeit that this is clearly unwise, as held in ***Muldoon* v *Wood*** (1998) (unreported, CA).

For more on the effects of unilateral mistakes as to identity refer to Chapter 10.

3. The effect of the doctrine of undisclosed principal

While the principal remains undisclosed the agent may sue and be sued on the contract by the third party. Once the existence of the principal becomes disclosed then the right of the agent to sue is lost. As regards the rights of the third party when the existence of the principal is revealed, they may elect to sue either the agent or the principal. Such

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election will arise when the third party unequivocally indicates against whom they are going to enforce the contract. It should be noted that the third party could still sue the agent despite the fact that the identity of the principal could have been discovered. The decision to sue either the agent or the principal lies entirely in the hands of the third party, as stated by Ward LJ in ***Muldoon* v *Wood***. Once the election is made then the third party cannot afterwards retract it and purport to sue the other person, as was held in ***Clarkson, Booker Ltd* v *Andjel*** [1964] 2 QB 775.

Where the third party enters into the contract with the agent believing them to be the principal, then the third party is entitled to set off any debts owed by the agent to the third party against the principal. Broadly, this equates with the rule that applies in assignment of contract, in that the principal takes the benefits of the contract entered into by the agent, but subject to any equities that might arise against the agent, as stated in ***Cooke & Sons* v *Eshelby*** (1887) 12 App Cas 271. In that case the agent acting for an undisclosed principal eventually sued the third party who claimed a right of set-off relating to a debt owed by the agent to the third party in respect of an account held in the agent's name. The third party admitted that he entered the contract with the agent without being aware that he acted for the principal. It was held by the House of Lords that the right of set-off should fail. In order to exercise the right the third party would have to show that he had inquired of the agent as to whether he was contracting on behalf of himself.

The effects as between the principal and the agent

Apart from the express and implied obligations that are imposed on the principal and the agent via their agreement with one another there exists a set of general duties that overlay the relationship that exists between the parties.

The duties owed by the agent to the principal

The relationship of the agent to the principal is a fiduciary one. The nature of the fiduciary relationship is wide and encompasses a range of duties within it. Thus, for instance, it is a duty of the agent not to subdelegate their authority to another person. The principle is sometimes summed up in the expression ***delegatus non potest delegare***. The agent has a duty to act for their principal personally unless given the authority by the principal to subdelegate.

Similarly, an agent must not put themself in a position where their own interests conflict with the duties they owe to their principal. They must, of course, not allow the duties they owe to various principals to conflict where, for instance, they act as a mercantile agent. This particular duty raises a variety of issues. An agent must maintain the confidentiality of their principal's affairs. Converse to the duty of confidentiality is the duty to disclose all relevant information to the principal. Disclosure encompasses the duty to account for all moneys received by the agent on behalf of the principal and to keep proper accounts of all transactions. Part and parcel of this aspect of the agent's relationship with the principal is the duty not to make a secret profit out of the relationship. In ***De Busche* v *Alt*** (1878) 8 ChD 286 an agent was instructed to sell his principal's ship for not less than $90,000. With the consent of the principal the agent employed a sub-agent, the defendant. The defendant bought the ship himself for $90,000 and soon afterwards sold the ship for $160,000. The plaintiff, the principal, claimed that the defendant should account for the profit made by the sale. It was held that the defendant was the plaintiff's agent and that he was in breach of his duty to the principal and he was therefore compelled to account for the profit he had made.

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The agent will have to account for any profits made by virtue of confidential information that comes his way because of his position as agent. In ***Boardman* v *Phipps*** [1967] 2 AC 46 agents acting on behalf of trustees acquired some shares for them, at the same time also purchasing some shares for themselves. It was held that despite the fact that there was no intentional wrongdoing on the part of the agents and that the principal trustees had not suffered any loss, the agents were bound to account for the profits made out of the transaction. From this position it is clear that where a profit is made from intentional wrongdoing then the agent will have to account for any moneys accruing to them from their wrongful conduct. An agent will be required to account for any bribes paid to them. For this purpose a bribe is a commission paid to the agent without the knowledge of the principal. In ***Boston Deep Sea Fishing and Ice Co. Ltd* v *Ansell*** (1888) 39 ChD 339 a director of a company was paid a bonus by two other companies, of which he was also a director, in respect of orders placed with those companies by the first company. He was held to be liable to account for those commissions to the first company since they had been obtained by virtue of his position within the company.

Apart from duties which are clearly of a fiduciary nature there are other duties relating to the exercise of one's duty as an agent. An agent must, for instance, carry out their principal's lawful instructions and must do so with reasonable care and skill. The lack of a contract between the agent and the principal does not prevent the existence of such a duty. In the absence of a contract, a principal can rely on such a duty being imposed in tort, although the standard of care here is likely to be lower than would be imposed in a contract where the agent professes a special skill. The latter point makes a great deal of sense since it is clear that one would not expect a higher or the same level of care from a person who undertakes a commitment to act as an agent free of charge than from one whom one pays as part of a contractual relationship.

The duties owed by the principal to the agent

The duties owed by the principal to the agent largely revolve around the recovery of remuneration from the principal in respect of commission or expenses incurred by the agent by virtue of acting within their office. The main duties are:

1. The duty to remunerate the agent for his services

Normally this duty will only arise where the principal has expressly or impliedly agreed to pay for the agent's services, though in the case of a professional agency the courts will often imply such a duty into the contract. The entitlement to remuneration only arises where the agent has fulfilled the requirements of the agency agreement. Where an agent is an employee, the remuneration arises as part of their salary. Where, however, the agent is independent, or where the employee can earn a commission in addition to their salary, the commission only arises where the event on which it is payable actually comes about. Thus an estate agent on a 'no sale, no fee' basis is entitled to commission only when a sale actually materialises. Where no such term is included in the agreement then the precise circumstances in which the commission becomes payable largely depend on the circumstances of the individual case.

2. The duty to indemnify the agent for liabilities incurred

If an agent incurs liabilities or expenses in the performance of their duties to the principal, then the agent is entitled to be indemnified by the principal for those expenses or

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liabilities reasonably incurred by the agent. Such duty to indemnify the agent will also arise where the liability incurred by the agent arises by way of tortious liability, as in ***Adamson* v *Jarvis*** (1827) 4 Bing 66, where the principal instructed his agent, an auctioneer, to sell certain goods for him at auction. The agent sold the goods but in fact they were not owned by the principal and, as a consequence, the agent had to pay damages. It was held that the principal was liable to indemnify the agent in respect of the damages. The duty to indemnify does not arise where the liability incurred by the agent arose by way of an illegal act or where the liabilities were incurred by the agent through their own fault. Further, the principal has no duty to indemnify the agent where the agent acted in an unauthorised manner.

3. The agent's lien over his principal's property

An agent is entitled to exercise a lien over his principal's property, which is in the possession of the agent, in respect of debts owed by the principal to the agent arising out of the agency relationship. It should be stated that the right of lien is only a possessory right which gives the agent no right to sell the goods to settle the debt, and a court order is required to exercise such a right of sale. Since the right is a possessory one it is lost when the agent parts with possession of the goods. It is in this last instance that the **right of stoppage** *in transitu* arises, but before we discuss this right it should be noted that the agreement can preclude a right of lien from arising.

4. The agent's right of stoppage *in transitu*

Should the agent lose possession of the principal's goods thereby precluding the agent from exercising the right of lien, the agent may recover the goods by way of stoppage *in transitu*. Stoppage *in transitu* simply involves the agent ordering the carrier to return the principal's goods to the agent, whereupon the agent immediately exercises their right of lien over the goods.

The effect of making settlement with the agent

The necessity here is to discover the respective liabilities of the principal or the third party where one of them pays money to the agent, with the intention of settling their respective debts, and the agent subsequently absconds with the proceeds. Will the third party or the principal be liable to pay again?

Settlement by the third party

If the third party settles with the agent, who fails to hand the payment to the principal, the normal rule is that the debt is not discharged and the third party remains liable on the debt to the principal. The rule is based on the presumption that an agent who is authorised to sell is not necessarily authorised to accept payment, as stated in ***Butwick* v *Grant*** [1924] 2 KB 483. The general rule may be overturned if the agent has actual authority to receive payment or where such authority is given to the agent by way of apparent authority or ratification by the principal. Where the general rule is overturned in this way the third party must nevertheless comply with the nature of the authority given to the agent. If, for instance, the agent is given authority to accept payment but only in the form of a cash payment, then the effect of the third party settling the debt by negotiable instrument will not discharge their liability to the principal.

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Settlement by the principal

A similar general rule to that seen in the case of third parties, above, also applies in the case of settlement by the principal to the agent, in that the principal's liability continues in respect of the debt owed. The general rule may be overturned where the third party indicates that they look to the agent alone for settlement of the debt, with the result that the principal pays the moneys to the agent. Further, the third party may be estopped from claiming the debt from the principal where they lead the principal to assume that the debt has already been discharged, as was held in ***Heald* v *Kenworthy*** (1855) 10 Ex 739. The latter exception cannot, however, apply where the principal is undisclosed since it was held in ***Irvine & Co.* v *Watson & Sons*** (1880) 5 QBD 414 that estoppel cannot arise where the third party was unaware of the existence of the principal.

The effect as between the agent and the third party

The general rule is that the agent incurs no liability and acquires no rights on the contract that is concluded between the principal and the third party; there are, however, certain exceptions to this general rule.

The liability of the agent

1. Where the principal is undisclosed

It has already been noted that should the agent contract on behalf of an undisclosed principal then the agent has personal liability on the contract since to all intents and purposes the agent appears to the third party to be the principal. Further, even if the principal subsequently becomes disclosed the third party retains an election as to whether to sue the now disclosed principal or the agent.

2. Where the agent contracts in a personal capacity

Whether an agent has contracted in a personal capacity is largely a matter as regards the construction of the contract. The contract may be constructed in such a way that the agent as well as the principal will be a party to the contract. It has also been seen in the case of ***Kelner* v *Baxter***, above, that an agent who contracts on behalf of a non-existent principal is presumed to have contracted in a personal capacity, though the situation in that case is now governed by statutory provision. This position, however, is also subject to the construction of the contract.

An agent who, while acting on behalf of the principal, makes a misrepresentation will be liable in damages in tort, either in deceit or negligent misstatement. This liability does not extend, however, to liability under s 2(1) of the Misrepresentation Act 1967, as was held in ***Resolute Maritime Inc.* v *Nippon Kaiji Kyokai*** [1983] 1 WLR 857.

3. Liability for unauthorised acts

If the agent purports to act for a principal but without having authority to do so, the third party may bring an action against the agent for damages on one of three grounds:

1 negligent misstatement;

2 the tort of deceit;

3 breach of warranty of authority.

