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THE LAW COMMISSION

ILLEGAL TRANSACTIONS: THE EFFECT OF ILLEGALITY ON CONTRACTS AND TRUSTS

CONTENTS

	Paragraph	*Page*
PART I: INTRODUCTION	**1.1-1.24**	**1**
1. THE SCOPE OF THIS PROJECT	1.1-1.11	1
(1) Transactions which involve the commission of a legal wrong	1.6	3
(2) Transactions which are otherwise contrary to public policy	1.7-1.11	3
2. AN OVERVIEW OF THE AIM OF THIS PROJECT	1.12-1.15	7
3. STRUCTURE OF THE PAPER	1.16-1.17	8
4. AN OVERVIEW OF OUR PROVISIONAL PROPOSALS	1.18-1.21	9
5. COMPATIBILITY OF OUR PROVISIONAL PROPOSALS WITH THE EUROPEAN CONVENTION ON HUMAN RIGHTS	1.22-1.23	10
6. ACKNOWLEDGEMENTS	1.24	10
PART II: THE EFFECT OF ILLEGALITY I: CONTRACTS	**2.1-2.78**	**11**
1. THE ENFORCEMENT OF CONTRACTUAL OBLIGATIONS	2.2-2.31	11
(1) Contracts rendered unenforceable by statute	2.3-2.19	12
(2) Contracts rendered unenforceable at common law	2.20-2.31	21
(a) Contracts to commit a legal wrong or carry out conduct which is otherwise contrary to public policy	2.20-2.23	21
(b) Where one or both parties enter into the contract for the purpose of furthering the commission of a legal wrong or carrying out conduct which is otherwise contrary to public policy	2.24-2.28	24
(c) Where one or both parties commits a legal wrong or acts in a manner which is otherwise contrary to public policy in the course of performing the contract	2.29-2.31	26
2. THE REVERSAL OF UNJUST ENRICHMENT	2.32-2.56	27

(1) Illegality as a defence to restitutionary claims	2.34-2.48	28
(a) Failure of consideration	2.35-2.37	28
(b) Mistake	2.38-2.42	30
(c) Duress	2.43-2.44	32
(d) Vulnerability	2.45-2.48	33
(2) Illegality as a restitutionary cause of action: the doctrine of *locus poenitentiae*	2.49-2.56	35
3. THE RECOGNITION OF CONTRACTUALLY TRANSFERRED OR CREATED PROPERTY RIGHTS	2.57-2.69	38
(1) Title may pass under an illegal contract	2.57-2.61	38
(2) The recovery of property in which a limited interest has been created under an illegal contract - the reliance principle	2.62-2.67	40
(3) Exceptions	2.68-2.69	43
4. THREE OTHER ISSUES	2.70-2.78	44
(1) Damages for a different cause of action	2.70-2.72	44
(2) Severance	2.73-2.74	45
(3) Linked contracts may be tainted by illegality	2.75-2.78	46
PART III: THE EFFECT OF ILLEGALITY II: TRUSTS	**3.1-3.68**	**49**
1. THE GENERAL SCOPE OF THIS PART	3.1-3.4	49
2. "APPARENT GIFTS" AND RESULTING TRUSTS	3.5-3.31	50
(1) Where a resulting trust is unenforceable because its existence can only be shown by "relying" on illegality: the "reliance principle"	3.8-3.24	51
(a) The reliance principle	3.9-3.13	52
(b) The withdrawal exception	3.14-3.18	54
(c) The application of the principles illustrated	3.19-3.24	56
(2) Where a resulting trust will not arise, or will be unenforceable, for some reason other than the reliance principle	3.25-3.31	58
(a) A resulting trust will not arise, or will be unenforceable, where the turpitude of the beneficiary is gross	3.26-3.27	59
(b) A resulting trust will not arise, or will be unenforceable, where statute expressly or impliedly so provides	3.28-3.31	59
3. EXPRESS TRUSTS AND RESULTING TRUSTS ARISING ON FAILURE OF EXPRESS TRUSTS	3.32-3.58	61
(1) Express trusts which are invalid (or "void") for illegality	3.33-3.50	61
(a) Express trusts which fall within this category	3.33-3.34	61
(b) The implications of an express trust or condition being "invalid"	3.35-3.50	61
(i) The ordinary proprietary consequences of a decision that an express trust or condition is "void"	3.37-3.39	62

(ii) Does the reliance principle have any role to play in the event that an express trust or condition is void for illegality?	3.40-3.50	64
(2) Express trusts which are valid, notwithstanding illegality	3.51-3.58	68
(a) Express trusts which fall within this category	3.52-3.56	69
(i) Express trusts created for an "illegal consideration"	3.53-3.54	69
(ii) Express trusts created to facilitate fraud on a third party	3.55-3.56	71
(b) The implications of an express trust being not invalid but "unenforceable"	3.57-3.58	72
4. CONSTRUCTIVE TRUSTS GIVING EFFECT TO INTENTIONS	3.59-3.68	72
(1) Common intention constructive trusts	3.61-3.64	73
(2) Trusts (including "secret trusts") imposed on persons who receive property on the faith of an undertaking to hold for another	3.65-3.66	75
(3) The constructive trust arising from a specifically enforceable contract	3.67	76
(4) The constructive trust in Re Rose which gives effect to incomplete transfers	3.68	76
PART IV: THE EFFECT OF ILLEGALITY III: THE REJECTION OF THE "PUBLIC CONSCIENCE" TEST	**4.1-4.5**	**78**
PART V: THE CASE FOR LEGISLATIVE REFORM	**5.1-5.13**	**81**
1. COMPLEXITY	5.2	81
2. INJUSTICE	5.3-5.7	81
3. UNCERTAINTY	5.8-5.9	83
4. UNLIKELIHOOD OF JUDICIAL REFORM	5.10	84
5. CONCLUSION	5.11-5.13	84
PART VI: SHOULD ANY DOCTRINE OF ILLEGALITY BE MAINTAINED?	**6.1-6.12**	**86**
1. UPHOLDING THE DIGNITY OF THE COURTS	6.4-6.6	87
2. THE PLAINTIFF SHOULD NOT PROFIT FROM HIS OR HER OWN WRONGDOING	6.7-6.8	88
3. DETERRENCE	6.9-6.10	88
4. PUNISHMENT	6.11	89
5. CONCLUSION	6.12	90
PART VII: OPTIONS FOR REFORM I: CONTRACTS	**7.1-7.117**	**91**
1. OUR PROVISIONALLY PREFERRED BASIC APPROACH TO REFORMING ILLEGALITY: DISCRETION RATHER THAN STRICT RULES	7.2-7.26	91

(1) The enforcement of contractual obligations	7.5-7.16	93
(a) Contracts which involve the commission of a legal wrong	7.5-7.12	93
(b) Contracts which are otherwise contrary to public policy	7.13-7.16	96
(2) The reversal of unjust enrichment (where a contract is unenforceable for illegality)	7.17-7.22	98
(3) The recognition of contractually transferred or created property rights	7.23-7.26	100
2. STRUCTURING THE DISCRETION	7.27-7.43	102
(1) The seriousness of the illegality	7.29-7.32	102
(2) The knowledge and intention of the plaintiff	7.33-7.37	103
(3) Whether denying relief will act as a deterrent	7.38	104
(4) Whether denying relief will further the purpose of the rule which renders the contract illegal	7.39-7.40	105
(5) Whether denying relief is proportionate to the illegality involved	7.41-7.42	106
3. WHAT SHOULD BE THE STARTING POINT OF THE PROVISIONALLY PROPOSED DISCRETION?	7.44-7.57	106
4. ILLEGALITY AS A RESTITUTIONARY CAUSE OF ACTION: THE DOCTRINE OF *LOCUS POENITENTIAE*	7.58-7.69	110
5. THE SCOPE OF THE PROVISIONALLY PROPOSED DISCRETION	7.70-7.72	114
6. GIVING THE COURTS A DISCRETION TO GO BEYOND TREATING ILLEGALITY AS A DEFENCE TO STANDARD RIGHTS AND REMEDIES	7.73-7.87	116
7. SHOULD THE COURT BE GIVEN A DISCRETION IN CONTRACTUAL DISPUTES INVOLVING ILLEGALITY TO MAKE AN AWARD ON TERMS THAT THE PLAINTIFF MAKES A PAYMENT OR TRANSFERS PROPERTY TO A PERSON WHO IS NOT A PARTY TO THE ILLEGAL CONTRACT?	7.88-7.93	121
8. THE INTERACTION OF THE PROVISIONALLY PROPOSED DISCRETION AND STATUTORY PROVISIONS WHICH DEAL WITH THE EFFECTS OF ILLEGALITY	7.94-7.102	124
9. MISCELLANEOUS ISSUES	7.103-7.106	127
(1) Severance	7.103	127
(2) Tainting	7.104	128
(3) Changes in the law	7.105-7.106	128
10. THE EFFECT OF OUR PROVISIONAL PROPOSALS	7.107-7.116	129
(1) How our provisional proposals might have operated in relation to some past cases	7.108-7.113	129
(2) How our provisional proposals might apply to hypothetical examples	7.114-7.116	131

11. GENERAL QUESTION ON DISCRETIONARY APPROACH 7.117 132

PART VIII: OPTIONS FOR REFORM II: TRUSTS 8.1-8.131 133

1. ABANDONING THE RELIANCE PRINCIPLE 8.4-8.20 133

(1) The difficulties with the reliance principle 8.5-8.13 134

(a) The lack of convincing rationale and the arbitrariness of the principle 8.5-8.7 134

(b) The uncertainties of the reliance principle 8.8-8.11 135

(c) Conclusion 8.12-8.13 136

(2) Options for reform, if the reliance principle is abandoned 8.14-8.20 136

2. A DISCRETIONARY MODEL FOR ILLEGAL TRUSTS 8.21-8.125 139

(1) What do we mean by an "illegal trust"? 8.21-8.41 139

(a) Trusts which are "illegal trusts" (that is, our proposed "definition" of illegal trusts) 8.22-8.32 139

(i) Trusts which it is legally wrongful to create or to impose 8.24 140

(ii) Trusts which are created to facilitate a fraud, or which arise out of a transaction or arrangement with that purpose 8.25-8.26 140

(iii) Trusts which are created in order to facilitate some other legal wrong, or which arise out of a transaction or arrangement with that purpose 8.27 141

(iv) Trusts which are created in return for an "illegal consideration" 8.28-8.29 141

(v) Trusts which expressly or necessarily require trustees to commit a legal wrong or which tend or are intended to do so 8.30 142

(vi) Trusts which expressly or necessarily require a beneficiary to commit a legal wrong or which tend or are intended to do so 8.31 142

(vii) Trusts which are otherwise contrary to public policy at common law 8.32 142

(b) Trusts which are not "illegal trusts" 8.33-8.41 143

(i) A trust which neither expressly nor necessarily requires a trustee to perform an illegal act nor tends nor is intended to do so does not become an "illegal trust" where the trustee in fact performs such an act 8.34 143

(ii) A trust which neither expressly nor necessarily requires a beneficiary to perform an illegal act nor tends nor is intended to induce such an act does not become an "illegal trust" where the beneficiary purports to satisfy a condition by performing such an act 8.35-8.37 143

(iii) A trust where the trust property is used to achieve some fraudulent or other illegal purpose is not an "illegal trust" where the intention to use the trust property for that purpose was formed only after the date on which the trust was created or arose 8.38-8.39 144

(2) Trusts which involve the breach of a statutory prohibition where the statute expressly lays down what the consequences of that breach should be	8.42-8.43	146
(3) Should the provisionally proposed discretion be a discretion to "invalidate" an illegal trust, or a discretion to render such trust simply "unenforceable"?	8.44-8.50	146
(4) What factors should structure the discretion?	8.51-8.63	148
(a) The seriousness of the illegality	8.53	148
(b) The knowledge and intention of the beneficiaries of the illegal trust	8.54-8.56	149
(c) Whether invalidity would tend to deter the illegality	8.57-8.58	149
(d) Whether invalidity would further the purpose of the rule which renders the trust "illegal"	8.59	150
(e) Whether invalidity is a proportionate response to the claimant's participation in the illegality	8.60-8.62	150
(5) Should our provisionally proposed discretion also apply to a "default trust" which takes effect in the event that an express illegal trust is held to be invalid under that discretion?	8.64-8.74	151
(a) Should the law ever declare invalid a "default trust" which takes effect in the event that an express illegal trust is invalid on grounds of illegality?	8.64-8.71	151
(b) A separate discretion dealing with the validity of default interests in favour of persons who settle property on illegal trusts	8.72-8.74	154
(6) Who should be entitled to the trust property if a resulting trust, constructive trust or "default trust" is held to be invalid under our provisionally proposed discretion?	8.75-8.82	155
(a) Can a trustee take the benefit of property if a resulting trust, constructive trust or "default trust" is invalid, or is the property bona vacantia?	8.75-8.79	155
(b) A possible additional consideration if a trustee is ever allowed to take the benefit	8.80-8.82	156
(7) What should be the starting point of the provisionally proposed discretion?	8.83-8.85	157
(8) Should the court have a discretion to recognise the validity of an illegal trust on terms that the beneficiary makes a payment or transfers property to a third party?	8.86-8.88	158
(9) How should the provisionally proposed discretion interact with the equitable maxim that "he who comes to equity must come with clean hands"?	8.89-8.91	158
(10) What should be the effect of the invalidity of the illegal trust in relation to acts carried out pursuant to that trust?	8.92-8.115	160
(a) The liability of the trustee for acts of administration occurring before any court order	8.96-8.100	161

(b) The effect of dispositions by trustees occurring before a court order and the recipient's title and liability 8.101-8.107 162

(c) The effect of dispositions by beneficiaries to "third parties" occurring before a court order 8.108-8.115 164

(11) Severance 8.116-8.125 164

3. THE EFFECT OF OUR PROVISIONALLY PROPOSED DISCRETION 8.126-8.129 170

4. ILLEGAL TRANSACTIONS THAT ARE NEITHER CONTRACTS NOR TRUSTS 8.130-8.131 171

PART IX: SUMMARY OF PROVISIONAL RECOMMENDATIONS AND CONSULTATION ISSUES **9.1-9.44** **174**

PART I
INTRODUCTION

1. THE SCOPE OF THIS PROJECT

1.1 Under item 4 of the Sixth Programme of Law Reform[1] we are to examine "the law on illegal transactions, including contracts and trusts". On a very general level, we are here concerned with transactions that involve "reprehensible conduct"; and we are considering whether the involvement of that reprehensible conduct means that the usual rights and remedies of the parties to the transaction should be affected in any way. So, for example, we will be asking whether the fact that a party commits a crime in the course of carrying out his or her side of a contract means that he or she should be denied the usual rights of enforcement if the other contracting party fails to perform. Or whether the fact that a party, while not intending to make a gift of property, has transferred the legal title to another in an attempt fraudulently to conceal its true beneficial ownership should mean that he or she is prevented from enforcing the resulting trust that, the fraudulent motive apart, would generally arise in his or her favour.

1.2 The need for reform in this area was highlighted by Lord Goff of Chieveley in his dissenting speech in *Tinsley v Milligan*.[2] He specifically called for a review by the Law Commission. In that case, the defendant in possession proceedings claimed a beneficial interest in a house, the legal title to which was in the plaintiff's sole name. The defendant's claim was based on the contribution which she had made to the purchase price. The plaintiff resisted the claim on the basis that she and the defendant had been defrauding the Department of Social Security, and that the arrangements with the property had been made with this illegal purpose in mind. A majority of the House of Lords held that, notwithstanding the illegality, the defendant was entitled to the interest which she claimed. Other recent cases on illegal transactions include: a claim by a builder for a *quantum meruit* for work done under a building contract in relation to which he had agreed to provide a false estimate so that the building owner could defraud his insurance company;[3] a claim to enforce an agreement whereby a solicitor had agreed, in breach of the Solicitors' Practice Rules, to share his fees in return for introductions from and work performed by a third party;[4] and a claim by a father for the return of shares which he had transferred to his son in order to deceive his creditors and protect his assets.[5]

1.3 In the Sixth Programme we specifically left open the possibility of including the law on illegality in relation to tort claims within this project.[6] But we have now

[1] Sixth Programme of Law Reform (1995) Law Com No 234.

[2] [1994] 1 AC 340, 364. See paras 3.9 to 3.12 below.

[3] *Taylor v Bhail* [1996] CLC 377 (see para 2.37 n 110 below).

[4] *Mohamed v Alaga & Co* [1998] 2 All ER 720 (see para 2.37 below).

[5] *Tribe v Tribe* [1996] Ch 107 (see paras 3.14 to 3.18 below).

[6] See the description of item 4 of the Sixth Programme of Law Reform (1995) Law Com No 234.

decided that this is not appropriate. We are not aware that the law in this area is presently giving rise to concern[7] and we consider that the inclusion of tortious claims would have expanded the scope of our project to such an extent that it would have become unwieldy. Where, however, the success of a tortious claim depends on, or is concerned with, a transaction, and that transaction is an "illegal transaction" to which our provisional proposals would apply, we anticipate that the courts would take into account the effect of our provisional proposals on the transaction so as to ensure that the effect of illegality on the tortious claim does not produce an inconsistent result.[8]

What is meant by an "illegal transaction"?

1.4 This is a surprisingly difficult question to answer. Indeed, a central problem which confronts any attempt at statutory reform of this area of the law is the extremely fluid nature of the notion of "illegality" and the absence of any simple agreed definition of what constitutes an "illegal transaction".[9] Clearly a transaction involves reprehensible conduct where its formation, purpose or performance involves the commission of a legal wrong. But the law relating to illegality is not generally regarded as so limited. That is, a transaction is also regarded as being "illegal" where it involves conduct of which the law disapproves as being contrary to the interest of the public, even though that conduct is not actually unlawful. And although any transaction which involves the commission of a legal wrong might be regarded as contrary to public policy (so that the former is merely a subcategory of the latter),[10] for the purposes of exposition we have found it helpful to separate the two. We have therefore taken as the very broad remit of our project on illegal transactions: any transaction which involves (in its formation, purpose or performance) the commission of a legal wrong (other than the mere breach of the transaction in question)[11] or conduct which is otherwise contrary to public policy.

1.5 Clearly this is a very wide description of an illegal transaction, and will include many transactions where the rights and remedies of at least one of the parties are unaffected by the involvement of illegality. For example, the fact that one party has committed an offence in the performance of a contract will, except in exceptional circumstances, not affect the right of the other party to enforce the contract.[12] However, we have deliberately chosen a broad remit so that we can

7 "The overall approach of the courts tends ultimately to be pragmatic and very much dependent on the facts of the particular case": *Clerk & Lindsell on Torts* (17th ed 1995) p 67.

8 Our provisional proposals may, of course, have a "knock on" effect in other areas of the law. For example, a trustee who enters into an illegal contract in breach of trust will not be held liable for loss to the beneficiaries if the contract is held to be enforceable so that there is no loss to the trust fund. An employee who seeks to recover for loss of earnings following dismissal on grounds of sex discrimination may be able to succeed in his or her claim if the contract of employment is held to be enforceable by him or her despite the involvement of illegality: cf *Hall v Woolston Hall Leisure Ltd* [1998] ICR 651.

9 *Chitty on Contracts* (27th ed 1994) para 16-001; G H Treitel, *The Law of Contract* (9th ed 1995) pp 389-390; and N Enonchong, *Illegal Transactions* (1998) pp 1-2.

10 G H Treitel, *The Law of Contract* (9th ed 1995) p 389.

11 Plainly civil wrong cannot here include breach of the very transaction in question otherwise every contract or trust would be illegal once there was a breach of that contract or trust.

12 See paras 2.16 to 2.19 and paras 2.29 to 2.31 below.

examine exactly when and how the involvement of illegality (that is the commission of a legal wrong or conduct otherwise contrary to public policy) does affect the validity or efficacy of a transaction. We now explain what we mean by the commission of a "legal wrong" or conduct which is "otherwise contrary to public policy".

(1) Transactions which involve the commission of a legal wrong

1.6 By commission of a legal wrong we mean to include not only the commission of a crime or a civil wrong but also the breach of a statutory prohibition.[13] So, for example, a contract has been held to be unenforceable where its formation involved the commission of a statutory criminal offence[14] and where its object was the commission of a common law tort.[15] And an interest under a trust may be unenforceable where the plaintiff needs to rely on his or her own fraudulent conduct in order to establish the claim.[16] We look at exactly how and when the involvement of a legal wrong may affect the validity or efficacy of contracts in Part II and trusts in Part III.

(2) Transactions which are otherwise contrary to public policy

1.7 We have said that a transaction is contrary to public policy if it involves conduct of which the law disapproves as being against the interest of the public.[17] However, such a description is clearly very wide and might include transactions which one would not generally class as being "illegal". We therefore need to make clear at the outset that by referring to transactions which are "otherwise contrary to public policy" we do not mean to include a whole range of transactions which fail for more specific vitiating factors. That is, we do not intend our project to deal with transactions which fail on the grounds of (i) non-compliance with formalities; (ii) inequality or unfairness,[18] for example misrepresentation, undue influence, duress, unconscionability or inequality of bargaining power; and (iii) lack of capacity. Although in general terms one might say that these transactions are void, voidable or unenforceable because it would be contrary to public policy to recognise or enforce them, in each case there are more specific reasons for invalidating the

[13] By statutory prohibition, we mean to refer not only to prohibitions contained in primary legislation, but also to prohibitions contained in any subordinate legislation such as orders, rules, regulations and bye-laws made under any Act. It has also been suggested that transactions which breach those Articles of the EC Treaty and those regulations and directives made thereunder which are directly applicable may be affected by illegality: *Chitty on Contracts* (27th ed 1994) para 16-005 and see A Jones, "Recovery of Benefits Conferred under Contractual Obligations Prohibited by Article 85 or 86 of the Treaty of Rome" (1996) 112 LQR 606. And see *Gibbs Mew plc v Gemmell* [1998] PLSCS 228; *Inntrepreneur Pub Co (CPC) Ltd v Price* [1998] EGCS 167; and *Courage Ltd v Crehan* [1998] EGCS 171.

[14] *Re Mahmoud v Ispahani* [1921] 2 KB 716 (contract to supply goods was unenforceable because the purchaser committed an offence by purchasing the goods without the licence required by the Defence of the Realm Regulations).

[15] *Allen v Rescous* (1676) 2 Lev 174; 83 ER 505 (contract to assault a third party).

[16] See paras 3.8 to 3.13 below.

[17] See para 1.4 above.

[18] We do not intend, therefore, that our project should cover the law relating to unfair contract terms or penalty clauses.

transaction.[19] There is, for example, a large body of case law relating to when a contract is voidable for undue influence. But contracts vitiated by undue influence are not generally, if ever, classed as "illegal" and we do not intend to deal with them in this project.

1.8 What type of transaction may then be regarded as "illegal" because contrary to public policy? Numerous examples can be found in the case law. As we go on to explain,[20] we do not regard it as part of our project to clarify exhaustively what should constitute conduct that is contrary to public policy. However, at present, several categories are well established and it is worth mentioning them if merely by way of example: transactions which interfere with the administration of justice;[21] which are prejudicial to the status of marriage[22] or which tend to involve or promote sexual immorality;[23] which involve doing an illegal act in a friendly foreign

[19] J D McCamus, "Restitutionary Recovery of Benefits Conferred under Contracts in Conflict with Statutory Policy - the New Golden Rule" (1987) 25 Osgoode Hall LJ 787, 792-793 and 852-857 argues that it is often difficult to distinguish between cases of illegality, non-compliance with formalities and lack of capacity; that the "illegality" cases are merely points on a broader spectrum of contracts which conflict with statutory policy; and that the legal rules that are applied should be the same in each case. And see B Dickson, "Restitution and Illegal Transactions" in A Burrows (ed), *Essays on the Law of Restitution* (1991) ch 7 at p 183. We are sensitive to this argument to the extent that we would not wish our reform proposals to cut across the law closely linked to illegality: see paras 7.4, 7.80 and 7.83 below.

[20] See para 1.14 below.

[21] *Kearley v Thomson* (1890) 24 QBD 742 (a contract by the defendants not to appear at the public examination of a bankrupt and not to oppose his order of discharge in return for payment by the plaintiff of debts owed by the bankrupt was held to be illegal). Fry LJ said (1890) 24 QBD 742, 745: "The tendency of such a bargain as that entered into between the plaintiff and the defendants is obviously to pervert the course of justice. Although the defendants were under no obligation to appear, they certainly were under an obligation not to contract themselves out of the opportunity of appearing." See also, *Giles v Thompson* [1994] 1 AC 142 (a contract which is champertous or involves an element of maintenance is contrary to public policy and unenforceable - although in that case an agreement by a car hire company to fund a motorist's action for damages following a car accident was held to be valid).

[22] *Fender v St John-Mildmay* [1938] AC 1 (although in that case a promise made by one spouse, after a decree nisi had been pronounced, to marry a third party after the decree had been made absolute, was held to be valid); *Westmeath v Westmeath* (1831) 1 Dow & Cl 519; 6 ER 619 (a settlement in contemplation of the future separation of a married couple was held to be contrary to public policy and void).

[23] *Pearce v Brooks* (1866) LR 1 Exch 213 (a contract for the hire of a brougham which the plaintiff coachbuilder knew the defendant, a prostitute, intended to use to attract customers was held to be illegal); *Re Vallance* (1884) 26 Ch D 353 (a bond in consideration of future non-marital cohabitation was said to be contrary to public policy and void, although in that case there was no evidence that the bond was given in consideration of future cohabitation). For a discussion of this head of public policy, see J L Dwyer, "Immoral Contracts" (1977) 93 LQR 386.

country;[24] or which are in restraint of trade.[25] Such transactions have all been held to be unenforceable or invalid as contrary to public policy.[26]

1.9 The courts seemingly recognise that public policy may change, and transactions which were once regarded as contrary to public policy may become acceptable and vice versa.[27] There remains, however, some debate over whether the courts may actually create new heads of public policy.[28] In practice, this debate may not be of great practical importance, since there is often little difference between the creation of a new head of public policy and the extension of an existing category to a new situation.[29]

1.10 One category, that we have found especially difficult to decide whether to include within the scope of this project, is what might be broadly called "statutory invalidity". By "statutory invalidity" we mean to refer to a transaction which (or a term of which) is made void, voidable, unenforceable or in some other sense ineffective by statute, *but which does not involve any conduct that is expressly or impliedly prohibited*. For example, the Gaming Act 1845 provides that: "All contracts or agreements ... by way of gaming or wagering, shall be null and void".[30]

[24] *Foster v Driscoll* [1929] 1 KB 470 (an agreement to smuggle whisky into the United States during prohibition was held to be illegal).

[25] *Esso Petroleum Co Ltd v Harper's Garage (Stourport) Ltd* [1968] AC 269.

[26] A transaction may be contrary to public policy not only where it involves conduct that is contrary to public policy but also where it may *encourage* such conduct. As Lord Atkin said in *Fender v St John-Mildmay* [1938] AC 1, 12: "In cases where the promise is to do something contrary to public policy which for short I will call a harmful thing, or where the consideration for the promise is the doing or the promise to do a harmful thing a judge, though he is on slippery ground, at any rate has a chance of finding a footing. ... But the doctrine does not extend only to harmful acts, it has to be applied to harmful tendencies. Here the ground is still less safe and more treacherous." What is meant by "harmful tendencies"? Lord Atkin described it in the following terms [1938] AC 1, 13: "It can only mean, I venture to think, that taking that class of contract as a whole the contracting parties will generally, in a majority of cases, or at any rate in a considerable number of cases, be exposed to a real temptation by reason of the promises to do something harmful, ie, contrary to public policy; and that it is likely that they will yield to it." So, for example, in *Hall v Potter* (1695) Show 76; 1 ER 52, a marriage-brokage contract, although a proper match, was held to be unenforceable because otherwise it would provide an "evil example" to those who might be tempted to arrange improper marriages.

[27] See, for example, *Evanturel v Evanturel* (1874) LR 6 PC 1, 29, *per* Sir James W Colvile: "It was well observed during the argument that the determination of what is contrary to the so-called 'policy of the law' necessarily varies from time to time. Many transactions are upheld now by our own Courts which a former generation would have avoided as contrary to the supposed policy of the law." For examples see para 7.14 below.

[28] See, for example, Earl of Halsbury LC in *Janson v Driefontein Consolidated Mines Ltd* [1902] AC 484, 491: "I deny that any Court can invent a new head of public policy." But see Browne-Wilkinson J in *Coral Leisure Group Ltd v Barnett* [1981] ICR 503, 507: "This does not mean that the rules of public policy are fixed forever. But any variation in the rules to meet changing attitudes and standards of society will require either the intervention of Parliament or of the higher courts to declare what the new public policy is."

[29] See *Chitty on Contracts* (27th ed 1994) para 16-004 and H G Beale, W D Bishop and M P Furmston, *Contract Cases and Materials* (3rd ed 1995) pp 922-924.

[30] Section 18 of the Gaming Act 1845. Several examples can also be found in the trusts context. For example, the courts have powers to set aside certain dispositions which prejudice claims of creditors (ss 238-241 and ss 339-342 of the Insolvency Act 1986).

But the Act contains no prohibition on gaming or wagering,[31] and, historically, such contracts were generally valid at common law. Clearly one might regard such transactions as being contrary to public policy, albeit that that policy has been laid down by statute rather than the common law. But it is by no means certain that the rules on illegality apply in such cases.[32] To include all transactions (or terms of transactions) made ineffective by statute, but which do not involve the breach of any statutory prohibition, within our project would greatly increase its scope. In many such cases, the statute will, in any event prescribe what relief should be available; and, as we shall explain later,[33] where a statute does lay down a scheme of relief, we provisionally recommend that the courts should not have any power (under our proposed legislation) to override the provisions of the statute. We therefore do not intend to include within the scope of our project, transactions which are (or contain terms which are) ineffective only by reason that a statute expressly so provides.[34]

1.11 We have already mentioned that one type of transaction (or more frequently term of a transaction) which may be regarded as contrary to public policy is a covenant

[31] See *Haigh v The Town Council of Sheffield* (1874) LR 10 QB 102, 109, *per* Lush J: "[T]he ordinary practice of betting and wagering ... had been dealt with in a previous Act (8 & 9 Vict c 109) [Gaming Act 1845], by which ordinary betting was treated as a thing of neutral character, not to be encouraged, but on the other hand, not to be absolutely forbidden; and it left an ordinary bet a mere debt of honour, depriving it of all legal obligation, but not making it illegal." And see *O'Callaghan v Coral Racing Ltd*, *The Times* 26 November 1998.

[32] Most contract texts do not regard such transactions as "illegal" and therefore do not treat them as subject to the rules examined in this Paper: *Chitty on Contracts* (27th ed 1994) para 16-124; G H Treitel, *The Law of Contract* (9th ed 1995) p 477; and *Cheshire, Fifoot and Furmston's Law of Contract* (13th ed 1996) ch 10. And there are dicta in the cases to suggest that such a distinction should be drawn: see, for example, *United City Merchants v Royal Bank of Canada* [1983] AC 168, 189, *per* Lord Diplock. The position is less clear in the restitution texts, where no distinction is generally drawn between contracts which are ineffective because they involve the breach of a statutory prohibition and contracts which are ineffective pursuant to an express statutory provision to that effect but which do not involve any prohibited conduct. But we are not aware of any case law that suggests that the illegality rules would prevent recovery that might otherwise be available in the latter circumstance: see Lord Goff of Chieveley and G Jones, *The Law of Restitution* (4th ed 1993) ch 22 and A Burrows, *The Law of Restitution* (1993) ch 11 and pp 461-472. Although some trusts texts do include such cases within their chapters dealing with "illegal trusts" (for example, J E Martin, *Hanbury & Martin, Modern Equity* (15th ed 1997) ch 13 "Trusts which Contravene the Law") there is no suggestion that the common law or equitable rules on illegality, with which we are concerned in this Paper, are applicable.

[33] See paras 7.94 to 7.102 and paras 8.42 to 8.43 below.

[34] This position is the same as that which would appear to have been adopted in New Zealand, where legislation has been implemented in relation to illegal contracts. The New Zealand Illegal Contracts Act 1970 defines an "illegal contract" as "any contract that is illegal at law or in equity ...": section 3. The better view would appear to be that that provision does not include contracts that are ineffective solely pursuant to a statutory provision to that effect. Professor Brian Coote (writing in the New Zealand Law Commission's Report, Contract Statutes Review (1993) at page 176) stated: "The standard view is that all contracts are illegal if they are prohibited by an enactment (whether expressly or impliedly), or which have as their purpose the performance of an act which is so prohibited. Contracts made void or ultra vires by statute are not on that account illegal, unless the enactment also prohibits them, whether expressly or impliedly. ... [T]he fact that a contract has been made void by statute does not by itself make it illegal."

that is entered into in restraint of trade.[35] However, we intend to exclude this category from the scope of this Paper altogether and to leave the present law as it is. The common law has identified several tests for establishing whether a covenant in restraint of trade is "reasonable" and therefore enforceable.[36] Any reform of this area of the law would require a careful, specialist, examination of these complex rules and the policy issues that lie behind them. Such a task is beyond the scope of this Paper with its very broad focus on illegal transactions generally. And while it would be possible to avoid some of these difficult questions by confining the application of our provisional recommendations to covenants in restraint of trade that are "unreasonable" (so leaving the existing common law rules as to the "reasonableness" of the restraint in play) we are not convinced that such an approach would be sensible. Even reform of such limited application should involve a careful balancing of interests between those who stipulate for restraint of trade clauses and those who are bound by them.

2. AN OVERVIEW OF THE AIM OF THIS PROJECT

1.12 Having outlined the scope of this project, we need to explain what is its object. Our aim is to consider and suggest proposals for reform of the law on the effect on a transaction of the involvement of some element of illegality. That is, we are concerned with when and how the fact that a transaction involves the commission of a legal wrong (other than the mere breach of the transaction in question) or conduct that is otherwise contrary to public policy may affect its efficacy or validity. Frequent reference is made in the case law to two general principles: (i) that no action arises from an unworthy cause (*ex turpi causa non oritur actio*); and (ii) that where the guilt is shared the defendant's position is the stronger (*in pari delicto, potior est conditio defendentis*). However, the application of these maxims to individual cases has not been without difficulty. Their rigid adoption in every case would create manifest injustice. The case law therefore demonstrates the courts' willingness to manipulate the general rules and to create exceptions to their application in such a way as to reach the preferred outcome. The result is a body of case law which is uncertain, at times inconsistent, and which is by no means readily comprehensible.

1.13 Indeed in some areas the uncertainty and complexity is such that we have found it very time-consuming and difficult to ascertain and set out what the present law is. Textbook treatments differ markedly. We hope that, whatever the fate of our reform proposals, the sections of this Paper on the present law (Parts II-IV) will serve some purpose in making the present law on illegal transactions more accessible.

1.14 We do not intend to consider or propose reforms of the types of behaviour that constitute "illegality". Clearly, one would not expect a project on illegal transactions to discuss what conduct does or should amount to a legal wrong, whether criminal or civil. However, we also do not intend to consider the question of what types of conduct should be regarded as otherwise contrary to public policy. Any attempt to set out in legislation all transactions which are contrary to

[35] See para 1.8 above.

[36] J D Heydon, *The Restraint of Trade Doctrine* (1971); M Jefferson, *Restraint of Trade* (1996).

public policy would be extremely difficult, and require frequent modification. We believe that the courts remain the best arbiters of what transactions should be regarded as contrary to public policy, with Parliament intervening if ever the courts appear to err.[37] Such an approach, on matters which are inevitably controversial, would appear to be working well in practice.

1.15 Nor do we intend to enter into the on-going debate as to whether an English court would enforce a contract which is valid by its applicable, non-English, law but which has become illegal in the place of its performance as a result of a change in law since it was made.[38] Whether the court would enforce such a contract depends on whether the principle laid down in *Ralli Bros v Compania Naviera Sota y Aznar*[39] is a rule of English domestic law by which the contract is frustrated, or a rule of private international law, and, if a rule of private international law, how it fits in with the Rome Convention. In *Ralli Bros* an English court held that a contract governed by English law but to be performed in Spain was not enforceable following a change in Spanish law which made its performance there illegal. While the prevailing academic view would appear to be that the rule is one of English domestic law only,[40] the issue is one which is outside the remit of our project.

3. STRUCTURE OF THE PAPER

1.16 We consider the present law on illegality in relation to contracts in Part II and in relation to trusts in Part III. Although broadly the same principles can be seen to be running through these two areas, we have found it easier to see the principles that are in play by separating out the effects of illegality in this way. We also briefly consider in Part IV the House of Lords' recent rejection of the use of a "public conscience" test to decide what the effect of the involvement of illegality on transactions should be. In Parts V and VI we explain why we provisionally believe that legislative reform of this area of the law is needed, and what we believe are the policies that underlie the illegality rules.

1.17 We consider and set out our provisional recommendations for reform in relation to contracts and trusts in Parts VII and VIII respectively. While, for the purposes of exposition, we have found it helpful to separate out our proposals into these two separate Parts, it is, of course, important to recognise that the two sections overlap. That is, there may be fact situations which could fall within both the contracts and

[37] For example, the government has recently announced that it is examining the question whether legislation should be introduced to make pre-nuptial contracts, which the common law has traditionally regarded as contrary to public policy, enforceable: Supporting Families, Home Office Consultation Document 1998.

[38] Where such a contract is illegal *ab initio* there appears to be little doubt that an English court would refuse to enforce it as being contrary to English public policy: *Royal Boskalis Westminster NV v Mountain* [1998] 2 WLR 538, 555, *per* Stuart-Smith LJ; *Dicey and Morris on The Conflict of Laws* (12th ed 1993) p 1282 and CMV Clarkson and J Hill, *Jaffey on the Conflict of Laws* (1997) pp 237-240.

[39] [1920] 2 KB 287.

[40] *Cheshire and North's Private International Law* (12th ed 1992) pp 518-521; *Dicey and Morris on The Conflict of Laws* (12th ed 1993) pp 1243-1247; and CMV Clarkson and J Hill, *Jaffey on the Conflict of Laws* (1997) pp 237-240.

trusts Parts. This will be the case, for example, where parties enter into a contract to create a trust. Because of this potential for overlap, we have been careful to ensure that our provisional recommendations contained in Parts VII and VIII will apply in the same way to the same facts. Part IX contains a summary of our provisional recommendations and the issues on which we invite responses.

4. AN OVERVIEW OF OUR PROVISIONAL PROPOSALS

1.18 Our broad provisional proposal is that the present technical and complex rules governing the effect of illegality in relation to contracts 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.[41] We do not, however, recommend that the court should have an open-ended discretion to produce whatever it considers to be the "just" solution. That is, we provisionally propose that, generally, illegality should continue to be used only as a defence to what would otherwise be a standard claim for a contractual or restitutionary remedy or for the recognition of legal or equitable property rights.[42] We discuss one possible exception to this general rule (withdrawal during the *locus poenitentiae*), where illegality may act as a cause of action.[43]

1.19 We also provisionally recommend that the proposed discretion should be structured, in order to provide greater certainty and guidance. We therefore provisionally propose that, in exercising its discretion, a court should consider: (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 renders the transaction illegal; and (v) whether refusing to allow standard rights and remedies would be proportionate to the illegality involved.[44]

1.20 Where, however, a statute has expressly provided what should be the effect of the involvement of illegality on a transaction, we provisionally recommend that our proposed discretion should not apply. That is, we do not suggest that the courts should be able to use the discretion to override the express provisions of a statute.[45]

1.21 We consider that these provisional proposals would have two major advantages over the present law. First, a court would be able to reach its decision on the facts of a particular case using open and explicit reasoning, giving full effect to the relevance of the illegality on the transaction. Secondly, we believe that the provisional proposals would be likely to result in illegality being used less frequently to deny a plaintiff his or her usual rights or remedies. That is, under the

[41] See paras 7.2 to 7.26 and paras 8.14 to 8.20 below.

[42] See paras 7.73 to 7.87 below.

[43] See paras 7.58 to 7.69 below.

[44] See paras 7.27 to 7.43 and paras 8.51 to 8.63 below.

[45] See paras 7.94 to 7.102 and paras 8.42 to 8.43 below.

discretion, illegality would only act as a defence where there is a clear and justifiable public interest that it should do so.

5. COMPATIBILITY OF OUR PROVISIONAL PROPOSALS WITH THE EUROPEAN CONVENTION ON HUMAN RIGHTS

1.22 It is, of course, essential that our reform proposals are compatible with the European Convention for the Protection of Human Rights and Fundamental Freedoms (ECHR) which is to be incorporated into UK domestic legislation under the Human Rights Act 1998. In particular we must ensure that nothing that we propose will infringe a person's right to a fair trial (Article 6) or the principle of "no punishment without law" (Article 7). We are confident that this will not be the case. Nothing that we propose will deny a plaintiff access to the courts or to a fair and public hearing.

1.23 Under our provisional proposals the defendant may allege that the plaintiff has committed a criminal offence for the purposes of deciding the outcome of a civil dispute. Where such an allegation is made, the civil court may find that the plaintiff has committed a criminal offence, and, as a result may deny the plaintiff his or her usual civil rights and remedies. We do not envisage that either the defendant's allegation or the court's finding that the plaintiff has committed a criminal offence for the purposes of a civil trial would be construed as the plaintiff being "charged" or "held guilty" of a criminal offence for the purposes of Article 6(2) or 6(3) or Article 7. It is important to note that, if such a construction were taken, not only might our provisional proposals, but also the present illegality rules, infringe the ECHR. Nor do we believe that our provisional proposals will infringe Article 1 of the First Protocol, since, to the extent that the Article is applicable, we consider that the public interest provision would apply. Indeed, if anything, there is a greater risk of successful challenge under the present common law illegality rules, which provide no opportunity to assess the proportionality of allowing an illegality defence to defeat the plaintiff's claim to his or her usual rights and remedies and do not apply any test based on the public interest. **We would be very grateful if consultees with the relevant expertise could let us know whether they agree with our view that our provisional recommendations do not infringe the European Convention for the Protection of Human Rights and Fundamental Freedoms, and, if they do not agree, to explain their reasoning.**

6. ACKNOWLEDGEMENTS

1.24 We would like to thank Professor Richard Buckley of the University of Reading who has been our consultant on this project and provided invaluable help in the preparation of this paper; and Mr Martin Eaton of the Foreign and Commonwealth Office for his assistance in assessing the compatibility of our provisional proposals with the European Convention on Human Rights.

PART II
THE EFFECT OF ILLEGALITY I: CONTRACTS

2.1 We have explained in the Introduction[1] that we are concerned with transactions that involve the commission of a legal wrong (other than the mere breach of the transaction in question) or conduct which is otherwise contrary to public policy. In this Part we examine the effect that the involvement of that illegality (that is the legal wrong or conduct otherwise contrary to public policy) may have on the validity or efficacy of a contract.[2] We have divided our discussion into three main sections. First, we look at the question whether the courts will enforce a contract that involves illegality. Secondly, we consider whether, in those cases where the contract is not enforceable because of illegality, a party is able to seek restitution of benefits which he or she has conferred under it. Thirdly, we consider whether the courts recognise the validity of proprietary rights which have been transferred or created under such a contract. A final section looks at three other issues: damages for a different cause of action; severance; and the tainting of linked contracts.

1. THE ENFORCEMENT OF CONTRACTUAL OBLIGATIONS[3]

2.2 Illegality, where operative, acts as a defence to the general right that a party would otherwise have to enforce a contract (that is, it acts as a defence to what would otherwise be a valid claim for damages for breach of contract or to an action for the agreed price).[4] The rules relating to when illegality is a defence to the

[1] See para 1.4 above.

[2] Closely related to the rules on the effect of illegality is the principle that no man may benefit from his own crime. Under this principle, frequently referred to as the "forfeiture rule", it has been held that a murderer is not entitled to benefit under the will or intestacy of his victim (*Re Sigsworth* [1935] 1 Ch 89). (See now the Forfeiture Act 1982.) The application of the forfeiture rule to lesser crimes (in particular those that do not require *mens rea*) is far from clear. The rule has frequently been raised by defendants where the plaintiff seeks to enforce a contract which involves the commission of a statutory criminal offence, but mostly distinguished: see *Marles v Philip Trant & Sons Ltd* [1954] 1 QB 29, 39, *per* Denning LJ; and *St John Shipping Corporation v Joseph Rank Ltd* [1957] 1 QB 267, 292, *per* Devlin J.

[3] Although some of the cases describe contracts affected by illegality as being "void", we have deliberately not used this term. Not only does the case law illustrate that in certain instances it is only one party to the contract involving illegality who loses his or her usual contractual rights and remedies, but the use of the term "void" may cause confusion in relation to the proprietary consequences of an illegal contract which has been completed. Instead, we consider the "enforcement" of contractual obligations in this section, and go on to consider the "recognition of contractually transferred or created property rights" below (see paras 2.57 to 2.69).

[4] *A fortiori* where illegality acts as a defence to a claim for damages for breach of contract, *prima facie* it will also act as a defence to an order for specific performance: I C F Spry, *The Principles of Equitable Remedies* (4th ed 1990) p 143. Some commentators argue that specific performance may be denied even where damages for breach would be available. This might be the case where there is a substantial risk that performance would involve the commission of an illegality, even though the probable commission of the illegality has not been so clearly established that proceedings for damages would fail: I C F Spry, *The Principles of Equitable Remedies* (4th ed 1990) pp 143-144.

enforcement of contractual obligations are numerous and complex. It is difficult to extract the various principles applied by the courts and some of the decisions are hard to reconcile. The case law draws a distinction between contracts which are rendered unenforceable by statute (that is where the statute expressly or impliedly provides that a contract which involves the breach of one of its provisions should be unenforceable by either or both parties) and those which are rendered unenforceable by common law. We look at both these categories in turn.

(1) Contracts rendered unenforceable by statute

2.3 In *Curragh Investments Ltd v Cook*[5] the defendant claimed that a failure by the plaintiff to comply with certain statutory requirements relating to company registration had rendered the plaintiff's contract for the sale of land illegal and unenforceable. Although on the facts he rejected this contention, Megarry J accepted that:

> [W]here a contract is made in contravention of some statutory provision then, in addition to any criminal sanctions, the courts may in some cases find that the contract itself is stricken with illegality. ... If the statute prohibits the making of contracts of the type in question, or provides that one of the parties must satisfy certain requirements (eg by obtaining a licence or registering some particulars) before making any contract of the type in question, then the statutory prohibition or requirement may well be sufficiently linked to the contract for questions to arise of the illegality of any contract made in breach of the statutory requirement.[6]

2.4 The doctrine referred to in this passage is generally known as "implied statutory prohibition". It is not uncommon for a statute to provide expressly what should be the consequences for a contract which involves the breach of one of its provisions.[7] But where the statute is silent on the point, it will be necessary for the court to construe the legislation in order to determine whether the object of the statute is such as impliedly to prohibit a contract whose formation, purpose or performance involves a breach of its provisions[8] and thereby render it unenforceable by either or

[5] [1974] 1 WLR 1559.

[6] [1974] 1 WLR 1559, 1563.

[7] See, for example, s 5 of the Financial Services Act 1986 relating to agreements for investment business made by or through unauthorised persons: "... any agreement to which this subsection applies - (a) which is entered into by a person in the course of carrying on investment business in contravention of section 3 above ... shall be unenforceable against the other party; and that party shall be entitled to recover any money or other property paid or transferred by him under the agreement, together with compensation for any loss sustained by him as a result of having parted with it."

[8] Most cases involve conduct that is in breach of an express statutory prohibition. But the prohibition may be implied rather than express. For example, the relevant statute in *Cope v Rowlands* (1836) 2 M & W 149; 150 ER 707 (discussed at para 2.9 below) imposed a penalty on persons acting as a stockbroker without obtaining authorisation from the City of London. The court held that by imposing a penalty the statute implied that such conduct was prohibited. See also *Bartlett v Vinor* Carthew 251, 252; 90 ER 750, *per* Lord Holt: "Every contract made for or about any matter or thing which is prohibited and made unlawful by any statute, is a void contract, tho' the statute itself doth not mention that it shall be so, but only inflicts a penalty on the offender, because a penalty implies a prohibition, tho' there are no prohibitory words in the statute."

both parties.[9] Although in most cases the breach of statutory provision constitutes a criminal offence, this would not appear to be a prerequisite for the implied statutory prohibition doctrine to apply.[10]

2.5 Where the court finds that a contract is impliedly prohibited by statute it may be unenforceable by the plaintiff regardless of his or her intentions or knowledge of the breach. An unmeritorious defendant, who is aware of and might even have induced the breach of statutory provision, may therefore be able to rely on a defence of illegality in order to defeat a plaintiff's claim. This is illustrated by *Re Mahmoud and Ispahani*,[11] in which the plaintiff had agreed to sell linseed oil to the defendant. A statutory regulation provided that no person should buy or sell linseed oil except under, and in accordance with, the terms of a licence issued by the Food Controller. The plaintiff's licence allowed him to sell linseed oil only to persons who were also licensed. The defendant did not have a licence, but induced the plaintiff to enter into the contract by fraudulently misrepresenting that he did. The defendant subsequently refused to take delivery of the oil and the plaintiff sought to enforce the contract in an action for damages for non-acceptance. The Court of Appeal held that the contract was impliedly prohibited by statute and therefore unenforceable. Bankes LJ said: "[A]s the language of the Order clearly prohibits the making of this contract, it is open to a party, however shabby it may appear to be, to say that the Legislature has prohibited this contract, and therefore it is a case in which the Court will not lend its aid to the enforcement of the contract."[12]

2.6 But it is clear that not every contract which involves the breach of a statutory provision will thereby be impliedly prohibited and unenforceable. For example, in

[9] But see Gibbs ACJ in *Yango Pastoral Company Pty Ltd v First Chicago Australia Ltd* (1978) 139 CLR 410, 413: "It is often said that a contract expressly or impliedly prohibited by statute is void and unenforceable. That statement is true as a general rule, but for complete accuracy it needs qualification, because it is possible for a statute in terms to prohibit a contract and yet to provide, expressly or impliedly, that the contract will be valid and enforceable. However, cases are likely to be rare in which a statute prohibits a contract but nevertheless reveals an intention that it shall be valid and enforceable, and in most cases it is sufficient to say, as has been said in many cases of authority, that the test is whether the contract is prohibited by the statute."

[10] For example, in *Fuji Finance Inc v Aetna Life Insurance Co Ltd* [1997] Ch 173 the defendant insurance company argued, *inter alia*, that a contract which it had entered into with the plaintiff was unenforceable because it was not a contract of insurance as defined in the Insurance Companies Act 1982, and section 16(1) of that Act prohibited an insurance company from carrying on any activities otherwise than in connection with its insurance business. The Act specifically provided that a breach of section 16(1) did not amount to a criminal offence. Since the Court of Appeal held that the contract was a contract of insurance, the illegality point did not need to be decided. In *obiter dicta*, Morritt LJ and Sir Ralph Gibson expressed differing opinions. But neither were of the view that the fact that the breach was not a criminal offence was sufficient by itself to defeat the defendant's argument.

[11] [1921] 2 KB 716.

[12] [1921] 2 KB 716, 724. See also, Devlin J in *St John Shipping Corporation v Joseph Rank Ltd* [1957] 1 QB 267, 283: "[T]he court will not enforce a contract which is expressly or impliedly prohibited by statute. If the contract is of this class it does not matter what the intent of the parties is; if the statute prohibits the contract, it is unenforceable whether the parties meant to break the law or not."

St John Shipping Corporation v Joseph Rank Ltd[13] the plaintiff had carried grain for the defendants from Alabama to England. In doing so, the plaintiff had overloaded its ship so that the loadline was submerged. This was a statutory offence, and the plaintiff was prosecuted and fined for it. However, when the defendants sought to withhold part of the freight due, on the basis that the plaintiff had carried out the contract in an unlawful manner, the plaintiff was successful in enforcing the contract. Devlin J said that when construing the relevant statute two questions were involved. Does the statute mean to prohibit contracts at all? If so, does the contract in question belong to the class which the statute intends to prohibit? Contracts for the carriage of goods were held not to be within the ambit of the statute at all.[14]

2.7 Devlin J warned that the courts should not be too ready to imply a statutory prohibition. He said: "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."[15]

2.8 A similar approach was adopted by the Court of Appeal in *Archbolds (Freightage) Ltd v S Spanglett Ltd*.[16] The defendants owned a number of vans with "C" licences which, under the Road and Rail Traffic Act 1933, entitled them to carry only their own goods. They entered into a contract to carry the plaintiffs' whisky from Leeds to London. The plaintiffs believed that the defendants held "A" licences, which would have entitled them to carry other people's goods for reward. The whisky was stolen en route due to the negligence of the defendants' driver, and the plaintiffs claimed damages for the loss. The defendants pleaded that the contract was impliedly prohibited by the statute and therefore unenforceable. The Court of Appeal found for the plaintiffs. The Court held that the object of the Road and Rail Traffic Act was not to interfere with the owner of goods or his facilities for transport, but to control those who provided the transport, with a view to promoting transport efficiency. Transport of goods was not made illegal but the various licence holders were prohibited from encroaching on one another's territory, the intention of the Act being to provide an orderly and comprehensive service.[17]

[13] [1957] 1 QB 267. The decision is criticised in J D McCamus "Restitutionary Recovery of Benefits Conferred under Contracts in Conflict with Statutory Policy - the New Golden Rule" (1987) 25 Osgoode Hall LJ 787, 807 where it is suggested that the case was incorrectly decided and that the contract should have been held to be unenforceable, but the plaintiff entitled to a claim for the value of its services.

[14] [1957] 1 QB 267, 287-288.

[15] [1957] 1 QB 267, 288. See also, *Shaw v Groom* [1970] 2 QB 504, 523 where Sachs LJ said: "Today's generation is dominated by that ever mounting mass of legislative control ...: in support of that control numberless offences have been created each with its appropriate penalty, and it is for the courts to see that this does not result in additional forfeitures and injustices which the legislature cannot have intended." And see, *Belvoir Finance Co Ltd v Stapleton* [1971] 1 QB 210, 219.