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With regard to *negligent misstatement*, the agent may incur liability in tort where they fail to exercise due and reasonable care in representing either the extent of their agency or whether it exists at all. With respect to the *tort of deceit*, the agent will incur liability in deceit if they were aware that they did not possess either the agency or the authority that they represent to the third party. The legal basis for liability for *breach of warranty of authority* is somewhat confused. Some authorities consider that it stands outside the law of contract altogether and that its basis lies in the law of restitution. Others consider it to be the result of a collateral contract in which the agent warrants to the third party that not only does a principal exist but that the agent has the principal's authority to act on the principal's behalf. In ***Collen* v *Wright*** (1857) 8 E & B 647 the agent, purporting to act on behalf of his principal, Gardner, granted a lease of Gardner's land to the third party for 12 years. Gardner was able to show that the agent had no authority to grant a lease of such a long duration and as a result the action against him as principal failed. The third party then brought an action against the agent for breach of his collateral warranty that he had the authority to grant such a lease. Consideration for the collateral contract was apparently provided by the entry of the third party into the main contract.

Breach of warranty of authority has the advantage of carrying with it the strict liability inherent in the law of contract, and thus does not depend on the third party establishing the state of the agent's mind, as required in negligent misstatement and the tort of deceit, above. A further advantage is that the warranty is said to be a continuing warranty. The effect of this is that the agent remains liable despite the fact that while they originally had a valid authority at the time of the contract, this authority has either become invalid or ceased to exist without their knowledge.

A modern example of liability for breach of warranty of authority can be seen in the following case.

Nimmo v *Habton Farms* [2003] 1 All ER 1136 (CA)

The facts of the case were that Mr Nimmo, who was a bloodstock agent, entered into a contract for the purchase of a racehorse, High Spirits, for £70,000 'subject to veterinary inspection and approval of X-rays in the USA'. These conditions were satisfied but subsequently High Spirits contracted peritonitis and had to be destroyed prior to the completion of the contract. The claimant sued Mr Nimmo, the first defendant. It became established that in fact he had no authority to make the conditional contract on behalf of the second defendant and furthermore had no authority to inform the claimant that the contract was now unconditional and that the conditions had been satisfied. Mr Nimmo had warranted his principal's authority in making the contract on behalf of the second defendant when he had no such authority. Since the claimant had relied on that authority he was entitled to claim the £70,000 purchase price for breach of warranty of authority since this was an ordinary and natural consequence of the first defendant's breach. It should be noted, however, that this might not have been the result had the horse died much later since, if the purchaser had repudiated the contract, the claimant would have been obliged to mitigate his loss.

The rights of the agent

The rights of the agent to sue on the contract arise in much the same way as the agent's personal liabilities arose, as discussed above. If a person enters into a contract as a principal then they will be able to sue in that capacity despite the fact that they are described as an agent.

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The termination of the agency

The agency relationship may be terminated either by the actions of the parties themselves or by operation of law. It should be noted that in certain circumstances the agency relationship is irrevocable.

By the actions of parties

Just like any other contract, agency is a consensual relationship and, just as in discharge by agreement, it can be ended by the agreement of the parties. Further, the agreement might contain a time stipulation, so that once the fixed time for the continuance of the agency has ceased the agency is automatically terminated.

It is possible to terminate the agency agreement by notice or revocation, though it should be noted that some agreements contain an undertaking that the agency will not be terminated until a particular period has expired or until the agent has carried out their duties under the agency. It should be carefully noted that this does not amount to an irrevocable agreement since the agreement can plainly be terminated in such circumstances, although the party breaking the terms of the agency agreement will be liable for breach of contract.

Where the agency arises by way of apparent authority the revocation will only be effective against third parties if they have been given notice of the termination of the agent's authority.

By operation of law

In certain circumstances the agency will be brought to an end by the operation of the law. This may arise in several situations.

Death

The death of the principal automatically terminates the agency, although the agent may remain liable to the third party for breach of warranty of authority, even if the agent is unaware of the death of his principal. The death of the agent terminates the agency.

Unsound mind

The effect of the principal or the agent becoming insane is to terminate the agency, although it is possible for an agent to bind an insane principal to a third party by way of apparent authority, as was held in ***Drew* v *Nunn*** (1879) 4 QBD 661. In ***Yonge* v *Toynbee*** [1910] 1 KB 215, however, the agent had no authority to act and bind his insane principal but was nevertheless held to be liable to the third party by way of breach of warranty of authority.

Bankruptcy

The bankruptcy of the principal renders them legally incapable, the effect of which is automatically to terminate the agency. The same is not necessarily true of the agent although it is unlikely that they could sustain the position of agent when tainted with bankruptcy.

Frustration

Frustration will bring about the automatic termination of the agency just as in normal contractual rules.

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Irrevocable authority

In a limited number of cases the authority of the agent is rendered irrevocable.

Powers of attorney

If the **power of attorney** is expressed to be irrevocable and is given to secure the interests of the donee of the power, in our case the agent, then the power of attorney will remain irrevocable for so long as the interest of the donee continues to exist, by s 4 of the Powers of Attorney Act 1971. The power may be removed where the donee consents to its removal; the power does not, however, lapse on the death, bankruptcy, incapacity or dissolution of the donor of the power.

Personal liability incurred by the agent

If an agent incurs a personal liability or a personal loss by virtue of the exercise of his authority, the agency cannot be revoked by the principal without the consent of the agent. The rule is clearly desirable since otherwise the position of the agent would be severely prejudiced. There is one qualification to the rule, however, in that for it to apply the liability or loss must have been within the contemplation of the parties at the time the authority was conferred on the agent, as stated in ***Read* v *Anderson*** (1884) 13 QBD 779.

Authority coupled with an interest

The authority given to an agent will be irrevocable where the authority is coupled to a subsisting interest. This may arise where a principal authorises an agent to sell property and to deduct their fee from the purchase price, as in ***Gaussen* v *Morton*** (1830) 10 B & C 731. Here the principal has conferred an interest on the agent so that the agency cannot be unilaterally revoked by him, nor on his death or bankruptcy. It should be noted that the principle does not operate where the authority arises incidentally with respect to a subsisting agency. It was held in ***Smart* v *Sandars*** (1848) 5 CB 895 that the authority must be given with the specific intention of protecting the interests of the creditor.

The effect of European law on the agency relationship

The Commercial Agents (Council Directive) Regulations 1993 came into force on 1 January 1994 and made significant changes to the law of agency as it applies to self-employed commercial agents. The changes will affect existing as well as future commercial agency agreements and will imply certain rights and duties into these agreements. A principal will be unable to avoid the effects of the Regulations in agency contracts, though certain provisions within the Regulations apply only where the agency contract does not deal with a particular issue. In these circumstances where the agency contract differs from the provisions contained in the Regulations, the agency contract will be interpreted in favour of the agent. Where a provision within an agency contract cannot be interpreted in this way then it will be void as from 1 January 1994 insofar as it is inconsistent with the duties imposed by the Regulations.

Defining a commercial agent

The Regulations do not encompass all agency contracts – only those where the appointee is a commercial agent, which is defined by reg 2 as 'a self-employed intermediary who

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has continuing authority to negotiate the sale or purchase of goods on behalf of another person (the "principal"), or to negotiate and conclude the sale or purchase of goods on behalf of and in the name of that principal'.

Certain persons are excluded from the definition: first, the expression 'commercial agent' 'shall be understood as not including in particular' officers of companies or associations making contracts on behalf of their companies or associations, insolvency practitioners or partners making contracts that are binding on other members of the partnership; second, the Regulations do not apply to 'commercial agents whose activities are unpaid', commercial agents operating on the commodity exchanges and Crown Agents; third, the Regulations do not apply to commercial agents whose activities 'are to be considered secondary'. In order to decide whether an agent's activities are secondary, reg 2(3) makes reference to the Schedule, which in turn states that an agent's activities are secondary when 'it may reasonably be taken that the primary purpose of the arrangement with his principal is other than as set out in paragraph 2'.

Broadly speaking, the Schedule provides that the activities of a commercial agent will be considered to be secondary and therefore outside the Regulations where:

1 the principal is not the manufacturer, importer or distributor of the goods; or
2 the goods are not specifically identified with the principal in the market in question; or
3 the agent does not substantially devote the whole of their time to representative activities (whether for one principal or for a number of principals whose interests are not conflicting); or
4 the goods are normally available in the market in question other than by means of the agent; or
5 the arrangement is described as being other than one of commercial agency; or
6 'promotional material is supplied directly to potential customers'; or
7 persons are granted agencies 'without reference to existing agents in a particular area or in relation to a particular group'; or
8 'customers normally select the goods for themselves and thereby place their orders through the agent'.

Thus, unless the contrary is proved, agents acting on behalf of mail order catalogue firms in respect of consumer goods are presumed to fall outside the Regulations.

Rights and duties of commercial agents and their principals

Regulation 3(1) provides that a commercial agent in performing their activities 'must look after the interests of his principal and act dutifully and in good faith'. By reg 3(2) this general duty is supplemented in that it provides that a commercial agent must make proper efforts to negotiate and, where appropriate, conclude the transactions they are instructed to take care of. They must communicate to their principal all the necessary information available to them and comply with the reasonable instructions given to them by the principal.

From the above it will quickly be seen that these duties vary little from the position that already exists under the present common law. Regulation 4, however, imposes duties on principals that are rather more specific and onerous than those found in the common law.

By reg 4(1) a principal in their relations with their commercial agent 'must act dutifully and in good faith'. Under reg 4(2) a principal is required to provide their agent with

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the necessary documentation relating to the goods concerned and obtain the necessary information in order to enable the agent to carry out the terms of the agency contract. A principal must also notify their agent within a reasonable period should they, the principal, anticipate that the volume of commercial transactions is likely to be significantly lower than the agent could normally have accepted. A further duty is laid on the principal by reg 4(3) in that the principal is required 'to inform his commercial agent within a reasonable period of his acceptance or refusal of, and of any non-execution by him of a commercial transaction which the commercial agent has procured for him'. The essence of these provisions is that they will not only enable the agent to have some sort of guidance as to the extent of future commission earnings, but also enable the agent to be aware of any omissions of the principal in completing a commercial transaction.

It should be noted that the above rights and duties are mandatory, since by reg 5 they cannot be contracted out of. Similarly, reg 13, which gives both the commercial agent and the principal the right to receive from one another on request 'a signed written document setting out the terms of the agency contract including any terms subsequently agreed', cannot be contracted out of, by virtue of reg 13(2).

Express provisions as to remuneration and commission

If the agency contract does not specifically provide for remuneration (a situation that is likely to be fairly rare!), reg 6 provides that the agent is entitled to remuneration. The amount of remuneration is calculated according to the customary practice in relation to the goods the agent is buying and selling, together with the geographical area in which they are conducting the principal's business. Thus a commercial agent operating in Spain would be entitled to remuneration at the customary rates for that area. Should they wish to be remunerated at a higher rate, then they should negotiate that rate as an express term of the agency contract with the principal. If there is no customary rate, then the commercial agent is entitled to 'reasonable remuneration taking into account all the aspects of the transaction', an approach which is compatible with that of the common law, since there is no general customary practice with regard to the remuneration of agents in the UK.