[16] [1961] 1 QB 374.

[17] [1961] 1 QB 374, 386, *per* Pearce LJ.

2.9 How can one ascertain whether a statute impliedly prohibits, and thereby renders unenforceable, a contract which is entered into, or performed, in breach of its provisions? This depends upon considerations of public policy in the light of the mischief which the statute is designed to prevent, its language, scope and purpose, the consequences for the innocent party, and any other relevant considerations.[18] Several tests have been suggested. A distinction frequently referred to is whether the object of the statute in imposing sanctions for breach of its provisions is to increase the national revenue, for example by requiring a trader to purchase a licence, or whether it is also intended to protect the public. Implied illegality is more likely to be found in the case of a contract which involves the latter than the former. For example, in *Cope v Rowlands*[19] it was held that an otherwise valid brokerage contract made by a person who had failed to comply with a statutory requirement to obtain a licence from the City of London was unenforceable. Parke B said:

> [T]he question for us now to determine is, whether the enactment of the statute ... is meant merely to secure a revenue to the city, and for that purpose to render the person acting as a broker liable to a penalty if he does not pay it? or whether one of its objects be the protection of the public, and the prevention of improper persons acting as brokers? ... [T]he 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.[20]

2.10 By contrast, in *Smith v Mawhood*[21] the court held that a contract for the sale of tobacco had not been impliedly prohibited by statute and was therefore enforceable. The plaintiff vendor, a tobacconist, had failed to comply with a statutory requirement to take out a licence and display his name on his place of business, and the defendant purchaser had argued that this breach of statute rendered the sale contract unenforceable. Parke B said:

> I think that the object of the legislature was not to prohibit a contract of sale by dealers who have not taken out a licence pursuant to the act of Parliament. If it was, they certainly could not recover, although the prohibition were merely for the purpose of revenue. But, looking at the act of Parliament, I think its object was not to vitiate the contract itself, but only to impose a penalty on the party offending, for the purpose of the revenue.[22]

[18] *Phoenix General Insurance Co of Greece SA v Halvanon Insurance Co Ltd* [1988] QB 216, 273, *per* Kerr LJ.

[19] (1836) 2 M & W 149; 150 ER 707.

[20] (1836) 2 M & W 149, 158-159; 150 ER 707, 710-711.

[21] (1845) 14 M & W 452; 153 ER 552.

[22] (1845) 14 M & W 452, 463; 153 ER 552, 557.

2.11 However, this distinction is by no means decisive. For example, in *Shaw v Groom*[23] the Court of Appeal held that a tenancy is not impliedly prohibited by statute simply because the landlord committed a statutory offence by failing to supply her tenant with a proper rent-book. The Court held that on a true construction of the relevant statute, Parliament had not intended to preclude a landlord who failed to comply from recovering rent. And, as the High Court of Australia noted in a recent case, *Fitzgerald v F J Leonhardt Pty Ltd*[24] the purpose of the statute may be adequately served by the imposition of a penalty, notwithstanding that it is for the protection of the public.

2.12 A second test sometimes adopted is to ask whether the statute penalises the carrying out of a certain type of commercial activity in general, or whether it imposes penalties in relation to each individual contract. If the former is the case, that has occasionally been treated as an indication that no implied prohibition was intended. Thus in the Australian case of *Yango Pastoral Company Pty Ltd v First Chicago Australia Ltd*[25] the fact that the statute in question imposed a daily fine on unauthorised banking business regardless of the number of contracts entered into on that day was said to indicate that Parliament had not intended to prohibit each contract made in the course of the business but only to penalise the carrying on of the business without authority.[26] The distinction was applied to reach the opposite conclusion in *Victorian Daylesford Syndicate Ltd v Dott*.[27] Buckley J observed: "Not a bad test to apply is to see whether the penalty in the Act is imposed once [and] for all, or whether it is a recurrent penalty imposed as often as the act is done. If it be the latter, then the act is a prohibited act."[28]

2.13 Finally, it has been persuasively argued that an important consideration should be whether the statute necessarily contemplates the prohibited acts as being done in the performance of a contract.[29] So, for example, where a statute penalises the sale of certain products, one may readily imply that the legislature intended to prohibit a contract to sell that product. But, where a statute penalises the breaking of road speed limits, it would be a misuse of language to suggest that the statute impliedly prohibits a contract which necessarily involved the breaking of those limits.

2.14 What is not clear from the case law is whether a contract which is impliedly prohibited by statute is always unenforceable by both parties, or whether there are circumstances in which only one party will be affected. Some cases have assumed that both parties are unable to enforce a contract which is impliedly prohibited; and indeed the drastic consequences that would result have influenced the courts to hold that this cannot have been what Parliament intended. For example, in the Australian case of *Yango Pastoral Company Pty Ltd v First Chicago Australia Ltd*[30]

[23] [1970] 2 QB 504.

[24] (1997) 189 CLR 215.

[25] (1978) 139 CLR 410.

[26] (1978) 139 CLR 410, 415, *per* Gibbs ACJ; 435, *per* Murphy J.

[27] [1905] 2 Ch 624.

[28] [1905] 2 Ch 624, 630.

[29] R A Buckley, "Implied Statutory Prohibition of Contracts" (1975) 38 MLR 535.

[30] (1978) 139 CLR 410.

(referred to at paragraph 2.12 above) the defendants sought to avoid payment under mortgages and guarantees given to the plaintiff bank. They argued that since the bank had not obtained the statutory authorisation required to carry on banking business, the mortgages and guarantees were impliedly prohibited by statute. The Australian High Court said that the effect of finding an implied statutory prohibition would mean that all contracts entered into by the bank were impliedly prohibited and therefore unenforceable. This would include not only contracts by which the bank had agreed to lend money, but also those by which it had agreed to receive money from depositors. The result of accepting the defendants' argument might therefore be that innocent depositors, who had placed money with a bank which was carrying on unauthorised business, would be unable to seek the assistance of the courts to recover it.[31] The Court concluded that it was not rational to suppose that Parliament intended to inflict such dire consequences on innocent depositors and that therefore the statute did not prohibit and thereby invalidate contracts entered into in breach of the relevant section.

2.15 Similar considerations led the Court of Appeal in *Hughes v Asset Managers plc*[32] to hold that investment management agreements entered into by an unlicensed agent in breach of the Prevention of Fraud (Investments) Act 1958 were not impliedly prohibited. The plaintiffs had invested £3m with the defendant investment mangers pursuant to various investment management agreements. Following a fall in the stock market the value of the plaintiffs' investments fell by £1m. The plaintiffs brought the action to recover the loss on the ground that the individual agent who had signed the investment agreements on behalf of the defendants was not licensed as required by the 1958 Act and that as a consequence the agreements were rendered void. The Court of Appeal readily accepted that the 1958 Act had been passed in order to protect the investing public. However, it held that there was no basis in the words of the legislation, the type of prohibition or considerations of public policy for the assertion that Parliament must be taken to have intended that such protection required that any deals made through the agency of an unlicensed person should automatically be struck down. On the contrary, there was good reason why Parliament should have held the contrary view. As Saville LJ said:

> [I]t must be remembered ... that rendering transactions void affects both the guilty and the innocent parties. The latter, just as much as the former, cannot enforce a void bargain or obtain damages for its breach. In the context of the section under discussion this could well produce very great hardship and injustice on wholly innocent parties; for example, where the dealer fails to perform a bargain which would have resulted in a profit or saved the investor from a loss. In other words, the argument put forward by the appellants necessarily involves the proposition that Parliament has chosen to provide a defence against claims for breach of contract in favour of the very people who have ignored its licensing requirements. ... I can find nothing to indicate that this is what Parliament did, or intended to do, when

[31] (1978) 139 CLR 410, 415, *per* Gibbs ACJ; 427, *per* Mason J.

[32] [1995] 3 All ER 669.

enacting this statute, nor anything to indicate any good reason or public need for such a result.[33]

2.16 However, other cases suggest that in certain circumstances only one party will be affected by the illegality and the other party will be left to his or her usual contractual rights and remedies. Clearly, a statute may expressly lay down such an effect,[34] and some cases suggest that a statute may impliedly reach the same result. In *Anderson Ltd v Daniel*[35] the plaintiff agreed to sell "salvage" (the sweepings from the holds of ships that had carried certain chemical cargoes) to the defendant for use as fertiliser. The Fertilisers and Feeding Stuffs Act 1906 required that the vendor of fertiliser imported from abroad give the purchaser an invoice setting out its chemical contents. This would have been impractical in the case of salvage, and, in accordance with the custom of the trade, the vendor did not provide such an invoice. In an action by the vendor for the price, the purchaser argued that since the vendor had failed to supply the required invoice, he had committed a statutory offence in the performance of the contract which rendered the contract illegal and the price could not therefore be recovered. The Court of Appeal accepted this argument. Both Bankes and Scrutton LJJ described the contract as "illegal":[36] it was not necessary for the purchaser to show that the contract was illegal when it was entered into in order to avoid it; it was sufficient to show that the vendor failed to perform it in the only way in which the statute allowed it to be performed.[37] However, in a subsequent case, *Marles v Philip Trant & Sons Ltd*,[38] the majority of the Court of Appeal said that Bankes and Scrutton LJJ had been incorrect to describe the contract in *Anderson Ltd v Daniel* as "illegal". Rather, it was merely unenforceable by the vendor and, had the vendor repudiated the contract prior to performance, the purchaser would have been able to sue for non-delivery.[39]

[33] [1995] 3 All ER 669, 674.

[34] See, for example, section 132(1) Financial Services Act 1986.

[35] [1924] 1 KB 138.

[36] [1924] 1 KB 138, 144, *per* Bankes LJ; 147, *per* Scrutton LJ. Rather than describing the contract as illegal, Atkin LJ [1924] 1 KB 138, 149 said that it was "unenforceable by the offending party".

[37] The effect of the decision was reversed by section 1(2) of the Fertilisers and Feeding Stuffs Act 1926 which provided that failure to give a statutory statement in accordance with the provisions of the statute should not invalidate a contract for sale.

[38] [1954] 1 QB 29.

[39] [1954] 1 QB 29, 32, *per* Singleton LJ; 36, *per* Denning LJ. In this case seed merchants had sold some wheat seed to a farmer, but failed to supply him with a statement in writing showing that the seed satisfied the requirements as to purity and germination laid down by the Seeds Act 1920. Although the seed was pure, the farmer sued for breach of warranty because the seed had been sold to him as spring wheat when it was in fact winter wheat. He recovered damages from the merchants. The merchants then sued their supplier because he had also sold them the wheat as spring wheat. The supplier had no defence to this breach of warranty, but he argued that the merchants could not recover as damages the amount which they had paid to the farmer, because those were damages awarded against them in breach of an illegal contract (the illegality being the failure to supply the statement about purity and germination). The Court of Appeal held (Singleton LJ disagreeing) that to recover substantial damages the merchants would need to rely on their contract with the farmer. But recovery was ultimately allowed, since Denning LJ said that such reliance was

2.17 It has been suggested that, whenever it is the conduct of only one of the parties that is in breach of a statutory provision, the innocent party should not be deprived of his or her contractual rights.[40] However, the case law clearly does not bear this out, even though it is recognised that it is harsh not to do so. A notorious example is *Phoenix General Insurance Co of Greece SA v Halvanon Insurance Co Ltd*.[41] Kerr LJ (with whom Parker and Balcombe LJJ agreed) was of the view that contracts of insurance entered into by insurers who were not properly authorised under the Insurance Companies Act 1974 were impliedly prohibited by the Act.[42] The Act made it an offence for unauthorised insurers to carry on the business of "effecting and carrying out contracts of insurance". Kerr LJ said that had the provision merely prohibited insurers from carrying on the business of effecting contracts of insurance, then it would have been open for the court to hold that considerations of public policy precluded the implication that such contracts were prohibited and unenforceable. However, he reluctantly concluded that the extension of the prohibition to "*carrying out* contracts of insurance" had the unfortunate effect that contracts made without authorisation were prohibited by necessary implication and therefore illegal and void. In fact, the court held that what the insurers had done was authorised under the Act and that the insurance contracts in question were not therefore caught by the prohibition. But, had the court not been able to reach such a conclusion, Kerr LJ was clear that the result would have been "to prevent the insured from claiming under the contract and would merely leave him with the doubtful remedy of seeking to recover his premium as money had and received."[43]

permissible because the illegality was one of mere inadvertence and the damage did not result from that omission. Hodson LJ dissented: he held that because of the illegality in the performance of their contract with the farmer, the merchants could not rely on that contract in order to recover substantial damages from the supplier. Parliament shortly afterwards clarified the position by section 12(1) of the Agriculture (Miscellaneous Provisions) Act 1954 which provided that the validity of a contract for the sale of seeds or the right to enforce it shall not be affected by any illegality under the Seeds Act in the performance of the contract.

40 See *Chitty on Contracts* (27th ed 1994) paras 16-133 to 16-134. It is suggested there that any cases to the contrary are wrongly decided.

41 [1988] QB 216. See also *Mohamed v Alaga & Co* [1998] 2 All ER 720 (an agreement between a solicitor and the plaintiff (a lay person) whereby the solicitor agreed to share his fees with the plaintiff in consideration of the introduction of clients was prohibited by the Solicitors' Practice Rules 1990 and therefore unenforceable by the plaintiff. The Rules expressly prohibited a solicitor both from entering into such contracts and from making any payment in the performance of such contracts). See further para 2.37 below.

42 In its interpretation of the Insurance Companies Act 1974, the Court of Appeal approved the decision of Parker J in *Bedford Insurance Co Ltd v Instituto de Resseguros do Brasil* [1985] QB 966 but overruled the decision of Leggatt J in *Stewart v Oriental Fire and Marine Insurance Co Ltd* [1985] QB 988. The obiter dicta of Kerr LJ in *Phoenix General Insurance Co of Greece SA v Halvanon Insurance Co Ltd* have been followed in *Re Cavalier Insurance Co Ltd* [1989] 2 Lloyd's Rep 430 (see para 2.41 n 118 below); *Overseas Union Insurance Ltd v Incorporated General Insurance Ltd* [1992] 1 Lloyd's Rep 439; and *D R Insurance Co v Seguros America Banamex* [1993] 1 Lloyd's Rep 120.

43 [1988] QB 216, 273. The relevant provision has since been amended by s 132 of the Financial Services Act 1986 to enable the insured, but not the insurer, to enforce the insurance contract.

2.18 Similarly, in *Re Mahmoud and Ispahani*[44] (discussed at paragraph 2.5 above) it was not clear, and according to Bankes LJ and Atkin LJ immaterial,[45] whether the plaintiff, as well as the defendant, had committed a statutory offence by entering into the contract for the sale of linseed oil. In either case the plaintiff would have been unable to enforce the contract. *Re Mahmoud and Ispahani*[46] was followed by the Privy Council in *Chai Sau Yin v Liew Kwee Sam*.[47] The defendant bought a quantity of rubber from the plaintiff in breach of a Malayan statutory provision which required a purchaser of rubber to be licensed. After accepting delivery of the rubber, the defendant refused to pay the price. The Privy Council held that the sale contract entered into in breach of the licensing condition was impliedly prohibited by the statute and the defendant was able to rely on his own unlawful actions to defeat a claim by the plaintiff for the sale price. Yet the plaintiff had not been in breach of any statutory prohibition.

2.19 An alternative approach that is sometimes adopted is to distinguish between those contracts which involve the breach of a statutory prohibition in their formation, and those which involve the breach of a statutory prohibition in their performance. Where it is the formation of the contract that involves the breach of a statutory prohibition, then it is said that the contract will be unenforceable by both parties, even though only one may have acted unlawfully; but where it is the manner of performance that is prohibited, it is only enforceability by the party responsible for the prohibited action that is ever in doubt. The innocent party will always be entitled to sue.[48] There is support for this proposition in the case law,[49] but it is not a distinction that is always drawn. For example, in *Archbolds (Freightage) Ltd v S Spanglett Ltd*[50] (discussed at paragraph 2.8 above) the Court of Appeal regarded it as making no difference whether the contract of carriage specified for the whisky to be carried in the particular unlicensed van, or whether the defendants were entitled to carry it in any way they liked. But such a finding would have been essential if a distinction were to be drawn between a contract which was unlawful from the outset and a contract which, though it could be lawfully performed, the defendants had chosen to perform in breach of the statute.[51]

[44] [1921] 2 KB 716.

[45] [1921] 2 KB 716, 724 and 731 respectively.

[46] [1921] 2 KB 716.

[47] [1962] AC 304.

[48] See *Cheshire, Fifoot and Furmston's Law of Contract* (13th ed 1996) pp 366-368 and J Beatson, *Anson's Law of Contract* (27th ed 1998) pp 334-335.

[49] See, for example, *Re Mahmoud and Ispahani* [1921] 2 KB 716, 725, *per* Bankes LJ; 729, *per* Scrutton LJ.

[50] [1961] 1 QB 374.

[51] [1961] 1 QB 374, 383, *per* Pearce LJ. See further G H Treitel, *The Law of Contract* (9th ed 1995) p 444.

(2) Contracts rendered unenforceable at common law

(a) Contracts to commit a legal wrong or carry out conduct which is otherwise contrary to public policy

2.20 It is sometimes said that a contract to commit a crime or other act which is contrary to public policy is illegal and unenforceable by either party.[52] Such a contract is said to be "illegal as formed" or "illegal in its inception,"[53] and therefore unenforceable by either party, whether or not either or both are aware that the intended act is contrary to the law or public policy.[54] There is some support for this approach in the case law. In *J M Allan (Merchandising) Ltd v Cloke*[55] the plaintiffs hired a roulette wheel to the defendants with the express purpose that the wheel be used for a game which, unknown to either party, was unlawful under the Betting and Gaming Act 1960. When the plaintiffs discovered this, they suggested to the defendants that the game should be played according to varied legal rules. Instead, the defendants refused to pay the next hire instalment due and returned the equipment. In an action by the plaintiffs for money due under the contract, the defendants claimed that where a contract was made for the express purpose of violating the law, the contract was unenforceable. The Court of Appeal accepted

[52] See P S Atiyah, *An Introduction to the Law of Contract* (5th ed 1995) p 341 and *Cheshire, Fifoot and Furmston's Law of Contract* (13th ed 1996) p 385.

[53] *Cheshire, Fifoot and Furmston's Law of Contract* (13th ed 1996) pp 385-386. The distinction between contracts which are "illegal as formed" and contracts which are "illegal as performed" is frequently referred to in the case law: see, for example, *Re Mahmoud and Ispahani* [1921] 2 KB 716, 725, *per* Bankes LJ; 729, *per* Scrutton LJ; *Anderson Ltd v Daniel* [1924] 1 KB 138, 144, *per* Bankes LJ; 149, *per* Atkin LJ; *Edler v Auerbach* [1950] 1 KB 359, 367, *per* Devlin J. It is also made by some academic commentators: the distinction is adopted by Professor Prentice in his analysis in Chitty (*Chitty on Contracts* (27th ed 1994) ch 16) and by Professor Furmston (*Cheshire, Fifoot and Furmston's Law of Contract* (13th ed 1996) ch 11), but Professor Treitel rejects it (G H Treitel, *The Law of Contract* (9th ed 1995) pp 438-447).

[54] The legal wrong involved may be a statutory or common law wrong. As Professor Furmston points out, the question whether a contract is illegal at common law because it is a contract to breach a statutory provision is a separate question to that dealt with in paras 2.3 to 2.19 above (whether the contract is expressly or impliedly prohibited by statute). In practice, where the breach of a statutory provision is involved, the courts have usually concentrated only on the question of implied statutory prohibition: M P Furmston, "The Analysis of Illegal Contracts" (1966) 16 University of Toronto LJ 267, 281. Devlin J, however, drew attention to the distinction in his judgment in *St John Shipping Corporation v Joseph Rank Ltd* [1957] 1 QB 267, 283. He said that there are two general principles relating to illegal contracts. The first is that a contract which is entered into with the object of committing an illegal act is unenforceable; and the second is that the court will not enforce a contract which is expressly or impliedly prohibited by statute. He continued: "A significant distinction between the two classes is this. In the former class you have only to look and see what acts the statute prohibits; it does not matter whether or not it prohibits a contract; if a contract is deliberately made to do a prohibited act, that contract will be unenforceable. In the latter class, you have to consider not what acts the statute prohibits, but what contracts it prohibits; but you are not concerned at all with the intent of the parties; if the parties enter into a prohibited contract, that contract is unenforceable." See further, *Chitty on Contracts* (27th ed 1994) paras 16-122 to 16-123 and J Beatson, *Anson's Law of Contract* (27th ed 1998) pp 336-337.

[55] [1963] 2 QB 340. See also *The Gas Light and Coke Company v Samuel Turner* (1840) 6 Bing NC 324; 133 ER 127. The plaintiff let premises to the lessee with the express purpose that the premises should be used by the lessee in a manner prohibited by statute. The plaintiff's claim for rent due under the lease failed on the basis of the illegality.

the defendants' argument. Where there was a common design to use the subject-matter of the contract for an unlawful purpose, the contract was illegal and unenforceable, and it was no excuse for either party to say that they did not know the law.[56]

2.21 The same approach has been adopted in cases concerning contracts to do an act which is contrary to public policy. So, for example, in *Oom v Bruce*[57] it was assumed that a contract of insurance made with an alien enemy after the commencement of hostilities would be unenforceable by either party, even though neither party was aware at the time that the contract was made that war had been declared.

2.22 However, it must be doubtful whether the law is always so rigid.[58] The plethora of statutory regulation in recent years has seen the creation of numerous statutory offences that may be committed without any *mens rea*, are punishable only by a fine, and the breach of which may involve misconduct of a fairly trivial nature.[59] The idea of denying enforceability to both parties if a contract is "illegal in its inception" has been questioned by Pearce LJ in *Archbolds (Freightage) Ltd v S Spanglett Ltd*.[60] The defendants carried the plaintiffs' whisky from Leeds to London in a van which, unknown to the plaintiffs, was not licensed to carry goods for reward. The Court of Appeal upheld the trial judge's finding that the contract of carriage had not identified a particular van for its performance and was not,

[56] [1963] 2 QB 340, 348, *per* Lord Denning MR. And see *Nash v Stevenson Transport Ltd* [1936] 2 KB 128. *Waugh v Morris* (1873) LR 8 QB 202 was distinguished on the basis that in that case the actual contract could be, and in fact was, performed lawfully. The plaintiff contracted to carry hay from France to London for the defendant. Both parties assumed that the hay would be delivered to a particular dock in London but this was not stipulated in the charterparty. Unknown to either party, it had recently become unlawful to unload French hay in the United Kingdom under legislation made to prevent the spread of contagious diseases. When the defendant realised this, he unloaded the hay from alongside the ship into another vessel and exported it. However, this caused some delay and the plaintiff brought an action for the detention of his ship. His claim succeeded. The court accepted that where a contract is to do a thing which cannot be performed without a violation of the law it is void, whether the parties knew the law or not. But that was not the case here. It was not part of the contract that the hay should be landed. All that the plaintiff bargained for, and all that he can properly be said to have intended, was that, on the arrival of the ship in London, his freight should be paid and the hay taken out of his ship. See also, *Hindley and Company Ltd v General Fibre Company Ltd* [1940] 2 KB 517.

[57] (1810) 12 East 225; 104 ER 87.

[58] An early case which casts doubt on the rule is *Bloxsome v Williams* (1824) 3 B & C 232; 107 ER 720. The plaintiff contracted to buy a horse from the defendant on a Sunday, unaware that the defendant was a horse dealer and thereby committed an offence under the Sunday Observance Act 1677. The contract contained a warranty that the horse was sound. When the plaintiff discovered that this was not the case, he was held entitled to recover his money from the dealer. Although note that the decision, to the extent that it involved contractual enforcement rather than a claim for the recovery of money paid under a void contract, was doubted by Bankes LJ in *Re Mahmoud and Ispahani* [1921] 2 KB 716, 726.

[59] See, for example, M P Furmston, "The Analysis of Illegal Contracts" (1966) 16 University of Toronto LJ 267, 280: "Suppose, for instance, a contract is made to carry goods by road and the parties know that the goods can only be delivered by a short period of illegal parking. It seems very doubtful whether public policy really requires the carrier to be deprived of his freight ..."

[60] [1961] 1 QB 374.

therefore, one which was incapable of legal performance from the outset. However, Pearce LJ went on to consider what the position would be if the contract had specified the particular van. Having found that the contract of carriage was not impliedly prohibited by the Road and Rail Traffic Act 1933,[61] he went on to consider whether it would be unenforceable at common law. He accepted that a contract which, to the knowledge of both parties could not be carried out without the commission of an unlawful act would be unenforceable, but said that where one party was ignorant of the circumstances that would produce the illegality, he or she should not be debarred from relief.[62]

2.23 The position in relation to a contract to commit a civil wrong is even less clear.[63] A contract has been held to be unenforceable because it has as its object the commission of the tort of deceit,[64] but the language of the judgments is expressed sufficiently widely to cover the commission of any tort.[65] In one early case a contract to beat a third party was held to be illegal[66] and a contract to print matter known by both parties to be libellous has also been held to be illegal.[67] Where neither party is aware that performance of the contract will involve a tort, we are not aware of any case law to suggest that the contract is unenforceable.[68] Where only one party is aware that performance of the contract will involve a tort, he or she will not be able to enforce the contract, but the position of the innocent party is not clear.[69] It is similarly unclear what the effect is of entering into one contract in breach of another contract with someone else. In *British Homophone Ltd v Kunz and Crystallate Gramophone Record Manufacturing Co Ltd*[70] the defendant argued that a contract was unenforceable against him because the plaintiff had knowingly induced him to enter into it in breach of his (the defendant's) pre-existing contractual obligations to a third party. Although the court did not have to decide the point, du Parcq J said: "It seems to be consistent with principle that an agreement to do a legal wrong to a third party should be unenforceable by reason of its illegality."[71] At least one commentator has argued that in certain circumstances the second inconsistent contract should be unenforceable.[72]

[61] We deal with this part of the decision at para 2.8 above.

[62] [1961] 1 QB 374, 387. See also, [1961] 1 QB 374, 390-394, *per* Devlin LJ.

[63] See M P Furmston, "The Analysis of Illegal Contracts" (1966) 16 University of Toronto LJ 267, 283-286.

[64] *Brown Jenkinson & Co Ltd v Percy Dalton (London) Ltd* [1957] 2 QB 621.

[65] See, for example, *Brown Jenkinson & Co Ltd v Percy Dalton (London) Ltd* [1957] 2 QB 621, 629, *per* Morris LJ.

[66] *Allen v Rescous* (1676) 2 Lev 174; 83 ER 505.

[67] *Apthorp v Neville & Co* (1907) 23 TLR 575.

[68] Although where the tort is statutory, it would seem that the principles outlined in paras 2.3 to 2.19 above in relation to the doctrine of implied statutory prohibition are applicable (see especially para 2.4).

[69] G H Treitel, *The Law of Contract* (9th ed 1995) p 392.

[70] (1935) 152 LT 589.

[71] (1935) 152 LT 589, 592.

[72] H Lauterpacht, "Contracts to Break a Contract" (1936) 52 LQR 494.

(b) Where one or both parties enter into the contract for the purpose of furthering the commission of a legal wrong or carrying out conduct which is otherwise contrary to public policy

2.24 A party who enters into a contract with the intention of using it for the commission of a legal wrong[73] or carrying out conduct which is otherwise contrary to public policy, will not be able to enforce it.[74] Such guilty intent might involve the use of the subject matter of the contract for the commission of a legal wrong, or even the use of the contractual documentation for such a purpose.[75] The contract is unenforceable by the guilty party whether or not the other party shares the guilty purpose. The effect of the rule may therefore be to allow that "equally guilty" party to retain a substantial benefit without performing his or her side of the bargain.

2.25 But what if the guilty intent is held by one party only and the "innocent" party seeks enforcement? If he or she is not aware of the other party's intention to use the contract for the commission of a legal wrong or conduct which is otherwise contrary to public policy, clearly he or she will not be prevented from enforcing it.[76] However, where he or she has "participated" in the guilty purpose, it seems that he or she becomes tainted by the illegality and is prevented from enforcing the contract. What amounts to participation?[77] The case law is not clear on this point. One line of authority suggests that mere knowledge of the defendant's illegal purpose will cause the plaintiff's action to fail. In *Langton v Hughes*[78] a vendor sold goods to a brewer, knowing that the brewer intended to use them to make beer in contravention of a statute which prohibited the use of any substance other than malt and hops in the brewing of beer. The vendor failed in an action for goods

[73] As far as we are aware, the cases have all involved criminal rather than civil law wrongs.

[74] As Professor Furmston points out, "it is clear that there must come a point when the connection [of the contract] with the plaintiff's intention is too remote": M P Furmston, "The Analysis of Illegal Contracts" (1966) 16 University of Toronto LJ 267, 287. Where that point lies is not clear, although Professor Furmston suggests that the decision in *Alexander v Rayson* [1936] 1 KB 169 (see para 2.53 n 146 below) goes near to the limit of the law. And it would seem that the principle of unenforceability only applies where the illegal intention is formed before the contract is made: M P Furmston, "The Analysis of Illegal Contracts" (1966) 16 University of Toronto LJ 267, 288.

[75] See for example, *Alexander v Rayson* [1936] 1 KB 169 (discussed at para 2.53 n 146 below) (where the plaintiff had documented an agreement for lease in such a way that he could defraud the Revenue as to the true rent) and *Edler v Auerbach* [1950] 1 KB 359 (where a lessor let property to a lessee fraudulently misrepresenting that no planning permission was necessary for the lessee's intended use).

[76] See, for example, *Fielding & Platt Ltd v Najjar* [1969] 1 WLR 357 where an English manufacturer of machinery agreed to give the Lebanese purchaser an invoice in a form requested by the purchaser. The purchaser intended to use the invoice to deceive the Lebanese authorities. The vendor was held entitled to sue on the sale contract because he neither knew of the purchaser's unlawful object nor actively participated in it.

[77] R A Buckley, "Participation and Performance in Illegal Contracts" (1974) 25 NILQ 421; and N Enonchong, *Illegal Transactions* (1998) pp 284-291.

[78] (1813) 1 M & S 593; 105 ER 222.

sold and delivered, his knowledge that the purchaser intended to use the goods for an illegal purpose being sufficient to prevent him recovering.[79]

2.26 However, an alternative line of authority suggests that mere knowledge by itself will not be sufficient. In *Hodgson v Temple*[80] the plaintiff sold spirits to the defendant knowing that he intended to use them in an illegal manner. Despite his knowledge, the plaintiff was able to recover their price. Mansfield CJ said:

> This would be carrying the law much further than it has ever yet been carried. The merely selling goods, knowing that the buyer will make an illegal use of them, is not sufficient to deprive the vendor of his just right of payment, but to effect that, it is necessary that the vendor should be a sharer in the illegal transaction.[81]

2.27 But even on this view, the necessary degree of involvement which, together with knowledge, amounts to participation, need only be limited. In *Biggs v Lawrence*[82] vendors of whisky who sold it slung in "slings and half ankers" ready for smuggling by the purchaser were unable to recover in an action for its value because they were "agents to the very act of smuggling" and "participes criminis". In a case on similar facts, *Waymell v Reed*,[83] a vendor of lace who had packed it in the manner most suitable for, and with the intent of assisting in, the purchaser's plan to smuggle it into England, was unable to enforce the sale contract, even though he was not involved in the actual smuggling.

2.28 Where the innocent party becomes aware of the other's illegal purpose prior to the completion of the contract, he or she is bound to bring the contract to an end,[84] but may recover in respect of benefits already conferred on the defendant. Thus in *Clay v Yates*[85] a printer who, after commencing a printing job for the defendant, discovered that the document was libellous, was held to be justified in refusing to finish the job and entitled to recover for the work already performed.

[79] *Mason v Clarke* [1955] AC 778 may also be cited in support. The consideration of the evidence in this case was based on the assumption that mere knowledge of the illegal purpose, without more, would be sufficient to defeat an action on the contract brought by an otherwise innocent party. See also *Pearce v Brooks* (1866) LR 1 Exch 213 where the hirer of an ornate carriage to a prostitute was unable to sue on the hire contract because he knew of the immoral purpose for which she intended to use it.

[80] (1813) 5 Taunt 181; 128 ER 656. This case was heard less than five months after *Langton v Hughes* (1813) 1 M & S 593; 105 ER 222, which was not referred to in argument or judgment.

[81] (1813) 5 Taunt 181, 182; 128 ER 656. See also *Holman v Johnson* (1775) 1 Cowp 341; 98 ER 1120 and *J M Allan (Merchandising) Ltd v Cloke* [1963] 2 QB 340, 348, *per* Lord Denning MR: "Likewise with an unlawful purpose, active participation debars, but knowledge by itself does not."

[82] (1789) 3 TR 454; 100 ER 673. The case was cited in support of the judgment in *Hodgson v Temple* (1813) 5 Taunt 181; 128 ER 656.

[83] (1794) 5 TR 599; 101 ER 335.

[84] *Cowan v Milbourn* (1867) LR 2 Exch 230.

[85] (1856) 1 H & N 73; 156 ER 1123.

(c) Where one or both parties commits a legal wrong or acts in a manner which is otherwise contrary to public policy in the course of performing the contract

2.29 Generally, it seems that the commission of a legal wrong, or acting otherwise contrary to public policy, in the course of performing a contract does not, at common law, affect enforcement.[86] For example, in *Wetherell v Jones*[87] the plaintiff succeeded in an action for the price of goods delivered, despite his unlawful performance in providing an irregular statutory invoice. Lord Tenterden CJ said: "[W]here the consideration and the matter to be performed are both legal, we are not aware that a plaintiff has ever been precluded from recovering by an infringement of the law, not contemplated by the contract, in the performance of something to be done on his part."[88] Similarly, in *St John Shipping Corporation v Joseph Rank Ltd*[89] the shipper succeeded in his claim for freight despite his unlawful performance.[90]

2.30 In both these cases the legal wrong was a statutory offence, but the same principle has been applied in cases where the contract was performed in a manner which involved conduct otherwise contrary to public policy. This is illustrated by *Coral Leisure Group Ltd v Barnett*.[91] The plaintiff, an employee, sought to bring a claim for unfair dismissal against his employer. His pleadings alleged that his job, although he did not know this when he took up the position, was for an immoral purpose including the procurement of prostitutes for his employer's clients. The employer argued that the Industrial Tribunal should not hear the employee's application, since the employee was relying on an illegal contract. Browne-Wilkinson J ruled that the Industrial Tribunal should hear the case. He referred to the decision in *Wetherell v Jones*[92] as followed by Devlin J in *St John Shipping Corporation v Joseph Rank Ltd*[93] and said: "The fact that a party has in the course of performing a contract committed an unlawful or immoral act will not by itself prevent him from further enforcing that contract unless the contract was entered into with the purpose of doing that unlawful or immoral act or the contract itself (as opposed to the mode of his performance) is prohibited by law."[94]

[86] As we have seen, where the alleged legal wrong is statutory, an additional question may be whether the statute expressly or impliedly prohibits the enforcement of a contract which is performed in such a way that a statutory provision is broken (see paras 2.3 to 2.19 above).

[87] (1832) 3 B & Ad 221; 110 ER 82.

[88] (1832) 3 B & Ad 221, 226; 110 ER 82, 84.

[89] [1957] 1 QB 267 (discussed at para 2.6 above).

[90] See also, *Skilton v Sullivan, The Times* 25 March 1994 (CA).

[91] [1981] ICR 503.

[92] (1832) 3 B & Ad 221; 110 ER 82.

[93] [1957] 1 QB 267.

[94] [1981] ICR 503, 509. Browne-Wilkinson J pointed to the drastic consequences that would have arisen if an employee who knowingly broke the law in the course of his employment duties were to be prevented from enforcing his contract of employment or from complaining of unfair dismissal. He said [1981] ICR 503, 508: "Has the lorry driver who breaks the speed limit thereby lost any rights against his employer even if the employer knows of the breach of the speed limit and does not object at the time?"

2.31 However, if one party intends to perform the contract in a way that involves the commission of a legal wrong[95] or conduct otherwise contrary to public policy *at the time of entering into the contract* then he or she will not be able to enforce the contract. So, in *St John Shipping Corporation v Joseph Rank Ltd*[96] Devlin J said that had the shipper intended to overload his ship when he entered into the contract, he would not have been able to enforce it. Similarly, in *Coral Leisure Group Ltd v Barnett*[97] Browne-Wilkinson J said that the plaintiff's employment contract would have been void and unenforceable if the plaintiff had known from the outset that prostitutes were to be procured and paid for.[98] Furthermore, if the other party is aware of, *and participates in*,[99] that illegal performance, he or she will also lose his or her right to enforce the contract. For example, in *Ashmore Benson Pease & Co Ltd v Dawson Ltd*[100] the defendants had contracted to carry machinery for the plaintiffs. The defendants sent two articulated lorries to carry the load. These lorries could not legally be used to carry such a heavy amount, and there was evidence that the plaintiffs were aware of this. The plaintiffs watched the lorries being loaded. During the journey one of the lorries toppled over and the load was damaged. The plaintiffs sought damages for negligence, and the defendants pleaded that the contract was unenforceable for illegality. The Court of Appeal accepted the illegality defence. Not only were the plaintiffs aware of the defendants' intended unlawful performance, but they had participated in it by sanctioning the loading of the vehicle with a weight in excess of the regulations.[101]

2. THE REVERSAL OF UNJUST ENRICHMENT

2.32 Where a party brings a claim for the reversal of unjust enrichment in relation to benefits conferred under a contract which involves the commission of a legal wrong or conduct otherwise contrary to public policy, the illegality potentially has three roles to play. First, a party cannot succeed in a claim for restitution if the benefit which he or she is seeking to reverse was transferred under a contract which remains effective. In such a case the plaintiff must pursue his or her contractual remedies instead.[102] The illegality may be what renders the contract unenforceable, so allowing the plaintiff to pursue the restitutionary claim. Secondly, the illegality may act as a defence to what would otherwise be a standard restitutionary claim for the recovery of benefits conferred under an unenforceable

[95] As far as we are aware, the cases have all involved criminal rather than civil law wrongs.

[96] [1957] 1 QB 267, 287-288.

[97] [1981] ICR 503.

[98] [1981] ICR 503, 509. Although it would seem that where the party or parties were not aware that the intended performance was illegal and, on discovery, are subsequently content that the contract be performed in a legal manner within its terms, the contract is enforceable: *Waugh v Morris* (1873) LR 8 QB 202 (discussed at para 2.20 n 56 above).

[99] "[K]nowledge by itself it not, I think, enough. There must be knowledge plus participation": *Ashmore Benson Pease & Co Ltd v Dawson Ltd* [1973] 1 WLR 828, 836, *per* Scarman LJ.

[100] [1973] 1 WLR 828.

[101] [1973] 1 WLR 828, 833, *per* Lord Denning MR.

[102] Lord Goff of Chieveley and G Jones, *The Law of Restitution* (4th ed 1993) pp 45-46; and P Birks, *An Introduction to the Law of Restitution* (revised ed 1989) pp 44-48.

contract. The defence will succeed unless the parties are *non in pari delicto* (that is, they are not equally at fault). Thirdly, in a small number of claims, the illegality may itself provide the basis for the restitutionary cause of action. This is where the plaintiff claims to withdraw from an illegal transaction during the *locus poenitentiae* (the time for repentance).[103]

2.33 We have already examined when the involvement of illegality may render a contract unenforceable. In this section we go on to consider first, illegality as a defence to restitutionary claims; and secondly, illegality as a restitutionary cause of action under the doctrine of *locus poenitentiae*.

(1) Illegality as a defence to restitutionary claims

2.34 One might have expected to find that illegality has little role to play as a defence to claims for the restitution of benefits conferred under illegal contracts. After all, in a restitutionary claim the plaintiff is not seeking to enforce the illegal contract but rather to repudiate it and undo what has been executed. However, the courts have traditionally adopted a much tougher line, and the general rule is that illegality acts as a defence to a standard restitutionary claim except where the parties are "not equally at fault". Furthermore, the case law shows that a rather formal, technical approach is adopted in the assessment of the fault of the parties: recovery is allowed only where the plaintiff can show that he or she was induced to enter into the illegal contract as a result of the fraud, duress or oppression of the other party, that he or she was ignorant of a fact that rendered the contract illegal, or that he or she belonged to a vulnerable class protected by statute.[104] This means that illegality can generally be successfully raised as a defence to claims based on a failure of consideration, but not to claims based on other standard restitutionary grounds, such as mistake, duress or vulnerability. We now illustrate this by looking at claims based on each of these grounds in turn.

(a) Failure of consideration

2.35 The leading case here is *Parkinson v College of Ambulance Ltd and Harrison*.[105] The plaintiff had made a large donation to charity following the charity secretary's fraudulent misrepresentation that the charity would be able to procure him a knighthood on receipt. When the honour was not forthcoming, the plaintiff sought restitution of his donation. His action failed. Although there had been a total failure of consideration, a contract for the sale of honours was contrary to

[103] The traditional approach to explaining the effect of illegality on a restitutionary claim (as adopted by Lord Goff of Chieveley and G Jones, *The Law of Restitution* (4th ed 1993) ch 22) asserts that illegality will generally prevent a restitutionary claim, subject to two exceptions: (i) where the parties are *non in pari delicto* and (ii) where the plaintiff withdraws from the transaction. The difficulty with this analysis is that it does not identify the ground for restitution that the plaintiff relies upon. For this reason, the approach set out here, and first advanced by Professor Birks in *An Introduction to the Law of Restitution* (revised ed 1989) (pp 299-303 and 424-432) is preferred. See also A Burrows, *The Law of Restitution* (1993) pp 333-334 and A Burrows and E McKendrick, *Cases and Materials on the Law of Restitution* (1997) p 511.

[104] For detailed discussion of the illegality defence, see J K Grodecki, "In pari delicto potior est conditio defendentis" (1955) 71 LQR 254.

[105] [1925] 2 KB 1.

public policy and the plaintiff knew that he was entering into an illegal and improper contract. The parties were therefore found to be *in pari delicto*.

2.36 Another example of the illegality defence is found in *Berg v Sadler and Moore*.[106] The plaintiff was on a "stop list" of those to whom members of the defendants' tobacco association were not to supply cigarettes. In order to obtain cigarettes, the plaintiff arranged for a third party to buy them on his behalf from the defendants, without disclosing the true identity of the purchaser. After receiving payment, the defendants became suspicious and refused to hand over the cigarettes or return the money. The Court of Appeal refused the plaintiff's claim for money had and received. It upheld the trial judge's finding that the plaintiff was attempting to obtain goods by false pretences, and agreed that no court would assist the plaintiff in such circumstances.

2.37 In both of these cases the plaintiff was either the instigator of, or a party to, the illegality. The plaintiff was therefore unable to benefit from the *non in pari delicto* exception to the illegality defence. But a wider principle may also prevent recovery in this area: the court will not award restitution where the award would have the same effect as the enforcement of a contract which the common law or statute refuses to enforce.[107] This principle was applied recently in *Mohamed v Alaga & Co.*[108] The plaintiff entered into an agreement with the defendant solicitor whereby the plaintiff would refer clients to the solicitor and assist the solicitor in preparing the clients' asylum applications in return for a share in the solicitor's fees. The sharing of fees is prohibited by the Solicitors' Practice Rules, which the court treated as having the force of subordinate legislation. The plaintiff claimed in the alternative for payment under the contract or for restitution. Lightman J refused both claims. In respect of the restitutionary claim, he held that where a statute forbade the making of the contract, restitution would not be granted if the effect of its award would be to nullify the statutory prohibition.[109] Such would be the case here. Any claim in restitution would be limited, by virtue of the contract, to a payment out of the fees received from the referred clients, and such payment had therefore to involve the sharing of those fees, which was itself prohibited by the Solicitors' Practice Rules. And, even if the payments were not necessarily to be paid out of the fees received, nonetheless it would in substance be a payment in

[106] [1937] 2 KB 158. For a criticism of the reasoning in this case, see M P Furmston, "The Analysis of Illegal Contracts" (1966) 16 University of Toronto LJ 267, 290-291. Professor Treitel suggests that it was a misclassification to treat the sale contract induced by fraud as being "illegal": G H Treitel, "Contract and Crime" in *Crime, Proof and Punishment: Essays in Memory of Sir Rupert Cross* (1981) p 81 at p 107.

[107] See Lord Goff of Chieveley and G Jones, *The Law of Restitution* (4th ed 1993) pp 64-68.

[108] [1998] 2 All ER 720. For the purposes of deciding the case, the court assumed that the alleged agreement had been made and that the plaintiff was unaware of the illegality.

[109] Lightman J referred to the House of Lords' decision in *Boissevain v Weil* [1950] AC 327. There, the House of Lords held that money lent to a British subject in contravention of the Defence (Finance) Regulations 1939 was irrecoverable. Lord Radcliffe said [1950] AC 327, 341 that if the court were to allow a restitutionary claim "the court would be enforcing on the respondent just the exchange and just the liability, without her promise, which the Defence Regulation has said that she is not to undertake by her promise. A court that extended a remedy in such circumstances would merit rather to be blamed for stultifying the law than to be applauded for extending it".

consideration of the introduction of clients. Such payment was also prohibited by the Rules.[110]

(b) Mistake

2.38 It is reasonably clear that a party who enters into an illegal contract, as a result of a mistake of the facts constituting the illegality, may be granted restitution. In *Oom v Bruce*[111] the plaintiffs paid insurance premiums as agent of a Russian subject for a contract of insurance for goods on a ship sailing from Russia to England. Unknown to them, war had already broken out between Russia and England, rendering the contract illegal and unenforceable.[112] Their claim for recovery of the premiums was successful. Lord Ellenborough CJ said:

> [T]he plaintiffs had no knowledge of the commencement of hostilities by Russia, when they effected this insurance; and, therefore, no fault is imputable to them for entering into the contract; and there is no reason why they should not recover back the premiums which they have paid."[113]

2.39 What is of particular interest here is that the court did not consider the state of knowledge of the defendant. It seems likely that he too was ignorant of the outbreak of war. If so, the parties were in fact *in pari delicto*, both being equally innocent of the illegality. This would mean that in cases of restitution based on mistake of fact where the mistake is such as to mask the illegality, that in itself is

[110] See also the recent difficult case of *Taylor v Bhail* [1996] CLC 377 (CA) (noted by F D Rose, "Confining Illegality" (1996) 112 LQR 545). The defendant, the headmaster of a school that had been damaged by gales, agreed to award a contract to the plaintiff, a builder, provided that the builder would falsely increase his estimate of the cost of the works by £1,000, so that the defendant could claim the inflated sum from his insurers and pocket the £1,000 for himself. After completing the works, the plaintiff brought an action in the alternative to enforce the contract or for a *quantum meruit* in respect of work done but not paid for. The Court of Appeal refused both claims because of the involvement of illegality. While the specific ground on which the plaintiff was claiming restitution was not identified, Millett LJ held that his restitutionary claim failed for three reasons:

(1) The illegality renders any implied promise to pay a reasonable sum unenforceable - just as it renders the express promise to pay the contract price unenforceable.

(2) The defendant is enriched at the expense of the plaintiff - but his enrichment is not unjust. It is the price which the plaintiff must pay for having entered into an illegal transaction in the first place.

(3) The existence of a contract bars the remedy. To succeed, the plaintiff must repudiate the contract. But he may do so only if no part of the illegal purpose has been carried out. Once it has been carried out, it is too late to withdraw from the transaction, repudiate the contract, and claim restitution.

[111] (1810) 12 East 225; 104 ER 87. Followed in *Hentig v Staniforth* (1816) 5 M & S 122; 105 ER 996.

[112] See para 2.21 above.

[113] (1810) 12 East 225, 226; 104 ER 87, 88.

sufficient to defeat a defence based on illegality, regardless of the state of mind of the defendant.[114]

2.40 Until very recently, the traditional general rule was that payments made under a mistake of law were not recoverable.[115] However, the House of Lords has now held that this rule should be abolished, and no longer maintained as part of English law.[116] This means that whatever the law is on the effects of illegality on a claim for mistake of fact will apply equally to a claim for mistake of law. The crucial question would therefore appear to be whether the mistake of law masks the illegality (which will almost always be the case where an illegal transaction is in play).

2.41 In any event, however, an exception to the general rule preventing restitution for mistakes of law was accepted where the plaintiff was not *in pari delicto* with the defendant. The leading case is *Kiriri Cotton Co Ltd v Dewani*.[117] The respondent, a tenant, had paid a premium to the appellant landlord on taking up the sublease of a flat. Unknown to both parties, the payment of such a premium was contrary to the Ugandan Rent Restriction Ordinance. The respondent, after going into occupation, sought the return of the premium. The Privy Council upheld the respondent's claim. Lord Denning said:

> Nor is it correct to say that money paid under a mistake of law can never be recovered back. The true proposition is that money paid under a mistake of law, by itself and without more, cannot be recovered back. ... If there is something more in addition to a mistake of law - if there is something in the defendant's conduct which shows that, of the two of them, he is the one primarily responsible for the mistake - then it may be recovered back. Thus, if as between the two of them the duty of observing the law is placed on the shoulders of the one rather than the other - it being imposed on him specially for the protection of the other - then they are not *in pari delicto* and the money can be recovered back.[118]

[114] See also, *Cotronic (UK) Ltd v Dezonie* [1991] BCLC 721, although in that case the basis on which restitution was ordered was not discussed. See further, A Burrows, *The Law of Restitution* (1993) p 465.

[115] *Bilbie v Lumley* (1802) 2 East 469; 102 ER 448.

[116] *Kleinwort Benson Ltd v Lincoln City Council* [1998] 4 All ER 513.

[117] [1960] AC 192.

[118] [1960] AC 192, 204. See also *Re Cavalier Insurance Co Ltd* [1989] 2 Lloyd's Rep 430. An insurance company had written contracts of insurance in contravention of the Insurance Companies Acts 1974. When the company went into liquidation, the question arose whether the liquidator might properly admit proof from the policy holders in respect of sums that would have been payable under the policies or alternatively in respect of premiums that had been paid. Knox J held that following *Phoenix General Insurance Co of Greece SA v Halvanon Insurance Co Ltd* [1988] QB 216 (see para 2.17 above) no proof could be admitted of the sums payable under the policies, but, since the statutory duty was laid exclusively on the insurer for the protection of the insured, and the insured had no reason to suspect that they were being asked to enter into a void contract, the insured were not equally delictual with the insurer and were therefore entitled to recover the premiums paid by them.

2.42 Nor would the parties be *in pari delicto* where the payer's mistake of law is induced by the fraud of the payee. So, in *Hughes v Liverpool Victoria Friendly Society*[119] an innocent plaintiff who had paid premiums on an illegal contract of life insurance was able to recover what she had paid on the ground that the defendants fraudulently misrepresented to her that the transaction was legal. Because of the fraud, the plaintiff was not *in pari delicto* with the defendants. In contrast, in an earlier case, *Harse v Pearl Life Assurance Co*,[120] where the facts were similar but the defendant's misrepresentation had been innocent rather than fraudulent, the plaintiff's claim failed. The Court of Appeal held that since there was no inequality of *delictum*, the plaintiff could not recover.[121] However, if the effect of the House of Lords' abrogation of the mistake of law bar[122] is the assimilation of claims for mistake of law with claims for mistake of fact, then the position of the parties in this case may be regarded as comparable to that of the parties in *Oom v Bruce*[123] (that is, the mistake masked the illegality and recovery would be allowed).

(c) Duress

2.43 Illegality will not operate as a defence to claims for restitution based on duress. The duress renders the plaintiff innocent of the illegality and the parties will therefore be *non in pari delicto*. This is illustrated by *Smith v Cuff*.[124] The plaintiff sought a composition with his creditors. The defendant refused to enter the arrangement unless given promissory notes for the remainder of his debt.[125] When a subsequent holder of one of the notes enforced payment from the plaintiff, it was held that the plaintiff could recover the sums from the defendant as money had and received. Lord Ellenborough CJ said:

> This is not a case of par delictum: it is oppression on one side, and submission on the other: it can never be predicated as par delictum, when one holds the rod, and the other bows to it. There was an inequality of situation between these parties: one was creditor, the other debtor, who was driven to comply with the terms which the former chose to enforce.[126]

2.44 In *Davies v London and Provincial Marine Insurance Co*[127] friends of an employee of the insurance company were led to believe that the employee was about to be

[119] [1916] 2 KB 482.

[120] [1904] 1 KB 558.

[121] The decision has been frequently criticised as unduly harsh: J K Grodecki, "In pari delicto potior est conditio defendentis" (1955) 71 LQR 254, 264. Neither *Oom v Bruce* (1810) 12 East 225; 104 ER 87 nor *Hentig v Staniforth* (1816) 5 M & S 122; 105 ER 996 (see para 2.38 above) was cited to the Court of Appeal.

[122] *Kleinwort Benson Ltd v Lincoln City Council* [1998] 4 All ER 513.

[123] (1810) 12 East 225; 104 ER 87. See paras 2.38 to 2.39 above.

[124] (1817) 6 M & S 160; 105 ER 1203.

[125] Such an agreement has been held to be illegal as a fraud on the other creditors: *Cockshott v Bennett* (1788) 2 TR 763; 100 ER 411.

[126] (1817) 6 M & S 160, 165; 105 ER 1203, 1205. See also, *Atkinson v Denby* (1862) 7 H & N 934; 158 ER 749.