Where an agent is paid commission in respect of commercial transactions, the regulations provide that the rules governing payment should be categorised in two ways:

1. Transactions concluded during the agency contract

Where a commercial transaction is concluded during an agency contract the commercial agent is entitled to commissions on such contracts if:

1 'the transaction has been concluded as a result of his action' (reg 7(1)); or
2 'the transaction is concluded with a third party whom he has previously acquired as a customer', even if the order was not placed through that agent (reg 7(1)); or
3 the agent 'has an exclusive right to a specific geographical area or to a group of customers and where the transaction has been entered into with a customer belonging to that area or group' (reg 7(2)).

It can be seen, therefore, that an agent is entitled to commission not only on actual sales as in (1) above but also on passive sales as in (2). The position becomes even wider in relation to exclusive agents, as covered by (3), since here the agent is entitled to commission in relation to both passive and generic sales. In relation to (3) it may be seen that this is a major departure from the common law position. This provides that if a principal

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accepts a transaction that is not the result of the efforts of their exclusive agent, then that agent may take action for breach of an express term. The result of reg 7(2) is that the principal would now be liable by virtue of an implied term. A further result of reg 7(2) is that a principal would be obliged to pay commission to an exclusive agent despite the fact that the transaction was completed by the principal acting on their own behalf.

2. Transactions concluded after termination of the agency contract

In these circumstances at common law the question of entitlement to commission would be a matter for express agreement. In reg 8, however, it is implied that commission is payable to a commercial agent if:

> (a) the transaction is mainly attributable to [the agent's] efforts during the period covered by the agency contract and if the transaction was entered into within a reasonable period after that contract terminated; or
> (b) in accordance with the conditions mentioned in reg 7 . . . the order of the third party reached the principal or the commercial agent before the agency contract terminated.

From the above it may be seen that a problem can arise as to whether the principal should pay the commission to the outgoing commercial agent or to their successor. Regulation 9 attempts to draw the line here by providing that the successor has no entitlement to commission under reg 7 if, because of reg 8, the commission is payable to the outgoing commercial agent. It should be noted, however, that reg 9 provides that the commission should be shared between the outgoing agent and his successor if this is 'equitable because of the circumstances'. No attempt is made within the provision to define or explain the term 'equitable' and therefore it can only be assumed that a discretion will lie with a court to apportion the commission payable to the outgoing agent and their successor. A further important point that arises out of reg 9 is that a principal is liable to pay the correct sum due to the appropriate agent, though the principal may recover any sum paid to an agent if they have paid money to the other agent who is not in fact entitled to it.

By reg 10, commission becomes due when:

> (a) the principal has executed the transaction; or
> (b) the principal should, according to his agreement with the third party, have executed the transaction; or
> (c) the third party has executed the transaction . . .
>
> [or
> by reg 10(2)] . . . at the latest when the third party has executed his part of the transaction or should have done so if the principal had executed his part of the transaction, as he should have.

From this provision it may be seen that it is no longer possible for a principal to delay paying the commission merely because the principal has not yet been paid by the customer. By reg 10(3), commission is to be paid 'not later than on the first day of the month following the quarter in which it became due'. For this purpose (unless otherwise agreed by the parties) 'the first quarter period shall run from the date the agency contract takes effect, and subsequent periods shall run from that date in the third month thereafter or the beginning of the fourth month, whichever is the sooner'.

In relation to the assessment of the amount of commission due, reg 12 requires the principal to provide their commercial agent with a statement of the commission due and

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how the amount is arrived at. Further, if requested, the principal is under an obligation to supply to the agent all information available to the principal in order to enable the agent to check the statement. Thus a principal may be required to provide extracts from their own accounts in order to assist the agent in making their own assessment of the commission that should be payable. Such disclosure is avoided only if it is in the public interest not to provide the relevant information.

Termination of a commercial agency

With respect to agency contracts that are agreed to run for a fixed period of time, reg 14 provides that such agencies will be converted to a commercial agency for an indefinite term should the parties continue to operate the agency after the end of the fixed period. While this provision is no doubt intended to protect the agent's right to remuneration and commission, it may also have the effect of allowing a third party to enforce a contract against a principal as if there were an express agency agreement between the principal and the commercial agent, thereby avoiding the need to prove apparent or ostensible authority in respect of the agent's actions.

Where the agency contract is for an indefinite period of time, reg 15 allows either party to terminate the agency contract by the giving of notice. The period of notice depends on the length of time the agency contract has run. Thus, unless a longer notice is agreed between the parties, the period of notice will be one month for each year of the contract, up to a maximum of three months at any time after the start of the third year and all subsequent years. It should be noted that these provisions do not contradict the rules that govern notice to terminate contracts of employment, since an employee cannot be a commercial agent. Further, if a longer period of notice is agreed, the period to be given by the principal cannot be shorter than that to be given by the agent (reg 15(3)).

In relation to the rules relating to the termination of the agency contract, reg 16 provides that the above rules do not affect:

> the application of any enactment or rule of law which provides for the immediate termination of the agency contract –
>
> (a) because of the failure of one party to carry out all or part of his obligations under that constraint; or
> (b) where exceptional circumstances arise.

The effect of this provision is that it is still open for a principal summarily to dismiss his commercial agent who is discovered to be taking a secret profit, such as a bribe. Similarly, the provision preserves the effect of the doctrine of frustration.

Compensation for termination of the agency contract

One of the fundamental features of the Commercial Agents (Council Directive) Regulations 1993 is that they provide for an agent to be entitled to compensation for loss suffered as a result of their agency contract being terminated. By reg 17, a commercial agent may claim compensation for damage resulting from termination of the agency contract. Damage is deemed to occur particularly in circumstances which:

> (a) deprive the commercial agent of the commission which proper performance of the agency contract would have procured for him whilst providing his principal with substantial benefits linked to the activities of the commercial agent; [and/or]
> (b) have not enabled the commercial agent to amortize the costs and expenses that he had incurred in the performance of the agency contract on the advice of his principal.

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The agent is entitled to such compensation provided the agency contract has been terminated:

1 by the principal, except as a result of a default by the agent which has justified immediate termination; or

2 by the agent because of circumstances attributable to the principal; or

3 by the agent as a result of their age, illness, infirmity or death.

The right to compensation is lost if the agent does not notify the principal of their intention to claim within one year of the termination of the agency contract (reg 17(9)).

In addition to compensation for damages a commercial agent may also seek an indemnity from the principal. The entitlement to indemnity is provided by reg 17(3)–(5) and arises where the agent:

(a) . . . has brought the principal new customers or has significantly increased the volume of business with existing customers and the principal continues to derive substantial benefits from the business with such customers; and
(b) the payment of this indemnity is equitable having regard to all the circumstances and, in particular, the commission lost by the commercial agent on the business transacted with such customers.

Regulation 17(4) provides that the amount of the indemnity 'shall not exceed a figure equivalent' to an indemnity for one year calculated from the agent's average annual remuneration over the preceding five years and, if the contract goes back less than five years, the calculation shall be based on the annual average for the period in question.

A case that illustrates the application of the compensation procedures is ***Moore* v *Piretta PTA Ltd***.

Moore v *Piretta PTA Ltd* [1999] 1 All ER 174

The defendants (PPL) recruited the plaintiff in 1988 as an agent as part of a sales drive for their fashion garments. Initially the plaintiff signed a one-year contract and was provided with a car. After this there was a series of unsigned contracts entered into by the plaintiff. These contracts were always acted upon by him despite the fact that his sales territory changed, his car was taken away from him, his commission fluctuated and ultimately all expenses had to be borne by himself. Eventually the plaintiff signed a contract in 1994, which was governed by the Commercial Agents (Council Directive) Regulations 1993. On this basis the contract provided for an indemnity on the termination of the contract by virtue of the Regulations. In October 1994 PPL gave notice to the plaintiff that it would be terminating his contract on 2 May 1995. The plaintiff claimed an indemnity on the basis of the Regulations.

It was held that the plaintiff was entitled to an indemnity. The court decided that while reg 18 made provision for the exclusion of an indemnity under reg 17, this did not include the expiry of the term of the agency or contract, nor the expiry and renewal of such a contract. The defendant alleged that the expression 'agency contract' in reg 17(1) meant that the indemnity covered only the period of the present contract. The court rejected this argument and considered that the expression meant simply 'the agency'. This construction accorded with the German law from which the Regulations derived. This being the case the plaintiff was entitled to an indemnity for the whole period of his agency from January 1988 until May 1995. The plaintiff had brought in new customers during this period, and indeed had increased business from existing customers. He was thus entitled to an indemnity

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under reg 17(3)(a) above in that he had 'brought the principal new customers' and had 'increased the volume of business with existing customers'. The court considered that the calculation of the benefit to PPL by the plaintiff was not limited by the Regulations to one year after the termination of the agency contract. Three years later the benefit was calculated at £113,000. The court deducted from this amount, however, any benefits derived from pre-existing business, expenses and accelerated receipts. On this basis it considered that the plaintiff should receive an indemnity of £9,000, albeit that this figure would be capped by the formula in reg 17(4) so that the plaintiff was awarded £66,526 to which interest and VAT would be added. The court stated that the notion of mitigation of loss had no application where the indemnity was to be calculated.

Restraint of trade

By reg 20(1), restraint of trade clauses are allowed so that a commercial agent's right to act as an agent may be restricted once their contract with their present principal is terminated. There are, of course, conditions attached to this provision in that the restraint of trade clause, to be valid, has to be in writing and limited to the geographical area and/or a group of customers and to the kind of goods covered by the agency contract. Furthermore, by reg 20(2) the restraint must not last for more than two years after the termination of the agency contract.

For more on restraint of trade clauses refer to Chapter 12.

A rather more subtle means of controlling restraint of trade claims may be found in reg 20(3) which provides that other enactments and rules of law are preserved. Presumably, therefore, the common law requirement of reasonableness would also have to be satisfied in relation to the application of reg 20 in England and Wales.

Exclusive distributorship agreements

It can be seen that the Commercial Agents (Council Directive) Regulations 1993 profoundly affect commercial agency contracts to the extent that principals will no doubt, on assessing the impact of the Regulations, consider redrafting their present contracts. Many principals have reconsidered their use of commercial agency contracts and moved towards using employees as representatives or have adopted a franchise system for distributing goods to customers.

Many principals have moved towards adopting distributorship agreements, in which one party (the distributor) buys goods from a supplier in order to resell them to its own customers. There are thus two contracts: one between the supplier and the distributor and another between the distributor and the customer. Such arrangements have the advantage that they are regulated by the usual rules of contract and do not fall within the law of agency, and thus the distributor is not paid a commission but derives a profit in the mark-up between the buying and selling price of the goods. A further advantage that is not easily discernible is that where, in an agency agreement, a principal employs an agent to act on their behalf outside the United Kingdom but in other countries within the EU, the principal will have to account for VAT in the state where the agent conducts their business. This is not the case with distributorship agreements since here the VAT is the distributor's responsibility rather than the supplier's.

In assessing whether to enter into a distributorship agreement rather than an agency contract, a supplier needs to take many factors into account, apart from those already indicated. Thus the size and nature of the supplier's business will be an important consideration, since a small company may not have the means to monitor an agency

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contract effectively given the Regulations already discussed. The fact that the activities of an agent will bind their principal is also an important factor if the supplier is operating in an area where their knowledge of trading conditions is limited or non-existent. In these situations it may be better for the supplier to enter into a distributorship agreement. On the other hand, if the supplier wishes to retain control of the sales and distribution process where, for instance, the supplier is a manufacturer of goods that are custom-built for the eventual customer, then an agency contract may be more appropriate.

It should be noted that distributorship agreements can take various forms. Thus, for example, a sole or exclusive distributorship agreement would arise where a particular distributor has exclusive rights of distribution within a particular geographical area. It is, of course, also possible for a supplier to limit the operations of the distributor by restricting sales to customers who meet the supplier's specifications.

Summary

- A third party (the agent) can act on behalf of another (the principal).

The creation of the agency relationship

Agency by agreement

- Where an agency arises out of an agreement between the principal and the agent.
- The *actual* authority may be either *express* or *implied*.

Express authority

Can be verbal or written.

- Is created where *P* and *A* expressly agree that *A* should have authority.

Implied authority

- Generally:
  - Agency may arise from the conduct or relationship of the parties.
  - Implied authority arises out of an express authority.
  - The agent will have implied authority to carry out such acts as are ordinarily incidental to the performance of his duties under the express authority (***Mullens* v *Miller***).
- Incidental authority:
  - Created by implying an agent's authority from a particular trade usage or custom found in a particular marketplace.
  - An agent can perform such acts as are consistent with the trade usage or custom prevailing, provided that they are reasonable.

Apparent authority

Generally

- Also known as 'ostensible' authority, as well as 'usual' authority.
- Forms an application of the doctrine of estoppel.
- It arises where a principal, whether by words or conduct, creates an implication that the agent is entitled to act on his, the principal's, behalf when in fact no such authority actually exists.

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- An agent acting within this apparent authority will bind his principal to a third party despite the fact that he has no actual authority to do so.
- Where the principal having 'held the agent out' as having authority is estopped from denying this authority in order to avoid liability to a third party (***Spiro* v *Lintern***).

The criteria needed for establishing apparent authority

- According to ***Rama Corporation* v *Proved Tin and General Investments Ltd*** the criteria for establishing apparent authority by estoppel: (1) representation, (2) a reliance on that representation and (3) an alteration of his position resulting from such reliance.

Usual authority

- Definition in judgments is uncertain due to the inconsistent use of the expression.
- Term can mean implied actual authority or apparent authority.
- Limitation to usual authority: its existence depends on the class or character of the agent and on the common understanding within the particular trade to which he belongs concerning the authority of agents (***Daun* v *Simmins***).

Agency of necessity

- Agency is conferred in urgent situations when it is necessary for an individual to act without the principal granting them the authority.
- ***Couturier* v *Hastie***.
- ***Great Northern Railway Co.* v *Swaffield***.

Presumed agency

- Arises out of cohabitation – a wife is presumed to have the authority of her husband to pledge his credit for the necessary household items needed to maintain their station in life.

Ratification

- If the agent enters into a contract without authority the principal may decide to ratify the contract and adopt it.
- On ratification the principal will be bound whether the act of the agent is detrimental or beneficial to him and whether the liability arises in contract or in tort.

The effects of agency

The effects as between the principal and the third party

Where the principal is disclosed

Where the principal is undisclosed

The effects as between the principal and the agent

The duties owed by the agent to the principal

- The relationship of the agent to the principal is a fiduciary one.
- The nature of the fiduciary relationship is wide and encompasses a range of duties within it. Thus, for instance, it is a duty of the agent not to subdelegate his authority

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to another person – *delegatus non potest delegare*. The agent has a duty to act for his principal personally unless given the authority by the principal to subdelegate.

- An agent must not put himself in a position where his own interests conflict with the duties he owes to his principal.
- The agent will have to account for any profits made by virtue of confidential information that comes his way because of his position as agent – ***Boardman* v *Phipps*** [1967] 2 AC 46.
- Apart from duties which are clearly of a fiduciary nature there are other duties relating to the exercise of one's duty as an agent. An agent must, for instance, carry out his principal's lawful instructions and must do so with reasonable care and skill.
- The lack of a contract between the agent and the principal does not prevent the existence of such a duty.
- In the absence of a contract, a principal can rely on such a duty being imposed in tort, although the standard of care here is likely to be lower than would be imposed in a contract where the agent professes a special skill.

The duties owed by the principal to the agent

- The duties owed by the principal to the agent largely revolve around the recovery of remuneration from the principal in respect of commission or expenses incurred by the agent by virtue of acting within his office. The main duties are:
  1. The duty to remunerate the agent for his services.
  2. The duty to indemnify the agent for his services.
  3. The agent's lien over the principal's property.
  4. The agent's right of stoppage *in transitu*.

The effects as between the agent and the third party

The liability of the agent

- Where the principal is undisclosed.
- Where the agent contracts in a personal capacity.
- Liability for unauthorised acts: if the agent purports to act for a principal but without having authority to do so, the third party may bring an action against him for damages on one of three grounds:
  1. negligent misstatement;
  2. the tort of deceit;
  3. breach of warranty of authority.

The termination of the agency

- The agency relationship may be terminated either by the actions of the parties themselves or by operation of law. It should be noted that in certain circumstances the agency relationship is irrevocable.

The effect of European law on the agency relationship

- The Commercial Agents (Council Directive) Regulations 1993 came into force on 1 January 1994 and made significant changes to the law of agency as it applies to self-employed commercial agents.

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Further reading

Beale, Bishop and Furmston, *Contract – Cases and Materials*, 4th edn (Butterworths, 2001)

Beatson, *Anson's Law of Contract*, 28th edn (Oxford University Press, 2002)

Furmston, *Cheshire, Fifoot and Furmston's Law of Contract*, 15th edn (Oxford University Press, 2006)

Treitel, *The Law of Contract*, 11th edn (Sweet & Maxwell, 2003)

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21 Assignment of contractual rights

Aims and objectives

After reading this chapter you should be able to:

- Know how contractual rights may be assigned both at common law and equity.
- Know the requirements needed for an equitable assignment of contractual rights.
- Understand the principles applicable for a statutory assignment of contractual rights under the Law of Property Act 1925.
- Know some of the other factors that apply to the assignment of contractual rights, such as rights which are not assignable and issues relating to the assignment of liabilities.

Introduction

Assignment is a method by which a party to a contract transfers the benefits they have contracted to receive from the other party to a third party, who is themself able to enforce performance of the contract. There is no question of this situation breaking the privity of contract rule as discussed in Chapter 19 since a party is actually assigning their position to enforce the contract to the third party, the contract thus remaining essentially bilateral in character.

The right to enforce a contract is in fact a form of intangible property known generically as a 'chose in action', an expression which also encompasses property such as copyrights, patents, trade marks and actions in tort. It should be noted that the benefit assigned to the third party is not the material benefits that may result from the contract, but the right to enforce the contract. It should always be remembered that a contract is useless if it cannot be enforced and it is the fact of enforcement that produces the benefits from the contract. Thus the right to enforce the contract is a chose in action, since it is an intangible form of property that gives rights of action that may be claimed or enforced without the need for taking physical possession of the material benefits arising out of the contract.

This chapter will be concerned with the means by which this chose in action can be transferred voluntarily to another person. It is possible for involuntary assignment to take place either where a party to a contract dies or where they are declared bankrupt. In the case of death the contract survives both against and for the benefit of the estate, thus

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allowing the personal representatives of the deceased to sue or be sued on any contracts entered into by the deceased prior to their death, with the exception, of course, of those requiring personal services. In bankruptcy a person who is adjudicated bankrupt has all their property vested in the trustee in bankruptcy. This property will also include any rights possessed by the bankrupt by virtue of any contract entered into by them. The effect is that if the trustee considers that the estate of the bankrupt may benefit from the contract being enforced the trustee may take steps on behalf of the estate to enforce it. The ability of the trustee to enforce the contract varies, however, where the contract involves personal services since if there is a breach of contract after the commencement of the bankruptcy, the right to enforce the contract remains with the bankrupt. The trustee nevertheless has a subsequent power to intervene and take any moneys recovered by the bankrupt which are not required for the maintenance of the bankrupt. Where the breach occurs before the bankruptcy proceedings the right to take action passes to the trustee, though this will not apply to actions in respect of the reputation or character of the bankrupt, despite the fact that such action might arise out of a breach of contract.

Voluntary assignment at common law

At common law the general principle was that choses in action could not be assigned, with the exception of those involving the Crown and the assignments of negotiable instruments. The assignment of negotiable instruments, sometimes referred to as '**negotiability**', is an important exception which is virtually a subject in its own right, so discussion of it will be left for consideration elsewhere, in a more specialised mercantile law environment. The undoubted reason for the attitude of the common law courts was the desire to preserve the privity of contract rule which they feared would be undermined if the ability of the parties to assign their rights under a contract became widespread. It should be borne in mind that while the third party assignee could not enforce the contract against the promisor at common law, there was, nevertheless, a binding contract between the assignee and the assignor. The result of this was that the assignee could sue the assignor for breach of contract.

Despite the general rule of the common law not to allow assignment there were means of avoiding the rule so that the right to enforce a contract could be undertaken by a third party.

First, the promisee could always allow the third party to sue in the promisee's name. Usually the promisee would insist that the third party agree to indemnify the promisee against the legal costs of maintaining the action against the promisor.

Second, the promisee could give the third party a power of attorney, the effect of which would be to allow them to maintain the action as a representative of the promisee. This method was not particularly satisfactory for the third party since, just as in the case of the first exception above, it could be revoked by the promisee at any time and in any event it would end automatically on the death of the promisee. The rights of the third party were thus not guaranteed.

Third, it was possible for rights to be acquired by the third party by a process called '**novation**'. Novation is basically a contract entered into between the promisee, the promisor and the third party whereby the benefits of the contract would henceforth be owed by the promisor to the third party. Realistically this is not an assignment since the enforcement of the contract by the third party is based on the existence of a new contract between themself and the promisor and thus they would have to provide consideration

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in order that the second contract be enforceable. This exception is subject to the disadvantage that the consent of the promisor would always be required for the novation to work.

In truth, none of the methods discussed is a true assignment but merely a transaction which has the same effect as an assignment.

Voluntary assignment in equity

The problem of assignment at common law led to the development of a doctrine in equity which would permit the assignment of a chose in action whether or not it was in the nature of a legal or equitable chose. The means by which the assignment was accomplished and whether it could be enforced in the assignee's own name differed, however, according to whether the chose was equitable or legal and whether or not it was an absolute assignment.

The legal and equitable nature of the chose in action

Prior to the Judicature Acts 1873–75 a legal chose was one which could be enforced by action in law within the common law courts; for example, a debt due under a contract. Equity would recognise an assignment of a legal chose but was faced with a difficult predicament in that, while it would allow the assignee to succeed against the promisor, it had no jurisdiction to prevent the assignor from subsequently claiming from the promisor a second time. If the assignor undertook such an action then the promisor would himself have to present an action before the court of chancery in order to prevent the second recovery. Equity sidestepped this predicament by compelling the assignor, on the petition of the assignee, to sue in their own name, or at least lend their name to the assignee, the result of which was to have all the interests of the various parties decided by the same court.