[127] (1878) 8 Ch D 469.

prosecuted by the company for embezzlement. In order to prevent the prosecution taking place, they agreed to replace the sums allegedly missing. It subsequently transpired that charges could not have been brought for embezzlement in any event, and the friends sought to recover the money which they had paid to the company. The claim was resisted on the ground that what had occurred had constituted an attempt to compound a felony. Fry J held that the friends could recover the money paid because, although the contract was illegal, the friends paid under duress and were therefore *non in pari delicto*. He said:

> [I]t appears to me to be clear that illegality resulting from pressure and illegality resulting from an attempt to stifle a prosecution do not fall within that class of illegalities which induces the Court to stay its hand, but are of a class in which the Court has actively given its assistance in favour of the oppressed party, by directing the money to be repaid.[128]

(d) Vulnerability

2.45 By analogy with the duress cases discussed above, one would not expect illegality to act as a defence to a restitutionary claim based on undue influence (actual or presumed). Although there would not appear to be any direct English authority, one Australian case, *Andrews v Parker*,[129] may be cited to support such a conclusion. The plaintiff was persuaded to transfer the title to his house to the defendant, a married woman with whom he was having an affair, and whom the court found to be a "ruthless, cunning woman who came to realise that in the plaintiff she had found a man who would literally be as clay in the hands of a potter". On returning to her husband, the defendant refused to reconvey the house to the plaintiff as had been agreed. The Supreme Court of Queensland held that the plaintiff could recover the property. Even if the agreement between the plaintiff and the married woman could be regarded as based on an immoral consideration and therefore illegal, the plaintiff was not *in pari delicto* with the defendant, and therefore would be given relief against the transaction.

2.46 There is, in addition, a small group of English cases where one can regard the plaintiff's claim as based on the general category of "vulnerability" and which do involve illegality. These are cases where the plaintiff claims to recover benefits which he or she has conferred on the defendant in breach of a statutory provision, where that statutory provision has as its object the protection of a particular vulnerable class of which the plaintiff is a member.[130] In such cases illegality will

[128] (1878) 8 Ch D 469, 477.

[129] [1973] Qd R 93.

[130] An alternative approach is to treat this class of case as illustrating an independent restitutionary cause of action based on the illegality itself, which cannot be subsumed under the general category of vulnerability. Under this analysis one can distinguish the statutory class protection cases from restitution based on unconscionability or undue influence since in unconscionability and most undue influence cases, the plaintiff must show that the terms of the transaction are substantively unfair. In the statutory class protection cases the court is concerned with protection of the vulnerable class as a whole and the rule is aimed at preventing potential, rather than actual, exploitation. See further, A Burrows, *The Law of Restitution* (1993) pp 341-342 and A Burrows and E McKendrick, *Cases and Materials on the Law of Restitution* (1997) pp 521-523.

not act as a defence, since the parties are presumed to be *non in pari delicto*. Lord Mansfield explained the basis of the claim in *Browning v Morris*:

> [W]here contracts or transactions are prohibited by positive statutes, for the sake of protecting one set of men from another set of men; the one, from their situation and condition, being liable to be oppressed or imposed upon by the other; there the parties are not in pari delicto; and in furtherance of these statutes, the person injured, after the transaction is finished and completed, may bring his action and defeat the contract.[131]

2.47 The Rent Acts are a well-known example of class-protecting legislation. They provide expressly that premiums illegally charged in return for tenancies can be recovered by the tenant. The underlying policy of the Acts has also been applied, however, to order the repayment of sums in common law restitution actions, as well as cases actually based upon the statutory machinery for recovery. Such an order was made in *Gray v Southouse*,[132] even though the prospective tenants, who had been willing participants in the unlawful arrangement, were themselves guilty of aiding and abetting the criminal offence created by the Acts. Devlin J said:

> I have ... felt it necessary to consider whether [the statutory provision for recovery] ought not to be restricted to tenants who were not *participes criminis*, and was merely intended as a procedural means provided by the statute whereby they might get their money back. On the whole, however, I think that that is not the right meaning of the provision. ... The cases of innocent tenants must be very rare, and I can hardly believe that Parliament intended the wide words of the statute to be restricted to those exceptional cases. This is not a claim made under the Act, and the Act is not pleaded in support of it. All I have to do, therefore, is to satisfy myself that it is not contrary to public policy in this particular class of case that the plaintiffs should recover the sums for which they sue. I am satisfied that public policy puts no impediment in the way of their obtaining judgment.[133]

2.48 The scope of this claim based on statutory class-protection is far from settled[134] and the foundations of the claim are not certain.[135] It appears that it will not be

[131] (1778) 2 Cowp 790, 792; 98 ER 1364.

[132] [1949] 2 All ER 1019.

[133] [1949] 2 All ER 1019, 1020-1021.

[134] Although the judgments in several cases, including *Kiriri Cotton Co Ltd v Dewani* [1960] AC 192 and *Re Cavalier Insurance Co Ltd* [1989] 2 Lloyd's Rep 430 contain elements of class-protection reasoning, the main ground for restitution appears to be mistake of law, and we have dealt with them on that basis (see para 2.41 above). But contrast Lord Goff of Chieveley and G Jones, *The Law of Restitution* (4th ed 1993) p 507.

[135] There is some doubt whether a plaintiff seeking restitution under this head will be required to make counter-restitution. In *Lodge v National Union Investment Co Ltd* [1907] 1 Ch 300 the plaintiff was held entitled to recover his securities from an unregistered moneylender (since the purpose of the statute requiring registration was to protect persons in the plaintiff's position) but only on the basis that he gave counter-restitution in respect of the money he had borrowed. Subsequent cases have not followed the decision: see *Chapman v Michaelson* [1909] 1 Ch 238 and *Kasumu v Baba-Egbe* [1956] AC 539.

lightly invoked by the courts. For example, in *Green v Portsmouth Stadium*[136] the Court of Appeal refused a bookmaker's claim for recovery of course charges which he had paid the defendant in contravention of the Betting and Lotteries Act 1934. The court held that the statute was not enacted for the purpose of protecting bookmakers.

(2) Illegality as a restitutionary cause of action: the doctrine of *locus poenitentiae*

2.49 Illegality is being used to found a claim in restitution when the plaintiff relies on the doctrine of *locus poenitentiae*, that is, where the plaintiff claims to withdraw from the illegal contract during "the time for repentance". Here one cannot analyse the illegality as constituting a defence to a standard restitutionary claim: rather the law grants restitution, where it otherwise would not, precisely in order to discourage illegality.

2.50 The limits of this doctrine remain unclear. The early authorities suggest that it is broad. In *Taylor v Bowers*[137] the plaintiff had handed over certain goods to his nephew in order to deceive his creditors, one of whom, the defendant, was found to have been a party to the intended fraud. Before any composition with the creditors had been concluded, the nephew assigned the goods, apparently without the plaintiff's consent, to the defendant. The plaintiff successfully sued the defendant in detinue for the return of the goods.[138] Mellish LJ, with whom Baggallay JA agreed, said:

> [The plaintiff] is not bringing the action for the purpose of enforcing the illegal transaction. ... [I]f the illegal transaction had been carried out, the plaintiff himself in my judgment, could not afterwards have recovered the goods. But the illegal transaction was not carried out; it wholly came to an end. To hold that the plaintiff is enabled to recover does not carry out the illegal transaction, but the effect is to put everybody in the same situation as they were before the illegal transaction was determined upon, and before the parties took any steps to carry it out. ... If money is paid or goods delivered for an illegal purpose, the person who had so paid the money or delivered the goods may recover them back before the illegal purpose is carried out, but if he waits till the illegal purpose is carried out, or if he seeks to enforce the illegal transaction, in neither case can he maintain an action; the law will not allow that to be done."[139]

2.51 Subsequent cases have tended to adopt a conservative approach to the doctrine. In particular, two qualifications have usually been imposed: first, that the withdrawal must take place before any part of the illegal purpose has been

[136] [1953] 2 QB 190.

[137] (1876) 1 QBD 291.

[138] It is not clear from the reported case exactly what was the agreement between the plaintiff and his nephew. James LJ (and arguably Grove J) held that the plaintiff could recover because he could prove his title to the goods independently of the fraudulent transaction. This issue is discussed in paras 2.62 to 2.69 below.

[139] (1876) 1 QBD 291, 299-300.

completed; and secondly, that the plaintiff must genuinely repent of the illegality (although doubt has been cast on the latter requirement by the Court of Appeal in *Tribe v Tribe*[140]).

2.52 The need for early withdrawal was made clear in *Kearley v Thomson*.[141] The plaintiff, a friend of a bankrupt, had made an unlawful payment to the solicitors of a petitioning creditor in return for their undertaking not to appear at the bankrupt's public examination nor to oppose his discharge. The solicitors accordingly did not appear, and the bankrupt passed his public examination. But before the bankrupt had applied for his discharge, the plaintiff sued the solicitors for the return of the money that he had paid them. The Court of Appeal dismissed his claim. Fry LJ (with whom Lord Coleridge CJ agreed) expressly questioned the withdrawal principle laid down in *Taylor v Bowers*.[142] Even if it did exist, he held that it would not apply in the present case since the steps taken towards fulfilment of the unlawful purpose had been such as to preclude recovery. He said: "[W]here there has been a partial carrying into effect of an illegal purpose in a substantial manner, it is impossible, though there remains something not performed, that the money paid under that illegal contract can be recovered back."[143] It seems that *Taylor v Bowers* was distinguished on the basis that there, despite performance, no part of the illegal purpose, the fraud on the creditors, had been achieved.[144]

2.53 Particular emphasis was placed on the need for "repentance" in *Bigos v Bousted*.[145] The defendant had attempted to contravene the Exchange Control Act 1947 by arranging for the plaintiff to supply Italian currency to his wife and daughter in Italy. As security for the loan, the defendant had deposited a share certificate with the plaintiff. When the plaintiff reneged on the agreement, the defendant sought to recover the certificate on the basis that the contract, although illegal, was still executory and that he was allowed a *locus poenitentiae*. His claim failed on the ground that he had not withdrawn because he repented of the illegality, but rather because the illegal contract had been frustrated by the plaintiff's breach. Pritchard J said:

[140] [1996] Ch 107 (see para 2.54 below).

[141] (1890) 24 QBD 742.

[142] (1876) 1 QBD 291.

[143] (1890) 24 QBD 742, 747. *Kearley v Thomson* was distinguished in *Hermann v Charlesworth* [1905] 2 KB 123. The plaintiff had entered into a marriage brokage contract, whereby in return for payment she was supplied with introductions to men with a view to finding a marriage partner. The plaintiff was held able to sue for the return of her money even after she had received several introductions. Collins MR pointed out [1905] 2 KB 123, 135 that in *Kearley v Thomson* the illegal purpose, to defeat creditors, had been largely accomplished, for the contract was that the defendants should not appear at the public examination of the bankrupt, and that contract to abstain from appearing had been carried out. In the present case, the object of the contract being to bring about a marriage, the object could not be performed in part. Therefore, despite the fact that the defendant had taken certain steps and incurred some expense towards carrying out his part of the contract, the plaintiff's claim could succeed.

[144] See *Bigos v Bousted* [1951] 1 All ER 92, 97, *per* Pritchard J.

[145] [1951] 1 All ER 92. See also *Parkinson v College of Ambulance Ltd and Harrison* [1925] 2 KB 1, 16, *per* Lush J; and *Harry Parker Ltd v Mason* [1940] 2 KB 590.

> [The authorities] show ... that there is a distinction between what may, for convenience, be called the repentance cases, on the one hand, and the frustration cases, on the other hand. If a particular case may be held to fall within the category of repentance cases, I think the law is that the court will help a person who repents, provided his repentance comes before the illegal purpose has been substantially performed. ... [T]his case falls within the category of cases which I call the frustration cases.[146]

2.54 The need for repentance was, however, rejected by all members of the Court of Appeal in the most recent relevant authority, *Tribe v Tribe*.[147] The case dealt with the effect of illegality on trusts and we therefore do not discuss it in detail here but rather in Part III below. In contrast to Nourse LJ,[148] who gave the other reasoned judgment, it is clear that Millett LJ intended his reasoning to apply to all restitutionary claims. In concluding that genuine repentance was not necessary for a *locus poenitentiae* claim to succeed, Millett LJ said: "Justice is not a reward for merit; restitution should not be confined to the penitent. I would also hold that voluntary withdrawal from an illegal transaction when it has ceased to be needed is sufficient. It is true that this is not necessary to encourage withdrawal, but a rule to the opposite effect could lead to bizarre results."[149] On the other hand, Millett LJ recognised that the plaintiff must withdraw voluntarily (even if he or she does so only once the illegal transaction has ceased to be needed): and it is not sufficient that he or she is forced to do so because his or her plan has been discovered.[150]

2.55 A further limitation that is supported by early authority is that restitution will not be allowed if the transaction is so obnoxious that the court should not have anything to do with it. In *Tappenden v Randall*, Heath J said: "Undoubtedly there may be cases where the contract may be of a nature too grossly immoral for the

[146] [1951] 1 All ER 92, 100. The "frustration cases" to which Pritchard J referred were *Alexander v Rayson* [1936] 1 KB 169 and *Berg v Sadler and Moore* [1937] 2 KB 158. In *Alexander v Rayson* the plaintiff landlord attempted to deceive an assessment committee into making an inappropriately low valuation of his premises by disguising part of the rent he was receiving as a payment for services. The deception was discovered before the committee made its final assessment, so that the rateable value was ultimately calculated using the true rental figure. But the tenant sought to invoke the illegal scheme in order to avoid her obligations under the lease, and the Court of Appeal held that she could do so. Romer LJ observed [1936] 1 KB 169, 190 that: "Where the illegal purpose has been wholly or partially effected the law allows no *locus poenitentiae* ... . It will not be any readier to do so when the repentance, as in the present case, is merely due to the frustration by others of the plaintiff's fraudulent purpose." In *Berg v Sadler and Moore* [1937] 2 KB 158 (discussed at para 2.36 above) the plaintiff's illegal purpose was frustrated by the defendants' refusal to complete the transaction.

[147] [1996] Ch 107. See paras 3.14 to 3.18 below.

[148] Nourse LJ said [1996] Ch 107, 121: "I do not propose ... to become embroiled in the many irreconcilable authorities which deal with the exception in its application to executory contracts, or even to speculate as to the significance, if any, of calling it a *locus poenitentiae*, a name I have avoided as tending to mislead. In a property transfer case the exception applies if the illegal purpose has not been carried into effect in any way."

[149] [1996] Ch 107, 135.

[150] [1996] Ch 107, 135.

Court to enter into any discussion of it; as where one man has paid money by way of hire to another to murder a third person."[151]

2.56 Much has been written about what is and what should be the scope of the *locus poenitentiae* doctrine. Professor Birks argues that genuine repentance should be a requirement, unless the illegal purpose has not yet been achieved and recovery can only prevent its being achieved. If recovery were allowed when the plaintiff's illegal purpose was frustrated by the other party's refusal to carry out the transaction, he suggests that the effect would be to give the plaintiff a lever with which to compel performance and to deprive the other party of his incentive to abstain from the illegality.[152] However, Professor Birks is almost alone in insisting on genuine repentance. Professor Beatson suggests that the correct principle would be to allow recovery only where not to do so would increase the probability of the illegal purpose being achieved.[153] Dr Enonchong argues that the rules of title determine the limits of the doctrine: recovery should be allowed up until the point at which title passes to the defendant.[154] Professor Grodecki takes probably the widest view of the doctrine. He argues that, in order to give every encouragement to prevent illegal transactions being pursued, withdrawal should be allowed as long as the illegal purpose has not been fully carried out and regardless of the plaintiff's state of mind.[155]

3. THE RECOGNITION OF CONTRACTUALLY TRANSFERRED OR CREATED PROPERTY RIGHTS

(1) Title may pass under an illegal contract

2.57 Where property is transferred pursuant to a contract then ownership in the property can pass, notwithstanding the involvement of illegality and the fact that, if executory, the court would not have assisted in the enforcement of the contract.[156] This position was made clear in the decision of the Privy Council in *Singh v Ali*.[157] The defendant sold a lorry to the plaintiff, but, pursuant to a scheme between the parties to defraud the Malayan licensing authorities, registered the lorry in his own name. This enabled the defendant to obtain a permit to operate the lorry, which under statutory regulations then in force, the plaintiff would not have been able to

[151] (1801) 2 B & P 467, 471; 126 ER 1388, 1390. See also *Kearley v Thomson* (1890) 24 QBD 742, 747, *per* Fry LJ.

[152] P Birks, *An Introduction to the Law of Restitution* (revised ed 1989) pp 302-303.

[153] J Beatson, "Repudiation of Illegal Purpose as a Ground for Restitution" (1975) 91 LQR 313, 314.

[154] N Enonchong, "Title Claims and Illegal Transactions" (1995) 111 LQR 135, 156.

[155] J K Grodecki, "In pari delicto potior est conditio defendentis" (1955) 71 LQR 254, 261-263. See also R Merkin, "Restitution by Withdrawal From Executory Illegal Contracts" (1981) 97 LQR 420.

[156] But see M J Higgins, "The Transfer of Property under Illegal Transactions" (1962) 25 MLR 149 and S H Goo, "Let the Estate Lie Where it Falls" (1994) 45 NILQ 378 where the validity of this rule is doubted. They argue that the proposition that property (ownership or title) can pass under an illegal contract is inconsistent with legal theory and unsupported by authority. See also, *Cheshire, Fifoot and Furmston's Law of Contract* (13th ed 1996) pp 389-390.

[157] [1960] AC 167.

obtain for himself. The defendant later detained the lorry without the plaintiff's consent and refused to return it to him. The Privy Council held that property in the lorry had passed to the plaintiff, notwithstanding the illegality of the contract of sale, and that the plaintiff could therefore maintain an action against the defendant for the return of the lorry or its value. Lord Denning said:

> Although the transaction between the plaintiff and the defendant was illegal, nevertheless it was fully executed and carried out: and on that account it was effective to pass the property in the lorry to the plaintiff. ... The reason is because the transferor, having fully achieved his unworthy end, cannot be allowed to then turn round and repudiate the means by which he did it - he cannot throw over the transfer.[158]

2.58 This case was applied by the Court of Appeal in *Belvoir Finance Co Ltd v Stapleton*,[159] notwithstanding the fact that here the vendor transferred the relevant goods directly to a third party and the purchaser never took possession of them. The plaintiff finance company bought three cars from dealers and, without taking possession of the cars, let them out on hire purchase to a firm of which the defendant was a manager. Both the original sale contracts and the hire purchase contracts contravened relevant statutory restrictions and were considered to be illegal. But the Court of Appeal held that the plaintiff could nonetheless sue the defendant for conversion when he fraudulently sold the cars to innocent purchasers. Although the plaintiff had obtained the cars under contracts which were illegal and had never taken possession of them, the contracts had been executed and the property in the cars had passed to them. Lord Denning MR, referring to his earlier judgment in *Singh v Ali*,[160] said: "Although they obtained the car under a contract which was illegal, nevertheless inasmuch as the contract was executed and the property passed, the car belonged to the finance company and they can claim it".[161]

2.59 Two points remain unclear. First, at what point in time will the courts recognise that ownership of the property has passed under an illegal contract?[162] The cases frequently refer to the "execution"[163] of the contract, but it is not clear what this means. What if, for example, the transferor has delivered the property, but the transferee has failed to pay the price? Does "execution" require that both parties should have performed their side of the bargain? Such an approach might be

[158] [1960] AC 167, 176. Lord Denning referred to a dictum of Parke B in *Scarfe v Morgan* (1838) 4 M & W 270, 282; 150 ER 1430, 1435-1436 to support his proposition. There, the court was concerned with the validity of a bailee's lien on a mare, which the plaintiff argued was created under an illegal contract and therefore void. In fact, the court held that the contract was not illegal. But even if it had been created under an illegal contract, Parke B said that the lien would still have been valid, "because the contract was executed, and the special property had passed by the delivery of the mare to the defendant".

[159] [1971] 1 QB 210. See also, *Chief Constable of West Midlands v White* (1992) 142 NLJ 455.

[160] [1960] AC 167. See para 2.57 above.

[161] [1971] 1 QB 210, 218.

[162] For detailed discussion on this point, see A Stewart, "Contractual Illegality and the Recognition of Proprietary Interests" (1986) 1 JCL 134, 144-149.

[163] For example, *Scarfe v Morgan* (1838) 4 M & W 270, 281; 150 ER 1430, 1435; *Singh v Ali* [1960] AC 167, 176; *Belvoir Finance Co Ltd v Stapleton* [1971] 1 QB 210, 218.

regarded as more equitable, since it is less likely to result in the unjust enrichment of the transferee, but it would, on the other hand, give the transferee an incentive to perform the illegal contract.[164] In certain circumstances, for example, in relation to the sale of goods, contracts are subject to statutory provisions as to the passing of title.[165] But it is not clear that a purchaser could rely on the statutory rules to say that title has passed under an illegal contract which has been agreed but not performed. One argument would be that the statutory rules do not apply to illegal contracts.

2.60 The second point on which the position is not clear is whether the law is different as between, on the one hand, the purchaser and a third party and, on the other hand, as between the vendor and the purchaser. Professor Treitel points out that *Belvoir Finance Co Ltd v Stapleton*[166] was concerned only with the position between the purchaser and a third party. He suggests that it may not be used to support the proposition that a purchaser to whom property in goods has passed under an illegal contract can claim them, or damages for their conversion, from a vendor who has never delivered them. Such a claim, he says, would not differ in substance from a claim, which would not be directly enforced, for the delivery, or for damages for the non-delivery, of the goods under the illegal contract.[167]

2.61 As well as recognising that full legal title may pass under an illegal sale contract, it is clear that the courts also recognise that a limited interest in property may pass under an illegal contract. So, for example, if the lessor of premises under an illegal lease forcibly ejects the lessee before the expiry of the term, the courts will assist the lessee in regaining possession.[168]

(2) The recovery of property in which a limited interest has been created under an illegal contract - the reliance principle

2.62 Where a plaintiff has created only a limited interest in property (for example, by way of a lease, bailment or charge) under a contract that involves illegality, the plaintiff may recover back the property, provided that he or she does not need to rely on the illegality or on the illegal contract in order to prove his or her proprietary claim.

[164] Where the transferee's interest is limited, failure to pay the price may amount to the breach of an on-going obligation which terminates the interest, so that the transferor is entitled to recover on the basis of his or her reversionary interest: see *Bowmakers Ltd v Barnet Instruments Ltd* [1945] KB 65 discussed at paras 2.62 to 2.67 below.

[165] Sections 17 and 18 of the Sale of Goods Act 1979.

[166] [1971] 1 QB 210.

[167] G H Treitel, *The Law of Contract* (9th ed 1995) p 458. And see A Stewart, "Contractual Illegality and the Recognition of Proprietary Interests" (1986) 1 JCL 134, 141. But see R N Gooderson, "Turpitude and Title in England and India" [1958] CLJ 199, 213. Relying on, *inter alia*, *Doe d Roberts v R* (1819) 2 B & Ald 367; 106 ER 401 and *Phillpotts v Phillpotts* (1850) 10 CB 85; 138 ER 35 Gooderson argues that if the vendor has transferred a full title, but not possession, to the purchaser, then the purchaser can recover possession from him or her.

[168] *Feret v Hill* (1854) 15 CB 207; 139 ER 400. However, before a contract for an illegal lease is executed, no interest passes to the lessee, who may therefore be refused entry to the premises: *Cowan v Milbourn* (1867) LR 2 Ex 230.

2.63 The leading case on the application of this "reliance" principle is usually cited as the Court of Appeal's decision in *Bowmakers Ltd v Barnet Instruments Ltd*.[169] However, this difficult case itself illustrates the uncertainties surrounding the principle. The defendants hired machine-tools from the plaintiff finance company under three separate hire-purchase agreements. The agreements were part of an arrangement that contravened statutory regulations relating to pricing and licensing and it was assumed that they were therefore "illegal".[170] After paying some, but not all, of the agreed hire payments, the defendants sold the machine-tools hired under the first and third agreement to third parties and refused to deliver up on demand the tools subject to the second agreement. The Court of Appeal held the defendants liable to the plaintiff for conversion in respect of *all* the machine-tools. Du Parcq LJ, giving the judgment of the court, said:

> In our opinion, a man's right to possess his own chattels will as a general rule be enforced against one who, without any claim of right, is detaining them, or has converted them to his own use, even though it may appear either from the pleadings, or in the course of the trial, that the chattels in question came into the defendant's possession by reason of an illegal contract between himself and the plaintiff, provided that the plaintiff does not seek, and is not forced, either to found his claim on the illegal contract or to plead its illegality in order to support his claim.[171]

2.64 The case has been subjected to criticism on the ground that, at least with respect to the machine-tools which the defendants were merely detaining without paying for, if not also with respect to those which they had sold, the decision of the Court of Appeal was equivalent, for all practical purposes, to enforcing the illegal

[169] [1945] KB 65. In *Tinsley v Milligan* [1994] 1 AC 340 the majority of the House of Lords held that the reliance principle applied to equitable as well as legal interests. As the case is concerned with the effect of illegality on trusts, we deal with it in Part III below. In *Taylor v Bowers* (1876) 1 QBD 291 (discussed in para 2.50 above) James LJ (and arguably Grove J) allowed the plaintiff to recover on the basis that he did not need to rely on the illegal transaction in order to prove his title. James LJ said (1876) 1 QBD 291, 298: "Now the rule is, that a man certainly cannot recover goods in respect of which he is obliged to state a fraud of his own as part of his title. But that is not, according to my view, the position of this plaintiff. All the plaintiff has got to say is: 'These were my goods. I was possessed of these goods in 1868. I have never parted with them to anybody. They are my goods still. I never sold them, and I have never given them to anybody in such a way as to deprive myself of the right to possession of them.'" The point is frequently made that when this case was decided, it was not clear that title could pass under an illegal contract: see, for example, P Birks, *An Introduction to the Law of Restitution* (revised ed 1989) p 303 and Millett LJ in *Tribe v Tribe* [1996] Ch 107, 125. However, it should be noted that no actual assignment by the plaintiff was ever made, and the case may therefore be cited in support of the proposition that where a plaintiff has merely delivered possession to the defendant, without transferring any title, then, regardless of the involvement of any illegality, the plaintiff can recover possession on the strength of that title. See further, R N Gooderson, "Turpitude and Title in England and India" [1958] CLJ 199, 209 and N Enonchong, "Title Claims and Illegal Transactions" (1995) 111 LQR 135, 146-148.

[170] [1945] KB 65, 69. In fact, the plaintiff finance company had purchased the machine-tools from a third party under agreements which also contravened the statutory regulations. The defendants, however, conceded that the plaintiff had received good title: [1945] KB 65, 70. See A Stewart, "Contractual Illegality and the Recognition of Proprietary Interests" (1986) 1 JCL 134.

[171] [1945] KB 65, 71.

contracts of hire-purchase.[172] Moreover, it is hard to see how the plaintiff established its right to possession without "relying" on the illegal contracts. While the sale of the tools hired under the first and third contracts may have amounted to a repudiatory breach which would automatically terminate the defendants' special property in the tools, this does not explain how the plaintiff was able to recover the goods which the defendants simply kept. It may be that the second contract specifically provided that non-payment of hire would amount to a repudiatory breach entitling the plaintiff to take back the goods,[173] but, even if so, it is hard to see how the plaintiff could establish this without "relying" on the contract.[174]

2.65 In its decision in *Bowmakers Ltd v Barnet Instruments Ltd*[175] the Court of Appeal distinguished *Taylor v Chester*.[176] There the plaintiff deposited a half bank-note with the defendant as security for payment for wine and food consumed by him in a brothel. He then sought to recover the half-note by relying on his property in it, but was unable to do so since in order the defeat the defence that the note had been validly pledged, he "was 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".[177]

2.66 Subject to the two possible exceptions set out below, the picture that seems to be emerging here is that the courts simply ignore the illegality when considering the proprietary consequences of an illegal contract.[178] Admittedly this is not the language adopted by the courts, although Lord Browne-Wilkinson recently recognised that a person may rely on the illegal contract for the purpose of "providing the basis of his claim to a property right".[179] Some academics[180] have alternatively suggested that the cases show a distinction between the enforcement of rights created by an illegal contract (which the courts will not allow) and the enforcement of rights retained by a transferor after entering into an illegal contract (which the courts will allow) and which the transferor may evidence by referring to

[172] C J Hamson, "Illegal Contracts and Limited Interests" (1949) 10 CLJ 249, 258-259.

[173] See G H Treitel, *The Law of Contract* (9th ed 1995) p 453. The terms of the hire purchase agreements are not set out in the reported case.

[174] H Stowe, "The 'Unruly Horse' has Bolted: *Tinsley v Milligan*" (1994) 57 MLR 441, 447; A Burrows, *The Law of Restitution* (1993) pp 470-471; *Cheshire, Fifoot and Furmston's Law of Contract* (13th ed 1996) p 396.

[175] [1945] KB 65.

[176] (1869) LR 4 QB 309.

[177] (1869) LR 4 QB 309, 314, *per* Mellor J.

[178] N Enonchong, "Title Claims and Illegal Transactions" (1995) 111 LQR 135, 140-144 and A Burrows, *The Law of Restitution* (1993) p 469.

[179] *Tinsley v Milligan* [1994] 1 AC 340, 370. See para 3.10 below.

[180] B Coote, "Another Look at *Bowmakers v Barnet Instruments*" (1972) 35 MLR 38, 48. And see, A Stewart, "Contractual Illegality and the Recognition of Proprietary Interests" (1986) 1 JCL 134,142-144.

the illegal contract.[181] However, where the reference, as in the *Bowmakers* case, is such as to show that in accordance with the contractual terms the defendant's right to possession has terminated, it is hard to see how that does not amount to enforcement of rights created by the illegal contract.

2.67 Several commentators have noted the difficulties caused by the reliance principle in relation to illegal leases.[182] Under general principles an illegal lease will vest a term of years in the tenant (see paragraph 2.61 above), and at the end of the term of years the landlord will be able to recover possession without relying on the illegality. However, what if the tenant fails to pay the rent in the interim? The landlord will presumably be able neither to enforce the lease nor to demand back the property, since failure to pay rent does not automatically terminate a lease.[183] In *Alexander v Rayson*[184] the Court of Appeal suggested that the tenant would effectively be able to live in the leased property rent-free. But one could argue that the lessor is no more required to "rely" on the illegal lease in order to reclaim the property for failure to pay rent than the hirer in *Bowmakers Ltd v Barnet Instruments Ltd*[185] had to rely on the illegal hire purchase agreements to succeed in his claim for conversion, in which case the lessor's claim should succeed.[186]

(3) Exceptions

2.68 It would seem that there are at least two exceptions to any general rule that the courts recognise that title may pass under an illegal contract. First, dicta in one case suggest that where the turpitude of the plaintiff is very gross, the court would not be prepared to assist the plaintiff by recognising that title had passed under the contract. Thus it was suggested that if the goods claimed by the plaintiff are of such a kind that it is unlawful to deal in them at all, as for example, obscene books,[187] the court would not intervene.

2.69 Secondly, the court will not recognise that property has passed under a contract which is entered into in contravention of a legislative provision and that legislative provision is construed to provide that not only should the contract be unenforceable, but also ineffective. This would appear to be one of two grounds

[181] For criticism, see N Enonchong, "Title Claims and Illegal Transactions" (1995) 111 LQR 135, 142-143.

[182] See, for example, *Cheshire, Fifoot and Furmston's Law of Contract* (13th ed 1996) p 393; and J Beatson, *Anson's Law of Contract* (27th ed 1998) p 394.

[183] See G H Treitel, *The Law of Contract* (9th ed 1995) pp 454-455.

[184] [1936] 1 KB 169, 186.

[185] [1945] KB 65.

[186] C J Hamson, "Illegal Contracts and Limited Interests" (1949) 10 CLJ 249, 256-257. Professor Treitel argues that the analogy between illegal leases and the illegal hire purchase agreements in the *Bowmakers* case is false, if, as he suggests, the explanation for the *Bowmakers* decision is that the hire purchase agreements contained a term that the hirer's special property should automatically come to an end on failure to pay the hire. For a lease cannot determine automatically on the lessee's failure to pay hire, since the law does not recognise a lease for an uncertain period. See G H Treitel, *The Law of Contract* (9th ed 1995) p 455.

[187] *Bowmakers Ltd v Barnet Instruments Ltd* [1945] KB 65, 72, *per* du Parcq LJ.

for the decision in *Amar Singh v Kulubya*.[188] On an appeal from the decision of the Court of Appeal for Eastern Africa, the Privy Council allowed a lessor of 'mailo' lands to evict a lessee from them because the lease had been entered into in contravention of legislation which provided that it was an offence for a landowner to lease mailo lands to a non-African and for a non-African to take such lands on lease without the consent of the Governor. The lessee was a non-African and no consent had been obtained. Lord Morris said: "In view of the terms of the legislative provisions [the defendant] could not assert that he had acquired any leasehold interest. ... As a non-African he had no right without the consent in writing of the Governor to occupy or enter into possession of the land or to make any contract to take the land on lease."[189]

4. THREE OTHER ISSUES

(1) Damages for a different cause of action

2.70 Even where the court is not prepared to enforce a contract which involves illegality, the plaintiff may still be entitled to damages for a different cause of action. First, the plaintiff may be able to bring an alternative claim in tort.[190] In *Shelley v Paddock*[191] the defendants, who were resident in Spain, agreed to sell property there to the plaintiff, who was resident in England. The plaintiff paid the purchase price to the defendants, who fraudulently misrepresented that they were acting on behalf of the owners of the property. But the plaintiff, unaware of the statutory requirement, failed to obtain Treasury permission to remit money to persons abroad as required by the Exchange Control Act 1947. When it transpired that the defendants were unable to make good title to the property and had, in fact, defrauded the plaintiff, she brought an action in tort for deceit to recover back the price which she had paid. By way of defence, the defendants raised the plaintiff's failure to obtain Treasury permission and alleged that the transaction was illegal and unenforceable. The plaintiff's claim was upheld by the Court of Appeal. Lord Denning MR observed that the defendants were "guilty of a swindle" and concluded that it was "only fair and just that they should not be allowed to keep the benefit of their fraud."[192] Similarly, in *Saunders v Edwards*[193]

[188] [1964] AC 142. See, C J Hamson, "Contract - Illegality - In Pari Delicto" [1964] CLJ 20 and N Enonchong, "Title Claims and Illegal Transactions" (1995) 111 LQR 135, 144-145. The second ground for the decision was that the relevant legislation had as its object the protection of Africans as a class and the lessor was a member of that class. See paras 2.46 to 2.48 above.

[189] [1964] AC 142, 150.

[190] Although note that illegality may also act as a defence to a claim in tort. For examples of how it operates in recent cases, see *Clunis v Camden and Islington Health Authority* [1998] 2 WLR 902 and *Standard Chartered Bank v Pakistan National Shipping Corporation and Others (No 2)* [1998] 1 Lloyd's Rep 684.

[191] [1980] QB 348.

[192] [1980] QB 348, 357. See R A Buckley, "Fraudulent Breach of an Illegal Contract" (1978) 94 LQR 484.

[193] [1987] 1 WLR 1116. See also, *Re Mahmoud v Ispahani* (discussed at para 2.5 above) where Bankes LJ and Scrutton LJ both expressly left open the possibility that the plaintiff may have some form of action against the defendant in respect of the defendant's fraudulent misrepresentation: [1921] 2 KB 716, 726, *per* Bankes LJ; 730, *per* Scrutton LJ.

the plaintiffs were able to recover damages for fraudulent misrepresentation despite their own involvement in alleged illegality. The plaintiffs had agreed to buy a flat and furniture from the defendants for a price which, apparently at the suggestion of the plaintiffs, falsely inflated the value of the chattels in order to avoid stamp duty. The plaintiffs were induced to purchase the flat by the defendants' fraudulent misrepresentation that the flat included a roof terrace. Their claim for damages was upheld. The possible illegality involved in the apportionment of the price in the contract was held to be wholly unconnected with their cause of action for fraudulent misrepresentation.[194]

2.71 But it is clearly not in every case that the courts will be prepared to allow the plaintiff an alternative remedy. In *Parkinson v College of Ambulance Ltd and Harrison*[195] the secretary of a charity fraudulently misrepresented to the plaintiff that if the plaintiff made a large donation to the charity he or the charity was in a position to ensure that the plaintiff would receive a knighthood. After making the donation but not receiving the knighthood the plaintiff brought an action against the charity and its secretary claiming, *inter alia*, damages for deceit. Lush J held that, despite the defendant's fraud, the plaintiff's claim failed since the contract in this case had an element of turpitude in it and this ruled out not only a contractual claim to enforce the contract but also a tort claim for deceit.

2.72 Secondly, the courts may be prepared to imply the existence of a collateral contract between the parties which is untainted by the illegality of the main contract. In *Strongman (1945) Ltd v Sincock*[196] the plaintiffs were builders who had undertaken certain work on the defendant's premises. Under regulations then in force, licences were required to cover the work. The defendant, an architect, promised that he would obtain them, but failed to do so. On completion, the defendant sought to avoid payment, relying on the illegality. The Court of Appeal held that the builders could not sue on the building contract itself, which was illegal, but that the assurance given by the architect amounted to a collateral contract by which the architect promised that he would get any necessary supplementary licences, or if he failed to get them, that he would stop the work. The plaintiffs were allowed to recover, as damages for breach of that promise, exactly the sums due to them under the building contract which was unenforceable for illegality.[197]

(2) Severance

2.73 In certain circumstances the courts are prepared to sever the objectionable part of a contract in order to facilitate the enforcement of what remains. In practice, this

[194] [1987] 1 WLR 1116, 1127, *per* Kerr LJ; 1132, *per* Nicholls LJ; 1134, *per* Bingham LJ.

[195] [1925] 2 KB 1 (see para 2.35 above).

[196] [1955] 2 KB 525. See also, *Archbolds (Freightage) Ltd v S Spanglett Ltd* [1961] 1 QB 374, 392, *per* Devlin LJ.

[197] Note the suggestion by Professor Treitel that a balancing of the public and private interest in such a case might suggest that restitution would have been the more appropriate solution, so that the innocent builder would not be penalised by losing the value of his work, but would, on the other hand, only recover its reasonable value, so as not to make a profit from doing (though unwittingly) an illegal act: G H Treitel, "Contract and Crime" in *Crime, Proof and Punishment: Essays in Memory of Sir Rupert Cross* (1981) p 81 at p 91.

will not be permitted if the promise involves serious moral turpitude, such as the deliberate commission of a serious criminal offence.[198] So, for example, a contract whose object was to defraud the Revenue has been held to be incapable of severance.[199] On the other hand, promises which are in restraint of trade, or which oust the jurisdiction of the court, may be severed, thereby permitting the remainder of the contract to be enforced.

2.74 Where permitted, severance may operate in one of two ways. First, the court may reduce the scope of the promise, by "blue pencilling" the objectionable parts. The courts will not, however, rewrite the promise. The parties must therefore have indicated in their drafting that the promise is divisible into a number of independent parts. Secondly, the court may sever an entire promise, provided that it does not constitute the whole of the consideration. For example, in *Goodinson v Goodinson*[200] a husband and wife entered into an agreement whereby the husband was to pay the wife maintenance in consideration for the wife covenanting to indemnify the husband against all debts to be incurred by her, not to pledge the husband's credit and not to commence or prosecute any matrimonial proceedings against the husband. This third covenant was contrary to public policy as being a covenant to oust the jurisdiction of the court. However, the court held that this covenant did not vitiate the rest of the agreement, since it was not the only, nor the main, consideration provided by the wife. She was therefore able to sue on the agreement when her husband fell into arrears with the maintenance payments.

(3) Linked contracts may be tainted by illegality

2.75 Where a second contract is founded on or consequent upon a first, illegal, contract, that second contract may also be illegal. It is irrelevant that the second contract is itself innocuous or that it formed no part of the first illegal transaction.[201] So, in *Fisher v Bridges*[202] a contract of security for the payment of an illegal debt was held to be unenforceable. The plaintiff had agreed to sell land to the defendant for a price, all of which the defendant paid except for £630. The defendant executed a deed by which he covenanted to pay £630 to the plaintiff. The plaintiff conceded that the contract for the sale of land was illegal and unenforceable, but sought to enforce the covenant. Jervis CJ said: "It is clear that the covenant was given for payment of the purchase money. It springs from, and is a creature of, the illegal agreement; and, as the law would not enforce the original illegal contract, so neither will it allow the parties to enforce a security for the purchase money, which by the original bargain was tainted with illegality."[203]

2.76 A contract may be tainted by the illegality of another contract, even where the parties are not the same. In *Spector v Ageda*[204] the defendants had been lent money

[198] See *Bennett v Bennett* [1952] 1 KB 249, 253-254. See also *Taylor v Bhail* [1996] CLC 377.

[199] *Miller v Karlinski* (1945) 62 TLR 85.

[200] [1954] 2 QB 118.

[201] *Cheshire, Fifoot and Furmston's Law of Contract* (13th ed 1996) p 399.

[202] (1854) 3 El & Bl 643; 118 ER 1283.

[203] (1854) 3 El & Bl 643, 649; 118 ER 1283, 1285.

[204] [1973] Ch 30.

under a contract which contravened the Moneylenders Act 1927. When they failed to keep up with the repayments, the plaintiff agreed to lend them a sufficient sum to repay the creditor. The plaintiff was the sister of the creditor and had acted as her solicitor. At the time that she made the loan to the defendants, she was aware of the doubts about the enforceability of the original loan. The defendants used the loan to repay the original creditor, but did not repay the plaintiff. In an action by the plaintiff for payment of money due, Megarry J relied on *Fisher v Bridges*[205] to hold that the action failed. He said: "In [*Fisher v Bridges*], the subsequent transaction was between the original parties: but a third party who takes part in the subsequent transaction with knowledge of the prior illegality can, in general, be in no better position."[206]

2.77 A cheque given in pursuance of an illegal transaction is unenforceable between the parties to the transaction, despite the "strong and compelling reasons for treating the rights and obligations which arise from commercial documents such as bills of exchange, letters of credit and performance bonds as being autonomous and as having an existence of their own which is unaffected as far as possible by the rights and obligations which spring from associated transactions".[207] And, in certain circumstances, a letter of credit may not be enforceable against a bank where the underlying contract to which it relates is illegal.[208]

2.78 There clearly must be some limit to this "tainting" principle. This is illustrated by *Armhouse Lee Ltd v Chappell*.[209] The Court of Appeal was prepared to accept that while some aspects, at least, of a contract entered into by a subscriber who dials an advertised telephone sex line might not be enforceable, this did not affect the enforceability of a contract entered into between the telephone sex line provider

[205] (1854) 3 El & Bl 643; 118 ER 1283.

[206] [1973] Ch 30, 44. It would appear from his judgment that Megarry J intended to limit the tainting principle to cases where the party to the second contract was aware of the illegality of the first contract. See also, *Cannan v Bryce* (1819) 3 B & Ald 179; 106 ER 628. See *Chitty on Contracts* (27th ed 1994) para 16-140 and G Virgo, "The Effect of Illegality on Claims for Restitution in English Law" in W Swadling (ed), *The Limits of Restitutionary Claims: A Comparative Analysis* (1997) p 141 at p 148.

[207] *Mansouri v Singh* [1986] 1 WLR 1393, 1403, *per* Neill LJ.

[208] *Group Josi Re v Walbrook Insurance Co Ltd* [1996] 1 WLR 1152, 1164, *per* Staughton LJ.

[209] *The Times* 7 August 1996.

and a third party for advertising services. This latter advertising contract was “at one remove” from the contract for sexual services.

PART III
THE EFFECT OF ILLEGALITY II: TRUSTS

1. THE GENERAL SCOPE OF THIS PART

3.1 In this Part we focus on the effect of illegality on the validity and/or enforceability of a trust. Every major trusts law textbook affords separate consideration to illegal trusts.[1] Some of the trusts considered are invalid because they involve or are connected to unlawful conduct. Thus a condition in a trust inciting a beneficiary to do any act prohibited by law is void;[2] and a trust whose creation involves the breach of a statutory prohibition may be invalid by statute.[3] However, most of the examples given are not of trusts which involve unlawful conduct as such (however indirectly) but are illustrations of express trusts which involve conduct which is otherwise "contrary to public policy".[4] They parallel the category of contracts which are "contrary to public policy" at common law.

3.2 But even if a trust is not invalid, a person claiming to enforce it may fall foul of the "reliance principle". This principle is of uncertain scope and effect. We have already examined it in relation to contractually transferred or created property rights.[5] In the trusts context, it basically means that a claim to enforce a trust will fail if the person claiming to enforce it is not able to establish his or her entitlement without "relying" on his or her illegality (the "reliance principle"). The leading authority on this principle is *Tinsley v Milligan*,[6] which we discuss in detail below. As we shall see, it is difficult to be sure which trusts are unenforceable on this ground.[7] The law on the effect of illegality on the validity or enforceability of a trust is therefore uncertain.

3.3 Where a trust is void, the disposition of beneficial ownership which would arise if the trust was valid never takes effect. The effect of the illegality on the trust is substantive. Beneficial ownership, in default of the invalid trust, is decided in accordance with a set of default rules applied in equity.[8] Where, in contrast, a trust is not invalid but unenforceable under the reliance principle, the trust still

[1] See, for example, D J Hayton, *Underhill and Hayton, Law of Trusts and Trustees* (15th ed 1995) Art 11 (express trusts) and Art 30 (resulting trusts); J E Martin, *Hanbury & Martin, Modern Equity* (15th ed 1997) ch 13; P Pettit, *Equity and the Law of Trusts* (8th ed 1997) ch 11 and 12; A J Oakley, *Parker & Mellows, The Modern Law of Trusts* (7th ed 1998) ch 7 (express trusts) and pp 249-253 (resulting trusts).

[2] See C H Sherrin, R F D Barlow and R A Wallington, *Williams on Wills* (7th ed 1995) p 337, nn 5 and 6, citing dicta in *Mitchel v Reynolds* (1711) 1 P Wms 181, 189; 24 ER 347, 350; *Earl of Shrewsbury v Hope Scott* (1859) 6 Jur NS 452, 456; *Re Piper* [1946] 2 All ER 503.

[3] See para 3.34 below.

[4] See para 3.33 below.

[5] See paras 2.62 to 2.67 above.

[6] [1994] 1 AC 340. See paras 3.9 to 3.12 below.

[7] See paras 3.40 to 3.50, paras 3.53 to 3.56, and paras 3.61 to 3.64 below.

[8] See further para 3.36 below.

notionally exists. "The effect of illegality is not substantive but procedural."[9] But no court will enforce the trust against the legal owner at the instance of the notional beneficiary. Whether any other person, such as creditors or legatees, may be able to claim under or through the beneficiary is unclear.[10]

3.4 Much of this Part should be viewed as a novel and tentative attempt to produce some order out of apparent chaos.[11] We have found it convenient to begin by considering how illegality may affect resulting trusts (other than resulting trusts which may arise on the failure of an express trust). We then consider the effect of illegality on express trusts, and on the trusts (frequently referred to as "automatic"[12] resulting trusts) if any,[13] which arise if that express trust is invalid. We finally give brief consideration to the effect of illegality on certain types of constructive trust: those which in some sense give effect to the intention of one or more parties.

2. "APPARENT GIFTS" AND RESULTING TRUSTS

3.5 Under general trust principles, where one person provides some or all of the consideration for the purchase of property in another's name, or transfers property[14] to another for no consideration, it is presumed that that other holds the property on resulting trust for the contributor or transferor. This is known as the "presumption of resulting trust". The presumption of resulting trust can be rebutted by evidence that the contributor to the purchase or the transferor of the property intended to make a gift to the recipient. And sometimes equity will presume, from the relationship between the parties, that the intention was to make a gift. This is the "presumption of advancement".[15] The presumption of advancement can be rebutted by evidence that the contributor to the purchase or the transferor of the property did not intend to make a gift to the transferee.

9 *Tinsley v Milligan* [1994] 1 AC 340, 374, *per* Lord Browne-Wilkinson.

10 See further paras 3.57 to 3.58 below.

11 For an alternative analysis of the effect of illegality on trusts, see N Enonchong, *Illegal Transactions* (1998) pp 165-190. He draws a distinction between cases where the intended beneficiary of the trust is a person other than the settlor, and cases where the beneficiary and the settlor (transferor/contributor) are one and the same. He says that in the former case, the illegal object of the settlor's intentions is frustrated by preventing the beneficiary from benefiting and by enforcing a resulting trust in favour of the settlor instead. But in the latter class of case, to enforce the resulting trust would be consistent with the settlor's illegal intentions, and different rules are therefore applied.

12 Although note that the validity of this term has been doubted: see *Westdeutsche Landesbank Girozentrale v Islington LBC* [1996] AC 669, 708, *per* Lord Browne-Wilkinson.

13 Cf if the property is *bona vacantia*. See *Westdeutsche Landesbank Girozentrale v Islington LBC* [1996] AC 669, 708, *per* Lord Browne-Wilkinson.

14 It is unclear whether a resulting trust will be presumed where one person voluntarily transfers land to another. This depends on the effect of s 60(3) of the Law of Property Act 1925: see further para 3.22 n 54 below.

15 See D J Hayton, *Underhill and Hayton, Law of Trusts and Trustees* (15th ed 1995) ch 6; J E Martin, *Hanbury & Martin, Modern Equity* (15th ed 1997) ch 10; P Pettit, *Equity and the Law of Trusts* (8th ed 1997) ch 9. The relevant relationships currently appear to be limited to (i) father and child and (ii) husband and wife. Cf the decision of the High Court of Australia in *Nelson v Nelson* (1995) 184 CLR 538 (recognising a presumption of advancement between mother and daughter).

3.6 It is clear that a transaction which ordinarily gives rise to such a resulting trust may be affected by illegality. In a number of reported cases, one person has transferred property to another or contributed to the purchase of property in another's name in order to facilitate fraud on a third party. Often the intention has been to conceal the equitable interest of a transferor (or contributor) of the property transferred or purchased, in order to defraud creditors,[16] tax authorities,[17] or authorities administering social security benefits.[18] In other cases, the intention has been to clothe the transferee with apparent absolute ownership, so as, for example, to provide him or her with the necessary qualification for some public office which he or she would not otherwise have.[19] In such circumstances, will courts enforce the equitable rights which (if no illegal purpose had been involved) the transferor or contributor would have had under a resulting trust?

3.7 The current position under English law seems to be that, in general, illegality does not prevent a resulting trust from arising on ordinary principles, notwithstanding that the resulting trust involves or is connected with some form of illegality. This is certainly the case where the resulting trust arises out of a transaction which was intended to facilitate fraud.[20] However, such a trust will not be enforceable by the beneficiary if he or she must lead evidence of the illegality in which he or she is implicated to show that the trust exists.[21] This emerges from the speeches of the majority of the House of Lords in *Tinsley v Milligan*.[22] In addition, it is also conceivable that a resulting trust will be unenforceable or will never arise if the turpitude of the beneficiary is gross[23] or if a statute expressly or impliedly so provides.[24]

(1) Where a resulting trust is unenforceable because its existence can only be shown by "relying" on illegality: the "reliance principle"

3.8 A resulting trust which would otherwise be valid and enforceable may be unenforceable by the transferor or contributor if he or she must lead evidence of illegality in which he or she was implicated (such as a scheme to defraud some third party) in order to show that it exists. Conversely, such a trust will be enforceable if it is not necessary to rely on such evidence. This is the "reliance principle", which was recently authoritatively accepted by a majority of the House of Lords in *Tinsley v Milligan*.[25] In a subsequent case, *Tribe v Tribe*,[26] the Court of

[16] See, eg, *Gascoigne v Gascoigne* [1918] 1 KB 233.

[17] See, eg, *Re Emery's Investments Trusts* [1959] Ch 410.

[18] See, eg, *Tinsley v Milligan* [1994] 1 AC 340.

[19] See, eg, *Platamone v Staple* (1815) G Coop 250; 35 ER 548.

[20] See *Tinsley v Milligan* [1994] 1 AC 340.

[21] See paras 3.9 to 3.13 below.

[22] [1994] 1 AC 340.

[23] See paras 3.26 to 3.27 below.

[24] See paras 3.28 to 3.31 below.

[25] [1994] 1 AC 340. A G J Berg, "Illegality and Equitable Interests" [1993] JBL 513; R A Buckley, "Social Security Fraud as Illegality" (1994) 110 LQR 3; N Cohen, "The Quiet Revolution in the Enforcement of Illegal Contracts" [1994] LMCLQ 163; N Enonchong, "Illegality: The Fading Flame of Public Policy" (1994) 14 OJLS 295; S H Goo, "Let the

Appeal has confirmed that, even if a transferor or contributor cannot establish his or her equitable interest without relying on his or her own illegality, he or she will nevertheless be permitted to do so if he or she "withdrew" from the illegal transaction before the illegal purpose was wholly or partly carried into effect. This is the "withdrawal exception".

(a) The reliance principle

3.9 In *Tinsley v Milligan*,[27] the facts of which we have already briefly set out,[28] the parties were cohabitees who had both contributed to the purchase price of a house. The house had, however, been solely registered in Miss Tinsley's name in order to enable Miss Milligan to make false claims to the Department of Social Security. The proceeds of the fraud were used by both parties, but they did not amount to a substantial part of their joint income. The parties subsequently quarrelled and Miss Tinsley moved out. She brought a claim against Miss Milligan for possession of the house, asserting her legal title to it.[29] Miss Milligan counterclaimed for an order for sale and a declaration that the house was held by Miss Tinsley in trust for them both in equal shares. Miss Tinsley contended that because of the illegal scheme, Miss Milligan could not establish any equitable interest in the house under a trust.

3.10 A bare majority of the House of Lords[30] upheld a majority decision of the Court of Appeal[31] which had confirmed the finding of the trial judge in favour of Miss Milligan. Lord Browne-Wilkinson, in the leading majority speech, said that three propositions emerged from the authorities on the position at law:

> (1) property in chattels and land can pass under a contract which is illegal and therefore would have been unenforceable as a contract;
>
> (2) a plaintiff can at law enforce property rights so acquired provided that he does not need to rely on the illegal contract for any purpose other than providing the basis of his claim to a property right;

Estate Lie where it Falls" (1994) 45 NILQ 378; M Halliwell, "Equitable Proprietary Claims and Dishonest Claimants: A Resolution?" [1994] Conv 62; H Stowe, "The 'Unruly Horse' has Bolted: *Tinsley v Milligan*" (1994) 57 MLR 441; N Enonchong, "Title Claims and Illegal Transactions" (1995) 111 LQR 135.

[26] [1996] Ch 107.

[27] [1994] 1 AC 340.

[28] See para 1.2 above.

[29] At some stage, Miss Milligan repented of the frauds and disclosed them to the DSS. It is not clear whether this was before the proceedings for possession were commenced by Miss Tinsley (the version of facts given by Nicholls LJ in the Court of Appeal, at [1992] Ch 310, 315-317, and in the headnotes to both the Court of Appeal and House of Lords decisions) or shortly afterwards (the version of the facts appearing from Lloyd LJ's judgment in the Court of Appeal: [1992] Ch 310, 339G). This difference was not material on the approach adopted by the majority of the House of Lords.

[30] Lords Jauncey, Lowry and Browne-Wilkinson; Lords Keith and Goff dissenting.

[31] [1992] Ch 310 (Lloyd and Nicholls LJJ, Ralph Gibson LJ dissenting).

(3) it is irrelevant that the illegality of the underlying agreement was either pleaded or emerged in evidence: if the plaintiff has acquired legal title under the illegal contract that is enough.[32]

3.11 Miss Tinsley argued that Miss Milligan was asserting merely an equitable interest, legal title being solely in Miss Tinsley's name, and that different rules applied to equitable interests.[33] Lord Browne-Wilkinson recognised that earlier authorities, primarily decisions of Lord Eldon, supported Miss Tinsley's assertion that equity would not assist a person who had transferred property to another for an illegal purpose.[34] However, his Lordship considered that the law had developed since these early cases. It was more than one hundred years since the administration of law and equity became fused and the reality of the matter was that English law now has one single law of property made up of legal and equitable interests.[35] Although for historical reasons legal estates and equitable estates have differing incidents, the person owning either type of estate has a right of property, a right *in rem* not merely a right *in personam*, and the same rules ought to apply to both. A party to illegality could accordingly recover by virtue of a legal or an equitable property interest if, but only if, he or she could establish that interest without relying on his or her own illegality.[36]

3.12 Applying that principle in *Tinsley v Milligan*, the majority held that Miss Milligan was entitled to a declaration that the property was held by Miss Tinsley on trust for both of them in equal shares. One ground for Miss Milligan's claim was that she was a beneficiary under a traditional resulting trust.[37] On general principles, if there had been no element of illegality, her contribution to the purchase of the property should have given rise to a (presumed) resulting trust in her favour. To establish her claim, she only had to prove her contribution to the purchase. She

[32] [1994] 1 AC 340, 370C-D.

[33] [1994] 1 AC 340, 370E.

[34] See, in particular, *Muckleston v Brown* (1801) 6 Ves 52, 69; 31 ER 934, 942: "[T]he plaintiff stating, he had been guilty of a fraud upon the law, to evade, to disappoint, the provision of the Legislature, to which he is bound to submit, and coming to equity to be relieved against his own act, and the defence being dishonest, between the two species of dishonesty the Court would not act; but would say, 'Let the estate lie, where it falls'." And see *Curtis v Perry* (1802) 6 Ves 739; 31 ER 1285; *ex parte Yallop* (1808) 15 Ves 60; 33 ER 677; see also, for example, *Cottington v Fletcher* (1740) 2 Atk 155; 26 ER 498 and *Groves v Groves* (1829) 3 Y & J 163; 148 ER 1136.

[35] [1994] 1 AC 340, 371A-C.

[36] The minority (Lord Goff with Lord Keith agreeing) was of the view that Lord Eldon's line of authority remained in tact and that equity would not assist a person who transferred property to another for an illegal purpose. Lord Goff explained that this rule was founded on the "cleans hands" maxim: the court will not assist a person seeking the aid of equity unless he or she comes to equity with clean hands. Nor did Lord Goff agree that the law should develop in the direction espoused by Lord Browne-Wilkinson. While in the present case he agreed that it would seem particularly harsh not to assist Miss Milligan, he said that this would not always be the case. In some instances the fraud would be far more serious and might be uncovered not as a result of confession but only after police investigation and trial.

[37] But it appears that her claim may also have succeeded on the basis of a common intention constructive trust. See paras 3.61 to 3.64 below.

could thus establish her equitable interest without relying in any way on her own illegality.

3.13 The test established by the House of Lords in *Tinsley v Milligan*[38] was applied by the Court of Appeal in *Silverwood v Silverwood*.[39] Shortly before her death an elderly grandmother transferred the bulk of her savings into two accounts in the name of her grandchildren at the Halifax Building Society. She subsequently applied to the DSS for income support without disclosing the Halifax accounts, and received income support up to the date of her death. Her estate claimed that the Halifax accounts were held for her on resulting trust. The grandchildren did not dispute that a resulting trust arose, but argued that the estate had led evidence of a fraud on the DSS in support of its case and should not therefore be assisted by the court. Applying the reliance principle as set out in *Tinsley v Milligan*, the Court of Appeal found for the estate. In order to establish title under the resulting trust, the estate had no need to prove why the money was transferred to the grandchildren, and the illegality did not, therefore, of necessity form part of the estate's case.

(b) The withdrawal exception

3.14 As an exception to the general rule that a person may not rely on the illegality of his or her transaction in order to assert title, the plaintiff may do so if he or she withdraws from the transaction before the illegal purpose has been wholly or partly carried into effect. In *Tribe v Tribe*[40] the Court of Appeal confirmed that this rule operated as a general exception to the reliance principle.

3.15 The plaintiff, the major shareholder in a retail company, was himself tenant of premises which the company occupied. As such, he anticipated that he would shortly be obliged to pay for significant repairs to the properties, and that he would have to sell his shares in the company to meet the obligation. The plaintiff therefore transferred his shareholding to his son, with the intention of deceiving his creditors and protecting his assets. In the event, no repairs were carried out, and the need to deceive the creditors never arose. The father then reclaimed the shares, but the son refused to return them. The father brought proceedings for a declaration that he was beneficial owner of the shares and an order for delivery of them. His son argued that, after *Tinsley v Milligan*,[41] recovery would not be permitted where a presumption of advancement arose between the parties and where revealing the true purpose of the transfer in order to rebut the presumption necessarily involved disclosing the illegality.

3.16 The Court of Appeal accepted that this was the general position. However, it held that, by way of an exception, a person would be entitled to lead evidence of his or her illegality to rebut the presumption of advancement where he or she was able to

[38] [1994] 1 AC 340.

[39] (1997) 74 P&CR 453. See also *Lowson v Coombes, The Times* 2 December 1998.

[40] [1996] Ch 107. N Enonchong, "Illegality and the Presumption of Advancement" [1996] RLR 78; F D Rose, "Gratuitous Transfers and Illegal Purposes" (1996) 112 LQR 386.

[41] [1994] 1 AC 340.

show that the illegal purpose had not been carried into effect. The father's claim in *Tribe v Tribe* thus succeeded.

3.17 We saw in Part II that the withdrawal doctrine provides an independent ground of restitution in relation to benefits conferred under an illegal contract.[42] To the extent that the policy which underlies the withdrawal doctrine in the context of illegal contracts and trusts is a common one, its scope should arguably be similar. In *Tribe v Tribe*, Nourse LJ limited his judgment to the exception as it applies in property transfer cases,[43] but Millett LJ considered that the doctrine in all cases should be the same. This would arguably be consistent with Lord Browne-Wilkinson's dicta in *Tinsley v Milligan*.[44] Although Millett LJ did not attempt to define the precise limits of the exception, he held that genuine repentance was not required. Voluntary withdrawal is necessary, so that a transferor who is forced to withdraw because his or her plan is discovered may not take advantage of the exception, but it is sufficient for a transferor to withdraw voluntarily from an illegal transaction "when it has ceased to be needed".[45] The actual decision in *Tribe v Tribe* itself reveals the width of the withdrawal exception.

3.18 *Tribe v Tribe* is not in fact the first equity case which recognises such an exception. In several earlier cases (though by no means all)[46] courts have upheld a fraudulent transferor's claim to an interest in the property transferred on the basis that the illegal purpose has not been carried into effect. In many, no presumption of advancement arose between transferor and transferee.[47] They might now be supported on the different and/or additional ground that the transferor could establish his or her interest under a resulting trust without relying on his or her own illegality.[48] In fact, it is implicit in the reasoning in several of them that the result would have been different, had the illegal purpose been carried into effect;[49] such a suggestion is obviously difficult, if not impossible, to reconcile with *Tinsley v Milligan*.[50] Nevertheless, those earlier decisions may provide some indication of the likely extent of the withdrawal exception in the trusts context.

[42] See paras 2.49 to 2.56 above.

[43] He said that he did not intend "to become embroiled in the many irreconcilable authorities which deal with the exception in its application to executory contracts": [1996] Ch 107, 121.

[44] [1994] 1 AC 340, 371. See para 3.11 above.

[45] [1996] Ch 107, 135.

[46] Cf *Roberts v Roberts* (1818) Dan 143; 159 ER 862 and *Groves v Groves* (1829) 3Y & J 163; 148 ER 1136.

[47] See, eg, *Symes v Hughes* (1870) LR 9 Eq 475.

[48] See *Tinsley v Milligan* [1994] 1 AC 340.

[49] See, eg, *Perpetual Executors and Trustees Association of Australia Ltd v Wright* (1917) 23 CLR 185.

[50] [1994] 1 AC 340. But see Millett LJ's suggestion in *Tribe v Tribe* [1996] Ch 107, 128-129 (considered at para 3.24 below) that the transferee may be able to rebut the presumption of resulting trust by relying on conduct of the transferor which is inconsistent with him or her retaining beneficial ownership.

(c) The application of the principles illustrated

3.19 Although simply stated, the reliance principle is far from easy to apply. The precise rationale for the principle is (as we shall see in Part VIII) difficult to identify, yet the consequences for an unsuccessful claimant can be serious. If a court refuses to enforce a resulting trust in his or her favour (because it cannot be shown without leading evidence of his or her illegality) the claimant's property is in effect expropriated in favour of a person who may also be implicated in the illegality and who knows that he or she was never intended to take the benefit of the property.

3.20 To the extent that the reliance principle only rarely prevents the enforcement of resulting trusts, it may reflect an instinct that illegality should only exceptionally lead to such a severe consequence as the forfeiture of a person's property, especially where that forfeiture would be in favour of a person who may have been a willing party to the illegality. And it is certainly arguable that, as first formulated in the common law cases, the principle was largely used to eliminate the adverse impact of illegality on dispositions of property. Thus it has been said of that category of case that, "as far as proprietary rights and remedies are concerned, and subject to extreme exceptions, the law simply ignores the illegality".[51]

3.21 However, as it stands, the reliance principle turns on matters of form and not of substance. Whether it renders a property interest under a trust enforceable or unenforceable depends on whether it is possible for the claimant to establish his or her entitlement without leading evidence of the illegality. It turns crucially on what must be proven and by whom. This inevitably presents the risk that the principle may operate to bar the enforcement of a proprietary interest *and* that it will do so in an arbitrary manner. It seems to do just that in the trusts context.

3.22 The arbitrariness of the principle can be illustrated by the simple case in which an owner of property conveys the property to another, without intending to part with beneficial ownership, in order to facilitate a fraud on a third party. At least before any third party has been deceived, the transferor should have no difficulty in establishing that the transferee holds the property on resulting trust for him or her.[52] But once a third party has been deceived, the transferor's ability to prove a resulting trust in his or her favour, and to have that trust recognised and enforced by the court, appears to turn on the identity of the transferor and transferee. If the relationship between transferor and transferee is such that equity presumes that a gift was intended (the "presumption of advancement"), it is likely that the transferor's claim will fail. He or she cannot rebut the presumption of advancement without leading evidence of the fraudulent purpose (which he or she

[51] A Burrows, *The Law of Restitution* (1993) p 469.

[52] This might be because the transferor can rely on a presumption of resulting trust in his or her favour and the transferee is not able to rebut that presumption without leading evidence of the fraudulent purpose of the transfer (see, eg, *Tinsley v Milligan* [1994] 1 AC 340) or because (having withdrawn "in time") the transferor is permitted to rely on evidence of his or her fraudulent purpose in order to rebut the presumption of advancement and so to establish affirmatively the facts which give rise to a resulting trust (as in, eg, *Tribe v Tribe* [1996] Ch 107).

is not permitted to do).[53] On the other hand, where no such relationship exists, it is likely that the transferor's claim will succeed. He or she will usually[54] be able to show that a presumption of resulting trust arises in his or her favour without needing to lead evidence of the fraudulent purpose:[55] and the transferee is unlikely[56] to be able to rebut the presumption of resulting trust.[57] This distinction is impossible to defend.

3.23 Such arbitrariness has already been the source of considerable judicial[58] and academic[59] criticism and offers a powerful argument for reform of this area. However, the important point for present purposes is that it also complicates the task of identifying the current scope and impact of the reliance principle. There is a strong temptation for future courts to avoid or temper any harsh and arbitrary consequences by careful "interpretation" of the scope of the principle or by recognising exceptions to it. Perhaps the most important example is the very wide withdrawal exception which was recently recognised in *Tribe v Tribe*.[60] But the withdrawal exception is by no means the only illustration.

3.24 In the Australian case of *Nelson v Nelson*,[61] for example, Dawson J adopted so restrictive a view of the meaning of "reliance" that a court would never be

[53] See, in particular, *Tinsley v Milligan* [1994] 1 AC 340 and earlier cases, which are at least consistent with this view, including: *Gascoigne v Gascoigne* [1918] 1 KB 233; *Re Emery's Investment Trusts* [1959] Ch 410; and *Chettiar v Chettiar* [1962] AC 294.

[54] Although the point is not settled, the effect of s 60(3) of the Law of Property Act 1925 may be that no presumption of resulting trust in favour of the transferor arises on the voluntary conveyance of land to another. If so, a transferor will need to establish a resulting trust affirmatively, without the aid of any presumption: see D J Hayton, *Underhill and Hayton, Law of Trusts and Trustees* (15th ed 1995) Art 31(3); P Pettit, *Equity and the Law of Trusts* (8th ed 1997) p 161; R Chambers, *Resulting Trusts* (1997) pp 18-19.

[55] The transferor merely needs to prove that he or she voluntarily transferred property to the transferee.

[56] But see *Tribe v Tribe* [1996] Ch 107, 128-129, *per* Millett LJ, discussed at para 3.24 below.

[57] The transferee will reinforce, rather than rebut, the presumption of resulting trust by leading evidence of the fraudulent purpose of the transaction: the very reason why it was fraudulent was that the intention was to transfer merely legal title and not in addition beneficial ownership.

[58] See the dissenting speech of Lord Goff in *Tinsley v Milligan* [1994] 1 AC 340, with which Lord Keith agreed; the comments by Millett and Nourse LJJ in *Tribe v Tribe* [1996] Ch 107; the comments by Nourse LJ in *Silverwood v Silverwood* (1997) 74 P&CR 453, 458; the comments by Robert Walker LJ in *Lowson v Coombes, The Times* 2 December 1998; and the judgments in the decision of the High Court of Australia in *Nelson v Nelson* (1995) 184 CLR 538.

[59] A G J Berg, "Illegality and Equitable Interests" [1993] JBL 513, 517-518; N Cohen, "The Quiet Revolution in the Enforcement of Illegal Contracts" [1994] LMCLQ 163, 168; N Enonchong, "Illegality: The Fading Flame of Public Policy" (1994) 14 OJLS 295, 299; S H Goo, "Let the Estate Lie Where it Falls" (1994) 45 NILQ 378, 379; M Halliwell, "Equitable Proprietary Claims and Dishonest Claimants: A Resolution?" [1994] Conv 62, 66; H Stowe, "The 'Unruly Horse' has Bolted: *Tinsley v Milligan*" (1994) 57 MLR 441, 446; R A Buckley, "Law's Boundaries and the Challenge of Illegality" in R A Buckley (ed), *Legal Structures* (1996) p 229 at pp 231-234; D Davies, "Presumptions and Illegality" in A J Oakley (ed), *Trends in Contemporary Trust Law* (1996) ch 2.

[60] [1996] Ch 107, considered at paras 3.14 to 3.18 above.

[61] (1995) 184 CLR 538, considered at para 3.28 below.

prevented from enforcing a resulting trust, whether the particular claimant benefited from the presumption of resulting trust or must rebut the presumption of advancement.[62] He suggested that the transferor could rely on evidence of the illegal purpose to show that he or she did not intend to make a gift to the transferee, since what the transferor was relying on was his or her lack of donative intention, not the illegal reason or motive. A different technique for reducing or eliminating the importance of which presumption (if any) applies was proposed by Millett LJ in *Tribe v Tribe*.[63] In his view, a transferee could rebut the presumption of resulting trust by leading evidence of acts of the transferor which were inconsistent with him or her retaining beneficial ownership.[64] If correct,[65] this may introduce a distinction between unexecuted and executed illegal schemes, which transcends and marginalises the distinction between the presumptions. If a scheme is unexecuted, the courts will enforce a resulting trust in the transferor's favour, whichever presumption (if any) applies.[66] If, however, a scheme is executed, the courts will not enforce the resulting trust, whichever presumption (if any) applies.[67] On this basis a claimant would "forfeit" his or her property rights once the wrongful purpose has been carried into effect, but not otherwise.

(2) Where a resulting trust will not arise, or will be unenforceable, for some reason other than the reliance principle

3.25 If a resulting trust can be shown without the need to lead evidence of illegality, it will generally be enforceable by the trust beneficiary. But it may well be that there are further grounds on which such a trust may, on occasion, be unenforceable or never arise, because of illegality. We tentatively canvass two possibilities below.

[62] (1995) 184 CLR 538, 580.

[63] [1996] Ch 107.

[64] [1996] Ch 107, 128-129, *per* Millett LJ.

[65] It is not easy to see how Millett LJ's observations can be reconciled with the result in *Tinsley v Milligan* [1994] 1 AC 340, in which Miss Milligan had obviously done acts which were inconsistent with her having any beneficial interest in the house (ie she had made social security claims on the false basis that she did not own an interest in the house). Miss Milligan nevertheless succeeded on the basis that she could rely on a presumption of resulting trust. There was no suggestion in the majority judgments that Miss Tinsley could have rebutted that presumption by leading evidence of Miss Milligan's fraudulent claims. See, similarly, J E Martin, *Hanbury & Martin, Modern Equity* (15th ed 1997) p 253: "The problem with this is that the example is difficult to distinguish from *Tinsley v Milligan* itself"; and see P Pettit, *Equity and the Law of Trusts* (8th ed 1997) pp 204-205.

[66] Either the transferor will be able to establish and rely on a presumption of resulting trust (as in *Tinsley v Milligan* [1994] 1 AC 340); or the withdrawal exception will enable the transferor to establish a resulting trust in his favour, even if he must rely on the illegality in order to do so (eg if he must rebut the presumption of advancement) (as in *Tribe v Tribe* [1996] Ch 107).

[67] Either the transferee will be able to rebut the presumption of resulting trust (by relying on acts inconsistent with the transferor retaining beneficial ownership) and the transferor will be unable to establish a resulting trust affirmatively without relying on the illegality; or the transferor will be faced with the presumption of advancement and will be unable to rebut it without relying on the illegality (as in *Chettiar v Chettiar* [1962] AC 294).

(a) A resulting trust will not arise, or will be unenforceable, where the turpitude of the beneficiary is gross

3.26 An important, perhaps essential, part of Lord Browne-Wilkinson's justification for applying the reliance principle to claims to enforce resulting trusts, was (as we have seen) the view that common principles should be applied to the enforcement of legal and equitable proprietary interests alike.[68] It is not clear that the reliance principle is the only principle which governs the enforcement of legal proprietary interests. It may be that, in certain cases, even if the plaintiff would otherwise be able to show his or her proprietary interest without relying on the illegality, the court will refuse to intervene where the turpitude involved is very gross.[69]

3.27 Such an additional ground of unenforceability is attractive, in so far as it tempers the otherwise indiscriminate operation of the reliance principle.[70] But it must be admitted that the authority for this, even in relation to legal title, is slight.[71]

(b) A resulting trust will not arise, or will be unenforceable, where statute expressly or impliedly so provides

3.28 It is conceivable that a statute could exceptionally provide, by its express terms or by implication, that a resulting trust which would ordinarily arise shall not arise or (even if it does) shall not be enforceable, because of some illegality.[72] In *Nelson v Nelson*[73] a majority of the High Court of Australia rejected the reliance principle as a test of enforceability in favour of an approach which looked to the policy of the rule of law which the transaction infringed. A resulting trust would only be unenforceable if the statute, or its policy, so required. In that case a mother had purchased property in the name of her children. The purpose of the arrangement was not to benefit the children, but rather to enable the mother to purchase another house with the benefit of a government subsidy which was only available to those who did not already own homes. In order to obtain the subsidy, the mother falsely declared that she did not already have a financial interest in a house other than the one for which the loan was sought. On the sale of the first house the daughter sought a declaration that she, rather than her mother, had a beneficial interest in the proceeds of sale. The High Court of Australia held that a presumption of advancement arose between the mother and daughter, and the daughter argued that under the reliance principle as set out in *Tinsley v Milligan*[74] the mother was therefore unable to enforce her beneficial ownership. However,

[68] See para 3.11 above.

[69] See para 2.68 above.

[70] It would therefore address at least some of Lord Goff's reservations about the majority's approach: see *Tinsley v Milligan* [1994] 1 AC 340, 362, *per* Lord Goff.

[71] See dicta in *Bowmakers Ltd v Barnet Instruments Ltd* [1945] KB 65, 72 (CA).

[72] See, for analogies in the context of "illegal contracts", paras 2.3 to 2.19 above.

[73] (1995) 184 CLR 538. See D Davies, "Presumptions and Illegality" in A J Oakley (ed), *Trends in Contemporary Trust Law* (1996) ch 2; A Phang, "Of Illegality and Presumptions - Australian Departures and Possible Approaches" (1996) 11 JCL 53; P Creighton, "The Recovery of Property Transferred for Illegal Purposes" (1997) 60 MLR 102; and D Maclean, "Resulting Trusts and Illegal Purposes" (1997) 71 ALJ 185.

[74] [1994] 1 AC 340. See paras 3.9 to 3.12 above.

the majority of the High Court rejected the reliance principle, and instead held that a trust was unenforceable only where the policy of the statute required. In this case, they held that the policy of the relevant legislation governing state subsidies did not require such a draconian measure.[75]

3.29 If such an approach were followed in English law, it would appear to constitute an additional test of unenforceability. Thus a resulting trust would be unenforceable if it could be shown only by relying on the illegality, or (even if it could be shown without having to rely on the illegality), if a statute, expressly or impliedly, so required. There is some suggestion of this additional ground in two early English cases,[76] in which title to property was subject to a statutory registration scheme and legal title was registered in the name of another.

3.30 The first case is *Curtis v Perry*,[77] in which ships were purchased with partnership funds, but registered solely in the name of one partner, Nantes. When the other partner, Chiswell, a Member of Parliament, discovered this, the ships were shown as partnership property in the partnership books, but, with Chiswell's connivance, remained registered in the sole name of Nantes. This was done in order to evade a statutory prohibition against ships being used for government contracts if owned by a Member of Parliament. In a dispute between the partnership creditors and Nantes' separate creditors as to the ownership of the ships, Lord Eldon found in favour of the latter. He held that Chiswell was not permitted to argue that he had any equitable interest in a ship registered solely in the other partner's name in order to evade the statutory prohibition. He was seeking to rely on his own fraud in order to claim an interest in the property.

3.31 In *Curtis v Perry*, Lord Eldon did not consider it necessary to discuss an additional reason for rejecting Chiswell's claim: that it was contrary to the policy of the registration statute for him to assert ownership in the property when he was not the registered owner. However, in a subsequent case, *ex parte Yallop*,[78] his Lordship expressed the view that Chiswell was prevented from recovering also on the ground that "he had broken in upon the policy of the Act of Parliament; and could not be permitted to say, he had property of this nature, not subject to the regulations of the Act".[79] In *ex parte Yallop*[80] itself, two partners purchased a ship using partnership funds, but registered it, for reasons that are not apparent, only in the name of one. The registration was taken to be conclusive.

[75] Although a majority held that recognition of Mrs Nelson's interest was conditional on her either paying to the Commonwealth, or allowing her daughter to retain, an amount equal to the unlawful subsidy that she had obtained: see para 7.91 below.

[76] See the comments of Millett LJ in *Tribe v Tribe* [1996] Ch 107, 126 and see P Pettit, *Equity and the Law of Trusts* (8th ed 1997) pp 203-204.

[77] (1802) 6 Ves 739; 31 ER 1285.

[78] (1808) 15 Ves 60; 33 ER 677.

[79] (1808) 15 Ves 60, 70; 33 ER 677, 681.

[80] (1808) 15 Ves 60; 33 ER 677.

3. EXPRESS TRUSTS AND RESULTING TRUSTS ARISING ON FAILURE OF EXPRESS TRUSTS

3.32 There are, in principle, many different ways in which an express trust may be "tainted" by unlawfulness. Some express trusts are certainly invalid at common law on grounds of public policy. It is also conceivable that a statute could invalidate a trust or term. We consider some examples below. However, not all express trusts which involve or are connected with illegality are invalid: though the category of valid express "illegal trust" is an indeterminate one, it unquestionably exists. What is less clear is whether, following *Tinsley v Milligan*,[81] any of these valid "illegal trusts" are nevertheless unenforceable because a claim to enforce them cannot be established without relying on the illegality. In the following paragraphs we offer our tentative views on which types of "illegal trusts" have which effects, and we seek to explain what those differing effects are.

(1) Express trusts which are invalid (or "void") for illegality

(a) Express trusts which fall within this category

3.33 Trusts or terms which fall within the category of trusts which are contrary to public policy at common law are generally said to be "void". As we have already noted, many of these trusts do not involve any element of unlawfulness but are otherwise contrary to public policy.[82] Illustrations are trusts or terms which encourage the separation of spouses; or which purport to alter the ordinary rules for the devolution of property (for example, on bankruptcy); or which infringe the rules against perpetuities and accumulations.

3.34 It is not easy to identify how many trusts or terms which do in fact involve some element of unlawfulness are "void" on grounds of public policy at common law. Some may be invalid because a statute so declares.[83] It is likely that a trust or term which requires a beneficiary to commit an unlawful act falls within this category.[84] It is rather less clear whether every trust or term which is "unlawful" *per se* or which requires a trustee to commit an unlawful act will do so. On the other hand, it appears that an express trust which is created in order to facilitate a fraud, and perhaps to facilitate some other legal wrong, is a valid trust.[85] And whilst some decisions suggest otherwise, an express trust which is created in return for an illegal consideration may also be valid, provided that the trust is not independently objectionable.[86]

(b) The implications of an express trust or condition being "invalid"

3.35 If an illegal express trust or term affecting beneficial entitlement (a "condition") is void, the disposition of property by the settlor or the testator will never take effect as he or she intended. The intended beneficiary will never obtain an equitable

[81] [1994] 1 AC 340.

[82] See para 3.1 above.

[83] See, for example, section 29 of the Exchange Control Act 1947, now repealed.

[84] See para 3.1 n 2 above.

[85] See paras 3.55 to 3.56 below.

[86] See paras 3.53 to 3.54 below.

interest, or his or her interest will never be qualified (as the trust-creator intended) by the illegal condition.[87]

3.36 Equity has a fairly well-established set of principles for determining whom, if anyone,[88] has beneficial ownership of property which has been placed on a void express trust or on trust subject to a void condition (the "default beneficial ownership"). Similar principles were applied, prior to *Tinsley v Milligan*,[89] to cases in which the ground of invalidity was illegality, rather than some other reason, such as uncertainty. There is no reason to think that that decision displaces those rules. But it does raise the problematic question: is the enforceability of the "default" beneficial ownership determined by applying the reliance principle? In the following sections, we first elaborate the legal rules which usually determine the default beneficial ownership; and secondly give consideration to whether (which is not yet clear) the reliance principle has any place in this context.

(i) The ordinary proprietary consequences of a decision that an express trust or condition is "void"

3.37 Under general trust rules applying where property is transferred to another on an express trust which fails for reasons other than illegality (such as uncertainty or impossibility) trust property which is not otherwise expressly disposed of will generally result back to the settlor[90] under a so-called "automatic" resulting trust. If expressly disposed of, the express disposition may[91] be accelerated to take effect on failure of the initial interest, at least if the subject matter can be sufficiently ascertained and the disposition is not otherwise objectionable.[92] Where, however, the trust which fails is a "charitable trust", special considerations may apply. In particular, the property may be applied *cy-pres*.

3.38 Where what is void is not the entire trust, but rather a condition that is attached to an interest under the trust, there are two possible consequences. The interest might fail in its entirety. If so, the position is as if the trust fails: there is a gap in the beneficial ownership which must be filled. Or the interest might vest or take effect, but free of the condition: it becomes, to that extent, absolute. Here there is no gap needing to be filled. The rules which have been developed to determine whether the consequence is the first, or the second, are not easy to justify. Thus an interest will fail where it is subject to a condition precedent which is attached to real property, or which is attached to personalty where the condition is illegal because it involves *malum in se*,[93] or if the interest is a determinable interest and the

[87] See further paras 3.37 to 3.39 below.

[88] Cf if the property is *bona vacantia*.

[89] [1994] 1 AC 340.

[90] Or, if the trust is testamentary, to his estate. See, for example, R Chambers, *Resulting Trusts* (1997) pp 56-66 on the possible "alternative" responses.

[91] For a discussion on when the complex rules on acceleration apply, see A M Prichard, "Acceleration and Contingent Remainders" [1973] CLJ 246.

[92] See further para 3.53 n 137 below.

[93] *Re Moore* (1888) 39 Ch D 116.

determining event is illegal.[94] It should also fail if performance of the condition (which fails for illegality) was the sole motive for a bequest.[95] But an interest will take effect free of any condition, not only where the condition is a condition subsequent,[96] but also where it is a condition precedent attached to personalty and involving *malum prohibitum*.[97] We discuss these principles in more detail in Part VIII.[98] It is sufficient at this point to note that, though difficult to explain, they are recognised by all the major texts on trusts as representing the present law,[99] and they may not be limited to conditions which fail for illegality.[100]

3.39 An important point, which should be implicit in the preceding paragraphs, is that the fact that a trust is "illegal" does not mean that the entire disposition will fail. In some cases, such as where illegality is the consideration for a trust, it may be that the whole instrument is tainted.[101] But this will not inevitably be the case. It will often happen that only one trust created by an instrument is illegal, or that only a term or condition in the trust is "illegal". If the illegal and void provision can be separated from (or one might say, by analogy to the approach to contracts, "severed from") the other provisions, without defeating the purpose of the settlor in creating the trust, it is likely that the remainder of the trust can be enforced.[102] Three examples should be sufficient to illustrate this important point. The first example is where property is to be held on successive trusts, only the first of which is illegal and invalid. Provided that the subject matter of the subsequent trusts can be ascertained with sufficient certainty, those trusts should not fail as a result of the illegality and invalidity of the first.[103] A second example is where a testator bequeaths property to another subject to several conditions, only some of which are invalid because they are contrary to public policy. At least if the conditions are

[94] *Re Moore* (1888) 39 Ch D 116.

[95] C H Sherrin, R F D Barlow and R A Wallington, *Williams on Wills* (7th ed 1995) pp 340-341.

[96] *Re Beard* [1908] 1 Ch 383.

[97] *Re Piper* [1946] 2 All ER 503; *Re Elliott* [1952] Ch 217.

[98] See paras 8.117 to 8.125 below.

[99] D J Hayton, *Underhill and Hayton, Law of Trusts and Trustees* (15th ed 1995) p 202; J E Martin, *Hanbury & Martin, Modern Equity* (15th ed 1997) pp 333-334; P Pettit, *Equity and the Law of Trusts* (8th ed 1997) pp 197-198.

[100] See *Re Elliott* [1952] Ch 217 (expressing the principle as one applicable to "impossible conditions").

[101] See, eg, older cases involving trusts in favour of a mistress and her future illegitimate children, which were wholly void as tending to promote continued immorality: see D J Hayton, *Underhill and Hayton, Law of Trusts and Trustees* (15th ed 1995) p 196.

[102] See, eg, *Re Hepplewhite Will Trusts, The Times* 21 January 1977, which decides that, where a testator bequeaths personalty subject to several conditions precedent, some of which are valid and some of which are invalid (as contrary to public policy), the valid conditions are separable from the others and the gift is good, subject to the valid conditions. See also the approach evident in United States case law: A W Scott & W F Fratcher, *The Law of Trusts* (4th ed 1987 and later supplements) vol 1A, § 65 and especially § 65.1, pp 376-378.

[103] See, eg, *Mitford v Reynolds* (1842) 1 Ph 185; 41 ER 602, cited in D J Hayton, *Underhill and Hayton, Law of Trusts and Trustees* (15th ed 1995) p 196; see also J E Martin, *Hanbury & Martin, Modern Equity* (15th ed 1997) p 333 and A J Oakley, *Parker & Mellows, Modern Law of Trusts* (7th ed 1998) p 206.

conditions subsequent, the gift should take effect free of the invalid conditions but remain subject to the valid conditions.[104] The position is less clear where the conditions are, or include, illegal conditions precedent.[105] A third example is where a testator bequeaths property for the benefit of his or her children, and directs the trustee to invest the property in an illegal manner.[106] The direction requiring the trustee to commit a legal wrong would no doubt be invalid at common law on grounds of public policy (so freeing the trustee to invest the property in any lawful manner). But it is hard to imagine that the entire trust will fail because of the illegality and invalidity of the direction.[107]

(ii) Does the reliance principle have any role to play in the event that an express trust or condition is void for illegality?

3.40 A person claiming to be entitled to property on the failure of an express trust or condition in accordance with the above rules[108] will seek the enforcement of an equitable proprietary interest. In *Tinsley v Milligan*[109] Lord Browne-Wilkinson proposed that the principles which governed the validity and enforcement of proprietary interests were (or should be) the same, whether the origin of the interest was the common law or equity.[110] Does this mean that the enforceability of proprietary interests which arise on the failure of an express trust for illegality (for example, of interests arising under an automatic resulting trust) are to be determined in accordance with the reliance principle and the withdrawal exception?

[104] See para 3.38 above, noting that an invalid condition subsequent will not cause the interest qualified to fail, but the interest will take effect free of the invalid condition, at least where performance of the invalid condition was not the sole motive for the gift.

[105] In general, if a condition precedent is illegal and invalid, the interest to which it is attached will fail, possibly on the technical ground that the invalid condition can never be satisfied and so the interest can never vest: see para 3.38 above. If that is correct, the interest should fail if it is subject to several conditions, only one (or some) of which are illegal conditions precedent. However, the position is different if the interest is an interest in personalty, and the invalid condition involves *malum prohibitum* rather than *malum in se*. The interest will not fail but will take effect free of the invalid condition precedent but subject to the valid conditions. This appears from *Re Hepplewhite Will Trusts, The Times* 21 January 1977. See, P Pettit, *Equity and the Law of Trusts* (8th ed 1997) p 198 fn 7, suggesting that the decision in *Re Hepplewhite Will Trusts* that the interest is valid is limited to the case in which the condition is *malum prohibitum*.

[106] See, eg, *Stout v Stout* 192 Ky 504, 233 SW 1057 (1921) (property bequeathed to various beneficiaries with directions that the trustee employ the property in the carrying on of an unlawful business: ie selling alcohol) cited by A W Scott & W F Fratcher, *The Law of Trusts* (4th ed 1987 and later supplements) vol 1A, § 61, fn 2. For other illustrations, see generally A W Scott & W F Fratcher, *op cit*, § 65.1, pp 376-378.

[107] In *Stout v Stout* 192 Ky 504, 233 SW 1057 (1921), referred to in n 106 above, the settlor's paramount purpose was to benefit his children; the direction was not an essential part of the settlor's purpose in creating the trust.

[108] See paras 3.37 to 3.39.

[109] [1994] 1 AC 340.

[110] See para 3.11 above.

3.41 The answer to that question is not yet clear. It is hard to find positive support in the authorities for this proposition, except for Lord Browne-Wilkinson's dicta.[111] If it does apply, it is hard to predict how the principle and its exception might be interpreted in this context, and so to predict how far such proprietary interests are unenforceable as a result. And it is in any case difficult to see why, as a matter of policy, it would be appropriate for courts to apply the reliance principle to this category of trust.[112]

The authorities

3.42 We are not aware of any case that has justified the enforcement or non-enforcement of a proprietary interest specifically in terms of the reliance principle, where the interest has arisen on the failure of an express trust for illegality.[113] The results in many cases (in which claims by persons other than the settlor have succeeded) could be explained in terms of the principle, to the extent that it only precludes reliance on *one's own fraudulent or illegal purpose*.[114] What we lack is a decision which considers a claim by a settlor to property under an automatic resulting trust, or under an express "default" disposition in his or her favour, after his or her intended express trust has been held to be void for illegality.

3.43 In one case, *Rowan v Dann*[115] (decided before the House of Lords' decision in *Tinsley v Milligan*)[116] the Court of Appeal invoked the reliance principle to justify the enforcement of an automatic resulting trust which arose on the failure of an express trust which was created for an illegal purpose. Three men were discussing entering into a joint business venture (cattle embryo transplanting) which would involve the use of the farmland of one of their number (Mr Rowan). Unfortunately, Mr Rowan's financial position was precarious and he feared that his creditors might be able to take possession of his land - so denying the use of it to the joint venture. In order to keep his land out of the hands of his creditors, Mr Rowan therefore granted "tenancies" of the land to the defendant (Mr Dann). As it happened, the joint venture never got off the ground. At first instance, Millett J held that the tenancy was actually held by Mr Dann on trust to apply it as an asset for the joint venture and for the participants therein; on the failure of that limited purpose, the tenancy was held on resulting trust for Mr Rowan. On appeal, the defendants contended that the improper purpose of the transaction (to defeat Mr Rowan's creditors) tainted the resulting trust and thus rendered it unenforceable.

[111] However (as we note at paras 3.42 to 3.45 below) it is not necessarily inconsistent with many cases in this area. Cf N Enonchong, *Illegal Transactions* (1998) pp 166-168. He states that a settlor, although a party to the illegality, can enforce a resulting trust which arises on the failure of an express trust for illegality.

[112] However, (as we shall see in Part VIII) this objection could equally be raised to the application of the principle to resulting trusts which arise on voluntary transfers.

[113] Cf *Muckleston v Brown* (1801) 6 Ves 52, 68; 31 ER 934, 942, *per* Lord Eldon LC (indicating that a court may assist the heirs of a person who settles property for a fraudulent object to recover the property, even though it would not have assisted the settlor himself).

[114] This limitation was not explicitly stated in *Tinsley v Milligan* [1994] 1 AC 340. It may well explain why persons other than the settlor can always recover: see para 3.47 below.

[115] (1992) 64 P&CR 202.

[116] [1994] 1 AC 340.

The Court of Appeal rejected this argument on a variety of grounds. One was that Mr Rowan could show his entitlement under a resulting trust without needing to lead evidence of the improper purpose.[117]

3.44 *Rowan v Dann*[118] offers at least some indication that courts would be prepared to apply the reliance principle in order to determine the enforceability of resulting trusts which arise on the failure of an express trust. But *Rowan v Dann* was an "easy" case for the reliance principle: the principle was invoked to justify recovery by the settlor on facts which clearly justified that result. And the court was not strictly considering the sort of case with which we are currently concerned. In *Rowan v Dann* the express trust did not fail because of the improper purpose of the transaction, but because the express trust was for a limited purpose (ie the joint venture) which was not *per se* improper, and that purpose had failed. Mr Rowan did not need to plead the improper purpose which in fact underlay the transaction to justify his claim to be entitled to the property under a resulting trust. The case is thus of little assistance in deciding whether a settlor would be precluded (by the reliance principle) from claiming property under a resulting trust which arises because the express trust which he or she has created is "void" for illegality.

3.45 Current trusts textbooks offer little additional clarification. Several appear to treat it as uncontroversial that a resulting trust arises in favour of the settlor where an express trust is void for illegality, but rather ambiguously go on to suggest that the courts may not assist the settlor to enforce his or her equitable interest if the purpose of the trust was "fraudulent".[119] Other texts seem to indicate, in contrast, that a settlor will not be able to establish a resulting trust in his favour unless he can establish the trust without relying on the illegality,[120] or the withdrawal exception applies,[121] or another exception exists and applies, such as that the parties are not *in pari delicto* and the settlor is less at fault.[122] These propositions

[117] (1992) 64 P&CR 202, 209, *per* Scott LJ; 211, *per* Woolf LJ. Apart from the "no reliance" ground, there was the fact that the illegal scheme was still executory ((1992) 64 P&CR 202, 209-211, *per* Scott LJ) and that the "equitable balance" favoured recovery by Mr Rowan, given that the improper purpose was common to all parties and that to deny him recovery would deny him the proprietary right which the law would otherwise allow (p 211, *per* Scott LJ). See also Woolf LJ, noting that the enforcement of the resulting trust would bring the land back into the possession of the debtor, which would benefit, rather than disadvantage, his creditors (p 212, *per* Woolf LJ).

[118] (1992) 64 P&CR 202.

[119] J E Martin, *Hanbury & Martin, Modern Equity* (15th ed 1997) p 333; P Pettit, *Equity and the Law of Trusts* (8th ed 1997) p 202.

[120] D J Hayton, *Underhill and Hayton, Law of Trusts and Trustees* (15th ed 1995) Art 30(1)(b); cf A W Scott & W F Fratcher, *The Law of Trusts* (4th ed 1987 and later supplements) vol V, § 422.5.

[121] D J Hayton, *Underhill and Hayton, Law of Trusts and Trustees* (15th ed 1995) Art 30(1)(a); Lord Goff of Chieveley and G Jones, *The Law of Restitution* (4th ed 1993) pp 567-568; A W Scott & W F Fratcher, *The Law of Trusts* (4th ed 1987 and later supplements) vol V, § 422.2.

[122] D J Hayton, *Underhill and Hayton, Law of Trusts and Trustees* (15th ed 1995) Art 30(1)(c) ("the effect of allowing the trustee to retain the property might be to effectuate an unlawful object, to defeat a legal prohibition, or to protect a fraud"); A W Scott & W F Fratcher, *The Law of Trusts* (4th ed 1987 and later supplements) vol V, § 422.3 (where the settlor and trustee are not *in pari delicto*) or § 422.4 (where the settlor was not blameworthy).

are not specifically limited to "fraudulent" trusts. Unfortunately, both sets of texts cite similar (and similarly inconclusive) cases for their different propositions.

The practical impact of applying the principle

3.46 It is far from clear how, if the reliance principle does apply to the interests arising on the failure of an express trust for illegality, it would affect claims to enforce such interests. A person who claims such a proprietary interest (for example by an automatic resulting trust) will almost invariably be forced to lead evidence of the illegality. His or her claim cannot succeed unless the express trust can be shown to have failed. Unless the trust fails for some other reason, the claimant will have to plead that the trust failed *on grounds of illegality*. Thus there is a sense in which that person must "rely" on the illegality.

3.47 There seems to be no doubt that a claimant other than an *inter vivos* settlor can enforce the property rights which he or she acquires on the failure of an express trust or condition for illegality. Courts have, for example, enforced automatic resulting trusts in favour of a testator's estate;[123] and they have enforced as absolute the interest of donees which were subject to illegal and void conditions subsequent[124] or precedent (where the condition is attached to an interest in personalty and the illegality is *malum prohibitum*).[125] The explanation for recovery in those cases is not articulated in terms of the reliance principle, although it is possible that the result would not be different if it was. A sensible limitation on the reliance principle would be that a trust can be enforced if the claimant does not have to rely on *his or her own illegal purpose* or (at most) an illegal scheme in which he or she participated, in order to establish his or her claim. "Innocent" claimants do not rely on any illegal purpose of their own, but of another: that of the trust-creator. Matters become more difficult, however, if the settlor him or herself attempts to enforce his or her default property rights. The settlor must plead his or her own illegal purpose in order to establish his or her entitlement. In such cases it is arguable that the reliance principle (if applicable) could preclude his or her claim. There is, as we have noted, unfortunately no obvious authority for or against this proposition.

3.48 The effect of so interpreting the reliance principle would be harsh and arbitrary. It would lead in practice to expropriation of a settlor's "property"[126] in favour of the intended trustee *wherever* the settlor transferred property on an express trust which is void for illegality, irrespective of the seriousness of the illegality in question and of the intended trustee's participation. Yet it is not evident that the sorts of illegality which invalidate an express trust are more heinous than the fraudulent purposes which are exemplified in cases such as *Tribe v Tribe*[127] and *Tinsley v*

[123] See, eg, *Thrupp v Collett* (1858) 26 Beav 125; 53 ER 844.

[124] See, eg, *Re Caborne* [1943] Ch 224 (condition inducing separation of spouses).

[125] See, eg, *Re Piper* [1946] 2 All ER 503 and *Re Elliott* [1952] Ch 217 (conditions precedent attached to an interest in personalty, where the illegality is *malum prohibitum*).

[126] The "property" is the settlor's in the sense that he or she would (but for the illegality) be recognised by the law as having an equitable interest in it under an automatic resulting trust or under an express "default" trust.

[127] [1996] Ch 107; see, for a brief account of the facts, para 3.15 above.

Milligan,[128] but which will not preclude a transferor from enforcing a resulting trust in his or her favour. This is *a fortiori* so because, in the case of express trusts which fail for illegality, the settlor's illegal object is frustrated at the outset (the law holding the express trust to be void), whereas, in the case of transfers of property for fraudulent purposes, the law may[129] allow recovery even where the fraudulent objective has been achieved, and no longer lies in "intention" only.

3.49 Unfortunately, such harsh and arbitrary consequences do not guarantee that the reliance principle would not be applied in this area. We have already seen[130] that the extent to which a property interest is enforceable or unenforceable under the reliance principle depends crucially on matters of form (in particular, how and by whom certain facts must be pleaded); it does not turn on matters of substance (such as the seriousness of the illegality). The distinction between those cases in which the presumption of advancement applies between a transferor and transferee and those in which it does not, which recent English case law accepts, has illustrated the arbitrary distinctions which the principle may produce. To apply the reliance principle in the suggested way to trusts which arise on the failure of an express trust would simply add another arbitrary distinction.

3.50 Nevertheless, these consequences suggest that, even if the reliance principle were to be applied in this context, courts would endeavour to find ways of avoiding the conclusion that it precludes a settlor from enforcing a trust in his or her favour.[131] One possibility is that a settlor does not "rely" (impermissibly) on his or her illegal purpose when he or she uses it to explain why the express trust which he or she executed in favour of another has failed for illegality. A second possibility is that, even if a settlor does rely (impermissibly) on the illegality when he or she only relies on it to explain why the express trust has failed, he or she will be able in every case to take advantage of the withdrawal exception. One would anticipate that, if the reliance principle is relevant when an express trust fails because of illegality, the withdrawal exception should also apply. The reasoning would be that, where the express trust or condition is void, the law has frustrated the illegal purpose of the settlor at the outset.[132] This reasoning could only be justified (if at all) on the basis of a very wide interpretation of the withdrawal exception.

(2) Express trusts which are valid, notwithstanding illegality

3.51 Even if an express trust is not void for illegality, it may nevertheless be unenforceable, at least if it cannot be established without the need for the claimant to "rely" on some illegality. This category, and the implications of such a trust being "unenforceable", are unclear.

[128] [1994] 1 AC 340; see, for a brief account of the facts, para 3.9 above.

[129] See paras 3.9 to 3.13 above.

[130] See paras 3.19 to 3.24 above.

[131] See, for recent illustrations of a similar process of tempering the harshness of the illegality rules in the context of voluntary transfer or purchase money resulting trusts, para 3.24 above.

[132] See Lord Goff of Chieveley and G Jones, *The Law of Restitution* (4th ed 1993) p 568, suggesting that the reason why the estate can recover when a testamentary trust fails for illegality is that the illegal purpose is never carried into effect.

(a) Express trusts which fall within this category

3.52 We tentatively suggest that the following are two illustrations of illegal but valid express trusts:

(i) Express trusts created for an "illegal consideration"

3.53 First are trusts which are executed in return for an "illegal consideration".[133] The English cases involving this category appear to be few and contradictory.[134] It is likely that the court will not enforce a promise to create a trust for an illegal consideration.[135] But if the trust has been constituted without the assistance of the court, it is probable that the trust is valid, not void,[136] at least unless the trust is independently void at common law on grounds of public policy[137] or by statute. This appears from the difficult case of *Ayerst v Jenkins*,[138] in which the legal personal representatives of the settlor argued that a trust in favour of his deceased wife's sister was invalid or should be set aside, because it had been created for an illegal consideration (an "illegal marriage" between settlor and sister). The application failed, apparently on the ground that the trust was irrevocably constituted and was a valid trust. It is also consistent with the approach to the transfer or creation of property rights (generally) pursuant to an "illegal contract".[139] A case which is impossible to reconcile with this analysis is *Phillips v Probyn*,[140] which involved very similar facts.[141] The decision was that the trust in favour of the settlor's deceased wife's sister was invalid and that the property

[133] This includes cases in which the consideration is the promise or performance of a legal wrong or of something which is otherwise contrary to public policy. English trusts textbooks contain no specific discussion of this category, with the exception of D J Hayton, *Underhill and Hayton, Law of Trusts and Trustees* (15th ed 1995) pp 312-314, citing *Ayerst v Jenkins* (1873) LR 16 Eq 275 (CA) and *Phillips v Probyn* [1899] 1 Ch 811 (North J). See, however, H A J Ford & W A Lee, *Principles of the Law of Trusts* (3rd ed 1996) para 7223, citing *Ayerst v Jenkins*, *op cit*. Cf the lengthy discussion of United States cases in A W Scott and W F Fratcher, *The Law of Trusts* (4th ed 1987 and later supplements) vol 1A, § 64.

[134] The only regularly cited English cases involve trusts in consideration of an "illegal marriage" between a widower settlor and his deceased wife's sister: *Ayerst v Jenkins* (1873) LR 16 Eq 275 (CA) and *Phillips v Probyn* [1899] 1 Ch 811 (North J); see also *Pawson v Brown* (1879) 8 Ch D 202 (Malins VC). For other illustrations, see the United States cases discussed in A W Scott and W F Fratcher, *The Law of Trusts* (4th ed 1987 and later supplements) vol 1A, § 64.

[135] See *Ayerst v Jenkins* (1873) LR 16 Eq 275, 282-283.

[136] See *Ayerst v Jenkins* (1873) LR 16 Eq 275 and H A J Ford & W A Lee, *Principles of the Law of Trusts* (3rd ed 1996) para 7223. Cf the contrary decision in *Phillips v Probyn* [1899] 1 Ch 811 (North J), discussed below.

[137] For example, the trust may tend to induce the separation of spouses, and so be void at common law on grounds of public policy: see para 3.33 above.

[138] (1873) LR 16 Eq 275 (CA).

[139] See paras 2.57 to 2.66 above.

[140] [1899] 1 Ch 811 (North J).

[141] The primary difference, which North J treated as decisive, was that the action had not been brought by the settlor or by a person claiming through or under him; it was an application by the trustee of the settlement for court directions.

should be held for the settlor's heir at law. North J's grounds for distinguishing *Ayerst v Jenkins* cannot be supported.[142]

3.54 If, which appears to be the better view, a trust which is created for an illegal consideration is generally[143] valid, a difficult issue is whether the trust can be enforced by the beneficiary, and if not, on what basis. A number of American decisions seem to be consistent with the proposition that, in that jurisdiction, the trust is enforceable by an innocent beneficiary,[144] but not by one who provided the illegal consideration knowing of the facts that made it illegal.[145] Before the majority's decision in *Tinsley v Milligan*,[146] it could have been argued that this was also the law in England.[147] But following that decision, the better view may be that such a trust is valid, and is enforceable by *any* beneficiary, unless the beneficiary needs to lead evidence of the illegality in order to establish his or her claim.[148] In other words, the reliance principle now determines the enforceability of trusts executed for an illegal consideration. That would certainly be consistent with the court's approach to "illegal contracts" generally, according to which property rights can be transferred or created pursuant to an illegal contract, and can be enforced if they can be established without needing to "rely" on the illegal contract.[149] It is difficult to know when, if ever, it will be necessary to lead evidence of the illegal consideration in order to establish a claim to enforce a trust which was created for such consideration.[150]

[142] D J Hayton, *Underhill and Hayton, Law of Trusts and Trustees* (15th ed 1995) pp 313-314. North J considered that the identity of the applicant was decisive. The settlor, and any person claiming through or under him, was not permitted to dispute the validity of the settlement (as in *Ayerst v Jenkins* (1873) LR 16 Eq 275 (CA)). But a creditor of the settlor ([1899] 1 Ch 811, 817, *obiter*) and a trustee of the settlement ([1899] 1 Ch 811, 817-818) were permitted to do so.

[143] Cf the qualification at para 3.53 n 137 above.

[144] See A W Scott and W F Fratcher, *The Law of Trusts* (4th ed 1987 and later supplements) vol 1A, § 64.1. "Innocent beneficiary" includes innocent third parties (see eg *Wright v Martin* 214 Ala 334, 107 So 818 (1926)) as well as those who provide the illegal consideration but are not aware of the facts which make it illegal (see *Lanhardt v Souder* 42 App DC 278 (1914)).

[145] See A W Scott and W F Fratcher, *The Law of Trusts* (4th ed 1987 and later supplements) vol 1A, § 64, pp 372-374.

[146] [1994] 1 AC 340.

[147] See, in particular, *Tinsley v Milligan* [1994] 1 AC 340, 355, *per* Lord Goff, noting that it was not necessary in *Ayerst v Jenkins* (1873) 16 Eq 275 to decide whether the beneficiary could claim.