If the chose in question was an equitable one then the matter was somewhat simpler since the court of chancery enjoyed sole jurisdiction over the matter. Here the assignee could bring the action in their own name and was not required even to make the assignor a party to the action. The reason for this was that there was no claim capable of being asserted at law. This situation might arise because the parties never intended that legal rights would exist as in, for instance, rights arising under a trust. Alternatively, the equitable chose might arise out of informality, where the parties have failed to comply with a formality required by the common law; for instance, they might have failed to use a deed or been parties to an ineffective deed. Lastly, the equitable chose might have arisen because the parties themselves possessed only equitable rights, in which case it would be impossible to carve a legal assignment out of an equitable interest.

With the passing of the Judicature Acts the above anachronism cried out for abolition. The main point of the legislation was to fuse the operation of equity and common law into a single system of courts and it was clearly incompatible to have the common law and equitable rules relating to equitable and legal choses being administered within the same courts. Section 25(6) of the Judicature Act 1873 provided for a new statutory form of assignment that would take effect in law. This statutory form of assignment will be considered later but it should be noted that it did not abolish assignment of choses in action in equity, which could and can still be fallen back on if the conditions required for a statutory assignment are not complied with.

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Whether or not the assignment is absolute

Absolute assignment

An absolute assignment occurs where the assignor has assigned their entire interest in the chose in action to the assignee. This is not to say that the assignor must have completely relinquished all further interest in the subject matter of the chose. Thus it was held in ***Hughes* v *Pump House Hotel Co*.** [1902] 2 KB 190 that an assignment of moneys due under various contracts as security for an overdraft was nevertheless unconditional and absolute, despite the fact that the assignor's rights to the debts owing to them were capable of being reassigned to them when the overdraft facility was no longer required. The fact that the right to reassignment is express or implied has no effect on the absolute nature of the assignment.

Non-absolute assignment

If the assignor reserves certain rights in the chose in action in spite of the assignment then the assignment is said to be non-absolute. This may occur in three circumstances:

1 where the assignee decides not to transfer the entire chose in action;
2 where the assignment is by way of a charge;
3 where the commencement or the cessation of the assignment is conditional upon an uncertain future event.

The assignee may decide *not to transfer the entire chose in action*, if, for instance, the assignor decides to transfer only part of their rights in a debt owing to them under a contract.

An assignment may be by way of a *charge*. Unlike a mortgage, which transfers an entire fund to the assignee, a charge only entitles the assignee to a payment out of the fund.

Jones v *Humphreys* [1902] 1 KB 10

In this case a schoolmaster, in consideration for a loan of £15, assigned such part of his income and salary as was necessary to discharge the loan, together with interest, or any further sums for which he might in the future become indebted to the plaintiff. It was held that this was not an absolute assignment of the schoolmaster's salary since it was only mere security that enabled the lender to have recourse to the salary should the state of indebtedness render this desirable. The assignment merely amounted to a charge on the salary and was thus not absolute.

The assignment will not be absolute where *its commencement or cessation is conditional upon an uncertain future event.*

Durham Brothers v *Robertson* [1898] 1 QB 765

A firm of building contractors executed an assignment which read:

> Re Building Contract, South Lambert Road. In consideration of money advanced from time to time we hereby charge the sum of £1,080, being the price . . . due to us from John Robertson in completion of the above buildings as security for the advances, and we hereby assign our interest in the above-mentioned sum until the money with added interest be repaid to you.

It was held that this assignment was not absolute but conditional. There was no question of the whole of the debt being assigned to the plaintiffs unconditionally but only such a sum as was necessary to discharge the advances made, together with interest.

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Beatson, *Anson's Law of Contract*, seems to suggest that one method of testing whether or not the assignment is conditional is by having reference to the state of knowledge of the promisor. If they cannot be sure whether they are paying their debt to the right person or not without knowing of the state of the accounts between the assignor and the assignee, then the assignment will be conditional and not absolute. If, however, as in ***Hughes* v *Pump House Hotel Co.***, the assignment passes the entire interest as security and there is a proviso for reassignment when the loan is repaid, the promisor knows to whom he is to pay his debt. The reason for this is that he will be given notice of the assignment and later, when the loan is repaid, he will be given notice of the reassignment, and the assignment will thus be absolute.

The requirements of an equitable assignment

1. Joinder of the assignor in an action by the assignee

Before discussing this requirement in detail we should note that an equitable assignment merely assigns the equitable title to the assignee. The result of this is that generally the assignee must join the assignor as a party to the action to enforce the chose in action against the promisor. The requirement of joinder, however, differs according to whether the chose in action is legal or equitable and whether it is absolute or non-absolute, as the following classification indicates:

1 the absolute equitable assignment of an equitable chose in action;
2 the non-absolute equitable assignment of an equitable chose in action;
3 the equitable assignment of a legal chose in action.

When there is an *absolute equitable assignment of an equitable chose in action*, the action is one which formerly could be dealt with exclusively within the court of chancery, so there is no need for the assignee to join the assignor in the action. The assignee can sue in their own name.

In a *non-absolute equitable assignment of an equitable chose in action*, as we have already seen, the assignor retains some interest in the chose in action. The consequence of this is that a court, in deciding the action between the assignee and the promisor, would not be able to make any adjudication of the rights and liabilities of the parties without having reference to the state of the accounts between the assignee and the assignor. The result is that the assignee must join the assignor into their action so that the court can come to a decision that will bind all the parties that are interested in the chose in action.

In an *equitable assignment of a legal chose in action*, whether the assignment is absolute or non-absolute, the assignee must in all cases join the assignor into their action. If the assignor refuses to allow this then the assignee can sue the assignor as a joint co-defendant. It should also be noted that these rules also apply if the assignor is attempting to recover the balance of the moneys owing to them by the promisor – the assignor must join the assignee into their action or treat the assignee as a co-defendant. The existence of these rules arose out of the procedural difficulties that occurred prior to the passing of the Judicature Act 1873, as already described above. Some authorities suggest other reasons but these are not particularly convincing.

2. The form of the assignment

Since equity looks to the intent and not to the form then generally no particular form is required to give effect to an equitable assignment. This statement is, however, somewhat

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simplistic since statutory regulation has overlaid this basic premise. The requirements as to form differ:

1 where there is an equitable assignment of a legal chose in action of personalty;
2 where there is an equitable assignment of an equitable interest;
3 according to the terms laid down in the Law of Property (Miscellaneous Provisions) Act 1989, s 2(1).

Where there is an *equitable assignment of a legal chose in action of personalty*, the basic premise still presides, in that no particular form is required, and it is thus possible for such an assignment to take place orally. In ***Thomas*** v ***Harris*** [1947] 1 All ER 444 certain life assurance policies were handed by a father to his son, and at the same time it was requested that the proceeds that arose on his death be used to buy a tombstone for his grave. This was held to be effective as a valid assignment despite the fact that no notice of the assignment was given to the insurance company.

It should be noted that it is always possible for the contract itself to provide that any assignment must comply with a certain formality such as writing.

An *equitable assignment of an equitable interest* is void unless it complies with s 53(1)(c) of the Law of Property Act 1925. This provides:

> [A] disposition of an equitable interest or trust subsisting at the time of the disposition must be in writing signed by the person disposing of the same, or by his agent thereunto lawfully authorised by writing or by will.

It should be noted that this provision covers equitable choses in action comprising both personalty and land.

The Law of Property (Miscellaneous Provisions) Act 1989, s 2(1) provides:

> A contract for the sale or other disposition of an interest in land can only be made in writing and only by incorporating all the terms which the parties have expressly agreed in the document or, where contracts are exchanged, in each.

The full extent of the effect of this provision has yet to be decided; suffice it to say that failure to comply with the provision will render the assignment void. It can be seen that the provision is almost analogous to s 53(1)(c) of the Law of Property Act 1925 above and there should be no difference between the two provisions as they affect an equitable assignment of an equitable chose in action of land. It is suggested, however, that s 2(1) will now require an equitable assignment of a legal chose in action of land to be in writing.

Despite the fact that certain types of equitable assignment are required to be in writing there is no requirement as to the form of that writing. The writing itself need not be expressed to be an assignment. In ***William Brandt's Sons & Co.*** v ***Dunlop Rubber Co.*** [1905] AC 454, Lord MacNaghten stated:

> An equitable assignment does not always take that form. It may be addressed to the debtor. It may be couched in the language of a command. It may be a courteous request. It may assume the form of mere permission. The language is immaterial if the meaning is plain. All that is necessary is that the debtor should be given to understand that the debt has been made over by the creditor to some third person.

It can be seen from the above that the writing encompassing the assignment can be directed to either the debtor (promisor) or the assignee.

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3. Notice

Notice may be either to the assignee or to the promisor (debtor).

An assignment is ineffective unless the assignor or someone acting on their authority has *communicated it to the assignee*. It is not certain why this requirement is particularly necessary since it was stated in ***Standing* v *Bowring*** (1885) 31 ChD 282 that a person can have property assigned to them without their knowledge, although this is subject to an implied right to repudiate the assignment when they gain knowledge of it.

The basic rule in *notice to the promisor (debtor)* is that notice of an equitable assignment to the debtor is not required to perfect the title. There are, however, sound reasons why such notice should nevertheless be given to the debtor.

First, should the debtor make any payments to the assignor in ignorance of the assignment, the assignee will nevertheless be bound with respect to those payments. The assignee will not, for instance, be able to recoup from the debtor any moneys lost by reason of the assignor absconding with moneys paid to the assignor by the debtor in ignorance of the assignment.

Second, by virtue of the rule in ***Dearle* v *Hall*** (1828) 3 Russ 1, an assignee should give notice to the debtor in order to preserve their rights of priority over any competing assignees that might exist. Failure to give notice will mean that an assignee will lose priority to another later assignee who has given notice to the debtor.

The form of the notice, as already stated, is largely irrelevant, except that in ***The Balder London*** [1980] 2 Lloyd's Rep 489 it was stated that the notice must clearly and unconditionally direct the debtor to pay or transfer the benefits under the contract to the third party as an assignee, rather than in some other capacity such as, for example, an agent for the promisee/creditor. If the notice does direct the debtor to pay the moneys to a third party as an agent of the promisee/creditor then the debtor will not be liable to the assignee should they pay the money to the promisee/creditor.

4. Consideration

The question of whether consideration is needed for an effective equitable assignment is universally accepted as one of great difficulty. It should be noted that this is not an issue that may be raised by the debtor/promisee since they are bound to pay the debt or transfer the benefits under the contract whether or not the assignment is gratuitous. All the debtor/promisee is concerned with is to whom they must pay the debt, and so on, in order to avoid becoming liable a second time for the same obligation.

The problem we are then faced with is whether, as between the assignor and the assignee, there is a need for the equitable assignment to be supported by consideration. The basic premise of equity is summed up in the maxim, 'equity will not assist a volunteer', but this is too wide since consideration is not an essential requirement in all situations. Before we consider voluntary assignments it should be stated that no problems arise where the assignment is supported by consideration, since on basic contractual rules the assignment is enforceable by and against the assignor and the assignee. Where the equitable assignment is voluntary the solution largely depends on whether the transfer is 'complete and perfect' or not, as the case may be.

To render a transfer 'complete and perfect' everything that needs to be done to effect the transfer or assignment must have been done. Thus, just as to render a gift of a chose in possession (that is, tangible property) complete, the actual property must be handed over to the donee, so that nothing remains to be done to give effect to the donor's intention, so the same is also true in the case of a voluntary equitable assignment of a

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chose in action. In the latter case all the formalities to give effect to the assignment of the chose in action from the assignor to the assignee must have been carried out. Failure to make the voluntary assignment complete and perfect will render the assignment invalid since 'equity will not perfect an imperfect gift'. In ***Milroy* v *Lord*** (1862) 4 De GF & J 264 Lord Turner expounded the principle in the analogous situation of voluntary settlements as follows:

> In order to make a voluntary settlement valid and effectual, the settlor must have done everything, which according to the nature of the property comprised in the settlement, was necessary to be done in order to transfer the property and render the settlement binding upon him.

The effect of the above on the various types of voluntary equitable assignments differs according to whether they are:

1 an agreement to assign a chose in action;

2 assignments of an equitable chose in action;

3 assignments of a legal chose in action.

An *agreement to assign a chose in action* relates to a future arrangement and clearly this is not capable of being 'completed and perfected' until the time of execution of the assignment arises. Such agreements then must be supported by consideration. The same is also true of an assignment of a future chose in action, since it was held in ***Glegg* v *Bromley*** [1912] 3 KB 474 by Parker J that 'nothing passes even in equity until the property comes into existence'. Consideration is thus required in respect of an assignment of such an interest.

In *assignments of an equitable chose in action*, if the assignor has done everything in their power to effect the transfer of the equitable chose in action to the assignee then the voluntary assignment will be valid. At that point the assignee is in a position to enforce their right to the chose in action since, as was stated in ***Voyle* v *Hughes*** (1854) 2 SM & G 18, 'an assignment without any valuable consideration is not a mere agreement but is an actual transfer of the equitable right'.

Assignments of a legal chose in action pose the particular problem of whether a voluntary equitable assignment of a legal chose in action can ever be 'complete and perfect'. The position here formerly was not clear since such choses in action had to be enforced within the common law courts by the assignee seeking the help of equity to compel the assignor to allow the assignee to sue in the assignor's name. Since collaboration of the assignor was needed to enforce the chose in action, the equitable assignment could not be said to be 'completed and perfected' and therefore consideration was required. Since the procedure now is that the assignee can simply add the assignor as a co-defendant if they refuse to collaborate with the assignee in allowing them to sue in the assignor's name, it would seem that the absolute assignment of a legal chose in action is valid despite the lack of consideration.

Statutory assignment

Generally

It was stated earlier that s 25(6) of the Judicature Act 1873 introduced a general form of statutory assignment. This form of assignment is now contained in s 136(1) of the Law of Property Act 1925. This provides:

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> Any absolute assignment by writing under the hand of the assignor (not purporting to be by way of charge only) of any debt or other legal thing in action, of which express notice in writing has been given to the debtor, trustee or other person from whom the assignor would have been entitled to claim such debt or thing in action, is effectual in law (subject to equities having priority over the right of the assignee) to pass and transfer from the date of such notice:
>
> (a) the legal right to such debt or thing in action;
> (b) all legal and other remedies for the same; and
> (c) the power to give a good discharge for the same without the concurrence of the assignor.

It should be noted that s 136 has not abolished equitable assignments and these will continue to exist where an assignment does not comply with the requirements of s 136. In truth all the provision has done is to allow the rights of the assignee to be exercised in a more direct manner so that they can sue in their own name without the need for joinder of the assignor arising, as stated in ***Tolhurst* v *Associated Portland Cement Manufacturers (1900) Ltd*** [1903] AC 414.

Care must be taken in construing the words 'any debt or other legal thing in action' in s 136(1). At first sight this appears to confine the statutory form of assignment to legal choses in action, that is, those choses in action which were formerly only enforceable within the common law courts. This provision has, however, been interpreted by the courts as including equitable, as well as legal, choses in action.

The provision does not require consideration to have been provided by the assignee in order to allow them to sue in their own name.

The essentials of a valid statutory assignment

The assignment must be absolute

The difference between absolute and non-absolute assignments has already been considered. If the assignment is conditional and non-absolute then the parties will have to fall back on the use of an equitable assignment for the assignment to be valid.

The assignment must be in writing

While the assignment must be in writing and signed by the assignor, there are no provisions as to the contents, though clearly the writing must inform the debtor to pay or hand the benefit of the contract to the assignee, as an assignee and not merely as an agent of the assignor. Apparently if the date or the amount of a debt which is the subject of an assignment is incorrectly stated, then the assignment will be invalid. It would seem that the main point is that the terms of the assignment must be stated with a sufficient degree of certainty.

Notice of the assignment must be given to the debtor/promisor

It was held in ***Holt* v *Heatherfield Trust Ltd*** [1942] 2 KB 1 that notice takes effect when it is received by the debtor/promisor. The postal rules, for instance, have no application here.

Other factors affecting all types of assignment

Priority of assignments

The problem that arises here occurs where an assignor decides to make two or more assignments of the same chose in action to two or more assignees. This in itself presents

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no difficulty, but if it transpires that moneys owed under the chose in action by the debtor are insufficient to meet the respective claims of the various assignees then the question of priority will arise.

The ranking of priority is determined by the rule in ***Dearle* v *Hall*** (1828) 3 Russ 1 which provides that assignees will rank in accordance with the dates on which notice of their respective assignments was given to the debtor. Thus an assignee who fails to give notice to the debtor will lose their priority to a subsequent assignee who, having no knowledge of the first assignee's interest, gives notice to the debtor prior to the first assignee.

The notice may be made orally unless the interest that is being assigned is an equitable interest in either land or personalty when s 137(3) of the Law of Property Act 1925 requires the notice to be in writing.

Where the interest to be assigned is an equitable interest under a trust fund then the assignee should give notice to all the trustees of the trust, though this is not a mandatory requirement.

Assignees take 'subject to equities'

When an assignee takes the assignment of the benefits of the contract from the assignor they also take the risk of any defences that may be available to the debtor/promisor against the assignor should the assignee have to take action against the debtor/assignor. The assignee is thus said to take the assignment 'subject to the equities' of the debtor/promisor.

The expression 'subject to equities' needs careful consideration since it is not confined solely to equitable remedies that may be available to the debtor. It will include common law remedies, so that any damages accruing to the debtor by virtue of a counter-claim may be set off against the assignee, provided they arise out of the contract which is the subject of the assignment, as stated in ***Newfoundland Government* v *Newfoundland Railway Co.*** (1888) 13 App Cas 199. Further, the debtor is entitled to make use of any rights arising out of mistake, misrepresentation or breach of contract perpetrated by the assignor.

With regard to the latter point also, some care needs to be exercised since the debtor cannot raise against the assignee any personal claims they may have against the assignor. This problem is particularly prevalent in claims of fraud that may have accrued against the assignor by the debtor. The problem is well illustrated by the following case.

Stoddart v *Union Trust* [1912] 1 KB 181

The Union Trust was induced into a contract to buy a newspaper by the fraudulent misrepresentation of a person named Price. The purchase price was £1,000, of which £200 was payable immediately and the rest by instalments. Price assigned the £800 debt to Stoddart who took it without knowledge of the fraudulent actions of Price. The Union Trust were subsequently sued by Stoddart for the moneys owing, but they counter-claimed for damages exceeding the £800 on the basis of the fraud that had been perpetrated on them by Price. They therefore claimed that they owed Stoddart nothing. It was held by the Court of Appeal that they could not owe Stoddart nothing since the claim represented a personal claim against Price and did not arise out of the contract being enforced by Stoddart. An anomaly occurs here since Stoddart was then in a better position than Price would have been under the same contract and this is clearly to the detriment of the debtor, the Union Trust. It may be that the Union Trust should have sought the rescission of the contract rather than merely damages, since this action would tend to strike at the existence of the contract itself rather than at the more personal liability of the assignor to pay damages.

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Where the equities accruing to the debtor arise out of a separate contract or transaction from the contract that is the subject of the assignment, the debtor cannot set off those equities against the assignee. The only exception to this is if the independent claim accrued before the debtor had notice of the assignment to the assignee. It can therefore be seen that the serving of notice of the assignment by the assignee to the debtor is particularly important in this context and certainly, in order to prevent the debtor setting up fresh equities against the rights of the assignee, as indicated in ***Roxburghe* v *Cox*** (1881) 17 ChD 520, should not be delayed.

It can be seen from the above rules that great care needs to be exercised by the assignee when they decide to accept an assignment from the assignor, since the assignee could be acquiring an interest in a chose which is far less valuable than it appears on the face of things. Thorough investigation of the circumstances in which the chose in action arose is highly desirable.

Rights which are non-assignable

Express exclusion of assignability

The contract entered into by the original parties may expressly provide that the contract is not capable of being assigned. Any subsequent assignment is invalid as it affects the debtor, though it is effective between the assignor and the assignee. In ***Linden Gardens Trust Ltd* v *Lenesta Sludge Disposals Ltd; St Martin's Property Corporation Ltd* v *Sir Robert McAlpine*** [1994] 1 AC 85, it was argued that an express provision prohibiting an assignment of property rights was contrary to public policy, since it rendered those rights inalienable, a principle that lies at the heart of English property law. It was then argued that contractual rights are themselves a form of property. Putting the two arguments together then produces the result that contractual exclusion of this right to assign one's contractual rights is per se unlawful. This was rejected by the House of Lords since there may be several reasons why this right to assign may need to be excluded, as one can see below.

Rights of action

A right to sue for damages, sometimes described as a 'bare right of action' cannot be assigned since this is contrary to the rules relating to champerty and maintenance. While this principle has been affirmed in the case of ***Trendtex Trading Corporation* v *Crédit Suisse*** [1982] AC 679, the House of Lords declared that such a right may be assignable where the assignee has a genuine legitimate interest of a financial or commercial nature in taking the assignment and subsequently enforcing the right in question. An example would be where the purchaser of land is able to sue the vendor's tenants for any breach of covenant that had arisen prior to the sale. These rights of the purchaser of the reversion of the lease are now contained in s 141 of the Law of Property Act 1925, though here the right to sue the tenants only extends to the situation where there has been a breach of a covenant that 'has reference to the subject matter of the lease', that is, the covenants affect the landlord qua landlord and the tenant qua tenant rather than merely being personal in nature.