[148] In *Tinsley v Milligan* Lord Browne-Wilkinson cited *Ayerst v Jenkins* (1873) 16 Eq 275 as important support for the proposition that not every illegal trust was unenforceable at the instance of a beneficiary who was involved in the illegality (as the "clean hands" principle favoured by the minority would have dictated): see [1994] 1 AC 340, 373. Dicta in *Ayerst v Jenkins* are certainly consistent with the view that the beneficiary (the settlor's deceased wife's sister) of the settlement could have enforced it, notwithstanding that she had provided the illegal consideration: see (1873) 16 Eq 275, 283-284.

[149] See paras 2.57 to 2.69 above.

[150] The beneficiary will only need to lead evidence of the declaration of trust and of the acquisition of the trust property by the trustee. The fact that the trust was executed for an illegal consideration ought to be irrelevant. It is well-established that, once constituted, a

(ii) Express trusts created to facilitate fraud on a third party

3.55 A person may transfer property on express trust for him or herself, or for another, in order to facilitate a fraud on a third party. It is extremely difficult to identify authorities which have involved claims to enforce such a trust,[151] and it will certainly not often be necessary expressly to declare such a trust.[152] Even so, before the majority's decision in *Tinsley v Milligan*,[153] it might have been argued that, where one person transferred property to another (without intending to transfer beneficial ownership) to facilitate fraud on a third party, a court of equity would not enforce a trust in favour of the transferor, whether the trust was an express trust[154] or a resulting trust. That approach would be consistent with many American cases.[155]

3.56 However, after *Tinsley v Milligan* the better view may be that all fraudulent trusts of this sort, whether they are express trusts or resulting trusts, are valid; and, moreover, that they will be enforceable at the instance of a beneficiary, unless the beneficiary cannot establish his or her claim without leading evidence of the fraudulent purpose of the transaction.[156] It is very difficult to see how it will ever be necessary for the beneficiary of an express trust to lead evidence of his or her fraudulent purpose in order to establish his or her claim.[157] If that is right, any express trust which was created for a fraudulent purpose should be enforceable.

trust is enforceable by even a volunteer beneficiary: see, eg, *Paul v Paul* (1882) 20 Ch D 742.

[151] A number of the early fraudulent transfer cases, which are generally cited as cases involving resulting trusts, could be analysed as involving effectively declared express trusts. Probably the most plausible candidate for this analysis is *Re Great Berlin Steamboat Co* (1884) 26 Ch D 616 (CA). Many cannot be so explained, because (i) a trust could not be effectively declared of the property transferred (typically land) unless the declaration of trust was in or evidenced by writing, and (ii) on the facts, the express declaration was or would have been informal. A recent case involving a fraudulent express trust is *Rowan v Dann* (1992) 64 P & CR 202, discussed at para 3.43 above. But here the Court of Appeal did not need to consider the merits of a claim to enforce the express trust (which was intended to defraud the creditors of the settlor): the claim was to enforce the resulting trust which arose because the express trust had failed for reasons other than illegality.

[152] After *Tinsley v Milligan* [1994] 1 AC 340 it may only be necessary for the transferor to declare a trust in favour of him or herself if (i) the transfer is to a person in whose favour the presumption of advancement operates; or (ii) if the presumption of resulting trust can be rebutted by the transferee without leading evidence of the illegality (see, in particular, *Tribe v Tribe* [1996] 1 Ch 107, 128-129, *per* Millett LJ, discussed at para 3.24 above). In each case, the transferor may be unable to establish a resulting trust in his or her favour without relying on the illegality.

[153] [1994] 1 AC 340.

[154] See, in particular, *Re Great Berlin Steamboat Co* (1884) 26 Ch D 616 (CA).

[155] See A W Scott and W F Fratcher, *The Law of Trusts* (4th ed 1987 and later supplements) vol 1A, § 63. Cf § 63.3, pp 370-371, referring to conflicting United States authorities as to whether, where the beneficiary of the fraudulent express trust is a third person and is innocent of any fraudulent purpose, he or she can enforce the trust.

[156] See paras 3.9 to 3.13 above, discussing the reliance principle in the context of resulting trusts. Cf also the withdrawal exception to the reliance principle, discussed at paras 3.14 to 3.18 above.

[157] The beneficiary will only need to show an effective express declaration of trust in his or her favour; he or she will not need to show the fraudulent motive for the declaration.

That would certainly be consistent with recent dicta of Millett LJ in *Tribe v Tribe*.[158]

(b) The implications of an express trust being not invalid but "unenforceable"

3.57 If a trust is merely unenforceable, then in principle the trustee still notionally holds the property on the illegal trust. The "default" trust which might otherwise arise, if the trust was *invalid*, will not arise. However, the beneficiary is unable to enforce the trustee's fiduciary obligations. Accordingly, at least so far as the beneficiary is concerned, the trustee should be free to treat the property as his or her own. The trustee is, to that extent, enriched. If the trustee transfers the property to another, he or she should incur no liability for breach of trust to the beneficiary;[159] the transferee should in practice be able to obtain effective title as if the trustee was full owner of the property (ie whether or not he or she is *bona fide* purchaser);[160] and it may be that the transferee should incur no personal liabilities to the beneficiary in respect of his receipt of the trust property.

3.58 One area of uncertainty under English law is whether a person who claims under or through the beneficiary can be in any better position than the beneficiary. In other words, is the ground of unenforceability merely a personal ground, so that an "innocent" person who claims under or through the beneficiary can subsequently enforce the trust (and any consequent liabilities) against the trustee? Early dicta suggested that this might be the case,[161] and a number of modern United States cases have favoured that result. However, later dicta have preferred the opposing view.[162] The point has not yet been authoritatively decided. The more recent view is certainly more consistent with general principle, according to which a person cannot usually give a better right than he or she has. But there may be policies which favour the alternative view at least in some cases. For example, it may seem particularly unjust to favour the claims of a trustee who is fortuitously benefited because the trust is "unenforceable" above the claims of "innocent" creditors, dependants or legatees of the beneficiary.[163]

4. CONSTRUCTIVE TRUSTS GIVING EFFECT TO INTENTIONS

3.59 We do not consider it to be necessary or appropriate, within this project on "illegal transactions", to examine comprehensively the law relating to constructive trusts.

[158] [1996] 1 Ch 107, 134, *per* Millett LJ, proposing that a fraudulent transferor can claim the property transferred if he or she can prove an express trust in his or her favour. See also *Tinsley v Milligan* [1992] Ch 310, 326-327, *per* Nicholls LJ.

[159] That liability assumes that the trustee has breached his or her fiduciary obligations. Even if those obligations still notionally exist, they are unenforceable by the beneficiary. And if the primary obligations are unenforceable, any secondary obligations arising on breach of those primary obligations must also be unenforceable.

[160] The beneficiary is the only person with a superior equitable claim to the property, against the trustee or a transferee from the trustee, but is not allowed to assert his or her claim.

[161] See *Muckleston v Brown* (1801) 6 Ves 52, 68; 31 ER 934, 942, *per* Lord Eldon.

[162] See *Ayerst v Jenkins* (1873) LR 16 Eq 275, 281, *per* Lord Selborne.

[163] See, in particular, the reasoning in some of the United States cases cited in A W Scott and W F Fratcher, *The Law of Trusts* (4th ed 1987 and later supplements) vol V, § 422.6.

Our interest is primarily in those actual or arguable varieties of constructive trust which, whilst imposed by operation of law, may in fact operate to give effect to the intentions of one or more parties (when those intentions could not be enforced as an express trust). These are: the "common intention constructive trust";[164] secret trusts; and trusts which compel a person, to whom property has been transferred *inter vivos* on the faith of an oral undertaking to hold for another, to abide by his or her undertaking. Related to these is the "constructive trust" which is imposed on the vendor of property under a specifically enforceable contract of sale. A final variety is the "constructive trust" which may be imposed to give effect to incomplete transfers of property. In the following paragraphs we offer some tentative opinions on the effect of illegality on such trusts.

3.60 Several other varieties of so called "constructive trust" are essentially bases for remedies for wrongdoing of a restitutionary[165] or compensatory[166] nature. Consideration of these has no more place in our paper on "illegal transactions" than a consideration of how illegality affects claims to remedies (whether restitutionary or compensatory) for torts.

(1) Common intention constructive trusts

3.61 Though it is difficult to be absolutely certain on this point, *Tinsley v Milligan*[167] can be read as supporting the view that equity will impose a constructive trust even if the common intention to share beneficial ownership has an underlying fraudulent motive. That trust will then be enforceable by a beneficiary if its existence can be shown without the beneficiary having to rely on his or her own illegality. Whether (and if so when) that will be possible is not yet clear.

3.62 The presumed resulting trust and the "common intention constructive trust" have not always been kept separate, but they are now generally accepted as distinct concepts.[168] The facts which must be proven in order to establish each variety of trust are not identical and the point in time at which the trust arises may differ. The interest of a beneficiary under a presumed resulting trust is limited to the direct financial contribution (if any) which he or she has made to the purchase of the property. But, at least if two parties have an "express common intention" to share beneficial ownership, which has been relied on by the claimant to his or her "detriment", the relevant interests under the common intention constructive trust will be what the parties expressly intended them to be (if they have discussed the

[164] See, for example, A J Oakley, *Constructive Trusts* (3rd ed 1997) pp 64-83; P Pettit, *Equity and the Law of Trusts* (8th ed 1997) pp 173-181.

[165] See, for example, the constructive trust imposed on a fiduciary who obtains a bribe or secret profit in breach of fiduciary duty: *Boardman v Phipps* [1967] 2 AC 46; *AG for HK v Reid* [1994] 1 AC 324 (PC).

[166] See, for example, the liability of a person who dishonestly procures or assists in a breach of trust or other fiduciary duty: see now *Royal Brunei Airlines v Tan* [1995] 2 AC 378 (PC).

[167] [1994] 1 AC 340.

[168] For recent expressions of concern by the Court of Appeal at the failure to keep the two concepts separate, see *Drake v Whipp* (1996) 28 HLR 531, 533.

matter)[169] or will be quantified by the court in the light of all of the circumstances of the case.[170]

3.63 Although in the main the judgments in the House of Lords in *Tinsley v Milligan*,[171] proceeded on the basis that Miss Milligan was claiming an equitable interest under a presumed resulting trust, there are passages in Lord Browne-Wilkinson's speech which suggest that the result would have been the same had she based her claim on a common intention constructive trust.[172] The reliance principle should logically apply to either type of claim: Lord Browne-Wilkinson considered that the reliance principle applied to the recognition and enforcement of equitable interests generally.[173] But whether a claim succeeds or fails by virtue of that principle will be substantially determined by what facts must be shown by a claimant in order to establish his or her claim.[174] And as we have already noted, the facts which must be proven in order to establish a presumption of resulting trust are not the same as those which must be proven for a common intention constructive trust. An "express common intention" constructive trust requires evidence of an express understanding that the property should be shared beneficially on which the claimant relied to his or her detriment.[175] An "inferred common intention" constructive trust needs evidence (probably at least including a direct financial contribution to the purchase of the property)[176] from which such an agreement or understanding can be inferred, as well as detrimental action by the claimant. But a presumption of resulting trust may arise simply from the claimant proving that he or she voluntarily transferred property to another or that he or she contributed to the purchase of property in another's name.

3.64 In *Tinsley v Milligan*, Lord Browne-Wilkinson seemed to accept that Miss Milligan could show an agreement to share beneficial ownership without needing to rely on the illegality:[177] she "had no need to allege or prove *why* the house was conveyed into the name of Miss Tinsley alone".[178] If that is correct, one might expect that a

[169] *Clough v Killey* (1996) 72 P&CR D22 (CA).

[170] *Drake v Whipp* (1996) 28 HLR 531 (CA). See, on the current approach to determining beneficial entitlement, D Wragg, "Constructive Trusts and the Unmarried Couple" (1996) 26 Fam Law 298.

[171] [1994] 1 AC 340.

[172] See, in particular, the ambiguities in the passages in Lord Browne-Wilkinson's judgment: [1994] 1 AC 340, 371C-D, 371H-372A, 376F-H.

[173] See, in particular, his reasoning at [1994] 1 AC 340, 370F-371C. And see *Lowson v Coombes*, *The Times* 2 December 1998.

[174] Cf Millett LJ in *Tribe v Tribe* [1996] Ch 107, 134, commenting that the reliance principle "is procedural in nature and depends on the adventitious location of the burden of proof in any given case".

[175] That "reliance" could include contributing to the purchase money.

[176] *Lloyds Bank plc v Rosset* [1991] 1 AC 107.

[177] See, in particular, the passage at [1994] 1 AC 340, 376F-G, in which his Lordship appears to be describing those facts which will establish a "presumption of resulting trust": "by showing that she had contributed to the purchase price of the house and that there was *common understanding between her and Miss Tinsley that they owned the house equally* " (emphasis added).

[178] [1994] 1 AC 340, 376F-G.

claim to enforce a common intention constructive trust should usually succeed notwithstanding any underlying illegal purpose. Whether it will invariably do so is a difficult question. On the one hand, the evidence which is adduced of express discussions may necessarily disclose the fraudulent purpose: shared beneficial ownership may only ever have been discussed as part and parcel of an illegal scheme. Will this constitute "reliance" on the illegal purpose? On the other hand, if the evidence of express discussions is slight and shared beneficial ownership is only explicable as part and parcel of an illegal scheme, courts may require cogent evidence that the parties had a dishonest intention, before they will infer a common intention.[179] In a case such as *Tinsley v Milligan*, in which a couple each contributed to the purchase of property in which they were intending to cohabit, a common intention to share beneficial ownership would be the natural (rather than the exceptional) inference.

(2) Trusts (including "secret trusts") imposed on persons who receive property on the faith of an undertaking to hold for another

3.65 If the owner of property transfers it to another during his or her lifetime, on the faith of an oral undertaking to hold the property on trust for the transferor or for a third party, equity may hold the transferee to be constructive trustee of the property and compel him or her to give effect to the undertaking.[180] Similarly if the owner of property leaves the property by will to another (whether or not he or she appears to be trustee on the face of the will) on the faith of an undertaking by that other to hold the property on trust, the legatee may hold the property on so-called "half" or "fully secret" trust on such terms as had been communicated to him or her.[181] If the transferor's intentions are "illegal" and would not be enforced if they were expressed in an express declaration of trust, in principle they should not be given any greater effect via the imposition of a constructive trust.[182]

3.66 For example, if a testator intends that the "secret trustee" should hold the property for another subject to an illegal condition, that condition should be invalid, just as it would be if it was included in an express trust.[183] Similarly, the effect of holding that the condition is invalid should be the same as if it was included in an express

[179] See, by analogy, *Tinker v Tinker* [1970] P 136.

[180] For discussion of the constructive trust (if any) which may arise in this situation, see, in particular, A J Oakley, *Constructive Trusts* (3rd ed 1997) pp 53-59. There is significant controversy about the proper classification of the trusts which arise in these cases, especially where the undertaking is to hold for a third party: see, in particular, D J Hayton, *Hayton and Marshall: Commentary and Cases on the Law of Trusts and Equitable Remedies* (10th ed 1996) pp 61-63; J D Feltham, "Informal Trusts and Third Parties" [1987] Conv 246; T G Youdan, "Informal Trusts and Third Parties: A Response" [1988] Conv 267.

[181] For discussion of such trusts, see, in particular, A J Oakley, *Constructive Trusts* (3rd ed 1997) ch 5, esp I-III. There is, again, significant controversy about the proper classification of half and fully secret trusts: see, in particular, A J Oakley, *op cit*, pp 260-262.

[182] See *Re Spencer's Will* (1887) 57 LT 519 where the Court of Appeal upheld the executors' claim that the court should consider parole evidence regarding the terms of a secret trust of property left by will in order to establish whether that trust was an "illegal trust". The arguments in the case assumed that, if the testator's intentions were illegal, the legatees would not succeed in a claim against the executors for the property.

[183] Cf paras 3.33 to 3.34 above.

trust. This might mean, in some cases, that the intended "secret trust" fails completely, so that the property is held on resulting trust for the testator's estate. In other cases, it may mean that the secret trustee is still compelled to hold the property for the intended beneficiary, but free of the illegal condition.[184] And if (which is as yet unclear),[185] the reliance principle is relevant to claims to enforce interests which would otherwise arise on the failure of an express trust for illegality, it should be similarly relevant to comparable claims where equity refuses to impose a constructive trust to give effect to (identical) illegal intentions.[186]

(3) The constructive trust arising from a specifically enforceable contract

3.67 A vendor of property under a specifically enforceable contract for the sale of land[187] is generally said to hold the property on constructive trust for the purchaser.[188] If the contract is one which equity would not specifically enforce, because it was affected by illegality, one would also anticipate that equity would refuse to impose a constructive trust.[189] Were it otherwise, a purchaser under a contract which was unenforceable for illegality could be in a better position than a purchaser under a contract which was unenforceable for some reason, not involving any turpitude on his or her part. And if equity never imposes a constructive trust in these circumstances, one never gets to the stage of having to ask whether the trust can be proven without "relying" on the illegality.

(4) The constructive trust in Re Rose which gives effect to incomplete transfers

3.68 In certain circumstances,[190] where one person purports to transfer legal title in property to another,[191] equity treats the transferor as trustee of the property for the

[184] Cf para 3.38 above.

[185] See paras 3.40 to 3.50 above.

[186] *Muckleston v Brown* (1801) 6 Ves 52; 31 ER 934, in which Lord Eldon expressed the wide principle that equity would not assist a party to illegality, involved a "secret trust" which was void for illegality (it infringed the mortmain legislation). The intended trust being void, the testator's heirs claimed the property under a resulting trust. The enforceability of that trust was apparently to be determined with the same "no assistance" principle as would have been applied to a resulting trust which arose on the failure of an *inter vivos* express trust for illegality.

[187] The trust is not limited to specifically enforceable contracts for the sale of land, though such contracts are the most common example.

[188] For discussion of this controversial category of constructive trust, see, in particular, A J Oakley, *Constructive Trusts* (3rd ed 1997) ch 6 and C Harpum, "The Uses and Abuses of Constructive Trusts: The Experience of England and Wales" (1997) 1 Edin LR 437, especially 453-457. It is important to distinguish this category of trust from the trust or lien which arises where the purchaser of land has paid all or part of the price to the vendor (whether or not the contract is specifically enforceable): see C Harpum, *op cit*, especially 454 and 457-459.

[189] This is a particular application of the general proposition that no constructive trust will arise if, for some reason, the contract is not specifically enforceable: *Howard v Miller* [1915] AC 318, 326 and *Central Trust and Safe Deposit Co v Snider* [1916] 1 AC 266, 272. Although, for a suggestion to the contrary, see *Tinsley v Milligan* [1994] 1 AC 340, 370-371, *per* Lord Browne-Wilkinson.

[190] See, in particular, *Re Rose* [1952] Ch 499 (CA).

intended transferee even before all necessary steps have been taken effectively to transfer that title.[192] If it was illegal to transfer the property in question, and such a transfer could never be valid at law or in equity, one would imagine that a court of equity would not hold the transferor to be trustee for the intended transferee. The position would be rather less clear if it would be illegal to transfer the property in question, but the transfer could in principle be validly effected at law or in equity.

[191] The same principles appear to apply whether the transfer is to trustees, on trust for a third person, or to the transferee beneficially: see, for example, P Pettit, *Equity and the Law of Trusts* (8th ed 1997) pp 94-95.

[192] For discussion of this category of trust, see, for example, A J Oakley, *Constructive Trusts* (3rd ed 1997) ch 8.

PART IV
THE EFFECT OF ILLEGALITY III: THE REJECTION OF THE "PUBLIC CONSCIENCE" TEST

4.1 In the late 1980s and early 1990s the courts began to reject the technical and inflexible rules outlined in Parts II and III in favour of a general principle that the courts would only refuse to assist the plaintiff where it would be an "affront to the public conscience"[1] to provide the relief which he or she sought[2] - the so-called "public conscience test".[3] Under this test a court was required to take into account all the surrounding circumstances of the case and then "weigh, or balance, the adverse consequences of granting relief against the adverse consequences of refusing relief."[4] Those rules which were previously regarded as laying down when the illegality defence would apply and what were the exceptions to its application were to be regarded as valuable guidelines, but they were no more than guidelines. Their value and justification lay in the practical assistance which they gave to courts by focusing attention on particular features which were material in carrying out the balancing exercise in different types of case. But they were not pre-programmed ready-made solutions which at the touch of a key would automatically yield the answer. The ultimate decision called for a value judgment.[5]

4.2 The application of the public conscience test is perhaps most graphically illustrated in *Howard v Shirlstar Container Transport Ltd*[6] where the plaintiff was allowed to enforce a contract despite having performed it in an illegal manner. The plaintiff, a pilot, agreed to retrieve the defendants' aircraft which was being detained in Nigeria in breach of the contract under which it had been let out on hire. This operation was contrary to the wishes of the Nigerian military authorities, and involved the plaintiff and his wireless operator in considerable personal danger. As a result, they left Lagos airport without obtaining permission from the air traffic control, which, under Nigerian law, constituted a statutory criminal offence. The defendants sought to avoid paying the plaintiff's fee by

1 *Euro-Diam Ltd v Bathurst* [1990] 1 QB 1, 35, *per* Kerr LJ.

2 This test was first considered by Hutchison J in *Thackwell v Barclays Bank Plc* [1986] 1 All ER 676 (a case concerning the recovery of property obtained illegally); and followed in *Saunders v Edwards* [1987] 1 WLR 1116 (see para 2.70 above); *Euro-Diam Ltd v Bathurst* [1990] 1 QB 1 (where the illegality defence was unsuccessfully raised by the defendant when the plaintiff sought to sue on a contract of insurance); *Howard v Shirlstar Container Transport Ltd* [1990] 1 WLR 1292 (see para 4.2 below); and by the majority of Court of Appeal in *Tinsley v Milligan* [1992] Ch 310 (see para 4.3 below).

3 See N Enonchong, "Illegality and the Public Conscience Test" [1992] LMCLQ 471 and "Illegality: The Fading Flame of Public Policy" (1994) 14 OJLS 295, 296-297; G Kodilinye, "A Fresh Approach to the Ex Turpi Causa and 'Clean Hands' Maxims" [1992] Denning LJ 93; J Martin, "Fraudulent Transferors and the Public Conscience" [1992] Conv 153 and H Stowe, "The 'Unruly Horse' has Bolted: *Tinsley v Milligan*" (1994) 57 MLR 441.

4 *Tinsley v Milligan* [1992] Ch 310, 319, *per* Nicholls LJ.

5 *Tinsley v Milligan* [1992] 310, 319-320, *per* Nicholls LJ.

6 [1990] 1 WLR 1292.

relying on his illegal performance, but the Court of Appeal held that the plaintiff was entitled to enforce the contract. The case was "plainly one where the plaintiff's claim should not fail", since there would be no affront to the public conscience to allow relief. The offences committed by the plaintiff were designed to free himself and his wireless operator from pressing danger.[7]

4.3 The majority of the Court of Appeal in *Tinsley v Milligan*[8] applied the public conscience test to find in favour of Miss Milligan. As Nicholls LJ explained: "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. That would be to visit on the defendant a disproportionate penalty."[9]

4.4 However, when *Tinsley v Milligan* was heard in the House of Lords,[10] both the majority and minority rejected the argument that there was any so-called public conscience test in English law.[11] Of the majority, Lord Browne-Wilkinson said that the consequences of being a party to an illegal transaction cannot depend on such "an imponderable factor" as the extent to which the public conscience would be affronted by recognising rights created by illegal transactions.[12] Of the minority, Lord Goff said that (1) the application of the public conscience test to the present case was inconsistent with numerous authorities binding on the Court of Appeal; (2) in considering now whether such a change in the law was desirable, it was by no means self-evident that the public conscience test would be preferable to the present strict rules;[13] and (3) if there were to be reform, it should only be attempted by legislation after a review by the Law Commission.[14]

4.5 In the recent decision of the High Court of Australia in *Nelson v Nelson*,[15] neither Deane, Gummow nor Dawson JJ considered the public conscience test. Toohey J adopted an approach which required a weighing of all the relevant circumstances

[7] [1990] 1 WLR 1292, 1301 and 1303.

[8] [1992] Ch 310 (for the facts of the case, see para 3.9 above). Although Lloyd LJ said he distrusted a test based on the public conscience, which "is so imprecise and difficult to apply", he thought it was binding upon him: [1992] Ch 310, 339. Ralph Gibson LJ dissented.

[9] [1992] Ch 310, 321.

[10] [1994] 1 AC 340.

[11] See also Dillon LJ's criticism of the public conscience test in *Pitts v Hunt* [1991] 1 QB 24, 56 in relation to a claim in tort. He said: "I find a test that depends on what would or would not be an affront to the public conscience very difficult to apply."

[12] [1994] 1 AC 340, 369.

[13] Lord Goff referred to Ralph Gibson LJ's dissenting judgment in the Court of Appeal where he said [1992] Ch 310, 334: "In so far as the basis of the *ex turpi causa* defence, as founded on public policy, is directed at deterrence it seems to me that the force of the deterrent effect is in the existence of the known rule and in its stern application."

[14] [1994] 1 AC 340, 362-364.

[15] (1995) 184 CLR 538. See para 3.28 above.

and which he recognised was similar to the public conscience test.[16] But McHugh J specifically rejected such an approach. He said:

> While it provides a ready means for a judge to do what he or she thinks is just in the circumstances of the particular case, it does so by means of an unstructured discretion. The so called "public conscience" test, although providing a flexible approach, leaves the matter at large. Greater certainty in the application of the illegality doctrine will be achieved if the courts apply principles instead of a vague standard such as the "public conscience".[17]

[16] (1995) 184 CLR 538, 596.

[17] (1995) 184 CLR 538, 612.

PART V
THE CASE FOR LEGISLATIVE REFORM

5.1 The present law on illegal transactions may be criticised for its complexity, its potential to give rise to unjust decisions and its lack of certainty. Following the House of Lords' decision in *Tinsley v Milligan*[1] wholesale judicial reform of the present rules seems unlikely.

1. COMPLEXITY

5.2 The crude and draconian nature of the general contractual illegality rules (that "no cause of action arises from an unworthy cause" and that "where the guilt is shared the defendant's position is the stronger") has resulted in the judges creating a large number of exceptions to their application.[2] The law has thereby been rendered needlessly complex, technical and difficult to justify. Why should it be, for example, that where a plaintiff chooses to perform a contract in an illegal manner after it has been made, this should not affect the contract's validity, but where the plaintiff holds this intention from the outset, he or she will apparently be unable to enforce it?[3] And we have seen that the rule whereby a person who transfers a limited interest in property under an illegal contract is able to rely on his or her reversionary rights to claim back the property when the transferee acts in breach of that contract is difficult to square with the rule which prevents a person from relying on an illegal contract.[4] In respect of trusts, we have seen that the present law - and in particular the application of the reliance principle - is so complex (and uncertain) that what we have set out as the present law in Part III has to be regarded as merely a tentative and novel attempt to produce some order out of chaos.[5]

2. INJUSTICE

5.3 Since Lord Mansfield's classic statement in *Holman v Johnson*,[6] it has been widely recognised that the illegality rules may lead to injustice and, in particular, to the unjust enrichment of the defendant at the plaintiff's expense. Lord Mansfield made it clear that an unmeritorious defendant could raise the illegality defence against the plaintiff's claim, despite the defendant's own involvement in the illegal act or purpose and even if the success of the defence would leave the defendant with an unearned windfall. As Lord Goff explained in his dissenting speech in *Tinsley v Milligan*: "It is important to observe that, ... the principle is not a

[1] [1994] 1 AC 340.

[2] N Enonchong, *Illegal Transactions* (1998) p 20.

[3] See paras 2.29 to 2.31 above.

[4] See paras 2.62 to 2.67 above.

[5] See para 3.4 above.

[6] (1775) 1 Cowp 341, 343; 98 ER 1120, 1121. The passage is cited at para 6.2 below.

principle of justice; it is a principle of policy, whose application is indiscriminate and so can lead to unfair consequences as between the parties to litigation."[7]

5.4 A particular focus for criticism in the contracts area is the notion of implied statutory prohibition. The fairness of a rule that prevents the enforcement of a contract but gives no weight to the seriousness of the illegality involved nor to the culpability of the party seeking to enforce may be doubted. For example, in *Mohamed v Alaga & Co*[8] the plaintiff entered into an agreement with the defendant solicitor whereby the plaintiff would refer clients to the solicitor and assist the solicitor in preparing the clients' asylum applications in return for a share in the solicitor's fees. After making several referrals and carrying out the work, the plaintiff claimed in the alternative for payment under the contract or restitution. Despite Lightman J's finding that it was highly blameworthy of the defendant to enter into such a contract, both of the plaintiff's claims were refused. The (guilty) defendant therefore benefited from the (innocent) plaintiff's work without being required to make any payment for it.[9]

5.5 Sometimes the "just" result is only achieved on appeal. For example, in *Shaw v Groom*[10] and *Mason v Clarke*,[11] had the plaintiffs not been able to appeal to the Court of Appeal or the House of Lords respectively, "harsh" decisions would have stood unchallenged. It seems reasonable to suppose that, given the uncertainty and complexity of the law, erroneous decisions are not infrequently being reached in the lower courts.

5.6 We have already noted that the law gives greater protection in relation to the recognition of proprietary interests transferred or created under illegal contracts than it does to personal claims arising under an illegal contract.[12] That is, while the law recognises that property may pass under an illegal contract, it will not enforce a contract which has not yet been carried out. One might argue that this is an out-moded approach which creates anomalies[13] and injustice, and is itself a reason for reform.

[7] [1994] 1 AC 340, 355.

[8] [1998] 2 All ER 720. See para 2.37 above.

[9] Other well-known examples include *Re Mahmoud v Ispahani* [1921] 2 KB 716 (see para 2.5 above); *Chai Sau Yin v Liew Kwee Sam* [1962] AC 304 (see para 2.18 above); and the dicta of Kerr LJ in *Phoenix General Insurance Co of Greece SA v Halvanon Insurance Co Ltd* [1988] QB 216 (see para 2.17 above).

[10] [1970] 2 QB 504 (see para 2.11 above).

[11] [1955] AC 778. A receipt in acknowledgement of a payment for the lease of certain shooting rights was expressed to be in respect of bailiff's wages, allegedly as part of a scheme by the vendor to defraud the Inland Revenue. It was argued, ultimately unsuccessfully, that merely being given this receipt fixed the otherwise innocent recipient with knowledge of the vendor's fraudulent scheme so that he had no enforceable right to the shooting rights.

[12] See para 2.57 above.

[13] See paras 2.59 to 2.60 above.

5.7 The law on illegality in relation to trusts may give rise to equally harsh decisions. As we have noted,[14] the effect of using the "reliance principle" to refuse the enforcement of a resulting trust is to put the technicalities of the pleadings before the merits of the case and to elevate the presumption of advancement to a decisive role in illegality cases when in other aspects of trusts law its influence is waning.[15] The potential for injustice is clear. Not only may a contributor or transferor be required to forfeit his or her equitable interest in a case where the illegality is slight, but the recipient or transferee may gain effective control of the property regardless of the merits of his or her own position.

3. UNCERTAINTY

5.8 Our review of the present law on illegal transactions in Parts II and III has shown that there are several areas where one cannot state with any certainty what the relevant rules are. For example, in relation to illegal contracts, we have seen that there are differences in the case law as to when one party's illegal purpose in entering into a contract will prevent the other party from enforcing it. Some cases hold that mere knowledge of the illegal purpose will be sufficient to defeat the otherwise innocent party's claim, while other cases suggest that something more than mere knowledge, vaguely referred to as "participation", is required.[16] Nor is it clear whether there is any significance in a contract being "illegal in its inception" as opposed to "illegal in its performance". Some cases suggest that a contract to do an act which is a legal wrong (and which is therefore "illegal in its inception") is unenforceable by either party whether or not either or both were aware that the intended act is contrary to the law. Other cases suggest that the position is not so rigid, and that an innocent party would be entitled to claim damages for breach.[17]

5.9 In relation to illegal trusts, we have seen that the scope of the "reliance principle" is uncertain. For example, it is not clear whether the principle has any role to play in determining the enforceability of an automatic resulting trust that arises on the failure of an express trust for illegality.[18] And even where it is clear that the principle does apply, there is some confusion as to how it operates in practice. In *Tinsley v Milligan*[19] Lord Browne-Wilkinson assumed that where a person purchased property in the name of another in order to conceal its true ownership and a presumption of advancement arose between them, the reliance principle would prevent the contributor from establishing a resulting trust in his or her favour: to show that no gift was intended the contributor would need to rely on the illegal purpose of the transaction.[20] But when such a case was before the High Court of Australia in *Nelson v Nelson*[21] Dawson J applied a much narrower

[14] See paras 3.21 to 3.22 above.

[15] See, for example, the remarks of Lords Reid and Diplock in *Pettitt v Pettitt* [1970] AC 777, 793 and 823-824.

[16] See paras 2.25 to 2.27 above.

[17] See paras 2.20 to 2.23 above.

[18] See paras 3.40 to 3.50 above.

[19] [1994] 1 AC 340 (see para 3.9 above).

[20] [1994] 1 AC 340, 372.

[21] (1995) 184 CLR 538 (see para 3.28 above).

interpretation of the reliance rule and allowed the contributor to recover. He drew a distinction between relying on the contributor's illegal reason or motive for the transfer, which was not permissible, and his or her intention to retain beneficial ownership on making the transfer, which was.[22]

4. UNLIKELIHOOD OF JUDICIAL REFORM

5.10 Following the rejection of the public conscience test by the House of Lords in *Tinsley v Milligan*,[23] any possibility of wholesale judicial reform appears blocked. Although the courts may further refine the application of the present rules to the particular case before them, in doing so they will have little opportunity to assess the structure of the illegality rules as a whole. Such tinkering at the edges is only likely to result in a body of case law that is ever more complex and uncertain.

5. CONCLUSION

5.11 Our review of the present law on illegal transactions has led us to conclude that in many aspects it is unnecessarily complex, may give rise to unjust decisions and is uncertain. We therefore consider that it is in need of reform. Our view is endorsed by the comments frequently found in judgments as to the unsatisfactory state of the present law;[24] and by academic criticism of the present law.[25] Practitioners have also indicated to us how difficult and confusing they find this area of the law.

5.12 Moreover we consider that reform by way of legislation, which provides the opportunity to deal with the relevant law as a whole, would result in a cleaner, quicker, and more coherent advance than any reform that could be achieved incrementally by the common law. We also consider it important that Lord Goff has suggested that any reform in this area should be instituted by the legislature;[26] that several academic commentators have suggested that legislative reform is the most sensible way forward;[27] and that legislation has been implemented, or recommended by law reform bodies, in several other jurisdictions.[28]

[22] (1995) 184 CLR 538, 580-581.

[23] [1994] 1 AC 340. See Part IV above.

[24] See, for example, Denning LJ in *Strongman (1945) Ltd v Sincock* [1955] 2 QB 525, 535: "It is said that, if damages could be recovered [for breach of a collateral contract], it would be an easy way of getting round the law about illegality. This does not alarm me at all." And see Nourse LJ in *Silverwood v Silverwood* (1997) 74 P&CR 453, 458: "This case is another illustration of the strait-jacket in which transfers of property made for illegal purposes have been encased by the decision of the House of Lords in *Tinsley v Milligan*."

[25] See the references at para 3.23 n 59 above. And see, for example, Lord Goff of Chieveley and G Jones, *The Law of Restitution* (4th ed 1993) pp 519-522; P S Atiyah, *An Introduction to the Law of Contract* (5th ed 1995) p 342; and G H Treitel, *The Law of Contract* (9th ed 1995) p 438.

[26] *Tinsley v Milligan* [1994] 1 AC 340, 364.

[27] J Shand, "Unblinkering the Unruly Horse: Public Policy in the Law of Contract" [1972A] CLJ 144, 164; A Stewart, "Contractual Illegality and the Recognition of Proprietary Interests" (1986) 1 JCL 134, 161; N Cohen, "The Quiet Revolution in the Enforcement of Illegal Contracts" [1994] LMCLQ 163; B Dickson, "Restitution and Illegal Transactions" in A Burrows (ed), *Essays on the Law of Restitution* (1991) p 171; N Cohen, "Illegality: The

5.13 **Our provisional view is therefore (a) that the law on the effect of illegality in relation to contracts and trusts is in need of reform; and (b) that legislative reform is to be preferred to leaving "reform" to the judiciary through development of the common law. If consultees do not agree, is there any limited area of the law on the effect of illegality which they consider is in need of legislative reform?**

Case for Discretion" in W Swadling (ed), *The Limits of Restitutionary Claims: A Comparative Analysis* (1997) p 186.

[28] Legislation has been adopted in New Zealand (Illegal Contracts Act 1970) and in Israel (Contracts (General Part) Law 1973, ss 30-31). Recommendations for legislative reform have been made by the Law Reform Committee of South Australia (37th Report Relating to the Doctrines of Frustration and Illegality in the Law of Contract, 1977); by the Law Reform Commission of British Columbia (Report on Illegal Transactions, 1983) (and see British Columbia Law Institute, Proposals for a Contract Law Reform Act (1998)); and by the Ontario Law Reform Commission (Report on Amendment of the Law of Contract, 1987).

PART VI
SHOULD ANY DOCTRINE OF ILLEGALITY BE MAINTAINED?

6.1 Before looking at the main options, and our provisional proposals, for legislative reform we believe that it is important to clarify that we are rejecting a radical and very simple but, in our view, inappropriate method of reform. This would be to dispense with any special rules for illegal transactions. Under such an approach it would no longer be possible to raise illegality as a defence to the validity or enforceability of a transaction. One could only favour such a radical reform, if one were convinced that there is no policy in support of the illegality rules that is of sufficient weight to justify the denial of normal legal rights and remedies.

6.2 The classic statement frequently cited in support of the illegality defence is that of Lord Mansfield in *Holman v Johnson*:

> The objection, that a contract is immoral or illegal as between plaintiff and defendant, sounds at all times very ill in the mouth of the defendant. It is not for his sake, however, that the objection is ever allowed; but it is founded in general principles of policy, which the defendant has the advantage of, contrary to the real justice, as between him and the plaintiff, by accident, if I may so say. The principle of public policy is this; *ex dolo malo non oritur actio*. No Court will lend its aid to a man who founds his cause of action upon an immoral or an illegal act. If, from the plaintiff's own stating or otherwise, the cause of action appears to arise *ex turpi causa*, or the transgression of a positive law of this country, there the Court says he has no right to be assisted. It is upon that ground the Court goes; not for the sake of the defendant, but because they will not lend their aid to such a plaintiff. So if the plaintiff and defendant were to change sides, and the defendant was to bring his action against the plaintiff, the latter would then have the advantage of it; for where both are equally in fault, *potior est conditio defendentis*.[1]

6.3 We need to look at this in a little more detail and examine why it is that the court will not "lend its aid to a man who founds his cause of action upon an immoral or an illegal act". Many policy arguments have been put forward to justify a doctrine of illegality.[2] Both for the purpose of refuting the above radical approach, and for informing our general reform strategy, we look at what would appear to be the four main ones in turn. In so doing we shall confine our attention to illegal contracts, although the same policies apply to illegal trusts. They are (1) upholding the

[1] (1775) 1 Cowp 341, 343; 98 ER 1120, 1121.

[2] See G L Williams, "The Legal Effect of Illegal Contracts" (1942) 8 CLJ 51, 61-65; J W Wade, "Benefits Obtained under Illegal Transactions - Reasons For and Against Allowing Restitution" (1946) 25 Texas Law Review 31; J K Grodecki, "In Pari Delicto Potior est Conditio Defendentis" (1955) 71 LQR 254, 265-273; J Shand, "Unblinkering the Unruly Horse: Public Policy in the Law of Contract" [1972A] CLJ 144; and G Virgo, "The Effect of Illegality on Claims for Restitution in English Law" in W Swadling (ed), *The Limits of Restitutionary Claims: A Comparative Analysis* (1997) ch 6 pp 156-158.

dignity of the courts; (2) the plaintiff should not profit from his or her own wrongdoing; (3) deterrence; and (4) punishment.

1. UPHOLDING THE DIGNITY OF THE COURTS

6.4 This policy reason can explain not only the courts' refusal to enforce illegal contracts, but also their reluctance to award restitutionary relief and their willingness to recognise the existence of proprietary interests. Rather than stooping to the indignity of inquiring into the relative merits and demerits of the parties, the policy argument is that the courts should simply leave matters as they are. There are several indications in the case law that this is indeed the thinking behind the courts' refusal to intervene. In the infamous *Highwayman's Case*,[3] the court not only threw out the claim by one highwayman for a fair share of profits against his fellow highwayman, but also fined the plaintiff's solicitors for bringing the claim, in order to reflect the "indignity to the court". In *Parkinson v College of Ambulance Ltd and Harrison*,[4] Lush J was concerned as to the type of action that might be brought before the court unless he were to hold that a contract promising that an honour would be conferred was contrary to public policy. He said: "No Court could try such an action and allow such damages to be awarded with any propriety or decency." And in *Tappenden v Randall*[5] Heath J suggested that: "Undoubtedly there may be cases where the contract may be of a nature too grossly immoral for the Court to enter into any discussion of it; as where one man has paid money by way of hire to another to murder a third person."

6.5 Further support for the existence of this policy may be found in the fact that the courts may, of their own motion, take note of the illegality of a transaction even if neither party raises the issue in pleadings.[6] As Scrutton LJ said in *Re Mahmoud v Ispahani*: "In my view the Court is bound, once it knows that the contract is illegal, to take objection and to refuse to enforce the contract, whether its knowledge comes from the statement of the party who was guilty of the illegality, or whether its knowledge comes from outside sources. The Court does not sit to enforce illegal contracts."[7]

6.6 We consider that this "dignity of the courts" policy justification does have merit. Where the transaction in dispute is morally very shocking, or the plaintiff's behaviour particularly heinous, the court may be justified in refusing to provide any assistance. The proper role of the court is not to provide an arena in which wrongdoers may fight over their spoils. However, the confines of this policy must also be recognised. That is, the dignity of the courts can only be at risk where the transaction involves illegality of a particularly serious nature, rather than the trivial breach of some technical statutory regulation. When we look at the various options for reform of the illegality rules, we therefore note that it is important that

[3] *Everet v Williams* (1725) reported at (1893) 9 LQR 197.

[4] [1925] 2 KB 1, 13.

[5] (1801) 2 Bos & Pul 467, 471; 126 ER 1388, 1390.

[6] *North-Western Salt Company Ltd v Electrolytic Alkali Company Ltd* [1914] AC 461 (HL).

[7] [1921] 2 KB 716, 729. For discussion of the pleading of illegality, see N Enonchong, *Illegal Transactions* (1998) pp 20-25.

under any new rules the courts' decisions should be able to reflect the seriousness of the illegality involved.[8]

2. THE PLAINTIFF SHOULD NOT PROFIT FROM HIS OR HER OWN WRONGDOING

6.7 In *Beresford v Royal Insurance Company Limited*,[9] Lord Atkin referred to "the absolute rule ... that the Courts will not recognise a benefit accruing to a criminal from his crime." While this rule has an application over a wider area than illegal transactions,[10] it is a maxim to which the courts frequently refer in illegality cases.[11]

6.8 We accept the value of this policy and, further, we believe that the illegality rules have an important role to play in applying it in the civil law context. Again, however, we would emphasise that it is important to recognise the limits of this policy. The policy can only apply where the plaintiff is indeed a "wrongdoer", and not in every case which involves some element of illegality. This has been recognised by the courts. For example, in *Strongman (1945) Ltd v Sincock*,[12] Denning LJ said: "It is, of course, a settled principle that a man cannot recover for the consequences of his own unlawful act, but this has always been confined to cases where the doer of the act knows it to be unlawful or is himself in some way morally culpable. It does not apply when he is an entirely innocent party."[13] In considering options for reform of the law below, we therefore recognise the importance of ensuring that any new rules allow for consideration to be given to the knowledge and intention of the party seeking to enforce his or her usual rights and remedies.[14]

3. DETERRENCE

6.9 The third policy is the desirability of deterring unlawful or immoral conduct. Judges frequently refer to this policy as a factor which influenced them in reaching their decision to deny the plaintiff the relief which he or she is claiming. For

[8] See paras 7.29 to 7.32 and para 8.53 below.

[9] [1938] AC 586, 599.

[10] In *Beresford v Royal Insurance Company Limited* [1938] AC 586 the personal representatives of a man who had shot himself sought to recover on life insurance policies that the deceased had taken out with the defendants. There was no suggestion that the insurance contracts were illegal, but the House of Lords held that the personal representatives were unable to recover, because if they could do so the estate would be benefiting from the deceased's suicide, and, at the time, suicide was a crime. For restitution for civil wrongs - which rests on the notion that no man should profit from his own wrong - see Law Commission Report No 247 Aggravated, Exemplary and Restitutionary Damages, Part III. The principle that no man shall profit from his own wrong is also relevant in a criminal law context, for example, in the confiscation orders that may be made in respect of drug trafficking offences under the Drug Trafficking Act 1994.

[11] See, for example, *St John Shipping Corporation v Joseph Rank Ltd* [1957] 1 QB 267, 292; *Marles v Philip Trant & Sons Ltd* [1954] 1 QB 29, 39.

[12] [1955] 2 QB 525.

[13] [1955] 2 QB 525, 535.

[14] See paras 7.33 to 7.37 and paras 8.54 to 8.56 below.

example, in *Taylor v Bhail*[15] Millett LJ said: "[I]t is time that a clear message was sent to the commercial community. Let it be clearly understood if a builder or a garage or other supplier agrees to provide a false estimate for work in order to enable its customer to obtain payment from his insurers to which he is not entitled, then it will be unable to recover payment from its customer and the customer will be unable to claim on his insurers even if he has paid for the work."[16]

6.10 We agree that deterrence should be an important policy behind the illegality rules. Although deterrence is generally seen as a function of the criminal law[17] and one might argue that those intent on committing serious crime would not be dissuaded by rules denying normal civil law remedies,[18] we believe that the illegality rules can and should be used to discourage unlawful or immoral conduct. As Professor Atiyah notes,[19] there may be instances where denying civil law remedies can prove a more successful deterrent than the criminal law. He points to the statutory controls that used to exist over hire-purchase transactions for the purpose of reducing the volume of consumer credit. The controls usually took the form of requiring a minimum deposit and a maximum repayment period. A finance company which let goods on hire-purchase in violation of these controls could not enforce the resultant hire-purchase contract on grounds of illegality. In such a case, Professor Atiyah suggests that the unenforceability of the contract may well have provided a more serious deterrent than the criminal law, if only because discovery and threat of prosecution were not very likely. Moreover, in the case of transactions regarded as illegal because contrary to public policy, the plaintiff may well not have committed any legal wrong. The risk that the civil law will refuse to recognise the usual rights and remedies therefore acts as the only legal deterrent to entering into the transaction.

4. PUNISHMENT

6.11 Although not frequently referred to in the case law, it is sometimes suggested that the courts should refuse a civil cause of action in cases involving illegal transactions in order to punish the plaintiff.[20] As with deterrence, punishment is generally

[15] [1996] CLC 377 (discussed at para 2.37 n 110 above).

[16] [1996] CLC 377, 383-384.

[17] Not all agree that deterrence is an appropriate policy for the civil law to be pursuing. For example, J Shand submits that the severity of the deterrence element in a criminal penalty is as much a matter of balancing factors of humanity or economic reality as is the punitive element. Therefore for the court, by refusing a remedy in relation to a transaction involving criminal conduct, to add to the deterrent element prescribed by Parliament in the criminal penalty, is "as obnoxious" as the double punishment involved: J Shand "Unblinkering the Unruly Horse: Public Policy in the Law of Contract" [1972A] CLJ 144, 155.

[18] In *Tribe v Tribe* [1996] Ch 107, 133-134 Millett LJ said: "It is, of course, artificial to think that anyone would be dissuaded by the primary rule [that precludes the court from lending its assistance to a man who founds his cause of action on an illegal or immoral act] from entering into a proposed fraud, if only because such a person would be unlikely to be a studious reader of the law reports or to seek advice from a lawyer whom he has taken fully into his confidence."

[19] P S Atiyah, *An Introduction to the Law of Contract* (5th ed 1995) pp 342-343.

[20] See J W Wade, "Benefits Obtained under Illegal Transactions - Reasons for and Against Allowing Restitution" (1946) 25 Texas Law Review 31, 35-36; and R A Buckley, "Law's

regarded as within the remit of the criminal rather than civil law. However, as we explained in our Report on Aggravated, Exemplary and Restitutionary Damages, we see no reason in principle why punishment should not also be regarded as an aim of the civil law.[21] We therefore accept that a legitimate aim of the illegality rules may be to punish the plaintiff for his or her obnoxious behaviour. Clearly such a policy needs careful application, and when we look at the options for reform, we note that it is important that any penal effect that the illegality rules may have on an illegal transaction must be proportionate to the illegality involved.[22]

5. CONCLUSION

6.12 In our view these four policy factors together show that there is a need for the retention of an illegality doctrine of some kind and that any reform of the illegality rules should reflect their application. It seems to us clear that in certain circumstances, and in particular where the illegality involved is exceptionally serious, it is right for normal legal rights and remedies to be denied. **It is therefore our strong provisional view that it would not be appropriate to adopt the radical approach of dispensing with all special illegality rules. In our view, a distinction should continue to be drawn between illegal transactions and valid transactions. We ask consultees whether they agree and, if not, to say why not.**

Boundaries and the Challenge of Illegality" in R A Buckley (ed), *Legal Structures* (1996) ch 9.

[21] Law Com No 247, para 5.25.

[22] See paras 7.41 to 7.42 and paras 8.60 to 8.62 below.

PART VII
OPTIONS FOR REFORM I: CONTRACTS

7.1 In this Part we consider options for reform of the law on illegality in relation to contracts. As we have explained earlier, we are focusing on the effects of a contract being illegal, rather than on the factors that constitute "illegality."[1] In the sections that follow we explain that we provisionally consider that the strict rules that currently apply in this area should be replaced in favour of a discretionary approach. We go on to consider the factors which we believe a court should take into account when exercising this provisionally proposed discretion. Next we look at the interaction between our provisional proposals and other statutory provisions which deal with the consequences of illegality. Finally we examine some miscellaneous issues that arise out of our provisional proposals.

1. OUR PROVISIONALLY PREFERRED BASIC APPROACH TO REFORMING ILLEGALITY: DISCRETION RATHER THAN STRICT RULES

7.2 We have said that we believe that there is a continued need for some doctrine of illegality in relation to illegal contracts and that, in certain circumstances, it is right that the law should deny the plaintiff his or her standard rights and remedies.[2] However, we have also explained how, in some situations, we believe that the plaintiff is being unduly penalised by the present rules.[3] This injustice would seem to be the inevitable result of the application of a strict set of rules to a wide variety of circumstances, including cases where the illegality involved may be minor, may be wholly or largely the fault of the defendant, or may be merely incidental to the contract in question. We consider that the best means of overcoming this injustice is to replace the present strict rules with a discretionary approach under which the courts would be able to take into account such relevant issues as the seriousness of the illegality involved, whether the plaintiff was aware of the illegality, and the purpose of the rule which renders the contract illegal. The adoption of some type of discretionary approach has the support of the vast majority of academic commentators in this area;[4] and it is the approach which has been followed in those jurisdictions where legislation has been implemented.[5] Moreover, we have

[1] See paras 1.12 to 1.15 above.

[2] See para 6.12 above.

[3] See paras 5.3 to 5.7 above.

[4] See, for example, J K Grodecki, "In pari delicto potior est conditio defendentis" (1955) 71 LQR 254; J Shand, "Unblinkering the Unruly Horse: Public Policy in the Law of Contract" [1972A] CLJ 144, 165; R Merkin, "Restitution by Withdrawal from Executory Illegal Contracts" (1981) 97 LQR 420, 444; A Stewart, "Contractual Illegality and the Recognition of Proprietary Interests" (1986) 1 JCL 134, 161; R A Buckley, "Social Security Fraud as Illegality" (1994) 110 LQR 3, 7-8; N Cohen, "The Quiet Revolution in the Enforcement of Illegal Contracts" [1994] LMCLQ 163 and "Illegality: the Case for Discretion" in W Swadling (ed), *The Limits of Restitutionary Claims*: *A Comparative Analysis* (1997) ch 7; N Enonchong, "Effects of Illegality: A Comparative Study in French and English Law" (1995) 44 ICLQ 196; and B Dickson, "Restitution and Illegal Transactions" in A Burrows (ed), *Essays on the Law of Restitution* (1991) ch 7.

[5] See the New Zealand Illegal Contracts Act 1970 and, to a more limited extent, sections 30-31 of the Israeli Contracts (General Part) Law 1973. Although the detail of the New

not been able to devise a new enlightened regime of "rules" that would provide satisfactory answers to all disputes involving illegal contracts. In our view, a balancing of various factors is required so that, put quite simply, the law on illegal contracts does not lend itself to a regime of rules.

7.3 A criticism of the now rejected public conscience test[6] was that it was "vague",[7] "imponderable"[8] and would result in inconsistent and incoherent law.[9] The same criticism could be made of a discretionary approach,[10] which indeed can be seen as restoring - by legislation - the "public conscience" test. However, we would answer these criticisms in three ways. First, as we shall see, we are not proposing that the courts should have the same discretion as that permitted by the "public conscience" test. Rather we propose that the courts' discretion should be carefully structured to ensure that all relevant policies are considered.[11] Secondly, we are not convinced that a discretionary approach would result in greater uncertainty than already exists in many areas of the current law. Any certainty that the present rules create is more illusory than real. It is not always clear what the rules are, and it is difficult to apply them to specific factual situations.[12] Thirdly, even if the suggestion that a discretionary approach would bring about greater uncertainty is correct, we believe that this is a price worth paying for the greater justice that it may bring.[13]

7.4 We have seen that, with a possible limited exception in the case of restitutionary claims based on the doctrine of *locus poenitentiae*,[14] illegality acts as a defence, rather than as a cause of action, under the present law. It is our provisional view that, in providing legislatively for the courts to exercise a discretion, rather than applying strict rules, it would be undesirable to depart from that basic defensive

Zealand legislation has been criticised (in particular for its failure to provide clear guidance as to its intended scope: see, M P Furmston, "The Illegal Contracts Act 1970 - An English View" (1972-1973) 5 NZULR 151) the introduction of a discretion in this area has been widely heralded as a success. See, for example, D W McLauchlan, "Contract and Commercial Law Reform in New Zealand" (1984-1985) 11 NZULR 36, 41; B Coote, "The Illegal Contracts Act 1970" in the New Zealand Law Commission, Contract Statutes Review (1993) ch 3; and R Cooke, in his review of *Consensus ad Idem: Essays in the Law of Contract in Honour of Guenter Treitel* (1998) 114 LQR 505, 509.

6 See Part IV above.

7 *Nelson v Nelson* (1995) 184 CLR 538, 612, *per* McHugh J.

8 *Tinsley v Milligan* [1994] 1 AC 340, 369, *per* Lord Browne-Wilkinson.

9 G Virgo, "The Effect of Illegality on Claims for Restitution in English Law" in W Swadling (ed), *The Limits of Restitutionary Claims: A Comparative Analysis* (1997) ch 6 p 173.

10 The adoption of a discretionary approach is rejected by G Virgo, "The Effect of Illegality on Claims for Restitution in English Law" in W Swadling (ed), *The Limits of Restitutionary Claims: A Comparative Analysis* (1997) ch 6 pp 178-179. And see F Rose, "Restitutionary and Proprietary Consequences of Illegality" in F D Rose (ed), *Consensus ad Idem: Essays in the Law of Contract in Honour of Guenter Treitel* (1996) ch 10 p 204.

11 See para 4.5 above for McHugh J's rejection of the "public conscience" test as providing an "unstructured discretion" in *Nelson v Nelson* (1995) 184 CLR 538, 612.

12 See paras 5.8 to 5.9 above.

13 J K Grodecki, "In pari delicto potior est conditio defendentis" (1955) 71 LQR 254, 260.

14 See paras 2.49 to 2.56 above.

role of illegality. In particular, we are anxious that a move to a discretionary approach should not cut across the common law approach to factors closely linked to illegality (such as formal requirements and capacity) that act defensively in rendering transactions unenforceable or void.[15] In developing the case for, and the scope of, a discretion, it is, therefore, illegality operating as a discretionary defence that we initially have in mind. We consider separately whether there is any need for reform, introducing a legislative discretion, of illegality as a restitutionary cause of action.[16] It follows that we are able to structure our main discussion of the case for, and the scope of, a discretion according to the same tripartite structure as we adopted in our review of the present law on illegal contracts in Part II. That is, we consider whether the courts should have a discretion as to the application of the illegality defence in relation to (i) the enforcement of contractual obligations; (ii) the reversal of unjust enrichment (where a contract is unenforceable for illegality); and (iii) the recognition of contractually transferred or created property rights.

(1) The enforcement of contractual obligations

(a) Contracts which involve the commission of a legal wrong

7.5 We have seen that where a plaintiff seeks to enforce a contract which involves the commission of a legal wrong (other than the mere breach of the contract in question), the defendant may plead illegality as a defence to what would otherwise be a standard remedy.[17] The courts have adopted a set of strict technical rules in order to establish whether or not the contract is enforceable. In some cases this has allowed the defendant to shelter behind the illegality and prevent the plaintiff claiming damages for breach of contract in circumstances where the plaintiff is unaware of the involvement of any illegality, which has arisen as a result of the defendant's conduct.[18] And not only may the plaintiff lose the opportunity to profit from the contract, but the defendant may retain any benefits already conferred at the plaintiff's expense.

7.6 In other cases, in order to avoid harsh decisions, the courts have drawn what appear to be arbitrary distinctions that are difficult to justify. For example, a distinction has sometimes been made at common law between cases where the plaintiff intended to perform the contract in an unlawful manner at the time at which he or she entered into it (in which case the contract is unenforceable) and cases where the plaintiff only formed the unlawful intention after the contract had been made (in which case the contract may be enforced). But it is hard to see the merits of such a distinction. In *St John Shipping Corporation v Joseph Rank Ltd*,[19] the shipper was entitled to his full freight because he only decided to overload his ship after he had agreed to carry the defendants' goods. Had he held this intention when he entered into the contract, Devlin J was of the opinion that he would not have been able to enforce it.[20] However, as Professor Treitel comments: "[I]t is not

[15] See further paras 7.73 to 7.87, especially para 7.83 below.

[16] See paras 7.58 to 7.69 below.

[17] See paras 2.2 to 2.31 above.

[18] See, for example, *Re Mahmoud v Ispahani* [1921] 2 KB 716 (discussed at para 2.5 above).

[19] [1957] 1 QB 267.

[20] [1957] 1 QB 267, 287-288. See further paras 2.29 to 2.31 above.

wholly clear why the purpose of the statute requires the contract to be unenforceable if it is known that the ship will be overloaded at the time of contracting, but not if this only becomes apparent while the goods are in the process of being loaded."[21]

7.7 In our provisional view these problems might be overcome if the current technical and confusing rules were replaced with a discretionary approach under which the court could decide whether or not it was in the public interest to enforce a contract which involved the commission of a legal wrong. Only by the adoption of such a discretion do we believe that fair decisions which reflect the policies behind the illegality rules could always be reached by the courts. The reference to the public interest would allow the courts to consider not only the general aim of doing justice between the parties to the dispute, but also to consider the wider policy issues (such as, upholding the dignity of the courts and deterring serious wrongdoing) that lie behind the present illegality rules. When those policy issues require that relief should be denied, the court may hold that the contract is not enforceable by the plaintiff, but in any other case the plaintiff should be left to his or her usual rights and remedies despite the illegality involved.[22] The result of the exercise of such discretion might be, of course, that the contract is enforceable by one party, in circumstances where it would not be by the other.

7.8 The introduction of such a discretion would, we believe, be of particular benefit in those cases presently falling within the implied statutory prohibition doctrine.[23] We have seen that the present rather formalistic approach adopted by the courts can result in unjust decisions.[24] As Professor Furmston notes, although in theory the implied statutory prohibition doctrine is a matter of legislative intention, in reality there is a large measure, conscious or unconscious, of judicial policy making.[25] And the frequency with which Parliament subsequently legislates to undo the effect of the judicial decisions suggests that the legislative intention is often wrongly construed.[26] By allowing the courts to decide whether or not it is in the public interest to enforce a contract which involves the breach of a statutory provision, not only would the courts be able to consider the purpose of the

[21] G H Treitel, "Contract and Crime" in *Crime, Proof and Punishment: Essays in Memory of Sir Rupert Cross* (1981) p 81 at p 95.

[22] See P Devlin, *The Enforcement of Morals* (1965) p 59: "The rule should be that everyone is entitled to his just deserts whether he has broken the law or kept it. The exception can be justified only when some other high purpose of society, higher than the grant of justice in the individual case, has to be served. When the grant of justice would cause public scandal, the merits of the individual case must yield to the necessities of the law. The law needs moral support and in return it must be prepared to support public morality; and where that would be outraged by the use of law, then, but only then, the law should refuse its aid."

[23] See paras 2.3 to 2.19 above.

[24] See para 5.4 above.

[25] M P Furmston, "Illegality - the Limits of a Statute" (1961) 24 MLR 394, 397. And see J Shand, "Unblinkering the Unruly Horse: Public Policy in the Law of Contract" [1972A] CLJ 144, 149: "The reality of the situation is that the legislator has probably never applied his mind to the problem of whether the contract or right should be enforceable." See also C Grunfeld, "Illegality - Statutory Criminal Offence in Performance of a Contract" (1957) 20 MLR 172.

[26] See, for example, para 2.16 n 37 and n 39 and para 2.17 n 43 above.

statutory provision which has been breached, but also other relevant issues such as the seriousness of the illegality involved and the proportionality of denying the claim. For example, it is hard to imagine that, if the Court of Appeal had been asking whether it was in the public interest to enforce the contract in *Phoenix General Insurance Co of Greece SA v Halvanon Insurance Co Ltd*,[27] the Court would have suggested that, had it not been able to find that the insurance company was in fact authorised to carry on the business, the insured should have been denied the right to enforce the insurance contract. None of the policy issues which support the illegality rules could be used to justify such a decision. There would have been no indignity to the court in assisting the insured; the insured were not trying to profit from their own wrong; the insurance company, which had committed the breach of statutory prohibition, was not likely to be deterred by the decision; and it was only the insured, the innocent party, who would have been "punished" by the outcome. Nor did the statute expressly lay down what should be the consequences of a contract which was entered into by the insurance company without authorisation.[28]

7.9 The discretionary approach enshrined in the New Zealand Illegal Contracts Act 1970 appears to have worked well in the area of implied statutory prohibition.[29] The courts have shown that they are willing to give effect to contracts which, although they involve the breach of a statutory prohibition, do not infringe the policy behind that prohibition. For example, in *Catley v Herbert*[30] the court validated a contract under which, in contravention of companies legislation, a company agreed to provide financial assistance for the purchase of its own shares. The court considered the clear purpose of the legislation to be the protection of the company's shareholders and creditors. On the facts of the case, no creditors were prejudiced and all shareholders affected were parties to the transaction. While the contract was technically unlawful, none of the reasons for which the legislation had been enacted had any application to the facts of the case. The court therefore ordered that the contract should be performed. On the other hand, in *NZI Bank Ltd v Euro-national Corporation Ltd*[31] the Court of Appeal refused to validate a contract which provided for financial assistance. In that case the major shareholders would have been adversely affected and had not been consulted about the scheme. The scheme was therefore inconsistent with the policy of the legislation.

7.10 **We ask consultees whether they agree with our provisional view that a court should have a discretion to decide whether or not illegality should act as a defence to a claim for contractual enforcement where the formation, purpose or performance of the contract involves the**

[27] [1988] QB 216. See para 2.17 above.

[28] For our provisional recommendation where a statute does expressly lay down what should be the consequences for a contract which involves a breach of the statute's provisions, see paras 7.94 to 7.102 below.

[29] See New Zealand Law Commission, Contract Statutes Review (1993) pp 17-21. But see B Coote, "Validation under the Illegal Contracts Act" (1992) 15 NZULR 80.

[30] [1988] 1 NZLR 606.

[31] [1992] 3 NZLR 528.

commission of a legal wrong (other than the mere breach of the contract in question). If consultees do not agree, we would ask them to explain why not.[32]

7.11 Where the plaintiff is seeking an equitable remedy for breach of contract, such as specific performance or an injunction, the equitable maxim "he who comes to equity must come with clean hands" may apply to deny the plaintiff relief. We consider the application of this maxim in further detail when we look at options for reform in relation to illegal trusts.[33] However, the provisional recommendation that we make there - that the maxim should have no application within the sphere of operation of our provisionally proposed discretion - is equally applicable in relation to claims for breach of an illegal contract. That is, we consider that it would be unfortunate if, under our provisionally proposed discretion, the court decided to award contractual enforcement, but the defendant was able to invoke the "clean hands" maxim in order to defeat the exercise of the discretion. In terms of the underlying policy and structure of the law one can say that our provisionally proposed discretion swallows up, and obviates the need for, a separate equitable discretion.

7.12 **Accordingly, we provisionally recommend that the equitable "clean hands" maxim should have no role to play in cases within the sphere of operation of our provisionally proposed discretion. We ask consultees whether they agree, and, if not, to explain why not.**

(b) Contracts which are otherwise contrary to public policy

7.13 So far we have only considered the enforcement of contracts that involve a legal wrong. The issue becomes more difficult where the contract is one which the court has declared to be otherwise contrary to public policy. The difficulty is that one cannot here separate the question as to whether the contract is contrary to public policy from the idea of giving the courts a discretion to refuse to enforce the contract as against the public interest. These are two sides of the same coin. In deciding whether or not a contract is contrary to public policy, the court is already effectively asking the question - would it be against the public interest to enforce the contract? Put another way, there is simply no scope for a discretion as regards enforceability which operates once the court has decided that a contract is contrary to public policy.

7.14 However, this assumes that the courts already have a discretion to determine what contracts, although they do not involve a legal wrong, should not be enforced in the light of the public policy of the present day. That is, the courts must be able to recognise that contracts which were once regarded as contrary to public policy may no longer be so today and that contracts which were previously regarded as innocuous, may now be contrary to public policy. The courts do recognise that they have some flexibility here.[34] For example, in a recent case[35] involving the

[32] Consultees who disagree may wish to bear in mind our general question posed at para 7.117 below.

[33] See paras 8.89 to 8.91 below.

[34] See para 1.9 n 27 above. For an early example of public policy changing over time see *Bowman v Secular Society Ltd* [1917] AC 406. In 1867 it had been held that a contract to

payment of contingency fees to solicitors (which, unless satisfying the requirements of the Courts and Legal Services Act 1990[36] were regarded as champertous and therefore contrary to public policy and void), Millett LJ said it was time to reconsider such arrangements afresh in the light of modern conditions: the Court of Appeal held that it was no longer to be regarded as contrary to public policy for a solicitor acting for a party to litigation to agree to forgo all or part of his or her fee if the case was lost, provided that the solicitor did not seek to recover more than his or her ordinary profit costs and disbursements if the case was won. Such flexibility in relation to precedent is not unique to this area of the law. For example, the courts have recognised that the question of what is a charitable trust changes over time.[37]

hire a meeting hall to promote atheism was contrary to public policy (*Cowan v Milbourn* (1867) LR 2 Ex 230) but this view was rejected by the House of Lords in *Bowman v Secular Society Ltd* [1917] AC 406. See also, for example, *Multiservice Bookbinding Ltd v Marden* [1979] Ch 84 where the High Court declined to follow *obiter dicta* in a judgment some 20 years earlier and held that an index-linked money obligation was not contrary to public policy. See also, *Stephens v Avery* [1988] 1 Ch 449 where, in a case in which the defendant claimed that a duty of confidence should not be enforced because the subject matter was grossly immoral, Sir Nicolas Browne-Wilkinson VC distinguished an earlier case, *Glyn v Weston Feature Film Company* [1916] 1 Ch 261 in which the court had refused to enforce a copyright on similar grounds. He said: "In 1915 there was a code of sexual morals accepted by the overwhelming majority of society. A judge could therefore stigmatise certain sexual conduct as offending that moral code. But at the present day no such general code exists. ... Only in a case where there is still a generally accepted moral code can the court refuse to enforce rights in such a way as to offend that generally accepted code." This reasoning was followed by the Court of Appeal in *Armhouse Lee Ltd v Chappell, The Times* 7 August 1996 where an award of damages was made for breach of a contract to advertise telephone sex lines. The case law on champerty and maintenance shows most clearly that what is regarded as contrary to public policy may change over time. See *Giles v Thompson* [1994] 1 AC 142, 164, *per* Lord Mustill: "[T]he law on maintenance and champerty has not stood still, but has accommodated itself to changing times: as indeed it must if it is to retain any useful purpose".

35 *Thai Trading Co v Taylor* [1998] QB 781. And see *Bevan Ashford v Geoff Yeandle (Contractors) Ltd* [1998] 3 WLR 172, 181, *per* Sir Richard Scott VC: "But notions of public policy change with the passage of time and an arrangement or agreement held in the past to be champertous and consequently unlawful and void need not necessarily be so held today". But note that in *Hughes v Kingston upon Hull CC, The Times* 9 December 1998 *Thai Trading* was held, by the Divisional Court of the Queen's Bench, to be wrong as inconsistent with the House of Lords' decision in *Swain v The Law Society* [1983] AC 598. We understand that there is to be an appeal to the House of Lords in *Thai Trading*.

36 See section 58 of the Courts and Legal Services Act 1990. See now the Conditional Fee Agreements Order SI 1998/1860 which extends the range of cases in which solicitors may enter into conditional fee agreements (including an uplift in fee if the case is won) to all civil cases excluding specified family proceedings.

37 See *IRC v McMullen* [1981] AC 1, 15, *per* Lord Hailsham: "What has to be remembered, however, is that ... both the legal conception of charity, and within it the educated man's ideas about education, are not static, but moving and changing. Both change with changes in ideas about social values. Both have evolved with the years. In particular in applying the law to contemporary circumstances it is extremely dangerous to forget that thoughts concerning the scope and width of education differed in the past greatly from those which are now generally accepted." See also *Heglibiston Establishment v Heyman* (1978) 36 P&CR 351 where the Court of Appeal was required to decide whether the cohabitation of an unmarried couple constituted the breach of a covenant not to use a property for an "immoral purpose". The court held that to the extent that an earlier decision of the

7.15 However, the ability of the courts to ignore earlier decisions on public policy is not free from doubt, and the lower courts in particular may feel bound by the earlier decisions of the Court of Appeal or House of Lords. We therefore provisionally consider that it would be sensible if our legislative proposals could make it clear that the question whether a contract which does not involve the commission of a legal wrong is otherwise contrary to public policy should be decided in the light of present day public policy.

7.16 **Accordingly our provisional view is that a court should not be given a discretion to enforce contracts which do not involve a legal wrong but which the court declares to be otherwise contrary to public policy. That is, the question of the enforcement of such contracts should continue to be governed by the common law. It is, however, our provisional view that a legislative provision should make it clear that the courts are to judge whether a contract is contrary to public policy in the light of policy matters of the present day and that contracts which were previously considered to be contrary to public policy may no longer be so and *vice versa*. We ask consultees whether they agree with these provisional views and, if not, to explain why not.**

(2) The reversal of unjust enrichment (where a contract is unenforceable for illegality)

7.17 In this area we do not feel we need to distinguish between contracts which involve a legal wrong and contracts which are otherwise contrary to public policy. The issues which arise are the same in both cases. Our review of the present law[38] has shown that where a plaintiff seeks restitution in respect of benefits that he or she has conferred under an illegal contract, an unmeritorious defendant may rely on the illegality defence in order to defeat the plaintiff's claim. A technical approach is taken to the question whether the parties are *in pari delicto* and the plaintiff's claim will fail unless he or she can show that, for example, he or she entered into the contract under duress, conferred the benefit by mistake, or was a member of a vulnerable class protected by statute. No weight would appear to be attached to the fact that the plaintiff is seeking to reverse, rather then exploit, the illegal contract, and that the failure of his or her claim may be to leave the (guilty) defendant with a large windfall.[39]

7.18 Particularly hard decisions may be reached where both parties are unaware of the illegality involved. One such case is *Harse v Pearl Life Assurance Co*.[40] A plaintiff who had unwittingly paid premiums under an illegal and void life insurance contract was held unable to recover them. The court ruled that because the defendant insurer was also unaware of the illegality of the insurance contract, the

Divisional Court in *Upfill v Wright* [1911] 1 KB 506 would have required such a finding, that decision should be regarded as wrong.

[38] See paras 2.32 to 2.48 above.

[39] See, for example, *Parkinson v College of Ambulance Ltd and Harrison* [1925] 2 KB 1 (discussed at para 2.35 above).

[40] [1904] 1 KB 558. See para 2.42 above.

parties were *in pari delicto* and the defendant could rely on the illegality defence to defeat the plaintiff's claim.

7.19 Some of the main criticisms of the illegality defence as it applies in restitutionary claims are summed up by Professor Rose: "[I]t is ... commonly accepted that the rules denying relief to a plaintiff who has been involved in illegality are crude and capricious, generally fail to discriminate between the relative demerits of the parties and may penalise a plaintiff disproportionately to the relevant wrongdoing."[41]

7.20 It is our provisional view that each of these criticisms may be met by the adoption of the same discretionary approach that we have provisionally recommended should apply in relation to the enforcement of contracts involving a legal wrong. That is the court should have a discretion whether or not to allow a plaintiff who, applying the standard law on restitution, has a claim for restitution[42] to recover benefits conferred under an illegal contract. So, for example, say that the plaintiff had carried dangerous goods for the defendant in flagrant breach of a statutory provision which required all carriers of such goods to be properly licensed. After the plaintiff has carried the goods, the defendant refuses to pay the fee. Under our provisionally proposed discretion, the court might decide that it would not be in the public interest to allow the plaintiff to enforce the contract. The plaintiff might then bring an alternative claim for a *quantum meruit* (based on failure of consideration) for the work which he had performed. If he can show that, under the general principles of the law of restitution he would be entitled to bring such a claim,[43] then, under our provisionally proposed discretion, the court would need to decide whether or not, despite the involvement of illegality, it should allow the restitutionary claim. Or, say that the plaintiff entered into an insurance contract with the defendant, an alien enemy, both parties being unaware that hostilities have broken out before the contract is made. The insured event occurs, but the defendant refuses to cover the plaintiff's claim. The court might decide that the insurance contract is contrary to public policy and therefore unenforceable. The plaintiff could then bring an alternative claim for the recovery of his premiums, based on a failure of consideration. If the plaintiff can show that under the general principles of restitution he would be entitled to bring such a claim, then, under our

[41] F D Rose, "Gratuitous Transfers and Illegal Purposes" (1996) 112 LQR 386, 388. See also, R Merkin, "Restitution by Withdrawal from Executory Illegal Contracts" (1981) 97 LQR 420, 443-444.

[42] That is, we do not provisionally recommend that the fact that the defendant, as a result of the unenforceability of the contract, would otherwise retain a benefit, is in itself sufficient to justify a restitutionary claim. This should be contrasted to the approach adopted under the Israeli Contracts (General Part) Law 1973. Section 31 imposes the same duty of mutual restitution that section 21 applies after rescission of a contract - that is, a general duty on each party to restore to the other party what he or she has received under an illegal contract or, if restitution is impossible or unreasonable, to pay him or her the value of what he or she has received. The court may, if it deems it just so to do and on such conditions as it sees fit, relieve a party from the whole or part of this obligation.

[43] In order to show that such a claim would succeed under the general principles of the law of restitution, the court will need to be satisfied that allowing the restitutionary claim would not undermine its refusal to enforce the contract: see the discussion at para 2.37 especially n 109 above.

provisionally proposed discretion, the court would need to decide whether or not, despite the involvement of illegality, it should allow the restitutionary claim.

7.21 In exercising its discretion, the court would be able to take into account factors which reflect the policy issues underlying the illegality rules, such as the seriousness of the illegality and the plaintiff's involvement in it. We look at these in detail below in examining whether the courts' discretion should be structured.[44]

7.22 **We ask consultees whether they agree with our provisional view that a court should have a discretion to decide whether or not illegality should be recognised as a defence to a claim for the reversal of unjust enrichment in relation to benefits conferred under a contract which is unenforceable for illegality. If consultees do not agree with this provisional view, we would ask them to explain why not.**

(3) The recognition of contractually transferred or created property rights

7.23 As we have seen,[45] the general position is that the law does recognise that property passes under an illegal contract. We have already suggested that the greater protection given by the present law to proprietary rights transferred or created under an illegal contract than to personal rights might be regarded as out-moded and that one could argue that the same rules should apply in both cases.[46] We therefore suggest that the same discretionary approach which we have provisionally recommended in relation to contractual enforcement and restitution should apply in relation to the recognition of contractually transferred or created property rights.

7.24 We believe that a great merit of this provisional proposal would be the abandonment of the "reliance" principle in this area. Even if, in reality, the courts frequently ignore its application, the mere fact that the courts pay lip service to such a principle is a cause of confusion and potential injustice.[47] For example, as we have seen in *Bowmakers Ltd v Barnet Instruments Ltd*,[48] there is no satisfactory explanation as to how the plaintiff was able to show title to the tools hired to the defendants under the second agreement without relying on the illegal contracts of

[44] See paras 7.27 to 7.43.

[45] See paras 2.57 to 2.69 above.

[46] See para 5.6 above.

[47] See R N Gooderson, "Turpitude and Title in England and India" [1958] CLJ 199, 210. And see J D McCamus "Restitutionary Recovery of Benefits Conferred under Contracts in Conflict with Statutory Policy - the New Golden Rule" (1987) 25 Osgoode Hall LJ 787, 816: "The availability of relief is dependent on the happenstance of the manner in which the proprietary aspects of the impugned transaction have been structured." For example, it would seem that a plaintiff who transferred his or her whole interest in property under an illegal contract in return for a promise that the defendant should return it in a number of years would be unable to claim back the property at the end of that period, since that would amount to enforcing the illegal contract. But had the plaintiff transferred only a limited interest in the property determinable in a number of years, he or she could claim the property back at the end of the period by arguing that this amounts to reliance on his or her reversionary rights, rather than the illegal contract itself.

[48] [1945] KB 65. See paras 2.63 to 2.64 above.

hire-purchase. To suggest, as the Court of Appeal did, that the plaintiff was able to do so merely invites confusion.

7.25 However, in relation to title questions, a further question arises since it is not only the original parties to the contract who may be affected. We also need to consider the position of a third party purchaser who has acquired apparent title from the transferee. We do not want to create even the possibility of the "proprietary" rights of a bona fide third party purchaser of the property, who did not have notice of the illegality, being undermined by the exercise of our proposed statutory discretion. This difficulty has been explicitly recognised by the New Zealand legislation. The New Zealand Illegal Contracts Act 1970 creates an exception, to its general principle that an illegal contract does not transfer or create property rights, in favour of a third party who, acting in good faith, for valuable consideration and without notice of the illegality, subsequently acquires property from one of the parties to an illegal contract.[49] We therefore provisionally propose that where property has been transferred to a third person for value who is unaware that the person transferring it to him or her acquired the property under an illegal contract then, whether or not the court would have recognised that property had passed under the first contract,[50] property should pass to the third person.[51]

7.26 **We ask consultees whether they agree with our provisional view that (a) a court should have a discretion to decide whether illegality should act as a defence to the recognition of contractually transferred or created property rights where the formation, purpose or performance of the contract involves the commission of a legal wrong (other than the mere breach of the contract in question) or is otherwise contrary to public policy; but (b) that illegality should not invalidate a disposition of property to a third party purchaser for value without notice of the illegality.**

[49] Section 6(1)(a) and (b). See also section 31 of the Israeli Contracts (General Part) Law 1973 which provides that the court may, if it considers it just to do so and on such considerations as it sees fit, relieve a party of the whole or part of the duty to make restitution. It has been suggested that the court should use its discretion to limit the transferor's right to restitution to a personal claim in any case where the property transferred under an illegal contract has been subsequently acquired by a bona fide third party for value: D Friedmann, "Consequences of Illegality under the Israeli Contract Law (General Part) 1973" (1984) 33 ICLQ 81, 94-95.

[50] The result may, therefore, be beneficial to the illegal contract transferee who, had he or she been unable to transfer title, would have faced a claim for breach of contract from the third party and, even though he or she had performed his or her side of the illegal contract, might have failed in a restitutionary claim against the illegal contract transferor if, because of the illegality, the court did not think that it was in the public interest for the claim to succeed. However, in these circumstances we consider that the importance of securing security of ownership for the third party should override considerations of the policies that lie behind the illegality rules and which might, otherwise, have deprived the transferee of recognition of his of her proprietary rights created under the illegal contract.

[51] That third person would then have good title to pass on to a subsequent purchaser, even if that subsequent purchaser were aware of the illegality. The validity of the subsequent purchaser's title would only be brought into question if the contract which he or she entered into with the third party was, itself, an illegal contract.

2. STRUCTURING THE DISCRETION

7.27 Our provisional proposals above in relation to the illegality defence have involved giving the courts a discretion to apply the public interest. We now need to consider the ingredients of (that is, the factors involved in applying) this discretion. As we have seen, some commentators reject the adoption of a discretionary approach because they believe that it will create uncertainty.[52] But we consider that that uncertainty can be reduced by structuring the discretion: that is, by providing guidance as to the factors that the court should consider when reaching its decision. In this section we consider what we provisionally believe those factors should be.

7.28 The aim of the provisionally proposed discretionary approach is to ensure that the courts' decisions reflect the policies that lie behind the illegality rules. In Part VI we identified four such policies: (i) upholding the dignity of the courts; (ii) preventing the plaintiff from profiting from his or her own wrongdoing; (iii) deterring illegality; and (iv) punishment. The relevant factors structuring the discretion should therefore be ones which ensure that those policies are properly reflected in the outcome of the particular case.

(1) The seriousness of the illegality

7.29 A major criticism of the present rules on the effect of illegality is that they take little account of the seriousness of the illegality that is involved. So, for example, it would appear that there is no difference in the rules applied where a party enters into a contract intending to commit murder in its performance, and where a party enters into a contract in the knowledge that he or she will have to commit a parking offence in order to perform it.[53]

7.30 On the one hand, the result of such rigidity is that the plaintiff may be required to forfeit his or her usual rights and remedies where the illegality is only slight and where his or her loss may be great. Indeed, the refusal to award civil relief can result in the plaintiff suffering an economic penalty far greater than any applicable criminal sanction. For example, in *St John Shipping Corporation v Joseph Rank Ltd* Devlin J pointed out that had the defendants' arguments in relation to statutory illegality been successful, "[a] shipowner who accidentally overloads by a fraction of an inch will not be able to recover from any of the shippers or consignees a penny of the freight".[54] He was pleased to be able to avoid such a result, yet was apparently prepared to accept that had the shipper *deliberately* contracted to overload his ship by a fraction of an inch, he would have forfeited his claim to the whole freight.[55]

7.31 On the other hand, the failure to take account of the seriousness of the illegality may allow the plaintiff to claim to fall within some technical exception to the

[52] See para 7.3 n 10 above.

[53] For criticism see, in particular, J D McCamus, "Restitutionary Recovery of Benefits Conferred under Contracts in Conflict with Statutory Policy - the New Golden Rule" (1987) 25 Osgoode Hall LJ 787, 821.

[54] [1957] 1 QB 267, 281.

[55] [1957] 1 QB 267, 287-288.

general non-recovery rules and recover even though his or her behaviour is heinous. As Lord Goff pointed out in his dissenting speech in *Tinsley v Milligan*, a strict application of the majority decision would mean that a plaintiff who had contributed towards the purchase price of a house to be used for terrorist activities would be able to invoke the assistance of the court in order to establish an equitable interest in the property.[56]

7.32 Yet if one looks at the policy issues that we have identified as lying behind the illegality rules, one can see that each bears far greater weight where the illegality involved is particularly serious. The dignity of the court can only be at risk where the conduct involved is morally "shocking". In many cases, particularly those involving statutory illegality, this will clearly not be the case. As Bingham LJ said in *Saunders v Edwards*: "[I]t is unacceptable that the court should, on the first indication of unlawfulness affecting any aspect of a transaction, draw up its skirts and refuse all assistance to the plaintiff, no matter how serious his loss nor how disproportionate his loss to the unlawfulness of his conduct."[57] The case law has already identified that the principle that the plaintiff may not profit from his or her own wrong is properly of limited application,[58] and the justification for pursuing the aims of deterrence and punishment is clearly that much greater where the illegality involved is serious. We therefore provisionally consider that in deciding whether or not it would be contrary to the public interest to allow the plaintiff's claim the court should consider the seriousness of the illegality involved. This would include considering whether the behaviour has been stigmatised as criminal, what sanctions might be invoked, and the manner in which the illegality was committed or intended.

(2) The knowledge and intention of the plaintiff

7.33 In some circumstances under the present law the knowledge and intention of the plaintiff[59] is very relevant to the effect of illegality on a contract. For example, at common law a contracting party does not lose his or her right to enforce a contract simply because the other party intends or chooses to perform it in an unlawful manner or for an unlawful purpose. The innocent party may still enforce the contract.[60] However, in at least two circumstances the knowledge and intention of the plaintiff would not seem to be taken into account. First, where the contract is held to be impliedly prohibited by statute;[61] and secondly, though more doubtfully, where the contract cannot be performed in accordance with its terms without the commission of a legal wrong or conduct otherwise contrary to public policy.[62]

[56] [1994] 1 AC 340, 362.

[57] [1987] 1 WLR 1116, 1134.

[58] See para 6.8 above.

[59] By "plaintiff" we mean to refer to the person who is seeking to rely on what would, illegality apart, be his or her normal legal rights and remedies.

[60] See paras 2.24 to 2.31 above.

[61] See para 2.5 above.

[62] See paras 2.20 to 2.23 above.

7.34 In claims for restitution we have seen that the *in pari delicto* rule does allow some consideration to be given to the guilt or innocence of the plaintiff. Thus illegality can seldom be pleaded as a successful defence to claims for the recovery of benefits conferred under contracts entered into as a result of duress or mistake. However, where both parties are guilty (or even both innocent), the defendant may shelter behind the illegality in order to resist the plaintiff's claim.

7.35 The adoption of the reliance principle in relation to the recognition of property rights created under illegal contracts has reduced the issue of the delictum of the parties to a purely technical and procedural question. Whether or not the plaintiff will be able to recover will turn on fortuitous factors such as how the agreement was structured and the technical rules of pleading.[63]

7.36 But it is our provisional view that the knowledge and intention of the plaintiff must play a central role in deciding whether the policy reasons which lie behind the illegality rules can be relevant to the particular case. Little weight can be given to the argument that it would be an indignity to the court to assist the plaintiff where he or she is wholly unaware of the involvement of illegality. And indeed the courts have recognised that the principle that the plaintiff should not be allowed to profit from his or her own wrongdoing should not be applied where the plaintiff does not know that the act is unlawful or is not in any way morally culpable.[64] Although in limited cases relief may be refused to an innocent party on the grounds that it will deter others or act as a punishment, such action is clearly harder to justify than where the plaintiff is aware of and intends the illegality.

7.37 We do not, however, provisionally recommend that, in deciding whether or not it is in the public interest to deny the plaintiff's claim, the courts should weigh up the plaintiff's "guilt" against that of the defendant. That is, we do not suggest that the courts should undertake a balancing exercise of the merits and demerits of the parties to the dispute, awarding relief only where the plaintiff is the more virtuous.[65] Since the illegality defence acts to deprive the plaintiff of rights or remedies which he or she would otherwise have been able to claim, it should only succeed where the plaintiff's conduct relating to the illegality makes such a result imperative in order to protect the public interest. The guilt or innocence of the defendant should have no bearing.[66]

(3) Whether denying relief will act as a deterrent

7.38 We have seen that deterrence is one policy that lies behind the illegality rules, and we provisionally recommend that the potential deterrent effect of their decision is another factor that the courts should take into account when deciding whether or not to allow the plaintiff's claim. The general principle is that refusing to award

[63] See para 7.24 above.

[64] *Strongman (1945) Ltd v Sincock* [1955] 2 QB 525, 535, *per* Denning LJ cited at para 6.8 above.

[65] In some cases, of course, the defendant's conduct will be relevant in assessing the plaintiff's knowledge and intention - for example, where the defendant has misled the plaintiff as to the legality of the contract.

[66] See *Taylor v Bowers* (1876) 1 QBD 291, 297, *per* James LJ.

the plaintiff relief will deter others from entering into or performing under similar illegal contracts. But clearly refusing relief will not act as an appropriate deterrent in all circumstances[67] and the court will need to act on a case-by-case basis. For example, following the decision in *Mohamed v Alaga & Co*,[68] one might argue that unscrupulous solicitors will not be deterred and may even be more likely to enter into contracts to share their fees in breach of the Solicitors' Practice Rules, knowing that any such contract would be unenforceable by the other party even after the performance of work.

(4) Whether denying relief will further the purpose of the rule which renders the contract illegal

7.39 We believe that a court should also have in mind the purpose of the rule which renders the contract illegal in the particular case before it. In each case the court should ask whether its decision will further the purpose which the rule promotes. This consideration clearly played a very important role in *Nelson v Nelson*.[69] In particular, McHugh J said that the courts should not refuse to enforce legal or equitable rights simply because they arose out of or were associated with an unlawful purpose unless, *inter alia*, "the imposition of the sanction is necessary, having regard to the terms of the statute, to protect its objects or policies".[70] Indeed Professor Treitel has suggested that this question, whether success or failure of the civil claim would be more likely to promote the purpose of the invalidating rule, should be the decisive issue in all cases.[71]

7.40 This factor must, however, be applied carefully. For although allowing the particular plaintiff before the court to enforce the contract might not defeat the purpose of the rule which rendered the contract illegal, the court must keep in mind the principle that like cases should be treated alike, and that allowing the plaintiff's claim might open the door to others. So, for example, one might say that the object of the Australian statute in the *Nelson* case - to provide subsidised housing for those in financial need - would indeed have been defeated if every person seeking financial assistance were able to hide his or her real assets and make a successful claim.

[67] Indeed some commentators argue that the policy of deterrence is just as likely to be achieved by allowing a remedy as by denying it, for if one party to an illegal transaction knew that the other party would be able to obtain restitution of benefits conferred, it would stop him or her entering into the illegal transaction in the first place: G H Treitel, "Contract and Crime" in *Crime, Proof and Punishment: Essays in Memory of Sir Rupert Cross* (1981) p 81 at p 100; G Virgo, "The Effect of Illegality on Claims for Restitution in English Law" in W Swadling (ed), *The Limits of Restitutionary Claims: A Comparative Analysis* (1997) p 141 at pp 183-184. See also, *Tinsley v Milligan* [1994] 1 AC 340, 368, *per* Lord Lowry.

[68] [1998] 2 All ER 720. See para 2.37 above.

[69] (1995) 184 CLR 538. See para 3.28 above.

[70] (1995) 184 CLR 538, 613.

[71] G H Treitel, "Contract and Crime" in *Crime, Proof and Punishment: Essays in Memory of Sir Rupert Cross* (1981) p 81.

(5) Whether denying relief is proportionate to the illegality involved

7.41 We have explained that we accept that punishment is a legitimate aim of the civil law.[72] However, it is not a policy that can be easily pursued by the present strict illegality rules. The simple refusal of civil relief is generally a very arbitrary and blunt method of meting out punishment, since the penalty is not in any way tailored to fit the illegality involved. And clearly there will be a risk of "double punishment" where the plaintiff has already been convicted of a criminal offence or made to pay damages for a legal wrong in respect of the same conduct.

7.42 Another factor that we therefore provisionally consider that the court should take into account is whether the penal effect of denying the plaintiff relief is proportionate to the illegality involved. If, for example, the illegality is trivial but the value of benefits which the plaintiff has conferred on the defendant is vast, then denying a restitutionary claim might be an excessive penalty. Likewise, if a sanction has already been imposed on the plaintiff in respect of his or her unlawful conduct, then the additional denial of civil relief might be regarded as unduly harsh. In those cases where criminal or other civil proceedings in respect of the same conduct are likely or have already been commenced but not yet concluded, the court may find it appropriate to use its inherent power to stay proceedings[73] and await the outcome of that other trial before coming to its decision.

7.43 **We ask consultees whether they agree with our provisional view that the proposed discretion should be structured so that the court should be required to take into account specific factors in reaching its decision; and that those factors should be: (1) the seriousness of the illegality involved; (2) the knowledge and intention of the plaintiff; (3) whether denying relief will act as a deterrent; (4) whether denying relief will further the purpose of the rule which renders the contract illegal; and (5) whether denying relief is proportionate to the illegality involved. We also ask consultees whether there are any other factors which they consider the courts should take into account in exercising the discretion. If consultees do not agree with our provisional view, we would ask them to explain why not.**

3. WHAT SHOULD BE THE STARTING POINT OF THE PROVISIONALLY PROPOSED DISCRETION?

7.44 So far, we have suggested that the court should have a discretion to decide whether illegality should act as a defence and that that discretion could be usefully structured. However, we now need to consider what, if any, starting point there should be for the exercise of the discretion. That is, for example, should a contract which involves the commission of a legal wrong be presumed to be unenforceable unless the court decides otherwise; or, should it be presumed to be enforceable unless the court declares that it is not?

[72] See para 6.11 above.

[73] The inherent jurisdiction of the court to stay proceedings is preserved under section 49(3) of the Supreme Court Act 1981.

7.45 We look first at the question of contractual enforcement. It is interesting to see the starting point chosen in other jurisdictions which have adopted a discretionary approach. The New Zealand Illegal Contract Acts 1970 provides that:[74]

> Notwithstanding any rule of law or equity to the contrary, but subject to the provisions of this Act and of any other enactment, every illegal contract shall be of no effect and no person shall become entitled to any property under a disposition made by or pursuant to any such contract ...

The Act goes on to confer a very wide power upon the court to grant relief to the parties to the illegal contract, including the power to award compensation or "validation" of the contract.[75]

7.46 Under the Israeli Contracts (General Part) Law 1973 "a contract the making, contents or object of which is or are illegal, immoral or contrary to public policy is void".[76] But, in so far as one party has fulfilled his obligation under the illegal contract, the court may "require the other party to fulfil the whole or part of the corresponding obligation".[77]

7.47 Both the New Zealand and Israeli statutes therefore start with the assumption that an illegal contract is unenforceable, but provide the courts with a discretion (in limited circumstances under the Israeli legislation) to order enforcement.

7.48 In its Report on Illegal Transactions, the Law Reform Commission of British Columbia considered whether the common law "general rule" that a court will not intervene to assist in an illegal transaction should be retained. It concluded that it should, but that the court should have a discretion to grant relief. It said:

> We have concluded that the general rule does perform a useful function. While the case for deterrence can be overstated, the general rule has some deterrent effect. ... Similarly, although the notion that no plaintiff with "polluted hands" should touch "the clear springs of justice" ... may be outdated, the law should be responsive to public attitudes, and given the large amount of public money underwriting the judicial system, it is right that transactions involving attempts to act in a fashion contrary to public policy should be *prima facie* unenforceable. While a potential litigant should not be punished in a civil proceeding, neither should the courts be compelled to adjudicate a dispute between highwaymen.[78]

[74] Section 6(1).

[75] Section 7(1).

[76] Section 30.

[77] Section 31.

[78] Law Reform Commission of British Columbia, Report on Illegal Transactions (1983) pp 55-56. Contrast the recommendations of the Law Reform Committee of South Australia (37th Report Relating to the Doctrines of Frustration and Illegality in the Law of Contract, 1977) and the Ontario Law Reform Commission (Report on Amendment of the Law of Contract, 1987). Both recommended that the courts should be given power to provide relief against the consequences of a contract being unenforceable because of illegality.

7.49 One might put forward, however, an argument to suggest that, contrary to these approaches in other jurisdictions, a better starting point in relation to our provisional proposals would be to provide that all contracts which involve a legal wrong are *prima facie* valid and enforceable, but that the court should have a discretion to refuse enforcement where the court considers that it would not be in the public interest to allow the plaintiff's claim. The scope of our provisional proposals is very much wider than that of the New Zealand and Israeli statutes and to suggest that any contracts which fall within it are *prima facie* unenforceable might cause needless commercial uncertainty. We are considering here the enforcement of any contract "the formation, purpose or performance of which involves a legal wrong (other than a mere breach of the contract in question)".[79] The New Zealand Illegal Contracts Act applies only to "any contract that is illegal at law or in equity". Although, not surprisingly, the Act has been much criticised for failing to provide a clear demarcation of its application,[80] the important point for us here is that there is no doubt that many of the contracts that we are here considering are excluded from it. There is never any doubt, therefore, that such contracts will be enforceable. The Israeli Act applies to any contract "the making, contents or object of which is or are illegal, immoral or contrary to public policy". Again, the scope of the statute is not as wide as our proposals because it would not appear to deal with contracts where the only illegality involved lies in the chosen mode of performance.

7.50 In addition, the concept of a "legal wrong" which we have adopted is very wide. It includes not only all criminal offences, which may range from the most heinous of crimes to a minor breach of statutory regulation, but also all civil wrongs (other than the mere breach of the contract in question) and breaches of statutory prohibitions.[81] But as we have seen, in relation to civil wrongs the case law suggests that it is only contracts which have as their object the deliberate commission of a tort that are currently unenforceable.[82] To suggest that all contracts that in their formation, purpose or performance involve the commission of a tort or breach of contract, even unintentionally, should be *prima facie* unenforceable, might cause unnecessary confusion. Owing to the potentially wide scope of the illegality rules, one might argue that the presumption that contracts involving a legal wrong are enforceable better reflects society's expectations of the law than that they are *prima facie* unenforceable.

However, they also both recommended that the common law rules by which relief may be granted to persons whose contract would otherwise be caught by illegality should be retained. Commenting on section 6 of the New Zealand Illegal Contracts Act 1970 which provides that every illegal contract shall be of no effect, the Law Reform Committee of South Australia wrote(at p 25): "Here we part company with the New Zealand draftsman. As we have already pointed out the common law has already provided a number of ways in which relief may be granted to persons whose contracts would otherwise be caught by illegality either at common law or by statute ... and it would seem unfortunate to force contracts with very varying kinds of illegality into a strait jacket".

79 See further paras 7.70 to 7.72 below.

80 M P Furmston, "The Illegal Contracts Act 1970 - An English View" (1972-1973) 5 NZULR 151.

81 See para 1.6 above.

82 See para 2.23 above.

7.51 Of course, it might at first sight look odd that a contract to commit murder would be *prima facie* enforceable. But there could be no doubt that, in the unlikely event that such a contract ever came before a court, the proposed discretion would be exercised to prevent enforcement. The starting point is merely intended to be an indicator of the position which seems likely to reflect the preferred outcome in the vast majority of cases. Provided that the discretion is exercised rationally, this "enforceable unless ..." approach should not lead to different results than the alternative "unenforceable unless ..." approach.

7.52 We should stress that, in our view, an "enforceable unless ..." approach would have much the same deterrence value as an "unenforceable unless ..." approach. A party who knowingly enters into a contract which involves a legal wrong could not be sure that the court would enforce it in the event that the other party failed to perform.

7.53 The same question arises in relation to claims for restitution pursuant to a contract which is unenforceable for illegality. Where the plaintiff can show that under the general principles of restitution he or she would be allowed to recover benefits conferred, should he or she have a *prima facie* claim, subject to the court's discretion to refuse the claim where it considers that it would not be in the public interest to allow it to succeed? Or should the plaintiff's claim be *prima facie* deemed to fail because of the involvement of illegality, unless the court declares otherwise? This issue is not directly addressed by the New Zealand legislation, but as we have already noted,[83] the Israeli legislation goes further than allowing a *prima facie* claim to restitution and imposes a duty to restore any benefit received under an illegal contract. And indeed one might argue that there is even stronger reason to suggest that the restitutionary claim should *prima facie* succeed despite the involvement of illegality, since here the plaintiff is not seeking the court's assistance to further the illegal activity, but rather to undo what has been done.

7.54 Under the present law, where a disposition of property is made under a contract which involves the commission of a legal wrong or which is otherwise contrary to public policy, that disposition, and any limitation accompanying it, is *prima facie* effective and enforceable.[84] What, if any, should be the starting point under our provisionally proposed discretion?

7.55 The position adopted by the New Zealand legislation is the converse of our present common law rules. Following the recommendations of the Contracts and Commercial Law Reform Committee, the New Zealand Illegal Contracts Act 1970 provides that generally no person shall become entitled to any property under a disposition made by or pursuant to an illegal contract.[85] And the Israeli Contracts (General Part) Law 1973 imposes a duty on each party to an illegal contract to restore to the other party what he or she has received under the contract or, if restitution is impossible or unreasonable, to pay him or her the value

[83] See para 7.20 n 42 above.

[84] See para 2.57 above.

[85] Section 6.

of what he or she has received.[86] As a result of this provision it has been suggested that under Israeli law illegal contracts are now governed by the general principle that they do not operate to transfer title from one party to another.[87]

7.56 On the other hand, one might argue that there is greater need for certainty in relation to the recognition of property rights, and that it would be more appropriate, less likely to cause uncertainty, and more in line with the existing case law, to presume in favour of the validity of any dispositions of property in the absence of compelling reasons to rebut this presumption.

7.57 **We ask consultees whether they consider that the starting point of the provisionally proposed discretion should be:**
(a) that illegality will act as a defence unless the court declares otherwise;
(b) that the plaintiff's claim will be allowed unless the court decides that because of the involvement of illegality it would not be in the public interest to allow the claim;
(c) one which varies according to whether the claim is for contractual enforcement; restitution pursuant to a contract which has failed for illegality; or the recognition of contractually transferred or created property rights; or
(d) that a claim by a party who has neither carried out nor intends to carry out the illegality will be allowed, unless the court declares otherwise; but a claim by a party who has carried out or intends to carry out the illegality will be refused, unless the court declares otherwise.
Alternatively we ask consultees whether they consider that it would be preferable that no starting point should be expressed.

4. ILLEGALITY AS A RESTITUTIONARY CAUSE OF ACTION: THE DOCTRINE OF *LOCUS POENITENTIAE*

7.58 So far we have only considered reform of the law on illegality acting as a defence. We now need to consider whether there are any circumstances in which the involvement of illegality should provide a cause of action. We have seen that under the present law while, in general, illegality acts as a defence to what would otherwise be standard rights and remedies, illegality can be used as a cause of action for a claim for restitution reversing benefits conferred, where the plaintiff claims restitution by seeking to withdraw from an illegal transaction.[88] We look below at this restitutionary cause of action, frequently referred to as the doctrine of *locus poenitentiae*, with a view to considering whether the rules should be retained, and, if so, in any way reformed.

7.59 An initial important point to note is that under our provisionally proposed reforms to the illegality defence, the scope of the *locus poenitentiae* doctrine would become

[86] Section 31. The court may, if it deems it just to do so and on such conditions as it sees fit, relieve a party of the whole or part of the duty to make restitution.

[87] D Friedmann, "Consequences of Illegality under the Israeli Contract Law (General Part) 1973" (1984) 33 ICLQ 81, 93 and N Cohen, "Illegality: the Case for Discretion" in W Swadling (ed), *The Limits of Restitutionary Claims*: *A Comparative Analysis* (1997) p 186 at p 195.

[88] See paras 2.49 to 2.56 above.

more limited. That is, if as seems likely[89] the law develops (as true principle dictates) to allow claims for restitution for a partial failure of consideration rather than insisting on a total failure of consideration, then in many cases the plaintiff would in any event be able to withdraw from a contract which is unenforceable because of illegality and recover benefits conferred on the defendant unless, under our provisionally proposed discretion outlined above,[90] the court considers that it would not be in the public interest to allow him or her to do so. The only cases in which the plaintiff will not be able to rely on a partial failure of consideration are, first, where the defendant has performed the whole of his or her side of the bargain or, secondly, where he or she is ready willing and able to perform the contract.[91] Even here, the plaintiff may be able to claim restitution for mistake of law, where the mistake was such as to mask the illegality of the contract.[92] We therefore need to consider whether the *locus poenitentiae* rule should be retained in order to provide the plaintiff with a cause of action (permitting withdrawal from the contract and the restitution of benefits conferred) in these two limited circumstances where the plaintiff was aware that the contract was illegal.

7.60 We have seen that there is some confusion over the precise scope of the *locus poenitentiae* doctrine. In particular there is confusion over whether the plaintiff need show genuine repentance and up to what point he or she may withdraw. The Court of Appeal in *Tribe v Tribe*[93] has recently decided the plaintiff may withdraw even after he or she has done all that was required under the contract, provided that the illegal purpose has not been achieved. The Court of Appeal judges further indicated that genuine repentance was not needed.

7.61 It seems to us that much of the confusion over the scope of the *locus poenitentiae* doctrine stems from the difficulty in finding its real justification. Two justifications may be put forward: first, deterrence, and, secondly, assistance to a plaintiff who has repented. We shall now examine each of these in turn, with particular reference to what form a statutory *locus poenitentiae* doctrine should take.

7.62 The justification based on deterrence is that to allow the plaintiff to withdraw from a contract involving illegality and to recover the benefits that he or she has conferred will deter illegality.[94] Either the plaintiff will be encouraged to repent and own up to the illegality, thereby bringing it out into the open and ensuring that he (or she) or the defendant are subject to any criminal sanction; or the defendant will be deterred from carrying out his or her side of the bargain because he or she knows that the plaintiff may seek to withdraw from the contract.

[89] See *Goss v Chilcott* [1996] AC 788.

[90] See para 7.22.

[91] *Thomas v Brown* (1876) 1 QBD 714.

[92] See paras 2.40 to 2.42 above.

[93] [1996] Ch 107. See para 3.14 above.

[94] If this is the justification, then the current *locus poenitentiae* exception would appear to be too narrowly drawn, and the plaintiff should be allowed to withdraw provided that the illegal purpose has not been completed, even if it has been partially achieved.

7.63 But this deterrent argument can be refuted. One could say that rather than encouraging repentance, the *locus poenitentiae* doctrine will encourage a plaintiff to enter into a contract for an illegal purpose. He or she will be in the unusual position of knowing that withdrawal is always possible, if it suits him or her to do so before completion of the illegality. And rather than deterring the defendant from performance, one could say that the *locus poenitentiae* rule encourages the defendant to perform as quickly as possible, so that the point is reached beyond which the plaintiff cannot withdraw. Overall, therefore, the deterrence argument would appear to be neutral, or, rather, its efficacy will vary from case to case. In any event, this justification cannot be used to support the present law, which, following *Tribe v Tribe*,[95] would seem to allow restitution whether or not restitution will increase the likelihood of thwarting the illegal purpose. As one commentator points out, the decision in that case neither deterred illegality nor protected creditors but, in allowing the father to recover his shares after the danger had passed, positively assisted him to achieve the exact illegal purpose which he intended.[96]

7.64 In our view therefore it is hard to generalise about the deterrent effect of the *locus poenitentiae* doctrine and each case will need to be considered on its own facts. But there is a strong case for saying that if the plaintiff is able to show that his or her withdrawal from an illegal contract will reduce the likelihood of the illegality being achieved, then this is a policy which the law should pursue. And in order to create an incentive for the plaintiff to withdraw, in such cases the law should provide the plaintiff with a right to recover benefits which he or she has already conferred on the defendant. Therefore, we provisionally propose that if the plaintiff can show that allowing him or her to withdraw from an illegal contract will reduce the likelihood of an illegal act being completed or an illegal purpose being accomplished,[97] the court should have a discretion to allow the plaintiff to do so and to recover any benefits which he or she has conferred on the defendant.