Personal contracts

If the contract involves the use of a personal skill or confidence then the parties can insist on the contract being performed personally by the other party. The reason for this is that the personal performance forms the essence of the contract and to allow assignment would be to alter the very nature of the contract itself without the consent of the other party. In ***Griffith* v *Tower Publishing Co. Ltd*** [1897] 1 Ch 21 it was held that a contract

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by an author to write a book for a publisher amounted to a personal contract so that the author could restrain the publisher from assigning the contract to another. The logic here is that the author entered into the contract with the publisher on the basis of the latter's skill and judgment in that capacity.

Public policy

As we saw in Chapter 12, the law does not allow a public servant to assign their salary (***Wells*** **v** ***Foster*** (1841) 8 M & W 149) and similarly it does not allow a wife to assign her rights to maintenance on grounds of public policy (***Re Robinson*** (1884) 27 ChD 160).

Assignment of liabilities

The general rule is that it is only the benefits of a contract that are assignable, not the burdens, unless the consent of the promisee is first obtained. The reasoning here is that it should not be possible to compel the promisee to accept performance of the contract from someone other than the promisor. It is nevertheless possible to achieve this position by novation since this results in the original contract being rescinded with the mutual agreement of the promisor and promisee, and a new one being substituted between the original promisor and the new promisee.

Summary

- Assignment is a method by which a party to a contract transfers the benefits he has contracted to receive from the other party to a third party, who is himself able to enforce performance of the contract.
- The right to enforce a contract is in fact a form of intangible property known generically as a 'chose in action'.

Voluntary assignment at common law

- A chose in action could not be assigned.
- The assignment of negotiable instruments, sometimes referred to as 'negotiability'.
- Ways to avoid the rule and allow the right to enforce a contract by having a transaction that has the same effect as an assignment:
  (i) the promisee could always allow the third party to sue in his name;
  (ii) the promisee could give the third party a power of attorney;
  (iii) third party acquires rights by a novation.

Voluntary assignment in equity

- Equity permits the assignment of a chose in action whether or not it was in the nature of a legal or equitable chose.

The requirements of an equitable assignment

Joinder of the assignor in an action by the assignee

- An equitable assignment merely assigns the equitable title to the assignee.
- Joinder requirements differ according to whether the chose in action is legal or equitable and whether it is absolute or non-absolute.

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The form of the assignment

- Originally – no particular form is required to give effect to an equitable assignment.
- Statutory requirements as to form have now overlaid this position in certain cases – LPA 1925, s 53(1)c.

Consideration

- No problems arise where the assignment is supported by consideration since on basic contractual rules the assignment is enforceable by and against the assignor and the assignee.
- Where the equitable assignment is voluntary the solution largely depends on whether the transfer is 'complete and perfect' or not, as the case may be.

Statutory assignment

Generally

- Law of Property Act 1925, s 136(1) now stipulates the statutory form of assignment.
- Section 136 has not abolished equitable assignments and these will continue to exist where an assignment does not comply with the requirements of s 136.

The essentials of a valid statutory assignment

Other factors affecting all types of assignment

Rights which are non-assignable

Further reading

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Glossary

ab initio From the beginning.

abrogate To repeal, annul, cancel, abolish (generally by formal action).

acceptance Acceptance of an offer to create a contract (i.e. an assent to all the terms of the offer) must be unqualified, and may be by words or conduct. It must generally be communicated to the offeror and must conform with the prescribed or indicated terms of the offer.

accord and satisfaction Occurs where, following the conclusion of a contract, one party obtains his release from his obligation under the contract by promising or giving consideration other than that which the other party has to accept under the contract. The new agreement is the 'accord'; the consideration is the satisfaction.

account, action for An action whereby a court can investigate sums due from one party to another resulting from transactions between parties, e.g. as between principal and agent.

adhesion contracts *See* **standard-form contracts**.

affirmation To declare expressly or impliedly with full knowledge of the facts an intention to proceed with a contract. Lapse of time may be evidence of affirmation.

anticipatory breach Term referring to the repudiation of a contract before the time for performance. The other party may immediately treat the contract as though it were discharged and sue for damages.

apparent authority *See* **ostensible authority**.

auction sales A public sale of property by an auctioneer to the highest bidder. An *auctioneer* is one who is licensed to conduct sales by auction. A contract comes into existence as the result of an auctioneer's acts, when a bid is accepted and his hammer falls (or in other customary manner) and a bidder may retract his bid until that event.

bilateral discharge Applies to executory contracts. Discharge may take the form of: extinction of the contract; extinction and substitution of a new agreement; partial dissolution of the contract, e.g. by modification of terms.

capacity The legal competence, power or fitness to enter and be bound by a contract. Thus, an infant generally lacks contractual capacity, save where he binds himself by contract for necessaries or for other matters relating to his benefit.

cartel An association of independent enterprises, possibly companies or other business organisations, that is created to monopolise the production or distribution of goods or services.

causation The relationship of cause and effect. Thus an injured party cannot recover for all loss since a causal link must be shown to exist between the loss suffered and the breach of contract.

caveat emptor Let the buyer beware. In general, the buyer is expected to look to his own interests.

champerty A criminal offence and a tort, abolished under Criminal Law Act 1967, whereby a person pays for another's legal action on condition that the damages or subject matter of the action was to be shared by them. Whilst champerty (and maintenance) has been abolished as a crime and a tort, it survives as a public policy rule capable of rendering a contract unenforceable.

chose in action All personal rights of property which can only be claimed or enforced by legal action rather than by taking physical possession.

collateral contracts Collateral contracts exist where there is one contract, the consideration for which is the making of some other contract, e.g. 'If you enter into this contract, then I will give you £1,000.'

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common mistake *See* **mistake, common**.

compositions with creditors Sum of money accepted by creditors in satisfaction, or adjustment, of a debt or debts.

condition precedent This is a condition which delays the vesting of a right until the occurrence of a particular event, e.g. 'to X if he graduates in law'.

condition A condition in a contract for the sale of goods is a vital stipulation, the breach of which may give rise to a right to treat the contract as ended or repudiated.

consensus ad idem Literally 'total agreement'. A binding contract requires *consensus ad idem* (agreement as to the same thing) by both parties.

consensus mistake This type of mistake arises where there is a mistake as to the terms of a contract which therefore precludes an agreement from arising. In other words this type of mistake prevents a consensus from arising between the parties. There are two basic types: mutual mistake and unilateral mistake – *see* below.

consideration That which is actually given or accepted in return for a promise. 'Some right, interest, profit or benefit accruing to one party, or some forbearance, detriment, loss, or responsibility given, suffered or undertaken by the other': ***Currie* v *Misa*** (1875) LR 10 Ex 153. Example: *X* receives £50 for which he promises to deliver goods to *Y*; the £50 is the consideration for the promise to deliver the goods. Consideration is required for the formation of all simple contracts. It must be legal; it must not be past; it must move from the promisee; it must be real, i.e. something of value in the eye of the law.

***contra proferentem* rule** The words or deeds should be interpreted most strongly against the person who uses them.

contributory negligence 'A man's carelessness in looking after his own safety.' A defence established where it is proved that an injured party failed to take reasonable care of himself, thus contributing materially to his own injury.

***de minimis* rule** Known more fully as '*de minimis non curat lex*'; or the law does not concern itself with trivialities.

***del credere* agent** An agent who receives a higher rate of commission than that which is usual, in return for a guarantee that his principal will receive due payment for goods sold.

delegatus non potest delegare A delegate cannot delegate. See now Trustee Act 2000, Part IV. 'The law is not that trustees cannot delegate: it is that trustees cannot delegate unless they have authority to do so': ***Pilkington* v *IRC*** [1962] 3 All ER 622.

deposits These are essentially the opposite of a penalty in that they are payable before a breach occurs, rather than after as in the case of a penalty. Deposits are normally regarded as part satisfaction of the contract price which may be retained should the purchaser fail to perform his side of the bargain.

discharge by agreement Generally, a release from an obligation; however in the law of contract it refers to the freeing of parties from their mutual obligations by performance, express agreement, breach, or under the doctrine of frustration.

discharge by breach Where a party fails to perform their side of the contract they will be in breach of contract, subject to mitigating factors.

discharge by performance Where the parties fully perform their part of the contract the contract will become discharged by virtue of the contract having been fully performed.

divisible contracts A contract in which the parties intend that their promises are to be independent of each other: ***Taylor* v *Webb*** [1937] 2 KB 283. An *entire* (or *indivisible*) contract is one in which there is agreement, implicit or explicit, that neither party may demand performance until he is ready to fulfil, or has fulfilled, his promise.

duress Actual violence or threats of imminent, although not necessarily immediate, violence to the person. Known also as *duress per minas* (by threats). A contract obtained by duress is voidable. 'Duress, whatever form it takes, is a coercion of will so as to vitiate consent': *per* Lord Scarman in ***Pao On* v *Lau Yiu Long*** [1980] AC 614.

economic duress Recovery of money paid under duress (i.e. illegitimate pressure resulting

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in compulsion), other than to the person, is not limited to duress to goods; it can include economic duress where it is constituted by a threat to break a contract, even though there is good consideration for that further contract: ***North Ocean Shipping Co.* v *Hyundai Construction Co.*** [1978] 3 All ER 1170; ***The Universe Sentinel*** [1983] AC 366. ('The victim's silence will not assist the bully, if the lack of any practicable choice but to submit is proved': *per* Lord Scarman.)

equitable estoppel A rule of evidence (and not a cause of action) preventing a person from denying the truth of a statement he has made previously, or the existence of facts in which he has led another to believe. Under the doctrine of *promissory estoppel*, where *X*, by words or conduct, makes to *Y* an unambiguous representation by promise or assurance concerning his (*X*'s) future actions, intended to affect the legal relationship between *X* and *Y*, and *Y* alters his position in reliance on it, *X* will not be allowed to act inconsistently with that representation.

exclusion clause This a clause 'which excludes or modifies an obligation, whether primary . . . or . . . secondary, that would otherwise arise under the contract by implication of law': *per* Lord Diplock in ***Photo Production Ltd* v *Securicor Transport Ltd*** [1980] AC 827.

executed consideration Consideration is *executed* when the act constituting the consideration is performed.

executory consideration Consideration is said to be *executory* when it is in the form of promises to be performed at a future date.

exemption clauses Clauses in an agreement seeking to exempt the parties from general liability or excluding or modifying their liability in certain circumstances.

expectation loss Damages that arise where a party is claiming damages for the gains that they could reasonably be expected to obtain from the completion of the contract, for example, loss of profits.

fitness for purpose Where goods are sold in the course of a business, and the buyer expressly or impliedly makes known to the seller any particular purpose for which the goods are being bought, there is an implied condition that they are fit for that purpose: Sale of Goods Act 1979, s 14(3).