7.65 However, we must ensure that the exercise of such a discretion does not clash with the discretion we consider the courts should have with regard to the enforcement of an illegal contract. The possibility that one party might seek to enforce a contract at the same time as the other party seeks to withdraw would not appear to have caused a problem to date. This may be because, under the present stringent rules, the illegal contract would have been unenforceable by either party. The effect of our proposed discretion is that the contract is more likely to be enforceable. Say, for example, that P agrees to lend money to D at a low rate of interest payable monthly for one year. By statute P requires a licence to act as a moneylender. P does not have such a licence, but tells D that he does. After lending the money and collecting the interest for two months, P repents of his illegal behaviour. He seeks to withdraw from the contract and recover the principal that he has lent to D. But D might seek to enforce the loan contract

[95] [1996] Ch 107.

[96] F D Rose, "Gratuitous Transfers and Illegal Purposes" (1996) 112 LQR 386, 390. See also, *Chitty on Contracts* (2nd cumulative supplement to the 27th ed 1997) para 16-154.

[97] The provisional proposal does not apply, therefore, where the illegality has been completed or frustrated, for example by the other party's refusal to perform or by extraneous circumstances.

because he thinks that it will be more expensive for him to borrow elsewhere. Under our provisionally proposed discretion such a claim might be successful. We therefore need to decide whether D's claim for enforcement, or P's claim to withdraw and have restitution (during the *locus poenitentiae*) should have priority.

7.66 If P's claim for restitution were given priority, then the deterrence of illegality in the particular case would be elevated to become the factor of overriding importance in deciding the outcome of disputes. Yet when we looked at the issues which we considered a court should take into account in deciding whether to allow a claim for contractual enforcement, we said that deterrence was but one relevant factor.[98] Other factors, such as the seriousness of the illegality and the furtherance of the rule which renders the transaction illegal should also be taken into account. While we recognise the importance of the deterrence factor, we do not provisionally believe that it should be given this overriding priority. We therefore consider that to succeed in a withdrawal claim, the plaintiff must first satisfy the court that the contract is ineffective against him or her. Therefore where the defendant has already performed his or her side of the bargain or is ready willing and able to do so *and,* despite the involvement of illegality, the defendant is not prevented from enforcing the contract (for example where the illegality involved is trivial), then the plaintiff should not be allowed to withdraw.

7.67 The second possible justification for the *locus poenitentiae* doctrine is that the law should assist a plaintiff who has repented of his or her illegality. It seems that, whatever the position in the past, this cannot be a justification of the present law, because after *Tribe v Tribe*,[99] it appears that genuine repentance is not a requirement. Under our proposals should we require repentance? As Professor Merkin notes,[100] a repentance requirement has advantages and disadvantages. On the one hand, it may be used to explain why restitution is permitted in circumstances where it would not usually be available (that is, where the plaintiff has no standard restitutionary cause of action on which to rely). On the other hand, a requirement for repentance may restrict the opportunity for plaintiffs to claim restitution and therefore lessen the possibility of averting illegality. Professor Merkin concludes that repentance will operate well in some cases but not in others. We tend to agree. We do not believe that repentance by itself can justify permitting a restitutionary claim. Where the illegality is merely technical, a greater evil may be invoked by allowing the plaintiff to renege on a contract which the defendant remains ready, willing and able to perform. Nor do we think that repentance should be a requirement. Whatever the motive, if the plaintiff's withdrawal from the contract will prevent a serious wrong, then withdrawal and restitution should be available in order to encourage the plaintiff not to go through with the contract. However, we do think that this factor may be relevant in deciding what is the just outcome of the case. We therefore provisionally propose that in deciding whether to allow withdrawal and award restitution on the ground

[98] See paras 7.27 to 7.43 above.

[99] [1996] Ch 107.

[100] R Merkin, "Restitution by Withdrawal from Executory Illegal Contracts" (1981) 97 LQR 420, 430.

that this will prevent illegality, a court should consider whether the plaintiff genuinely repents of the illegality.

7.68 Dicta in some cases suggest that the *locus poenitentiae* rule does not apply in cases of gross moral turpitude.[101] Generally speaking one might say that the more serious the illegality, the greater the urgency to encourage deterrence and therefore the greater the need for the withdrawal rule.[102] However, one can foresee that there might be circumstances in which it would not be appropriate for the law to intervene, although it is hard to imagine that such cases would ever come before a court. For example, it is questionable whether a drug dealer should be able to come to court to claim the return of drugs which he or she has handed over to a customer and for which he or she has not been paid. For this reason, we provisionally believe that the seriousness of the illegality should be another factor considered by the court in deciding whether or not to allow withdrawal and restitution.

7.69 **We therefore provisionally propose that:**
(a) a court should have a discretion to allow a party to withdraw from an illegal contract, and to have restitution of benefits conferred under it, where allowing the party to withdraw would reduce the likelihood of an illegal act being completed or an illegal purpose being accomplished: but that
(b) to succeed in a withdrawal claim the plaintiff must first satisfy the court that the contract could not be enforced against him or her.
(c) We further provisionally propose that in deciding whether or not to allow a party to withdraw and have restitution a court should consider (i) whether the plaintiff genuinely repents of the illegality (albeit that this should not be a necessary condition for the exercise of the discretion); and (ii) the seriousness of the illegality.
If consultees disagree with these provisional proposals, we ask them whether they regard withdrawal and restitution on the basis of a "*locus poenitentiae*" as a needless complication that could happily be done away with.

5. THE SCOPE OF THE PROVISIONALLY PROPOSED DISCRETION

7.70 Although perhaps implicit from what we have already provisionally proposed, we think it important to spell out separately and clearly the scope of our provisionally proposed statutory discretion. In the Introduction we explained that we saw the broad remit of our Paper as being transactions which involved reprehensible conduct. We therefore took as our starting point for an examination of the law of illegality in relation to contracts: any contract which involves (in its formation, purpose[103] or performance) a legal wrong (other than a mere breach of the

[101] *Tappenden v Randall* (1801) 2 B & P 467, 471; 126 ER 1388, 1390, *per* Heath J and *Kearley v Thomson* (1890) 24 QBD 742, 747, *per* Fry LJ. See para 2.55 above.

[102] See R Merkin, "Restitution by Withdrawal From Executory Illegal Contracts" (1981) 97 LQR 420, 434.

[103] By "purpose" we mean to include a contract which contains a term requiring the parties to carry out conduct which constitutes a legal wrong or is otherwise contrary to public policy or, even if not required by the terms of the contract, one or both parties intend to use the

contract in question) or conduct otherwise contrary to public policy.[104] Such a category is clearly very wide, and includes many contracts which, although connected with illegality, will not under the present law be affected by it in any way.

7.71 One might, therefore, be tempted to "hive off" certain contracts or classes of contract where it would be unusual for the illegality to have any effect. In particular, we have seen that the mere performance of a legal wrong or conduct otherwise contrary to public policy in the course of carrying out one's contractual obligations does not, unless the contract is impliedly prohibited by statute, generally invalidate a contract.[105] However, despite recognising its breadth, we provisionally recommend that our proposed statutory discretion should apply to the whole category which we have outlined above. That is, we think that there could be circumstances, particularly if the illegality involved is serious, where the court would not consider it to be in the public interest to recognise the plaintiff's usual rights and remedies under any contract which falls within this broad category.

7.72 **We therefore provisionally recommend that our proposed statutory discretion in relation to:**
(a) contractual enforcement should apply to all contracts which in their formation, purpose or performance involve a legal wrong (other than a mere breach of the contract in question);[106]
(b) the reversal of unjust enrichment should apply to all contracts which are unenforceable for illegality; and
(c) the recognition of contractually transferred or created property rights should apply to all contracts which in their formation, purpose or performance involve a legal wrong (other than a mere breach of the

contract for such an end. However, for the avoidance of doubt, we do not intend to include cases where, after the completion of a contract, one or both parties decide to use the property which they have received under the contract for an illegal purpose. The inclusion of these cases would render the provisionally proposed discretion unacceptably wide and would introduce an unacceptable degree of uncertainty in relation to property rights. For a similar limitation in relation to illegal trusts, see paras 8.38 to 8.39 below.

[104] See paras 1.1 to 1.5 above. Although note that we have excluded from the scope of this project contracts which are rendered ineffective by statute but which do not involve any conduct which is expressly or impliedly prohibited (para 1.10 above), and contracts which are in restraint of trade (para 1.11 above).

[105] See para 2.29 above.

[106] We have already explained that we do not provisionally recommend that the proposed statutory discretion in relation to the enforcement of contractual obligations should apply to contracts which involve conduct otherwise contrary to public policy (see paras 7.13 to 7.16 above). The criteria that the contract involves a legal wrong may mean that the civil court is called upon to decide whether the plaintiff has committed a criminal act. In these circumstances, the civil court might use its inherent power to stay the civil proceedings pending the outcome of any criminal proceedings (see para 7.42 above). If not, the court will adopt the civil standard of proof, but the "antecedent improbability of the [plaintiff's guilt] is 'a part of the whole range of circumstances which have to be weighed in the scale when deciding as to the balance of probabilities'": *Cross & Tapper on Evidence* (8th ed 1995) p 171 citing Morris LJ in *Hornal v Neuberger Products Ltd* [1957] 1 QB 247, 266.

contract in question) or conduct which is otherwise contrary to public policy.[107]

If consultees do not agree with our provisional recommendations, please would they explain what they consider the scope of our proposed discretion should be.

6. GIVING THE COURTS A DISCRETION TO GO BEYOND TREATING ILLEGALITY AS A DEFENCE TO STANDARD RIGHTS AND REMEDIES

7.73 In reaching the provisional recommendations outlined above, we have also implicitly considered, but not favoured, an alternative approach to reform which would involve giving the courts a discretion to go beyond treating illegality as a defence to standard rights and remedies (with the single exception of illegality being used as a cause of action for a restitutionary claim under the doctrine of *locus poenitentiae*).[108] Under this alternative more radical approach to the adoption of a discretion, the courts would not be required to stay within the limits of the general common law framework of rights and remedies, but, in a contractual dispute which involves illegality, would be allowed to make any adjustment to the rights and remedies of the parties as they consider fit.

7.74 In support of this more radical approach, it might be argued that the ambit of the illegality rules is so wide and covers so many different circumstances, that simply granting or denying the usual rights and remedies may not provide a just outcome to the dispute. In some cases, only a more sensitive approach which would allow the courts to provide a remedy reflecting the relative merits of the plaintiff and defendant and their potential gains or losses could result in a fair adjustment between the parties. In particular, the more radical approach would allow the courts to apportion losses suffered by either or both parties as result of expenditure incurred in reliance on a contract which is subsequently held to be unenforceable. Unless such an award can be made, one party may be left bearing most or the whole of the cost of the contract's failure.

7.75 There may already be some precedent in English law for such a flexible remedy. Under the Law Reform (Frustrated Contracts) Act 1943 the courts are given a limited discretion to adjust the rights and liabilities of parties to a frustrated contract which may go beyond merely reversing unjust enrichment to include some apportionment of losses.[109] Section 1(2) provides that all sums paid or payable prior to the time of discharge are recoverable by the payer, but a proviso is included which covers cases where the payee has incurred expenditure for the purpose of performing the contract prior to the time of discharge. In these cases

[107] Although note that we have excluded from the scope of this project contracts which are rendered ineffective by statute but which do not involve any conduct which is expressly or impliedly prohibited (para 1.10 above), and contracts which are in restraint of trade (para 1.11 above).

[108] See para 7.4 above.

[109] For discussion of the basis of the 1943 Act see articles by A Stewart and J W Carter, "Frustrated Contracts and Statutory Adjustment: The Case for a Reappraisal" [1992] CLJ 66; A M Haycroft and D M Waksman, "Frustration and Restitution" [1984] JBL 207; and E McKendrick, "Frustration, Restitution, and Loss Apportionment" in A Burrows (ed), *Essays on the Law of Restitution* (1991) p 147.

the court may allow the payee to retain or recover out of the sums paid or payable before discharge such amount as it considers just, not being more than the expenditure incurred. Section 1(3) provides that where one party to a contract has obtained a valuable benefit from the other party prior to the time of discharge, the benefited party must pay to the other party a "just sum" not exceeding the value of that benefit. But in assessing the just sum the court is to consider the amount of expenditure incurred by the benefited party.

7.76 And there may be even greater flexibility where a contract is set aside on terms under the controversial equitable doctrine of common mistake.[110] In *Solle v Butcher*[111] Denning LJ said that a court of equity could set aside a contract entered into by mistake "on such terms as the court thinks fit".[112] Although there have not been any reported cases to suggest that the courts would use this power to apportion losses incurred in reliance on the contract, in rare cases the courts have shown their willingness to impose terms over and beyond the restoration of the pre-contractual position where it is considered just to do so.[113]

7.77 An open-ended discretionary approach has been adopted in New Zealand. As we have seen, the New Zealand Illegal Contracts Act 1970 provides that all illegal contracts are of no effect,[114] but it goes on to confer a very wide power on the court to grant to the parties to the illegal contract and anyone else affected:

> ... such relief by way of restitution, compensation, variation of the contract, validation of the contract in whole or part or for any particular purpose, or otherwise howsoever as the Court in its discretion thinks just.[115]

7.78 In its Report which preceded the Act, the Contracts and Commercial Law Reform Committee of New Zealand said:

> The only argument against such a proposal that we feel the need to mention is this. It could be said that any such discretion would

[110] *Cheshire, Fifoot and Furmston's Law of Contract* (13th ed 1996) p 246.

[111] [1950] 1 KB 671.

[112] [1950] 1 KB 671, 690.

[113] See *Solle v Butcher* [1950] 1 KB 671 and *Grist v Bailey* [1967] Ch 532. And see the flexible approach adopted by the Court of Appeal in *Cheese v Thomas* [1994] 1 WLR 129 in relation to a claim for rescission for undue influence. The plaintiff had contributed to the purchase price of a house bought by his great-nephew on the basis that the plaintiff should have a licence to live there rent-free for the rest of his life and that on his death the house should belong unencumbered to the great-nephew. The Court of Appeal set aside the transaction for undue influence. But rather than awarding the plaintiff the return of his whole payment, the Court made a lower award to take into account the fact that the value of the house had fallen. Sir Donald Nicholls VC said [1994] 1 WLR 129, 136: "It is axiomatic that, when reversing this transaction, the court is concerned to achieve practical justice for both parties, not the plaintiff alone."

[114] Section 6. See para 7.45 above.

[115] Section 7(1). Although as we have already noted (see para 7.55 above) the New Zealand legislation provides special protection for a third party who, acting in good faith and unaware of the illegality, purchases for value property which has previously been transferred under an illegal contract.

> (because of the impossibility of foreseeing all possible circumstances) necessarily have to be largely unfettered and that conferring such boundless discretions on the courts is undesirable as a source of uncertainty and an abdication by the legislature of its proper functions in favour of the courts. We acknowledge the force of this contention but consider that to confer on the courts such powers as we propose is very much a lesser evil than to leave the law as it would otherwise stand ....[116]

7.79 A similar, though somewhat more restricted, approach has been put forward by the Law Reform Commission of British Columbia. In its Report on Illegal Transactions, the Commission recommended that as a general rule the court would not enforce an illegal contract, but this should be subject to the exercise of a discretionary power to grant relief from the consequences of the illegality. However, the Commission did not think that it would be right to follow the New Zealand legislation and recommend that the court should be permitted to award any relief as appears just. Such an approach was said to go further than is required to ameliorate the harsh results of the common law, would not provide guidance to anyone involved in an illegal transaction, and would possibly encourage and complicate litigation.[117] Instead, therefore, the Commission recommended that the courts should have the power to make an order for one or more remedies specified in the proposed legislation. Those remedies included: restitution, compensation, apportionment of loss and a wide power of severance.[118]

7.80 So why have we not provisionally favoured this broader discretionary approach? First, we are concerned about the uncertainty that it might cause and the possibility that it would give rise to an increase in litigation. Under our provisional recommendations it is likely that only a plaintiff who has knowingly been involved in particularly serious misconduct would be denied his or her standard rights and remedies. But a more flexible discretionary remedy would require an investigation by the court into the relative merits and faults of the two contracting parties. Such an approach might result in "palm-tree" justice and create far greater uncertainty than the current technical rules.[119] The structured discretion that we have provisionally proposed in relation to the operation of illegality as a defence should be able to fit into the present common law of rights and remedies without giving rise to the need to create a whole new and uncharted area of rights and remedies.

7.81 We do, however, recognise that one can only speculate about the risk of increased litigation. Some commentators do not accept that giving the courts an open-ended discretion to make such awards as they consider just necessarily results in more cases being brought before the courts. They point to the paucity of cases heard in relation to the admittedly limited discretion to adjust rights and liabilities under the Law Reform (Frustrated Contracts) Act 1943. To date there have only

[116] Report of the Contracts and Commercial Law Reform Committee of New Zealand, Illegal Contracts (1969) p 10.

[117] Law Reform Commission of British Columbia, Report on Illegal Transactions (1983) p 74.

[118] Law Reform Commission of British Columbia, Report on Illegal Transactions (1983) p 79.

[119] G Virgo, "The Effect of Illegality on Claims for Restitution in English Law" in W Swadling (ed), *The Limits of Restitutionary Claims: A Comparative Analysis* (1997) p 141 at p 142.

been two reported decisions.[120] One commentator has suggested that the reason for this is that the unpredictability of the courts' approach has deterred litigants from risking a trial.[121] Although the New Zealand legislation has been criticised for its uncertainty in several respects,[122] it would not appear to have resulted in a deluge of litigation. It has been reported that in the first fifteen years of its operation, some 20 cases were decided under it.[123]

7.82 But aside from the risk of uncertainty, we have not favoured this approach because we do not believe that a case has been made out for its need. That is, we do not agree that the illegality "defence-based" approach (together with a limited power to use illegality as a cause of action for a claim for restitution under the *locus poenitentiae* doctrine) will result in injustice. A plaintiff who is not permitted to enforce a contract because of the involvement of illegality is not necessarily left without any remedy. He or she may be able to claim damages for a different cause of action, for example in tort,[124] or may be able to claim restitution. If, as seems likely,[125] the law develops to allow restitution for a partial failure of consideration, the plaintiff will be able to bring such a claim in most cases where he or she has conferred benefits on the defendant. Although contractual enforcement may not be in the public interest, the court might have no objection to awarding a restitutionary claim.[126] Providing the court with a discretion to invent new remedies would therefore, in our provisional view, not only be likely to result in unprincipled and haphazard decisions, but is unnecessary to meet the problems created in this area.

7.83 The central point made in the previous paragraph may perhaps be best appreciated by focusing on loss apportionment, where probably the strongest case can be made for an open-ended discretion.[127] For example, where the plaintiff has incurred expenditure or performed work under an illegal contract which the defendant fails to perform, should the court decide that it is not in the public interest to allow the plaintiff to enforce the contract, the plaintiff will suffer the whole loss even though the parties may have been equally "guilty" of the illegality,

[120] *BP Exploration Co (Libya) Ltd v Hunt (No 2)* [1983] 2 AC 352 and *Gamerco SA v ICM/Fair Warning (Agency) Ltd* [1995] 1 WLR 1226.

[121] See B Dickson, "Restitution and Illegal Transactions" in A Burrows (ed), *Essays in the Law of Restitution* (1991) p 171 at p 178.

[122] See para 7.2 n 5 above.

[123] D W McLauchlan, "Contract and Commercial Law Reform in New Zealand" (1984-1985) 11 NZULR 36, 40-41. And see R Cooke, in his review of *Consensus ad Idem: Essays in the Law of Contract in Honour of Guenter Treitel* (1998) 114 LQR 505, 509.

[124] *Shelley v Paddock* [1980] QB 348. See para 2.70 above.

[125] See *Goss v Chilcott* [1996] AC 788.

[126] Although the court would be unlikely to allow the restitutionary claim where its effect would be to undermine the refusal to enforce the contract: see *Boissevain v Weil* [1950] AC 327 discussed at para 2.37 n 109 above.

[127] In the section that follows (see paras 7.88 to 7.93 below) we consider what the position should be where the parties have made a gain at the expense of a third party as a result of their illegal behaviour. There we ask the question whether the court should have a discretion to make an award in favour of the plaintiff only on condition that this benefit be returned to the third party.

or the defendant more so. However, it is our provisional view that a sufficient case for loss apportionment has not yet been made out. With the limited exceptions already referred to,[128] loss apportionment is not generally recognised as a remedy following a contract that fails. So, for example, there is no question of loss apportionment where a contract is unenforceable for lack of formality or void for lack of capacity. To provide such a remedy in illegality cases would therefore be out of step with, and cut across, the "seamless web" of the common law.[129] But, of course, if the case for loss apportionment can be made out, one might argue that our proposed reforms in relation to illegality could lead the way to reform in these other areas too. What then is the case for loss apportionment?

7.84 Two arguments in support of loss apportionment are generally put forward. The first is an economic argument. It suggests that loss apportionment is "economically sounder than the placing of loss on one party only, for each of the two parties may be able to bear half the loss without serious consequences when the whole loss might come close to ruining him".[130] But as Professors Stewart and Carter point out, "[i]t is just as conceivable that in any given case one party can bear all the loss easily while the other cannot bear even half of it without being forced into bankruptcy." They suggest that the only "economic" argument that can be relied upon is that "efficiency is best served by a predictable law which saves the parties litigation or arbitration costs in ascertaining their position."[131] Clearly, providing the court with a power to share out losses on the basis of the relative merits of the parties would not meet such an objective.

7.85 The second argument put forward to support loss-sharing is a "justice" based one. That is, where one or both parties to a contract suffer losses when their contract fails and neither is responsible for those losses in that neither has committed any recognised legal wrong against the other, the only "fair" result is that the losses should be shared between them in proportion to the "fault" which each bears for the contract's failure.[132] But we have difficulties with this argument. There is no general recognition that parties entering into a contract do so as a joint venture rather than for their own commercial advantage.[133] For example, cases involving inequality of bargaining power aside, there is no suggestion that where one party

[128] See paras 7.75 to 7.76 above.

[129] See paras 1.7 and 7.4 above.

[130] See G Williams, *The Law Reform (Frustrated Contracts) Act 1943* (1944) pp 35-36.

[131] A Stewart and J W Carter, "Frustrated Contracts and Statutory Adjustment: The Case for a Reappraisal" [1992] CLJ 66, 88.

[132] Most commentary on the issue of loss apportionment is found in relation to the effects of contractual frustration. See G Williams, *The Law Reform (Frustrated Contracts) Act 1943* (1944) pp 35-36. And see M P Sharp, "Promissory Liability" (1940) 7 U Chi L Rev 250; P D Weiss, "Apportioning Loss after Discharge of a Burdensome Contract: A Statutory Solution" (1960) 69 Yale LJ 1054; A M Haycroft and D M Waksman, "Frustration and Restitution" [1984] JBL 207, 217; and E McKendrick, "Frustration, Restitution, and Loss Apportionment" in A Burrows (ed), *Essays on the Law of Restitution* (1991) p 147.

[133] But see C Fried, *Contract as Promise* (1981) p 72: "By engaging in a contractual relation A and B become no longer strangers to each other. ... [T]hey are joined in a common enterprise, and therefore they have some obligation to share unexpected benefits and losses in the case of an accident in the course of that enterprise."

enters into a bad bargain the court should have some power to intervene for the sake of "fairness" and alter the terms to reflect the contract's true value. In any event, we suspect that under our provisionally proposed discretion, the circumstances in which the plaintiff would be refused contractual enforcement for the greater public interest will be limited to those cases where his or her behaviour is particularly abhorrent. It therefore seems likely that even if one believes that loss apportionment is required for the sake of "fairness" the circumstances in which such an award would be made in the plaintiff's favour are few and far between.

7.86 It is noteworthy that, in contrast to the New Zealand legislation and the proposals of the Law Reform Commission of British Columbia,[134] the wider discretionary remedy approach has not been adopted by the Israeli legislation. As we have seen,[135] it starts from the position that every illegal contract is void,[136] but goes on to impose a duty of restitution in respect of what has been received under an illegal contract,[137] provided that the court may "if it deems it just to do so and on such conditions as it sees fit, relieve a party of the whole or part of the duty". Restitution is therefore the routine remedy in Israeli law, but, section 31 continues, in so far as one party has fulfilled his obligation under the illegal contract, the court may "require the other party to fulfil the whole or part of the corresponding obligation". In exceptional circumstances therefore, and where one party has fulfilled his or her part of the illegal contract, the court has a discretion to award enforcement. The dominant view would appear to be that section 31 is exhaustive, and that the court has no power to award, for example, compensatory damages.[138]

7.87 **We ask consultees whether they agree with our provisional view that (with the exception of the *locus poenitentiae* doctrine) illegality should continue to act only as a defence to claims for standard rights and remedies and that, in particular, the courts should not be specially empowered to apportion losses under illegal contracts. If consultees do not agree, do they consider that a court should have an open-ended discretion to grant any relief that it considers just in relation to illegal contracts?**

7. SHOULD THE COURT BE GIVEN A DISCRETION IN CONTRACTUAL DISPUTES INVOLVING ILLEGALITY TO MAKE AN AWARD ON TERMS THAT THE PLAINTIFF MAKES A PAYMENT OR TRANSFERS PROPERTY TO A PERSON WHO IS NOT A PARTY TO THE ILLEGAL CONTRACT?

7.88 So far we have been considering only the position between the parties to the illegal contract themselves. However, a further question, which is conveniently considered here, is whether, in contractual disputes involving illegality, the courts

[134] See paras 7.77 to 7.79 above.

[135] See para 7.46 above.

[136] Section 30 of the Israeli Contracts (General Part) Law 1973.

[137] Section 31 of the Israeli Contracts (General Part) Law 1973. If restitution is impossible or unreasonable, the party is to pay to the other the value of what he or she has received.

[138] N Cohen, "Illegality: The Case for Discretion" in W Swadling (ed), *The Limits of Restitutionary Claims: A Comparative Analysis* (1997) ch 7 at p 204.

should have a discretion to make an award on terms that require the plaintiff to make a payment or transfer property to a person who is not a party to the illegal contract. That is, if, under the proposed statutory discretion, the court decides that illegality should not operate as a defence to the plaintiff's claim (or that a restitutionary claim based on the *locus poenitentiae* doctrine should be allowed) should the court be able to order that, as a condition of allowing the plaintiff's claim, the plaintiff should pay a sum of money or transfer property to a third person, such as the State or a charity?[139] Such a condition might be imposed on one of two bases. First, as a punishment to the plaintiff for his or her involvement in the illegality. Or secondly, in order to strip away gains that have been made as a result of the illegality and which the plaintiff will otherwise enjoy. We shall now look at each of these in turn.

7.89 At first sight, to suggest that the court might order that a payment be made to a person who is not a party to the action (such as the State) in order the punish the plaintiff might appear to blur the distinction between the functions of the civil and the criminal law.[140] But, in our Report on Aggravated, Exemplary and Restitutionary Damages, we explained that we consider punishment to be a legitimate aim of the civil law, and that civil punishment could be distinguished from criminal punishment.[141] Indeed in any case in which the plaintiff is, on the basis of illegality, refused a remedy to which he or she would otherwise be entitled, the plaintiff is, in one sense, being "punished". To suggest that he or she be allowed the remedy claimed but ordered to pay all or part to, say, the State, would simply be to alter the "beneficiary" of the plaintiff's punishment from the defendant to the State. Such action might be felt to be particularly appropriate where the defendant was also involved in the illegality.[142]

7.90 But this approach does create practical difficulties. For example, on what basis should the court assess the amount which should be diverted to the third party? And how would the third party enforce any condition imposed by the court in his or her favour?[143]

[139] Several commentators have suggested that such an award might be appropriate in some circumstances: see R Merkin, "Restitution by Withdrawal from Executory Illegal Contracts" (1981) 97 LQR 420, 444; N Enonchong, "Illegality and the Presumption of Advancement" [1996] RLR 78, 86-87; F D Rose, "Reconsidering Illegality" (1996) 10 JCL 271, 282; and B Dickson, "Restitution and Illegal Transactions" in A Burrows (ed), *Essays on the Law of Restitution* (1991) p 171 at p 176.

[140] See J K Grodecki, "In pari delicto potior est conditio defendentis" (1955) 71 LQR 254, 267; and G Virgo, "The Effect of Illegality on Claims for Restitution in English Law" in W Swadling (ed), *The Limits of Restitutionary Claims: A Comparative Analysis* (1997) ch 6 at p 179.

[141] Law Com No 247, para 5.25.

[142] See *Harry Parker Ltd v Mason* [1940] 2 KB 590, 603, *per* MacKinnon LJ: "I only wish that it were possible for this Court to order [the defendant] to pay this ill-gotten 11,875*l*. to a deserving charity. But, alas, we have no such power."

[143] Note that in our Report on Aggravated, Exemplary and Restitutionary Damages (1997) Law Com No 247, we did not regard this as an insuperable difficulty which should prevent the courts being given the power to make awards of exemplary damages in favour of the State, although we ultimately rejected this approach for different reasons (see paras 5.142 to 5.158).

7.91 The second basis on which a condition might be imposed in favour of a third party would be not to punish, but rather to strip away gains that have been made at the expense of a third party (usually the State)[144] as a result of the illegality. Where the illegal conduct has resulted in gains being made at the expense of a third party, unless the court, in deciding the rights and liabilities of the parties *inter se*, is given the power to order the disgorgement of those gains, then following the court's decision, one or both parties will retain a windfall benefit. In order to avoid this result, a court could be given the power, when judging disputes in relation to illegal contracts, to make the plaintiff's award conditional on a payment being made in favour of the third party at whose expense such gains would otherwise have been made. In the Australian case, *Nelson v Nelson*[145] the High Court adopted a similar approach. The majority held that Mrs Nelson could succeed in her claim to equitable ownership in the house only on the condition that she gave back to the Commonwealth (which was not a party to the action) the pecuniary advantage that she had gained by her deception. If she failed to do so, then an amount equal to that sum was to be retained by the trustee, and Mrs Nelson could recover only the remainder. In *Tinsley v Milligan*,[146] Miss Milligan had already made reparation to the DSS,[147] but had such a discretionary power been available, the Court of Appeal might have used it to allow the estate's claim in *Silverwood v Silverwood*[148] only on the basis that it repaid the income support falsely claimed. By using such a discretionary power, the court could recognise the plaintiff's usual rights and remedies, but at the same time would be able to ensure that the plaintiff did not benefit from his or her own wrongdoing.

7.92 On the other hand, one might argue that such an award is not justifiable. First, one could say that it is largely unnecessary. Where the parties have profited at the expense of a third party, that third party is likely to be available to intervene so that the windfall gains will have to be given up in any event. In *Nelson v Nelson* there was a statutory mechanism by which the Commonwealth could recover the pecuniary advantage that Mrs Nelson had fraudulently obtained. Secondly, one might argue that such an award is unprincipled: where gains have been made at the expense of a third party, it is for that third party to decide whether or not to seek their return. This argument was strongly supported by Toohey J and Dawson J in their minority judgments in *Nelson v Nelson*.[149] Neither agreed with the majority decision of the High Court of Australia that the declaration in favour of Mrs Nelson should be subject to her reimbursing the Commonwealth. Toohey J said: "In so far as there has been a breach of the Act, the remedy is in the hands of the Commonwealth. The Secretary may cancel the subsidy and thereafter require payment of the subsidy or part thereof or may write off the amount, waive the right of recovery or allow Mrs Nelson to pay the amount by instalments. There is no obvious reason why the Secretary would not cancel the subsidy and require its

[144] But the gains might have been made at the expense of any third party, such as a charity, which has been deceived by the parties' conduct.

[145] (1995) 184 CLR 538. See para 3.28 above.

[146] [1994] 1 AC 340.

[147] See para 3.9 n 29 above.

[148] (1997) 74 P&CR 453. For the facts of the case, see para 3.13 above.

[149] (1995) 184 CLR 538.

repayment. But that is a matter for the Secretary."[150] For the court, in adjudicating on the dispute between the contracting parties, to take such a decision might be regarded as a usurpation of another's role.

7.93 **We ask consultees whether they consider that in contractual disputes involving illegality the courts should be given a discretionary power to allow the plaintiff's claim only on the condition that the plaintiff makes a payment or transfers property to a person (such as the State) who is not a party to the illegal contract. If so, we ask consultees on what basis (that is, punishment or disgorgement of gain or both) they consider such an award should be made.**

8. THE INTERACTION OF THE PROVISIONALLY PROPOSED DISCRETION AND STATUTORY PROVISIONS WHICH DEAL WITH THE EFFECTS OF ILLEGALITY

7.94 In some cases legislation will not only prohibit, expressly or impliedly, contracts, but will also expressly lay down what are the consequences of a contract being entered into or performed in breach of such prohibition. In some cases a statute provides that such a contract is not fully effective;[151] whereas in others the statute provides that the parties' civil rights should not be affected.[152] How should our proposed statutory discretion operate in these cases? That is, should the courts have a discretion under the illegality rules to override these express statutory provisions?

7.95 We look first at the position where the statute expressly provides that one or both contracting parties' rights *are* affected by the breach. Should a court be permitted to enforce such a contract, in the exercise of the discretion proposed by us, if it considers that it would be in the public interest in the circumstances to do so?

7.96 Although the position was originally not clear,[153] it has now been held that such a power is available under the New Zealand Illegal Contracts Act 1970.[154] In *Harding v Coburn*[155] the plaintiff had bought farm land from the defendant but had

[150] (1995) 184 CLR 538, 597. And see Dawson J at (1995) 184 CLR 538, 581-582: "The Commonwealth may or may not wish to recover the amount of the subsidy from the mother and to do so wholly or in part or upon terms. That is a matter for the Commonwealth and I do not think that it is any part of the Court's function to assist it in these proceedings to which it is not a party".

[151] A wide variety of language may be used and one or both parties' rights may be affected. See, for example, section 132 of the Financial Services Act 1986; section 105 of the Companies Act 1985; and section 126 of the Rent Act 1977.

[152] For example, section 35 of the Trade Descriptions Act 1968 provides that: "A contract for the supply of any goods shall not be void or unenforceable by reason only of a contravention of any provision of this Act".

[153] In *Combined Taxis Co-operative Society Ltd v Slobbe* [1972] NZLR 354, 360 Wild CJ suggested that relief under the Act by way of validation might not be possible if another enactment expressly declared the contract void. See B Coote, "The Contracts and Commercial Law Reform Committee and the Contract Statutes" (1988) 13 NZULR 160, 163.

[154] *Harding v Coburn* [1976] 2 NZLR 577 approved by the Privy Council in *Ross v Henderson* [1977] 2 NZLR 458.

[155] [1976] 2 NZLR 577.

failed to comply with a statutory requirement that he file with the court a declaration as to non-ownership of other farm land within one month of the purchase. The purpose of the statutory requirement was to ensure that there was no aggregation of rural land, and any transaction entered into in contravention of it was deemed to be unlawful and of no effect. The purchaser claimed "validation" of the sale agreement under the Illegal Contracts Act 1970 and was successful. The Court of Appeal held that there was no inconsistency between an express statutory provision that a contract shall be of no effect and the exercise of the statutory discretion for relief under the Illegal Contracts Act. On the evidence the purchaser did not hold any other farm land so there was no question of aggregation and validation was permitted. Another example is *National Westminster Finance New Zealand Ltd v South Pacific Rent-a-Car*.[156] A large number of credit sale agreements for the purchase of motor vehicles were entered into in breach of a statutory requirement that a minimum deposit of 60% be paid. Under the legislation, the agreements were expressly declared void and the buyer was given the right to recover all money paid under them. Nevertheless the judge at first instance, in a decision upheld on appeal, used his powers under the Illegal Contracts Act to "validate" the agreements.

7.97 Although the extent to which the courts have made use of the power to validate has been questioned by some commentators,[157] this approach has been supported by the New Zealand Law Commission.[158] The Commission suggests that provided that the power is exercised with care, the courts' approach is sound in policy and principle. In relation to the decision in *National Westminster Finance New Zealand Ltd v South Pacific Rent-a-Car*[159] referred to above, the Commission has said:

> [T]he legislation's intended impact occurred when the contract was entered into. The resulting legal problems will not arise until later, when the vendor is likely to want to recover the money as quickly as possible. This is not at all inconsistent with the legislative purpose of restricting consumer credit. Validating the contract can be the simplest way of ensuring that all parties (especially guarantors) are made to pay for benefits received.[160]

7.98 However, it is our provisional view that the same approach should not be adopted here. It seems to us that it would constitute an unacceptable undermining of Parliamentary Sovereignty to provide, by our proposed legislation, that the courts may override express statutory provisions which deny a person his or her usual contractual remedies. Although this may cause harsh results, particularly where the statutory breach is merely procedural, one must assume that Parliament was aware of the consequences of its express legislative provisions. In many illegality cases, there will often be difficulty reconciling the just result between the parties with the greater public interest. Where Parliament has expressly provided that a

[156] [1985] 1 NZLR 646.

[157] Dr G P Barton, "Whither Contract?" [1981] NZLJ 369; B Coote, "Validation under the Illegal Contracts Act" (1992) 15 NZULR 80.

[158] New Zealand Law Commission, Contract Statutes Review (1993) p 20.

[159] [1985] 1 NZLR 646.

[160] New Zealand Law Commission, Contract Statutes Review (1993) p 20.

party's usual rights and remedies shall be affected by the breach, it has effectively stipulated that there is a need for the greater public interest to be paramount in this area. That is not a decision that the courts should be allowed to second guess. For example, no doubt the validation of the car credit-sale agreement in the New Zealand case, *National Westminster Finance New Zealand Ltd v South Pacific Rent-a-Car*[161] referred to above,[162] would not by itself have resulted in a threat to the economic stability of the country. But if the same arguments were to be put forward in relation to every case where the statutory deposit requirements were mistakenly not met, then presumably there would come a point where the purpose of the Act was defeated.[163] And as we have seen, there are valid policy arguments, in particular based on deterrence, for providing a blanket ban on the enforcement of certain types of contract. For example, the automatic statutory invalidity under discussion in *Harding v Coburn*[164] was a very effective means of ensuring that all the legislative requirements were complied with.[165]

7.99 In some cases a statute will not only expressly invalidate a contract which involves the breach of a statutory provision, but will also set out a scheme of relief from the consequences of that invalidity and/or make clear whether property passes under the contract.[166] In line with our provisional view that the courts should not enforce a contract which is expressly declared to be unenforceable by statute, where the statute goes on to express what the consequences of that invalidity should be, we do not propose that the courts should have the power under our proposed statutory discretion to override the rights or remedies laid down in the particular statute.[167]

7.100 Should the position be any different where a statute expressly provides that one or both parties' civil rights are *not* to be affected solely by reason of the fact that the contract which they have entered into involves the breach of a statutory provision? That is, should a court be given a discretion under our provisionally proposed recommendations to deny those usual rights or remedies where it considers that it would not be in the public interest to award them? Whether, under the present

[161] [1985] 1 NZLR 646.

[162] See para 7.96.

[163] See B Coote, "Validation under the Illegal Contracts Act" (1992) 15 NZULR 80, 103.

[164] [1976] 2 NZLR 577. See para 7.96 above.

[165] Dr G P Barton, "Whither Contract" [1981] NZLJ 369, 376-377.

[166] For example, section 5 of the Financial Services Act 1986 provides that where a person enters into a contract for investment business in breach of the statutory requirement that all persons carrying on such business should be properly authorised, the contract is unenforceable against the other party and that other party is entitled, *inter alia*, to recover any money or property paid or transferred by him under the agreement.

[167] So, for example, where a statute provides that a contract which involves a breach of one of its provisions is "unenforceable", we do not provisionally recommend that the court should have a discretion to enforce it. However, since the statute has not dealt with the question of the recognition of property rights or restitutionary remedies, if the contract has already been performed, our provisionally proposed discretion in relation to these two questions would apply. On the other hand, where a statute provides that a contract is "void", neither our provisionally proposed discretion in relation to enforcement or the recognition of property rights should apply, but that in relation to restitutionary remedies would apply.

law, the parties' rights and remedies will be wholly unaffected as a result of such a legislative provision depends on the court's construction of the statute. For example, in *SCF Finance Co Ltd v Masri*[168] the Court of Appeal held that even if the plaintiff had unlawfully accepted a deposit in the course of a deposit taking business in breach of section 1 of the Banking Act 1979, the plaintiff's contractual rights and obligations in respect of the contract pursuant to which the deposits was taken were unaffected. This was said to be the clear intention of the legislature since section 1(8) provided that a deposit taken in contravention of section 1 "shall not affect any civil liability arising in respect of the deposit or the money deposited." However, the Court expressly left open any consideration of the legal effect (and in particular the applicability of section 1(8)) if the parties were to enter into such a transaction and one or both were aware that illegality was involved.

7.101 We are not, however, convinced that this is the right approach for the courts to adopt. If Parliament intends the saving provision to apply only where the parties are unaware of the illegality, then it may expressly so provide. Where Parliament has expressly provided that the usual contractual rights and remedies should be available despite the breach, then again we believe that it would be an unacceptable undermining of Parliamentary Sovereignty for the courts to decide otherwise. But care must be taken to identify the limits of the savings provision. For example in *Chase Manhattan Equities Ltd v Goodman*,[169] Knox J held that a contract for the sale of securities entered into in breach of the Company Securities (Insider Dealing) Act 1985 was unenforceable, despite section 8(3) of the Act which provided that "no transaction is void or voidable" by reason only of a breach of the insider dealing prohibition. Knox J said: "The problem has to be solved by an identification of the purpose of Parliament in choosing the words actually used in s 8(3) rather than providing for transactions not to be enforceable in the stated circumstances. Unenforceable and voidable contracts are different in many respects and Parliament must be taken to have appreciated this."[170]

7.102 **Accordingly, our provisional view is that where a statute expressly lays down what should be the consequences for a contract, of the contract involving a breach of the statute's provisions, our proposed discretion should not apply. We ask consultees whether they agree. If consultees do not agree with our provisional view, do they consider that a court should be able to use our proposed discretion to override the provisions of the statute?**

9. MISCELLANEOUS ISSUES

(1) Severance

7.103 In Part II we explained that in limited circumstances the courts are prepared to sever the objectionable part of a contract in order to permit the enforcement of the

[168] [1987] QB 1002.

[169] [1991] BCLC 897.

[170] [1991] BCLC 897, 934. See now section 63(2) of the Criminal Justice Act 1993 which provides that no contract shall be "void or unenforceable" by reason only of a breach of the insider dealing prohibition.

part which remains.[171] For the avoidance of doubt, in cases where this is permitted at common law, we do not intend that our proposed discretion should apply. **Accordingly, our provisional view is that where (at common law) part of a contract is severed so that the remainder no longer falls within our broad definition of illegality, our proposed discretion should not apply. We ask consultees whether they agree with this approach, and if not, to explain why not.**

(2) Tainting

7.104 We saw in Part II that a contract may be unenforceable because it is "tainted" by the illegality of another contract with which it is connected.[172] Our proposals would clearly be relevant in such a case because, if adopted, they would govern the illegality of the first contract. But otherwise we believe that the tainting principle is a sensible one. **Accordingly our provisional view is that the tainting principle should be retained, and we ask consultees whether they agree. If not, do consultees consider that the tainting principle should be abandoned?**

(3) Changes in the law

7.105 What should be the position where there has been a change in the law, both in relation to a contract involving conduct which was lawful when the contract was entered into but which becomes unlawful; and a contract involving conduct which was unlawful when the contract was entered into, but which subsequently ceases to be so? Where previously lawful conduct becomes unlawful the effect may be to frustrate the contract.[173] Where this is the case, we believe that the rules relating to the effects of frustration, and in particular, where applicable, the Law Reform (Frustrated Contracts) Act 1943, should apply rather than our provisional proposals outlined above. There would appear to be no authority on what the position should be where previously unlawful conduct becomes lawful.[174] However, there would seem to be no reason of public policy not to enforce a contract that involves conduct which, though previously unlawful, is lawful when performed.[175] We therefore provisionally propose that such a contract should be fully enforceable.

[171] See paras 2.73 to 2.74 above.

[172] See paras 2.75 to 2.78 above.

[173] See G H Treitel, *The Law of Contract* (9th ed 1995) p 799. For example, in *Denny, Mott & Dickson Ltd v James B Fraser & Co Ltd* [1944] AC 265 the parties had agreed to trade in imported timber. After the agreement had been in operation for some 10 years, a government order was introduced which made the importation of timber illegal and would have made it illegal for the parties, even if timber had been available, to continue to trade on the agreed terms. The House of Lords held that the agreement was frustrated by the coming into force of the government order.

[174] See G H Treitel, *The Law of Contract* (9th ed 1995) p 398.

[175] Say, for example, the plaintiff agrees to carry goods for the defendant in an unlicensed vehicle at a time when a license for the carriage of such goods is required by statute. However, if, at the time when the carriage is actually undertaken or due, the statute has been repealed, there would seem to be no reason of public policy not to allow either party to enforce the contract. This is on the assumption, however, that the conduct, despite its

7.106 **We ask consultees whether they agree that where a change in the law means that (a) previously lawful conduct becomes unlawful, then the enforcement of any contract involving such conduct should be governed by the rules relating to frustration, rather than our proposed discretion; or (b) previously unlawful conduct becomes lawful (and is not otherwise contrary to public policy), any contract involving such conduct should be enforceable. If consultees do not agree, do they consider that in either case our proposed discretion should apply?**

10. THE EFFECT OF OUR PROVISIONAL PROPOSALS

7.107 It may now be helpful if we gave some examples of how we believe our provisionally proposed discretion would work in practice. We do this first by suggesting how some past cases might have been decided had the proposed discretion been in operation, and secondly by looking at various hypothetical examples. As a general point, however, we believe that the effect of our provisional proposals would be that illegality is less frequently raised as a successful defence than it can be under the present law. That is, we believe that it is only in those cases where the court finds that there is a clear public interest in denying the plaintiff his or her usual rights and remedies that it would allow the involvement of illegality in a contract to have this effect.

(1) How our provisional proposals might have operated in relation to some past cases

7.108 In *Mohamed v Alaga & Co*[176] the High Court held that a plaintiff, who had referred clients and carried out work for a solicitor under an agreement that the solicitor would share the fees which he received from the Legal Aid Board, was unable to enforce the contract or recover any sum in respect of the work that he had performed. The Solicitors' Practice Rules prohibited the sharing of fees and the agreement was held to be impliedly prohibited and therefore unenforceable. We suggest that had our provisionally proposed discretion been in operation, the court might have allowed the plaintiff to enforce the agreement, so that the (guilty) solicitor was not able to benefit at the (innocent) plaintiff's expense. The illegality involved was not heinous, and the plaintiff was wholly unaware of it. The High Court's decision would not seem likely to deter other unscrupulous solicitors (who are more likely to be aware of the decision than non-lawyers) from entering into similar arrangements; and the refusal of any relief seems wholly disproportionate to the plaintiff's involvement in the illegality. The main factor weighing against allowing the claim might therefore be whether refusing it would further the purpose of the practice rules, that is, the protection of clients' interests.[177] Against this, one might argue that the purpose of the rules could be sufficiently enforced by the professional sanctions to which the solicitor exposed himself.

legalisation, does not remain otherwise contrary to public policy. This will sometimes be the case. For example, although criminal and tortious liability for champerty has been abolished, a champertous agreement remains contrary to public policy: Section 14(2) of the Criminal Law Act 1967.

[176] [1998] 2 All ER 720. See para 2.37 above.

[177] [1998] 2 All ER 720, 724.

7.109 We have seen how in *Chai Sau Yin v Liew Kwee Sam*[178] the Privy Council refused to enforce a claim by the vendor for the sale price of rubber which the purchaser had bought in breach of a statutory regulation which required all purchasers of rubber to hold a licence. The purchaser was therefore able to rely on his own unlawful conduct to retain the rubber without making any payment for it. Had our provisionally proposed discretion been in operation, the court would have been able to consider all relevant factors and, we suggest, might have reached a different outcome. The illegality involved was not serious,[179] the plaintiff neither himself committed any offence nor was aware that the defendant was doing so, denying the plaintiff his remedy would not further the purpose of the regulation, and seems out of all proportion to the plaintiff's conduct. The only factor weighing against allowing the plaintiff's claim might therefore be the question of deterrence: denying this plaintiff's claim might ensure that future vendors of rubber checked more carefully that their purchasers held valid licences.

7.110 In *Taylor v Bowers*[180] the Court of Appeal allowed the plaintiff to sue the defendant in detinue for the detention of his goods because "[i]f money is paid or goods delivered for an illegal purpose, the person who had so paid the money or delivered the goods may recover them back before the illegal purpose is carried out".[181] We consider that if the facts of this case had been decided under our provisional proposals, the outcome would have been the same. That is, the plaintiff would be able to rely on our provisionally proposed *locus poenitentiae* in order to recover the goods. He would be able to show that by withdrawing from the transaction and recovering his goods, the purpose of the illegality (the fraud on his creditors) was less likely to be achieved. Although it is not clear that the plaintiff repented of his unlawful behaviour, and that behaviour might be regarded as serious, we consider that the clear advantage of reducing the likelihood of the plaintiff's illegal purpose being achieved, would weigh heavily in favour of recovery.

7.111 In *St John Shipping Corporation v Joseph Rank Ltd*[182] we have seen that the High Court allowed a shipper to enforce a claim for freight despite his unlawful performance of the contract. Devlin J said that he was able to reach this decision because the shipper did not intend the unlawful performance (overloading of the ship) at the time that he entered into the contract, but only at the later date when the freight was taken on board.[183] Although, under our provisionally proposed discretion we believe that the same outcome would have been reached, there would have been no need for such technical reasoning. That is, the date at which the shipper intended to overload his ship would no longer be a decisive factor in the outcome of the case.

[178] [1962] AC 304. See para 2.18 above.

[179] The rubber was sold to a partnership. One of the partners held the required licence, but had not included the other partners' names on the licence.

[180] (1876) 1 QBD 291. See para 2.50 above.

[181] (1876) 1 QBD 291, 300, *per* Mellish LJ.

[182] [1957] 1 QB 267. See paras 2.29 to 2.31 above.

[183] [1957] 1 QB 267, 283.

7.112 Again, we believe that if *Kiriri Cotton Co Ltd v Dewani*[184] had been decided under our provisional proposals, the outcome of the case (assuming that the contract was unenforceable by the landlord) would have been the same. That is, the tenant would be able to recover the illegal premium which he had paid to his landlord. All the factors seem to point in this direction. The illegality was not particularly serious and the plaintiff was unaware of it. Preventing his recovery would seem unlikely to prevent other tenants making the same mistake and would be a disproportionate penalty in respect of his behaviour; whereas allowing him to recover would further the purpose of the Rent Restriction Ordinance.

7.113 Finally, it seems likely that the same outcome would be reached if *Bowmakers Ltd v Barnet Instruments Ltd*[185] were decided under our provisionally proposed discretion. The abandonment of the reliance principle would, however, remove any need for argument over whether the plaintiff's claim amounted to an enforcement of its rights under the hire-purchase agreements with the defendants. The statutory breach would appear to have been minor, and neither party was aware of it. Denying the plaintiff its contractual rights would therefore have been out of all proportion to its involvement in the illegality and would not appear to further the purpose of the pricing regulations. The only factor which might weigh against recovery would therefore be the argument that denying recovery would deter other finance companies from entering into hire purchase agreements without ensuring that all statutory pricing requirements had been complied with.

(2) How our provisional proposals might apply to hypothetical examples

7.114 Where two parties enter into a contract whereby one agrees to inflict any form of physical harm on a third party, we have no doubt that, because of the seriousness of the illegality involved, the court would refuse in the exercise of our proposed statutory discretion to enforce the contract or provide any type of restitutionary relief in relation to payments made under it.

7.115 A courier delivers goods under a delivery contract which both parties know the courier will not perform without committing a parking offence. Although a consideration of the factors outlined in our provisionally proposed structured discretion do not all tend the same way, it seems likely the court would conclude that the courier could claim damages for breach of contract in the event that he was not paid the delivery charge. While the courier deliberately committed the offence and denying relief might deter others and further the purpose of the parking regulations, the offence is not serious and denying relief would be wholly disproportionate to the plaintiff's conduct.

7.116 A vendor delivers goods to a purchaser pursuant to a contract in which the goods are given a false trade description in contravention of the Trade Descriptions Act 1968. Nevertheless the vendor will still be able to enforce the contract if the purchaser fails to pay. Section 35 of the Act provides that a contract for the supply of goods shall not be void or unenforceable by reason only of a contravention of

[184] [1960] AC 192. See para 2.41 above.

[185] [1945] KB 65. See para 2.63 above.

the provisions of the Act. Our proposed statutory discretion would therefore not apply[186] and the contract would be enforceable.

11. GENERAL QUESTION ON DISCRETIONARY APPROACH

7.117 We have provisionally proposed legislation introducing a structured statutory discretion in place of the strict present rules operating in relation to illegality as a defence (and, under the *locus poenitentiae* doctrine, as a possible restitutionary cause of action). We are conscious, however, that some consultees may object to any discretionary approach. **Having set out the details of our provisional proposals, we would now ask those consultees who object to any discretionary approach to set out and explain what reforms, if any, they would prefer to make to the rules on illegality in relation to contracts.**

[186] See para 7.102 above.

PART VIII
OPTIONS FOR REFORM II: TRUSTS

8.1 We saw in Part III that trusts may be affected by illegality on a number of different grounds. Some trusts or provisions in trusts are void at common law on grounds of public policy.[1] It is also conceivable that a statute could specifically invalidate a trust.[2] And even if the illegality does not invalidate the trust, the beneficiary may not be able to claim under it where he or she cannot prove his or her interest without relying on some illegality.[3] This still leaves a significant but indeterminate category of trusts which directly or indirectly involve or are connected to illegality, but which are nonetheless fully valid and enforceable.