***force majeure* clauses** A superior force. An event that can generally be neither anticipated nor controlled, e.g. an industrial strike which leads to loss of profits. The circumstances must be abnormal and unforeseeable, so that the consequences could not have been avoided through the exercise of all due care.

forfeiture clauses These clauses normally arise in contract where there is a purchase of goods by instalments and the contract provides that should the purchaser default on any instalment then he must surrender the goods, at the same time forfeiting any instalments already paid. They are designed to ensure that the contract will be performed.

fraudulent misrepresentation A false representation made knowingly or without belief in its truth or recklessly, careless whether it be true or false: ***Derry* v *Peek*** (1889) 14 App Cas 337.

free on board contract Also known as an 'f.o.b. contract'. Goods are to be delivered on board by the seller, free of expense to the purchaser; they are not at the purchaser's risk until actually delivered on board, when property in them generally passes.

freehold land An estate of an uncertain length of duration.

frustration Where there is an extraneous event or change of circumstances so fundamental as to strike at the root of a contract as a whole and beyond what was contemplated by the parties, that contract is considered to be automatically frustrated.

hire purchase An agreement under which goods are delivered to the hirer in return for periodical payments by the hirer and the property in the goods passes to the hirer if the terms of the agreement are complied with and the hirer exercises his option to purchase or some other specified event occurs.

illegal contracts Contracts which are forbidden by statute or are contrary to common law or public policy and are, therefore, generally void.

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injunction An order of the court directing a person to refrain from doing or continuing to do an act complained of, or restraining him from continuing an omission. Non-compliance is a contempt of court.

innominate terms Terms neither named nor classified. Innominate terms in a contract are also known as 'intermediate terms'.

in pari delicto One who has participated in a wrongful act cannot recover damages resulting from the wrongdoing.

intermediate term *See* **innominate terms**.

intra vires Within its powers.

laches, doctrine of Negligence and unreasonable delay in the assertion of a right will defeat equities.

leasehold land A term of years or leasehold or the document used to bring into existence a term of years, i.e. an interest in land for a fixed period of a certain maximum duration.

letter of comfort This is a letter or memorandum usually written by a holding company to a lender about to lend money to a subsidiary of the holding company so as to reassure the lender of the financial viability of the subsidiary. Such letters are not guarantees in that the holding company is not willing to enter into a legally binding financial commitment.

lien A right to hold and retain another's property until a claim is satisfied.

limitation clause A clause that seeks to limit liability, usually up to a specific amount, as opposed to an exclusion clause that seeks to exclude liability entirely.

limitations of actions Provision whereby, after a certain period of time stated by statute, claims cannot be brought. Generally: in the case of land, 12 years from the date of accrual of action; in the case of tort and simple contract, 6 years from the date of accrual of action (for contract under seal, 12 years from the date of accrual).

maintenance A contract of maintenance arises where a person encourages and supports a course of litigation in which they have no interest.

merchantable quality 'Goods of any kind are of merchantable quality within the meaning of [this Act] if they are as fit for the purpose or purposes for which goods of that kind are commonly bought as it is reasonable to expect, having regard to any description applied to them, the price (if relevant) and all the other relevant circumstances': SGA 1979, s 14(6). Replaced by 'satisfactory quality': Sale and Supply of Goods Act 1994, s 1.

misfeasance Improper performance of some essentially lawful act.

misrepresentation A false statement which misrepresents an existing material fact: which is made before the conclusion of a contract with a view to inducing another to enter that contract; which is made with the intention that the person to whom it is addressed shall act on it; which is acted on, having induced the contract; which is not merely extravagant advertising.

mitigation of loss It is the duty of the claimant to take all reasonable steps to mitigate the loss caused by a breach of contract.

mistake, common Common mistake occurs where both parties to a contract make the same mistake.

mistake, mutual Mutual mistake occurs where the parties are at cross-purposes.

mistake, unilateral Unilateral mistake occurs where one party has made a mistake of which the other party is aware, but the latter keeps quiet and does nothing to correct it.

mutuality The general principle is that specific performance will not be awarded unless the order is available to both parties, that is, availability of the award is mutual.

necessaries Goods suitable to the condition in life of an infant or minor or other person and to his actual requirements at the time of the sale and delivery.

negotiability In relation to a negotiable instrument, the quality of it being transferable free from equities.

nemo dat quod non habet No one can give that which he has not. See Sale of Goods Act 1979, s 21(1). Thus, a person cannot give better title than he has.

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non est factum Literally 'it is not [his] deed'. This is a plea which denies that an instrument (deed) is that of the defendant, e.g. where there has been a mistake as to the nature of the transaction.

nonfeasance Failure to perform an act which one is bound by law to do.

non-pecuniary losses Loss of pleasure or where physical inconvenience flows from the breach of contract as opposed to losses that can be measured in financial terms.

novation Essentially a substituted agreement. Contract whereby a creditor at the request of a debtor agrees to take another person as debtor in place of the original debtor. The original debtor is thereby released from his obligations which fall on the new debtor. The new agreement requires consideration.

ostensible authority This type of authority, sometimes referred to as 'apparent' authority, really forms an application of the doctrine of estoppel. It arises where a principal, whether by words or conduct, creates an implication that the agent is entitled to act on the principal's behalf when in fact no such authority actually exists. An agent acting within this apparent authority will bind the principal to a third party despite the fact that the agent has no actual authority to do so.

parol evidence rule Where the record of a transaction is embodied in a document, extrinsic evidence is not generally admissible to vary, qualify or interpret the document or as a substitute for it.

penalties A threat, held over a party to a contract *in terrorem*. The plaintiff who brings an action to enforce a penalty can generally recover only the damage suffered.

power of attorney An instrument authorising one person to act for another during the absence of that other.

principal One on whose behalf an agent works.

privity of contract Principle based upon the relationship between the parties to a contract.

promissory estoppel *See* **equitable estoppel** above.

quantum meruit As much as he has deserved (i.e. earned). On breach of contract the party injured may be entitled to claim for work done and services performed to the extent that they have actually been completed.

quasi-contract Cases in which the law imposes on a person an obligation to make repayment on grounds of unjust benefit, e.g. when he has been enriched at the expense of another.

ratification Confirmation; approval. In the case of ratification of a contract made by an agent, the contract must be made on behalf of the principal; the principal must be competent at the time of the contract; there should have been an act capable of ratification.

rectification Where a written document does not accurately express an agreement between parties, as the result of some common mistake, equity has the power to rectify that mistake.

remoteness of damages In contract the general rule is that damages for breach will be too remote to be recovered unless such that the defendant, as a reasonable man, would have foreseen as likely to result: ***Hadley* v *Baxendale***.

res judicata A final decision pronounced by a competent judicial tribunal. There must be an end to litigation at some point and therefore parties are not allowed, having had a decision from a court, to start the litigation again on precisely the same question. Known also as 'action estoppel', it is one of the fundamental doctrines of all courts.

res sua 'One's own goods'. The phrase used where a person makes a contract to purchase that which, in fact, belongs to him. The contract is void for mistake as to title.

rescission Remedy for inducing a contract by innocent or fraudulent misrepresentation whereby the contract is abrogated. A party intending to rescind must notify the other party. A rescission *ab initio* results in the contract being treated as though it had never been. Right of rescission is lost: if *restitutio in integrum* (*see* below) is impossible.

restitutio in integrum Restoration to the original position. Right to rescind a contract for

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misrepresentation is lost if *restitutio in integrum* is not possible.

restitution The equitable doctrine of restitution refers to the case where, for example, an infant, having fraudulently obtained goods, is ordered to return his ill-gotten gains.

restitution, law of The body of law concerned with claims for the reversal of unjust enrichment, the prevention of one who has committed a wrong from profiting from it, the restoration of a claimant's property rights adversely affected by defendant's actions, and the provision of appropriate restitutionary remedies. Remedies, intended to effect 'a fair and just balance between rights and interests of the parties concerned', include rescission, award of interest, subrogation, equitable damages, restitutionary damages, account of profits.

restraint of trade Any contract which interferes with the free exercise of [a person's] trade or business, by restricting him in the work he may do for others, or the arrangements which he may make with others, is a contract in restraint of trade. It is invalid unless it is reasonable as between the parties and not injurious to the public interest.

restrictive covenants A covenant by which use of the covenantor's land is restricted for the benefit of the covenantee's adjoining land. Known also as a 'negative covenant'.

satisfaction *See* **accord and satisfaction**.

satisfactory quality Where the seller sells goods in the course of a business, there is an implied term that the goods supplied under the contract are of satisfactory quality. Goods are of satisfactory quality if they meet the standard that a reasonable person would regard as satisfactory, taking account of any description of the goods, the price (if relevant) and all the other relevant circumstances.

severance This is the removal of the illegal elements of a contract, leaving behind a valid enforceable agreement.

solus agreements An agreement whereby a retailer binds himself to buy a product from one source only. Example: garage proprietor agreeing to buy all his petrol from one oil company.

speciality contract A contract under seal or by deed.

specific performance An equitable, discretionary remedy whereby a party to an agreement is ordered by the court to perform his obligations according to the terms of that agreement. It is granted where the common law remedy of damages is inadequate.

standard-form contract Contracts the terms of which were not the subject of negotiations between the parties to them.

stoppage *in transitu* Right of stoppage *in transitu* is the right, under Sale of Goods Act 1979, ss 44–46, to stop goods in transit, to resume and to retain possession until the price is paid.

tender of performance Expressed readiness to perform an act in accordance with an obligation. May be equivalent to performance: ***Startup* v *Macdonald*** (1843) 6 Man & G 593.

trespass The unjustifiable interference with possession of goods or land. A tort involving 'direct and forcible injury'. In trespass to the person it involves assault or battery.

trust In essence, an equitable obligation which imposes on a person described as a trustee certain duties of dealing with property held and controlled by him for the benefit of the persons described as the beneficiaries, or, if there are not such persons, for some purpose recognised and enforceable at law.

trustee One who holds property on trust for another, known as *cestui que trust* or beneficiary.

uberrimae fidei Of the utmost good faith. Applies to a contract in which the promisee must inform the promisor of all those facts and surrounding circumstances which could influence the promisor in deciding whether or not to enter the contract.

ultra vires Beyond the powers. Term relating generally to the excess of legal powers or authority; specifically, the exercise by a corporation of powers beyond those conferred on it explicitly or implicitly.

undue influence Improper pressure on a person resulting in his being at a manifest disadvantage

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in relation to some transaction. Such a transaction may be set aside by the court.

unilateral contract A contract arising where an offer is made in the form of a promise to pay in return for the performance of an act, so that the performance of the act is taken to imply assent. *See*, e.g., ***Carlill* v *Carbolic Smoke Ball Co.*** [1893] 1 QB 256; ***NZ Shipping Co.* v *Satterthwaite & Co.*** [1975] AC 154.

unilateral discharge In a contract, the terms of which are carried out by *X*, but not by *Y* (the other party), the release of *Y* from his obligations by *X*.

void *ab initio* Void from the beginning; having no legal effect.

voidable contracts Capable of being voided, i.e. set aside. A voidable contract has legal effect until avoided at the option of one of the parties (e.g. where the contract has been induced by misrepresentation).

waivers These normally arise where one party requests an alteration of the terms of the contract and the other party agrees not to insist on strict compliance with the terms of the contract, so, for example, allowing late delivery at the request of the other party.

warranties A term that is collateral to the main purpose of a contract, the breach of which gives rise to a claim for damages, but not to a right to reject the goods and treat the contract as repudiated.

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