8.2 In Part V we criticised the present law on the effects of illegality on several bases. They were: complexity;[4] the law's potential to give rise to unjust decisions;[5] and uncertainty.[6] These criticisms apply to various aspects of the law in relation to the effect of illegality on trusts, just as they apply in relation to contracts. In our view, they require that serious consideration be given to statutory reform of this area, which, *prima facie*, should be along similar lines to that which we have provisionally recommended in Part VII for illegal contracts.[7]

8.3 We begin this Part by considering whether the reliance principle[8] should have any role as a test of the enforceability of a trust. The principle has been widely criticised since it was authoritatively propounded (or perhaps confirmed) by a majority of the House of Lords in *Tinsley v Milligan*.[9] Our strong provisional view is that the principle should be abandoned and we examine what, if any, principles should replace it. In our view, a case can be made for resolving the question of the validity of at least some "illegal trusts" by means of a statutory discretion. We give prolonged consideration to the extent and effect of that discretion.

1. ABANDONING THE RELIANCE PRINCIPLE

8.4 It appears, as we have seen,[10] that a trust, which is not otherwise invalid or unenforceable, may be unenforceable at the instance of a beneficiary if its existence cannot be shown unless he or she relies on (leads evidence of) illegality. It is difficult to identify a convincing rationale for the principle; there is

1 See para 3.33 above.

2 See para 3.34 above.

3 See paras 3.9 to 3.13 above.

4 See para 5.2 above.

5 See paras 5.3 to 5.7 above.

6 See paras 5.8 to 5.9 above.

7 For the importance of our provisional recommendations on contracts and trusts applying in the same way to the same facts, see para 1.17 above.

8 See paras 3.9 to 3.13 above.

9 [1994] 1 AC 340. For the critics, see para 3.23 above.

10 See paras 3.9 to 3.13, paras 3.40 to 3.50, paras 3.51 to 3.56, and paras 3.61 to 3.66 above.

considerable uncertainty about its applicability to trusts and its effect, where it applies; and it produces arbitrary and unjust results. In our view, the case for reform is compelling.

(1) The difficulties with the reliance principle

(a) The lack of convincing rationale and the arbitrariness of the principle

8.5 We sought to identify various policies which underlie special illegality rules in Part VI. They were: upholding the dignity of the court; preventing plaintiffs profiting from their wrongdoing; deterrence; and punishment. None of these policies is coherently reflected in the "reliance principle".

8.6 It is undeniable that these policies could sometimes be advanced if a court refused to enforce a trust. But whether or not a trust is unenforceable under the reliance principle does not primarily[11] depend on whether such policies are likely to be advanced. It depends on a purely formal test: whether it is necessary to lead evidence of the illegality in order to establish the claim. This turns on the irrelevant factors of how, and by whom, a claim must be pleaded. As a result, there is no guarantee that the test will yield results which are consistent with any of the policies which underlie special illegality rules.

8.7 Thus the reliance principle may compel courts to enforce a trust in favour of a person even though the illegality was serious and the substantive case for non-enforcement was strong.[12] Conversely, a court may be forced to refuse to enforce a trust in favour of a person when the illegality was venial, the substantive case for non-enforcement was weak, and non-enforcement would award a windfall to a person who was actively involved in, profited from, and/or instigated the illegality in question. Courts may also be obliged to treat identical forms of illegality in drastically and inexplicably different ways. The example may be given of a "fraudulent transfer" case. If the transferee is a person in whose favour the presumption of advancement applies, the transferor is likely to be unable to enforce a resulting trust in his or her favour.[13] In contrast, if the transferee is not such a person, the transferor is likely to succeed.[14] Attempts have been made by some judges to reduce the arbitrariness of the principle; but their success is only partial.[15]

[11] Cf the impact of the "withdrawal exception", discussed at paras 3.14 to 3.18 above.

[12] See, for example, the illustration given by Lord Goff in *Tinsley v Milligan* [1994] 1 AC 340, 362.

[13] See para 3.22 above.

[14] See para 3.22 above.

[15] See para 3.24 above, discussing Millett LJ's attempts in *Tribe v Tribe* [1996] Ch 107 to reduce the arbitrariness of the distinction between cases in which the presumption of advancement does, and does not, apply. He does not deal with the arbitrary distinction between cases in which a transfer is made for a fraudulent purpose, where the transferor is content to rely on a resulting trust in his or her favour, and those where the transferor makes an effective express declaration of trust in his or her own favour.

(b) The uncertainties of the reliance principle

8.8 Perhaps the major message to emerge from our description of the present law in Part III is the uncertainties of the reliance principle. We noted that it is unclear which trusts are potentially affected by that principle and that it can be very hard to decide whether it is necessary to "rely" on illegality in order to establish the trust. The position of third parties who claim through or under the "beneficiary" of an unenforceable trust is also uncertain.

8.9 The cases usually cited in support of the principle deal with trusts that arise out of transactions which are intended to facilitate fraud. However, in *Tinsley v Milligan*,[16] Lord Browne-Wilkinson expressed the principle as a test of the enforceability of all equitable interests.[17] It therefore potentially applies to any trust which (but for the reliance principle and despite its connection to some form of illegality) would be valid and enforceable. Unfortunately the case law does not provide us with any clear picture of what trusts fall within that category. They may include trusts which are created to facilitate a legal wrong or which arise out of transactions with that purpose, or trusts created for an "illegal consideration".[18] But either there is no case law indicating whether such trusts are in fact invalid because of the illegality; or the case law is confusing and contradictory.[19] There is also an argument that the principle might apply to resulting trusts which arise in favour of a settlor if an express illegal trust is void for illegality.[20]

8.10 In Part III we also observed that it can be very difficult to apply the reliance principle in practice, even if it is clear that it applies to the trust in question. The principle is a formal principle, which depends on what must be pleaded and by whom. It is not always clear precisely what must, rather than may, be shown in establishing particular claims.[21] And courts have a degree of latitude in deciding whether certain evidence must necessarily be proffered in support of a particular claim. This makes it hard to predict whether a claim will succeed (because it is not necessary to "rely") or fail (because it is necessary to "rely"). Thus if it is necessary to establish a "common intention to share beneficial ownership", is it "necessary" to show the illegal purpose of shared ownership? If it is necessary to establish that a person did not intend the other to have beneficial ownership, is it "necessary" to show the illegal motive for retaining beneficial ownership? The

[16] [1994] 1 AC 340, 371.

[17] See para 3.11 above.

[18] See paras 3.53 to 3.56 above.

[19] Cf, in particular, *Ayerst v Jenkins* (1873) LR 16 Eq 275 and *Phillips v Probyn* [1899] 1 Ch 811 (noted at para 3.53 above), which are impossible to reconcile.

[20] See paras 3.40 to 3.50 above.

[21] There is, for example, an on-going dispute about what must be shown to establish a resulting trust, where a presumption of resulting trust does not apply, or is rebutted, or is displaced by the presumption of advancement. Is it necessary to show an intention to retain beneficial ownership, or merely that the owner had no intention to benefit the transferee of the legal title? See, in particular, R Chambers, *Resulting Trusts* (1997).

uncertainty is heightened as the arbitrariness of the principle tempts courts to "reinterpret" the principle, or to recognise new exceptions to it.[22]

8.11 A final area of uncertainty concerns the position of persons who claim through or under a party to the illegality. Some dicta suggest that they might be in a better position;[23] but other dicta suggest that they will not be.[24] It would be surprising if assignees could be in a better position than their assignors. But, once again, this has not been authoritatively determined, and there are some arguments of policy which suggest that a more flexible rule might be appropriate.[25]

(c) Conclusion

8.12 **For these reasons, we provisionally propose that the reliance principle should be abandoned as a test of enforceability of a trust. Do consultees agree? If consultees do not agree with this provisional proposal, do they consider that the reliance principle is operating satisfactorily, or should be in any way reformed?**

8.13 What this proposal would mean is that, unless a trust is otherwise invalid or unenforceable for illegality, a claim to enforce it should not fail simply because the claim cannot be established without the claimant having to "rely on" (lead evidence of) illegality. In our view, the validity and enforceability of a trust involving illegality must depend primarily on the nature of the illegality in question and the policies which apply to it; it must not turn on how that illegality comes to the attention of the court. In the following section we consider whether, if the reliance principle is removed, it is necessary to introduce some other ground(s) on which "illegal trusts" may be held to be invalid or unenforceable.

(2) Options for reform, if the reliance principle is abandoned

8.14 In our view - and subject to hearing the opinions of consultees - the case for abandonment of the reliance principle, as a test of the enforceability of a trust, seems clear. But it is somewhat more difficult to decide what, if anything, should replace it. As we have explained, it is not easy to be certain about the present impact of the principle and this makes it difficult to be certain about the implications of its abandonment. We attempted to identify some of the likely examples in which it might apply in Part III. One obvious example is the resulting trust which arises in favour of a transferor who voluntarily transfers property to another in order to facilitate fraud.[26] Another possible example is an express trust

[22] See, for example, the "reinterpretation" of the reliance principle by Dawson J in *Nelson v Nelson* (1995) 184 CLR 538, 580 (considered at para 3.24 above) and the very wide "withdrawal exception" recognised in *Tribe v Tribe* [1996] Ch 107 (considered at paras 3.14 to 3.18 above).

[23] See *Muckleston v Brown* (1801) 6 Ves 52, 68; 31 ER 934, 942, *per* Lord Eldon. This is also a view favoured by a number of modern cases in the United States: see A W Scott & W F Fratcher, *The Law of Trusts* (4th ed 1987 and later supplements), vol V, § 422.6.

[24] See *Ayerst v Jenkins* (1873) LR 16 Eq 275.

[25] See para 3.58 above.

[26] See paras 3.9 to 3.13 above.

which is created for the same end.[27] A third possibility is an express trust which is executed in return for an illegal consideration.[28] It is not clear that the reliance principle would be applied in either the second or third cases, or that, even if it was, it would ever render either category of trust unenforceable in practice. On the other hand, it is clear that the reliance principle will be applied to the resulting trust (the first illustration), and may sometimes render such a trust unenforceable. This is, however, likely to turn on irrelevant considerations (in particular, whether a presumption of advancement arises in favour of the transferee).

8.15 Abandonment of the reliance principle would therefore appear to mean that (subject to the possible application of the equitable "clean hands" maxim)[29] all such trusts would be valid and enforceable, however serious the illegality. We do not think that that would be desirable. We provisionally believe that it would be proper for the law, in exceptional circumstances, to invalidate or refuse to enforce such illegal trusts. The very difficult question is on what basis should the law do so? In our view there are three possible ways forward once the reliance principle is abandoned:

(1) future development of this area could be left to the courts;

(2) legislation could introduce a set of statutory rules governing the effect of illegality on some or all trusts; or

(3) legislation could introduce a statutory discretion to decide the effect of illegality on some or all trusts.

8.16 We can see considerable initial attractions in the suggestion that, once the reliance principle has been abandoned, future development of this area should be left to the courts. In general, trusts which "involve" illegality have not caused, and would perhaps be unlikely to cause, significant difficulties for the courts. There is certainly a dearth of case law dealing with many of the forms in which a trust may "involve" a legal wrong.[30] And legislation reforming the law on the effect of illegality in New Zealand and Israel has been confined to illegal contracts.

8.17 There are nevertheless several difficulties with this minimalist option. An initial difficulty is that courts *have* developed inappropriate principles for at least one type of trust that "involves" a legal wrong: the resulting trust which arises out of a transaction entered into to facilitate fraud. At one time the courts applied a principle that was too harsh;[31] after *Tinsley v Milligan*,[32] they are required to apply a principle which is simply arbitrary.[33] In our view, only statutory reform could

[27] See paras 3.55 to 3.56 above.

[28] See paras 3.53 to 3.54 above.

[29] See para 8.89 below.

[30] Cf the well-established grounds on which an illegal trust may be invalid because it is "otherwise" (ie for some other reason) contrary to public policy: see para 3.33 above.

[31] See para 3.11 above.

[32] [1994] 1 AC 340.

[33] See paras 3.9 to 3.13 above, on the reliance principle.

produce a satisfactory solution for this type of case. A rule whereby all such trusts were invalid or unenforceable, or, alternatively, valid and enforceable, would not be appropriate. Only a discretion could enable a court to balance, as we provisionally believe it must in this area, all of the policy factors involved.[34] But a discretionary approach has been authoritatively rejected by English courts and is unlikely to be resurrected.[35] We should also emphasise that, whatever the position before *Tinsley v Milligan*,[36] proposals for legislative reform which were confined to illegal *contracts* - and hence failed to deal with the facts and decision in that leading case - could not now be regarded as acceptable.[37]

8.18 It is therefore our provisional view that some statutory reform, in the form of the introduction of a discretion, is appropriate and, once one accepts that a statutory discretion is required to deal with one limited category of trust which "involves" a legal wrong, it becomes hard to explain why courts should not have a similar discretion to decide the effects of other categories of trust which "involve" a legal wrong. Our concerns about wider statutory reform are not so much that a statutory discretion would produce the wrong results or have unfortunate side effects,[38] but that a statutory discretion may not be necessary as courts could be expected to reach appropriate decisions on the basis of general principles. In any case, that confidence *may* be undue. Many policies and interests need to be weighed when deciding what effect illegality should have on ordinary civil rights and obligations. The principles adopted would need to be highly refined (perhaps impossibly so) if they are to produce a proper balance in all of the diverse factual situations that could arise.

8.19 Since we also provisionally reject, as impossible to formulate, the option of laying down a set of statutory rules, we therefore provisionally propose that the courts should be given a statutory discretion to decide the effect of illegality on trusts in at least some cases. The rest of this Part is devoted to considering what the scope and effects of any such discretion might be.

[34] If the trust is invalid or unenforceable, the law expropriates the transferor's property and may confer a windfall gain on the transferee. Whether these consequences are appropriate can only properly be determined by considering, *inter alia*, the extent to which those consequences would be proportionate punishment for the transferor's wrongdoing in the light of the seriousness of the fraud contemplated and/or practised, the loss which would be caused to the transferor if his or her rights were unenforceable, and the other available means (if any) of punishing his or her conduct. See similarly para 7.2 above.

[35] The "public conscience test" did enable courts to balance all relevant factors in their complete discretion, and was once applied to determine the enforceability of resulting trusts arising out of fraudulent transactions: see eg *Tinsley v Milligan* [1992] Ch 310 (CA). But that test has since been authoritatively abandoned by the courts: *Tinsley v Milligan* [1994] 1 AC 340 (HL). See, further, Part IV.

[36] [1994] 1 AC 340.

[37] The proposals of the Law Reform Commission of British Columbia apply to all illegal transactions, including both contracts and trusts: Law Reform Commission of British Columbia, Report on Illegal Transactions (1983) pp 6-8.

[38] Cf paras 8.92 to 8.115 below, in which we consider the potentially adverse impact of a discretion on the position of trustees, beneficiaries and third parties.

8.20 **We ask consultees whether they agree with our provisional view that, once the reliance principle is abandoned, the creation of a statutory discretion to decide the effect of illegality on some or all trusts is the right way forward. If consultees do not agree, do they consider that (a) future development of this area of the law should be left entirely to the courts; or (b) legislative reform should introduce a set of statutory *rules* governing the effect of illegality on some or all trusts?**

2. A DISCRETIONARY MODEL FOR ILLEGAL TRUSTS

(1) What do we mean by an "illegal trust"?

8.21 Before the ambit of any discretion can be defined, it is first essential to identify the various ways in which a trust may involve or be connected to illegality. The major textbooks are unfortunately incomplete in this respect. No attempt has yet been made to analyse, systematically, how a trust may involve or be connected to some illegality. In general, treatments of "illegal trusts" focus on those trusts which are invalid or unenforceable at common law (as they are "contrary to public policy") or by statute. Such an approach is not adequate for our purposes. In several instances, a trust that involves or is connected to illegality is nonetheless fully valid and enforceable (or not clearly invalid and unenforceable). A comprehensive picture of what effect, if any, the involvement of illegality should have on a trust must embrace cases in which illegality now adversely affects the validity or enforceability of a trust *as well as those cases in which it does not, at present, do so*. For it cannot automatically be assumed that the courts have correctly concluded that a particular type of illegal trust is valid, just as it cannot be assumed, without more, that the courts have correctly concluded that other types of illegal trust are invalid or unenforceable.

(a) Trusts which are "illegal trusts" (that is, our proposed "definition" of illegal trusts)

8.22 We regard an "illegal trust" as comprising the following:

(1) a trust which it would be legally wrongful to create or impose;

(2) a trust which is created to facilitate fraud or which arises as a result of a transaction or arrangement with that objective;

(3) a trust which is created to facilitate some other legal wrong or which arises as a result of a transaction or arrangement with that objective;

(4) a trust which is created in return for the commission of a legal wrong or the promise to commit a legal wrong (an "illegal consideration");

(5) a trust which expressly or necessarily requires a trustee to commit a legal wrong or which tends or is intended to do so;

(6) a trust which expressly or necessarily requires a beneficiary to commit a legal wrong or which tends or is intended to do so; and

(7) a trust which is otherwise contrary to public policy at common law (that is, for some reason other than legal wrongdoing).

8.23 Although *prima facie* falling within the "definition" outlined above,[39] we do not mean to include here a trust which arises in the event that a primary express trust is invalid for illegality (for example, an "automatic" resulting trust in favour of the settlor). We believe that different considerations may apply in relation to the question of the validity of these trusts, and we consider them in detail in paragraphs 8.64 to 8.71 below. We do, however, intend to include those constructive trusts giving effect to intentions which we outlined in paragraphs 3.61 to 3.68 above.[40] In the paragraphs which immediately follow we explain the case for a discretion in relation to each category of illegal trust which we have identified.

(i) Trusts which it is legally wrongful to create or to impose

8.24 We have found it difficult to identify examples of trusts which fall within this category. One example might be a trust which is created in breach of contract.[41] It is thus not clear what principles would determine whether such trusts are valid and/or enforceable, and likewise, whether those principles would produce acceptable results. Nevertheless, a trust could fall within this category and it is not obvious that all such trusts should invariably be valid or invariably be invalid. It is our provisional view that a discretion is unlikely to be any less certain than the existing principles. A discretion would offer an important degree of flexibility which the present rules (whatever they are) could not provide; and in any case, trusts of this type are likely to be rare. Thus we anticipate that it will be rare for a trust *per se* to breach some statutory provision. Where a statute renders a trust "illegal" in this sense, the effect on the trust may be expressly stated. If so, the terms of the statute should prevail, and we consider this in paragraphs 8.42 to 8.43 below. But if the statute does not contain such a provision, it may be preferable to allow the courts to confront directly the question whether the trust should be valid in all the circumstances, rather than leave them to struggle to identify an unexpressed "parliamentary intention".

(ii) Trusts which are created to facilitate a fraud, or which arise out of a transaction or arrangement with that purpose

8.25 Trusts[42] which arise out of transactions or arrangements entered into with a fraudulent purpose are not invalid, but they will be unenforceable if the beneficiary must lead evidence of the illegal purpose in order to establish his or her claim.[43] The better view may now be that the same rules apply to express trusts created for

[39] See for example, categories (2) and (3) which would include an automatic resulting trust arising if the express primary trust is invalid.

[40] Although note that in some cases the effect of the illegality may be such that the constructive trust never arises. See especially para 3.67 above.

[41] Another example might be a trust created in contravention of section 765(1)(d) of the Income and Corporation Taxes Act 1988, by which it is unlawful in certain circumstances to transfer ownership (including a transfer of beneficial ownership) in shares without the consent of the Treasury.

[42] This includes purchase money and voluntary transfer resulting trusts, as well as common intention constructive trusts.

[43] See paras 3.9 to 3.13 and paras 3.61 to 3.64 above.

a fraudulent purpose.[44] The effect of these rules is, as we have already noted, wholly arbitrary.

8.26 It is our strong provisional view that a discretion is the only way forward for this type of illegal trust. The common law has proved unable to devise an appropriate rule to deal with this category of case. It is clearly wrong that the enforceability of such trusts should turn on form and not substance. But it would also, we believe, be wrong to apply a general rule (of validity or invalidity) to cases of this sort. Only a discretion can provide the necessary flexibility.

(iii) Trusts which are created in order to facilitate some other legal wrong, or which arise out of a transaction or arrangement with that purpose

8.27 The validity or enforceability of trusts which are created in order to facilitate some other legal wrong, or which arise out of transactions or arrangements with that purpose, is unclear.[45] It is possible that they would be treated in the same way as transactions which are intended to facilitate a fraud: that is, it seems likely that they would be valid, but might be unenforceable if the beneficiary could not establish his or her claim without leading evidence of the illegal purpose. If this is the case, the justification for the use of a discretion is the same as that outlined in paragraph 8.26 above in relation to trusts which facilitate fraud.

(iv) Trusts which are created in return for an "illegal consideration"

8.28 The validity or enforceability of a trust which is created for an illegal consideration is also unclear. There is some support in the case law for the proposition that, once constituted, such a trust is valid[46] and is enforceable by a beneficiary (at least if innocent).[47] That would arguably be consistent with cases on the creation or transfer of legal property rights pursuant to illegal contracts.[48] But another case apparently treats such a trust as invalid.[49] These decisions are impossible to reconcile and no clear, general principle emerges from them. If such illegal trusts are valid, it is not clear what impact (if any) *Tinsley v Milligan*[50] may have on their enforceability.

8.29 The justification for a discretion to invalidate these trusts is, we provisionally believe, once again clear. The present position is obscure and a general rule of validity (or, alternatively, of invalidity) could be too inflexible. In any case, it is strongly arguable that courts would have a discretion to invalidate this category of

[44] See paras 3.55 to 3.56 above.

[45] An example would be where two parties contribute to the purchase price of property which they intend to use as a bomb-making factory or for a drugs stash, but, for reasons of convenience rather than fraud, title to the property is transferred into the name of one party only.

[46] Cf if the trust is independently objectionable.

[47] See our discussion of the difficult decision in *Ayerst v Jenkins* (1873) LR 16 Eq 275 at paras 3.53 to 3.54 above.

[48] See paras 2.57 to 2.69 above.

[49] See *Phillips v Probyn* [1899] 1 Ch 811.

[50] [1994] 1 AC 340.

trust, as a result of our provisional proposals for "illegal contracts".[51] A trust which is created for an "illegal consideration" will be a trust created under an "illegal contract". We have provisionally proposed that a court should have a discretion to decide whether or not to recognise "property rights" that have been ostensibly created or transferred pursuant to an illegal contract. That discretion cannot be rationally limited to legal rights, or to equitable rights other than beneficial interests arising under a trust.

(v) Trusts which expressly or necessarily require trustees to commit a legal wrong or which tend or are intended to do so

8.30 An example of this category would be a trust which requires the trustee to invest the trust funds in an illegal scheme. Although we have been unable to find a clear rule to the effect that such a trust is invalid, it is hard to foresee that there are circumstances in which the courts would consider that it would be in the public interest to uphold the validity of such a trust.[52] On the other hand, it might be arguable that, where the illegality involved is trivial and invalidating the trust would affect beneficial entitlement, the court should have a discretion to uphold the validity of the trust. Prior to hearing the views of consultees, we would be wary of suggesting that there should be an absolute rule that any such trust was invalid.

(vi) Trusts which expressly or necessarily require a beneficiary to commit a legal wrong or which tend or are intended to do so

8.31 It is likely that a trust of this sort is void under the present law.[53] And we can see great merit in such a rule. There is a public interest in avoiding wrongdoing; and such wrongdoing would be encouraged and rewarded if the law upheld a trust whereby a beneficiary would obtain or retain an interest only if he or she committed a legal wrong. On the other hand, as we have discussed in relation to trusts which require the trustees to commit a legal wrong, it might be arguable that, where the illegality involved is trivial and invalidating the term would affect beneficial entitlement, the court should have a discretion to uphold the validity of the trust. Again, without hearing the views of consultees, we are wary of suggesting that there should be an absolute rule that any such trust was invalid.

(vii) Trusts which are otherwise contrary to public policy at common law

8.32 Many trusts which are often categorised as "illegal trusts" neither involve, nor are connected with, any legal wrongdoing. Instead, they are trusts which involve conduct of which the law disapproves as being contrary to the interest of the public.[54] This category is analogous to contracts which are contrary to public policy. We have had some doubts whether it is necessary to include this category within the provisionally proposed discretion. That is, we consider that it is difficult to separate the question whether a trust is contrary to public policy from the

[51] See paras 7.23 to 7.26 above.

[52] We consider the position where the term(s) requiring the legal wrong may be "severed" from the other terms of the trust in para 8.116 below.

[53] See para 3.1 n 2 above. We consider the position where the term(s) requiring the legal wrong may be "severed" from the other terms of the trust in para 8.116 below.

[54] See, for illustrations, para 3.33 above.

question whether it is in the public interest that the beneficial interests purportedly created by it should be valid. So, on this view, where the court declares that a trust is contrary to public policy, it is implicitly saying that it would not be in the public interest to recognise the trust as valid.[55] On the other hand, one could argue that such an approach is too draconian and that, conceivably, the finding that a trust is contrary to public policy should sometimes trigger less drastic consequences than declaring it to be invalid. Without hearing the views of consultees, we are therefore reluctant to suggest that any trust which a court declares is contrary to public policy should automatically be invalid.

(b) Trusts which are not "illegal trusts"

8.33 Our "definition" is not intended to capture all of the different ways in which a trust may "involve" illegality. In particular, we have limited the definition to trusts which involve or are connected to illegality *from their inception*. This has three more specific implications.

(i) A trust which neither expressly nor necessarily requires a trustee to perform an illegal act nor tends nor is intended to do so does not become an "illegal trust" where the trustee in fact performs such an act

8.34 We have excluded from the category of "illegal trusts" those trusts to which the only objection is that the trustee committed a legal wrong in the course of acting as trustee. Say, for example, that the trustee invests the trust fund in a fraudulent scheme. If the trust neither expressly nor necessarily requires the trustee to perform an illegal act, the objection is not to the trust as such, but to conduct of the trustee in administering the trust.[56] In our view, it would be an extreme and unnecessary response for a court to invalidate the trust itself for that reason, and we have no reason for thinking that a court would at present do so. The better view is that courts would instead provide remedies against the individual trustee (for example, by removing the trustee from his or her office) and/or invalidate the wrongful transaction, if any, to which the trustee was a party.

(ii) A trust which neither expressly nor necessarily requires a beneficiary to perform an illegal act nor tends nor is intended to induce such an act does not become an "illegal trust" where the beneficiary purports to satisfy a condition by performing such an act

8.35 A condition that is attached to an interest under a trust could be so expressed that it can *prima facie* be satisfied by legal conduct on the part of the beneficiary or by unlawful conduct. Such a condition neither "expressly" nor "necessarily" requires the beneficiary to commit a legal wrong; it may not be "intended" to do so; and it

[55] For a similar provisional view in relation to the enforcement of contracts which are contrary to public policy, see paras 7.13 to 7.16 above.

[56] Cf Part VII, where we include within the scope of our provisionally proposed discretion contracts where one party commits a legal wrong in performing the contract (paras 7.70 to 7.72). Nevertheless, we note that this is a very wide definition and that unilateral illegal performance should rarely render a contract unenforceable. The difference in approach to contracts and trusts here ultimately rests on the fact that one can divorce a trust from the particular trustee(s) more readily than one can divorce a contract from the particular parties to it.

may not "tend to induce" the commission of a legal wrong by him or her. If that is so, in our view the trust should not be regarded as an "illegal trust".

8.36 We agree that it would be unacceptable if a beneficiary was able successfully to claim to have satisfied a generally worded condition by committing a legal wrong. The beneficiary would thereby profit from his or her wrongdoing, and the law would encourage rather than discourage beneficiaries to act wrongfully. However, we are not satisfied that these undesirable consequences can only be avoided if the trust is regarded as an "illegal trust" which falls within the ambit of our proposed discretion.

8.37 We anticipate that courts would be inclined to construe a general condition in such a way that, in the absence of clear evidence of a contrary intention on the part of the settlor, it is impliedly limited to "lawful" performance. If that is correct, the difficulties to which we have referred will not arise. The beneficiary would not profit from his or her wrong, as he or she could never, in the absence of clear contrary intention, claim to have satisfied the condition by acting unlawfully. Where a clear contrary intention is shown, however, the trust would be "illegal" within the ambit of our proposed discretion.[57]

(iii) A trust where the trust property is used to achieve some fraudulent or other illegal purpose is not an "illegal trust" where the intention to use the trust property for that purpose was formed only after the date on which the trust was created or arose

8.38 One person may transfer property to another, without intending to make a gift to that other, but without *at that time* having any illicit motive. If the transfer is voluntary, equity will impose a resulting trust on the property in the transferee's hands in the transferor's favour.[58] At a later time, however, the transferor may decide to use the property in which he or she has a beneficial interest to commit a legal wrong. The resulting trust was obviously not an "illegal trust" at the date at which it arose: it was not "created" in order to facilitate an illegal objective and did not arise out of a transaction with that end.[59] But, in our view, neither should it become an "illegal trust" because the transferor only subsequently decides to use the trust property for an illegal purpose.[60] Similarly, the beneficiary of an express trust may, after the trust has been created, use the trust property for an illegal purpose.

8.39 There is little reason to think that such a trust would be invalid or unenforceable under the present law, *inter alia* because the beneficiary will not need to rely on his or her subsequent illegal purpose in order to establish his or her claim.[61] And we

[57] See para 8.31 above.

[58] See para 3.5 above.

[59] Cf our proposed "definition" of illegal trust in para 8.22 above.

[60] For a similar limitation in relation to illegal contracts, see para 7.70 n 103 above.

[61] For example, in the case of the voluntary transfer resulting trust, where the transfer was made for a legal motive, the transferor will be able to rebut the presumption of advancement (if any) which may arise by leading evidence of that legal motive. He or she will not need to rebut the presumption by leading evidence of the subsequent illegal motive; and such evidence could not rebut the presumption in any case, as it would not show what

do not consider that it would be appropriate to regard such trusts as "illegal trusts" which could be invalidated under our proposed discretion. That would make the court's discretion unacceptably wide. The subsequent illegal use by a trust beneficiary of trust property is but one illustration of a much more general fact pattern: that is, where a person to whom property is given[62] independently chooses at some later date to use the property to accomplish some illegal end. It cannot, in our view, be proper to permit courts to invalidate the rights conferred in all those cases. It would introduce an unacceptable degree of uncertainty into property rights, since any property right could be expropriated, in the court's discretion, if it happened to be exercised or used in an illegal manner *at any time after the date on which it arose*. Indeed, it is an abuse of language to describe the transaction by which the right was acquired as an "illegal transaction".[63]

8.40 **We ask consultees whether they agree with our provisional view that the illegal trusts made subject to a statutory discretion should be limited to:[64]**

(i) trusts which it would be legally wrongful to create or impose;

(ii) trusts which are created to facilitate a fraud or which arise from a transaction or arrangement with that objective;

(iii) trusts which are created to facilitate some other legal wrong or which arise from a transaction or arrangement with that objective;

(iv) trusts created in return for the commission of a legal wrong or the promise to commit a legal wrong (an "illegal consideration");

(v) trusts which expressly or necessarily require a trustee to commit a legal wrong or which tend or are intended to do so;

(vi) trusts which expressly or necessarily require a beneficiary to commit a legal wrong or which tend or are intended to do so; and

(vii) trusts which are otherwise contrary to public policy at common law.[65]

8.41 **If consultees disagree with our provisional proposals, please would they explain which trusts, if any, they consider should be made subject to our provisionally proposed statutory discretion.**

was the intention of the transferor at the time of the transfer (which is when any resulting trust would arise).

62 The property might be transferred absolutely, or the interest acquired by the other might be a more limited interest (such as an equitable proprietary interest or merely a possessory interest).

63 However, we have some doubts whether this argument remains valid where it is decided to use the trust institution itself (that is the separation of the legal and equitable title) for a fraudulent purpose after the date on which the trust is created. Say, for example, that in *Tinsley v Milligan* [1994] 1 AC 340 (see para 3.9 above) Miss Milligan had decided to defraud the DSS regarding her ownership of the house only after the conveyance to Miss Tinsley had been made. One might argue that it would be more sensible to subject such a case to our provisionally proposed discretion than to draw a hard and fast line between those cases where the trust was set up to facilitate fraud and those cases where it is decided to use the trust for fraudulent purposes only after it has been created.

64 And not including "default trusts" arising on the invalidity of an express illegal trust (see para 8.23 above).

65 Although see the doubts about the inclusion of this category which we raise in para 8.32 above.

(2) Trusts which involve the breach of a statutory prohibition where the statute expressly lays down what the consequences of that breach should be

8.42 We have found no current examples of trusts which statute expressly provides are invalid or unenforceable because they breach some provision in the statute.[66] But it is conceivable that such a situation could arise.[67] If it does, then in our view the express terms of the particular statute must be conclusive as to the invalidity or unenforceability of the trust. Our provisionally proposed discretion should not entitle a court to reach a different result. Similarly if the statute expressly provides that the breach should not render the trust invalid or unenforceable, we do not provisionally propose that the discretion should apply. We make a similar provisional recommendation in relation to illegal contracts[68] and our reasoning in that context is equally applicable to illegal trusts.

8.43 **Accordingly, our provisional view is that where a statute expressly lays down what should be the consequences for a trust, of the trust involving a breach of the statute's provisions, our proposed discretion should not apply. We ask consultees if they agree. If they do not, we ask them to explain why not.**

(3) Should the provisionally proposed discretion be a discretion to "invalidate" an illegal trust, or a discretion to render such trust simply "unenforceable"?

8.44 We saw in Part III that some illegal trusts are void or invalid,[69] but that others may be valid but unenforceable.[70] If courts have a discretion to determine the effect of an illegal trust, should that be a discretion as to "validity" or "enforceability"? The distinction between validity and enforceability appears to have several important implications in trusts law.

8.45 If a trust is invalid, under ordinary principles the trustee should hold the property for another, the "default beneficiary" (for example, on a resulting trust for the settlor or for the settlor's estate). The trustee cannot treat the property as his or her own; but nor can the trustee deal with the property as if the illegal trust was valid (for example, by transferring the property to the person who would be entitled to it on that assumption). If the trustee does either of these, he or she is likely to act in breach of trust and thus be liable to the default beneficiary.

[66] Cf, however, section 34 of the Race Relations Act 1976, which renders ineffective certain racially discriminatory provisions in charitable trust instruments. See also, for example, provisions which prohibit and render void "dispositions" of "property" (which might include the creation of a trust of the property), such as section 11(8) of the Channel Tunnel Act 1987.

[67] Cf, for example, section 29 of the Exchange Control Act 1947 (now repealed).

[68] See paras 7.94 to 7.102 above.

[69] See, in particular, para 3.1 above.

[70] See, in particular, para 3.2 above. There is at least one other situation outside the illegality context in which a trust is valid but unenforceable: that is a trust which fails to comply with the formalities required by section 53(1)(b) of the Law of Property Act 1925. See T G Youdan, "Formalities for Trusts of Land, and the Doctrine in *Rochefoucauld v Boustead*" [1984] CLJ 306.

Transferees from the trustee, including beneficiaries of the invalid illegal trust, will not necessarily acquire good title to the trust property and may be subject to personal restitutionary (or other) claims in respect of their receipt.

8.46 In contrast, if a trust is valid and merely unenforceable, the trustee still notionally holds the property on the illegal trust and therefore no default trust arises.[71] But the beneficiary cannot enforce the trustee's fiduciary obligations. As a result, the trustee will in practice be free to treat the property as his or her own. The trustee is, to that extent, enriched. If the trustee does transfer the property to another, he or she will incur no liability for breach of trust; the transferee should be able to acquire effective title as if the trustee was full owner of the property; and the transferee will not incur personal liabilities to the beneficiary in respect of his or her receipt of the trust property. Nevertheless, if the trustee does transfer the property to the beneficiary, the law is likely to recognise and enforce the beneficiary's title.

8.47 One important difference between invalidity and unenforceability may be the effect on creditors, legatees or dependants of the beneficiary. Under the present law, it is not clear whether unenforceability is merely personal, so that an "innocent" person who claims under or through the beneficiary can subsequently enforce the trust against the trustee.[72] Clearly a finding that the trust is invalid, would leave no such option available.

8.48 We provisionally propose that the discretion should be a discretion to declare a trust invalid or valid, rather than unenforceable. Unenforceability would effectively result in the trustee receiving a windfall gain.[73] And it may be inconsistent to hold that an illegal trust is invalid and ought not to be executed by the law, whilst condoning the acts of a trustee who is willing to execute the illegal trust without legal compulsion. If the trust was invalid, the trustee would be denied the windfall gain: he or she would hold the property on trust for another. In addition, the trustee could not legally execute the illegal trust and would be liable to account to the "default beneficiary" if he or she did so; and, at least in theory, claims could be available against the beneficiaries of the illegal and invalid trust for any property they had wrongfully received. Invalidity therefore avoids the unjust enrichment of the trustee; and appears more likely than unenforceability to avoid the illegality in question. We recognise that this might act harshly on those, in particular creditors, who might claim the property by or through the illegal trust beneficiary, and for whom a finding of personal unenforceability on the part of the illegal trust beneficiary only would be preferable. However, we provisionally believe that disadvantage to one party or another is an unavoidable consequence of the resolution of any dispute over who owns property.

[71] See also the discussion at para 3.57 above.

[72] See the discussion at para 3.58 above.

[73] Cf the discussion at paras 8.75 to 8.79 below in relation to whether, in certain circumstances, even invalidity could leave the trustee with a "windfall gain". The primary example is a case in which the trustee holds property on a resulting trust for the settlor or a person in an equivalent position (as in, eg, *Tinsley v Milligan* [1994] 1 AC 340) and that trust is held to be invalid.

8.49 **Our provisional view is therefore that courts should have a discretion to declare an illegal trust to be invalid or valid (rather than unenforceable or enforceable). If consultees do not agree with this provisional view, do they consider (a) that the courts should have a discretion to declare an illegal trust to be unenforceable or enforceable (rather than invalid or valid); or (b) that the courts should have a discretion to declare a trust to be invalid, unenforceable or valid and enforceable?**

8.50 In the rest of this paper we assume that the court's discretion relates to validity or invalidity. However, if consultees were to favour a discretion to declare the trust enforceable or unenforceable, then there are several further questions which we would need to consider (and on which consultees favouring this approach may wish to express their views). For example, if the trustee were to transfer trust property to the illegal trust beneficiary, should he or she then be entitled to retain it? Should there be merely a personal bar on the illegal trust beneficiary's claim, so that others, such as creditors, legatees or those entitled on intestacy, might still be able to claim by or through the beneficiary? And should the illegal trust beneficiary be able to assign his or her interest in the trust, or would this simply be a means whereby he or she could achieve indirect enforcement?

(4) What factors should structure the discretion?

8.51 If courts are to have a discretion to determine the validity of "illegal trusts", then for reasons which we have already discussed,[74] we consider it important that the discretion be "structured". Legislation should offer guidance as to the factors that a court should consider when reaching its decision. We set out below our provisional views on what those factors should be.

8.52 The listed factors are almost identical to those which we have thought appropriate for illegal contracts.[75] This is not surprising. The factors reflect a common set of policies which are in play when the law confronts the question whether "illegality" should affect parties' rights and obligations.[76] Any differences in the listed factors do not reflect different policies, but differences between the contexts in which they fall to be considered.

(a) The seriousness of the illegality

8.53 We have already observed that the policies which seem to underlie special illegality rules are of considerably greater weight where the illegality involved is particularly serious.[77] This insight is no less applicable to illegal trusts. Invalidity will result in the trust property being held for a person other than the person primarily intended to benefit by the settlor. It may be that such interference with the settlor's donative intention can only be tolerated in serious cases.

[74] See paras 7.27 to 7.28 (on the discretion in relation to illegal contracts).

[75] See paras 7.29 to 7.43 above.

[76] See Part VI above.

[77] See para 7.32 above.

(b) The knowledge and intention of the beneficiaries of the illegal trust

8.54 In Part VII we provisionally concluded that the knowledge and intention of the person claiming (for example) to enforce an illegal contract must be relevant to whether the claim should be allowed to succeed.[78] It can have an important impact on whether the various policies which underlie special illegality rules are effectively advanced by denying the claimant his or her ordinary entitlement. If he or she did not know of the illegality, it might be disproportionately punitive to deny the claimant his or her ordinary rights; the dignity of the court is less likely to be offended by enforcement; and non-enforcement may be an ineffective way of deterring the illegality. Conversely, if the claimant knew of the illegality, was actively involved in it and/or stood to benefit as a result, "punishment" is more likely to be appropriate and non-enforcement is more likely to be a proportionate response; the dignity of the court is more likely to be offended by enforcement; and non-enforcement may be a more effective way of deterring the illegality.

8.55 In our provisional view, a similar factor must be relevant to the validity of an illegal trust. Courts should take into account the knowledge and intention of the beneficiaries of the illegal trust, who stand to benefit if the illegal trust is valid and to lose if it is not. It is their putative rights that are adversely affected by the court's discretion. It must always be relevant to consider their responsibility (if any).[79]

8.56 We have reached no concluded view on whether it is also necessary specifically to require courts to consider the knowledge and intention of the settlor, where he or she is not a beneficiary of the illegal trust.[80] The justification for specifically referring to a settlor's knowledge and intention is a different one. A settlor does not derive rights from the illegal transaction (the trust) which may be adversely affected by the court's discretion.[81] But the settlor is responsible for the illegal transaction: he or she created the illegal trust. It is his or her dispositive intention which is thwarted, if the trust is invalid. It is arguable that his or her knowledge and/or intention may bear at least to some extent on the questions whether, for example, invalidity could deter similar dispositions in future cases or could be a proportionate response to the illegality.

(c) Whether invalidity would tend to deter the illegality

8.57 We have seen that an important justification for special illegality rules is the desirability of deterring illegality. In our provisional view, courts should always consider the potential deterrent effect of their ruling when they exercise the proposed discretion.[82] It is obviously impossible for courts to assess that effect with any degree of precision. Nevertheless, there are reasons for thinking that

[78] See paras 7.33 to 7.37 above.

[79] Cf para 3.54 above (trusts created for an illegal consideration) citing American case law which suggests that certain illegal trusts may be enforceable by an "innocent" beneficiary but not otherwise.

[80] Cf paras 8.72 to 8.74 below.

[81] Cf paras 8.64 to 8.74 below, discussing the possibility of a discretion to invalidate a default trust in favour of a person who creates an illegal and invalid trust.

[82] See para 7.38 above.

invalidity must have *some* effect in some types of case. If this is so, deterrence should be an important consideration in favour of invalidity, even though invalidity would not avoid the illegality in the particular case.

8.58 In general it appears that if the legally wrongful acts are complete and not continuing, invalidity will not avoid the illegality in the particular case. This is so whether the trust was created to facilitate a legal wrong (which has occurred); or was created in return for an illegal consideration (which is executed). But invalidity might still help to prevent illegality in future cases. Settlors are less likely to create such trusts if the trusts are likely to be struck down; and beneficiaries are less likely to commit a legal wrong in the expectation of obtaining an interest if it is clear that they will acquire no entitlement as a result, and may be required to repay anything which they wrongfully receive. On the other hand, if the legal wrong has not yet been committed, it is possible, though still not inevitable, that invalidity may prevent it from occurring.

(d) Whether invalidity would further the purpose of the rule which renders the trust "illegal"

8.59 In our provisional view, courts should always consider whether invalidity would further the purpose of the rule which renders the trust "illegal". For example, "invalidity" may constitute an unnecessary and unduly onerous way of avoiding the illegality in "fraudulent transfer" cases: that is, where a trust arises out of a transaction which is designed to facilitate fraud. "Validity" could very often sufficiently avoid the illegality. This is because the fraud may often be frustrated, not facilitated, by recognising the trust. The explanation is clear. The basis for the fraud is the separation of legal and equitable title.[83] If the beneficial owner subsequently seeks to have the property returned to him or her, there would no longer be any separation of title and the basis for the fraud would disappear. Accordingly, if it remains possible for the fraud to take place at that time, the court will tend to further the purpose of the rule which renders the trust "illegal" by upholding the validity of the trust in his or her favour. Fraud would be prevented, not facilitated, for the future.

(e) Whether invalidity is a proportionate response to the claimant's participation in the illegality

8.60 If a trust is invalid, the person who would otherwise have a right will lose that right. His or her expectations of benefiting may be disappointed and he or she may have irrevocably altered his or her position on the faith of those expectations. Invalidity could be said to have a "punitive" effect in such cases. In Part VI we accepted that civil courts could properly punish a person for his or her involvement in illegality by refusing to recognise and enforce his or her ordinary rights.[84] But we stressed that such punishment should be proportionate to the

[83] In most of the reported cases, the transaction facilitates fraud by concealing the transferor's continuing beneficial ownership of the property transferred; contrary to appearances, only legal title is actually transferred. The false representation may be that the transferor has no interest in the property or that the transferee has an absolute interest.

[84] See para 6.11 above.

claimant's wrongdoing.[85] In principle, this consideration should also be relevant to the court's discretion to invalidate a trust.

8.61 In our provisional view, this principle is weighty if the trust arises in favour of the settlor (or, in the case of a resulting trust, the transferor/contributor). Important illustrations are resulting trusts which arise out of a fraudulent transfer, or which arise in favour of a settlor who transferred property on illegal trust. In such cases, the court's decision that the trust was invalid would expropriate his or her property. Unless the illegality was serious or the value of the property small, invalidity will be objectionable as a disproportionate response to the wrongdoing. The financial loss so caused could vastly exceed the gain made and/or the maximum penalty which could be imposed in criminal or other proceedings.

8.62 The principle may be less weighty, however, if the beneficiary is some other person. The primary justification for enforcing express declarations of trust is to give effect to the intentions of the settlor (as the owner of the trust property). And if the law holds that, for reasons of public policy or otherwise, it is inappropriate for those intentions to be given legal effect, the fact that a beneficiary's expectations are disappointed should not persuade the court to take a different view. If it did, the beneficiary of an invalid illegal trust would be put in a better position than the beneficiary of a trust which is invalid or unenforceable for some other reason (eg uncertainty). That cannot be correct. It may be different, however, if the beneficiary is not merely a volunteer, but has provided consideration for the trust.

8.63 **We ask consultees whether they agree with our provisional view that the proposed discretion should be structured so that a court should be required to take into account specific factors in reaching its decision; and that those factors should be: (a) the seriousness of the illegality; (b) the knowledge and intention of the illegal trust beneficiary; (c) whether invalidity would tend to deter the illegality; (d) whether invalidity would further the purpose of the rule which renders the trust "illegal"; and (e) whether invalidity would be a proportionate response to the claimant's participation in the illegality. We also ask consultees whether there are any other factors which they consider the courts should take into account in exercising their proposed discretion. If consultees do not agree with our provisional views, we ask them to explain why not.**

(5) Should our provisionally proposed discretion also apply to a "default trust" which takes effect in the event that an express illegal trust is held to be invalid under that discretion?

(a) Should the law ever declare invalid a "default trust" which takes effect in the event that an express illegal trust is invalid on grounds of illegality?

8.64 Where an express trust is invalid, then a further question arises as to who is entitled to the "trust property". We observed in Part III that equity has a reasonably well-established set of principles which answer this question. If property is transferred on a trust, equity does not permit the trustee to treat the

[85] See paras 7.41 to 7.43 above.

property as his or her own.[86] If the entire trust fails, the trustee should hold the property on such express trusts as may have been declared and which can take effect in the event of the initial trust failing. In the absence of such a trust, the trustee will hold the property on resulting trust for the settlor or the settlor's estate.[87] Until now we have assumed that, where an express illegal trust is invalid, beneficial entitlement to the trust property should be decided in accordance with ordinary principles *and that the rights so determined will necessarily be valid and enforceable*.[88] We have not yet faced the question whether it would sometimes be appropriate for the courts to refuse to recognise any default trust interest, just because the occasion on which the trust arises is the invalidity of an express trust for illegality.

8.65 The only situation where such an approach might be justifiable is where the settlor stands to benefit if the default trust is valid.[89] A rule which denied the settlor his or her ordinary right to recover property which he or she had transferred on an invalid illegal trust would undoubtedly have an additional and severe punitive impact and it would also add to the deterrent impact of the law. It is also possible to conceive of cases in which the dignity of the court *could* be offended if a settlor is allowed to recover his or her property.

8.66 Nevertheless, we have some reservations about even the limited proposal that courts should be entitled to hold invalid the default trust which would ordinarily arise in favour of a settlor in the event that an express illegal trust is invalid.

8.67 Our first reservation is that such a response would be vastly disproportionate to the settlor's conduct in the great majority of cases. We see little problem with the law frustrating a settlor's intentions by invalidating an illegal trust which he or she purported to create. It is rather harder to accept, however, that the law should go further, and effectively forfeit an illegal trust settlor's property (for example, by holding invalid an automatic resulting trust which would otherwise arise in his or her favour). We accept that it is sometimes appropriate to expropriate a person's property as punishment for illegality which he or she has committed, facilitated and/or procured, or attempted to commit, facilitate and/or procure. We also accept that the civil law could be the proper mechanism for such expropriation. But it is essential that that punishment be proportionate. The value of the property transferred by the settlor may vastly exceed the likely size of a fine, if any, which could be imposed for the conduct or for equivalent conduct. Accordingly, it may only rarely (and then fortuitously) be a proportionate response to the settlor's

[86] Cf exceptionally if it can be shown that the settlor's intention was that the trustee should take the property beneficially in the event of the primary intended trust failing, or where the trustee is in fact the person who would benefit as a person entitled to the residuary estate of the settlor or as a person who would be entitled to the estate of the settlor on his or her intestacy.

[87] See para 3.37 above.

[88] See paras 3.40 to 3.50 above, in which we discuss whether under the present law the "reliance principle", as enunciated in *Tinsley v Milligan* [1994] 1 AC 340, requires a different conclusion.

[89] For example, because the settlor takes the property under an automatic resulting trust, or because he or she is the beneficiary of a secondary express trust.

personal wrongdoing[90] for the court to refuse to recognise a settlor's rights under a default trust.

8.68 Our second reservation is that in many cases, for example where the trust was testamentary, it would not be the settlor that is deprived of his or her usual beneficial entitlement, but rather some other person, such as the settlor's next-of-kin, creditors or assignees. None of the policies which justify special rules where illegality is involved[91] are convincingly advanced thereby. The court is not required to execute the illegal transaction; on the contrary, it is being asked to recognise rights which arise only once it has been decided that the illegal transaction is invalid. The parties who stand to benefit were not responsible for the objectionable transaction (ie the illegal and invalid trust). However outrageous the transaction, the dignity of the court is not, in our view, offended; nor does any party "profit" from his or her own wrong. And holding the default trust to be invalid would seem to add nothing significant to the punitive and/or deterrent effect (if any) of holding that the primary, "illegal" trust is invalid.[92] Clearly the present common law does enforce the default trust in testamentary cases.[93] However, in line with our view that where illegality affects a trust it should be rendered invalid, rather than merely unenforceable,[94] the effect of invalidating the default trust might be to exclude such third persons from their usual entitlement.

8.69 Our third reservation is that it is difficult to explain why, if this approach were adopted, as a matter of policy, the court should not also have a further power to expropriate the property of a settlor who chooses to *declare him or herself trustee* of an illegal trust for another. On ordinary principles, if that trust is invalid, the settlor regains (or perhaps more accurately, never loses) full ownership of the property.[95] The policy arguments for expropriation[96] are the same. The difference is a practical one. The same result (ie expropriation of the property which was settled on an illegal trust) could not be achieved by the "passive" device of refusing to enforce a trust in the settlor's favour. It would require an express power to compel the settlor to transfer the property which he or she had intended to hold on trust to the Crown. An *express* power of expropriation, conferred on a civil court, would be highly controversial.

8.70 Nevertheless, we are not convinced that these reservations are decisive. The argument for a further power to expropriate the property of a settlor who declares

[90] It is also possible that, in those few cases in which expropriation is likely to be appropriate, a concurrent sanction may well be available (in particular, through the criminal law) which provides a more sensitive mechanism for punishment.

[91] See Part VI above.

[92] Although it might be argued that if trust creators knew that property would go to (eg) the Crown, rather than to their estate, they would be deterred from creating illegal trusts.

[93] See para 3.47 above.

[94] See paras 8.44 to 8.49 above.

[95] The settlor has legal title and no other person can claim an outstanding and superior equitable interest, for the interest which he or she purported to create in favour of another is *ex hypothesi* invalid.

[96] See para 8.65 above.

him or herself trustee could be rebutted by the practical difficulties of such a power. The argument that expropriation is an extreme response is also not a fatal objection to a discretion to invalidate default interests: it merely requires that the discretion be exercised with utmost care. In any case, it is difficult consistently to reject a discretion to invalidate default interests in favour of the settlor of an illegal trust, in view of the provisionally proposed scope of our discretion to invalidate "illegal trusts". We have assumed that it is appropriate to confer a discretion on a court to invalidate money purchase and voluntary transfer resulting trusts which arise out of fraudulent transactions. Indeed, we have provisionally suggested that these cases provide one of the best illustrations of an "illegal trust" to which a discretion *must* be applied.[97] And yet very similar objections can be raised to this discretion as to a discretion to invalidate a default trust in favour of a settlor. In each case, if the trust is invalid, the property of the settlor or transferor is expropriated. It is very difficult to see how one can rationally permit a court to invalidate a fraudulent resulting trust in favour of the person who transferred the property, but absolutely refuse to allow a court to invalidate an automatic resulting trust in favour of a person who declared an illegal and invalid express trust.

8.71 **We would be grateful for consultees' views on whether courts should have:**
(a) a discretion to invalidate a default trust in favour of a person who transfers property on an illegal and invalid express trust; and/or
(b) the further discretion to order that a person who has declared him or herself trustee of an illegal and invalid express trust should transfer the trust property to the Crown.

(b) A separate discretion dealing with the validity of default interests in favour of persons who settle property on illegal trusts

8.72 In paragraphs 8.64 to 8.71 above, we posed the question whether the law would ever be justified in holding invalid a "default interest" which takes effect when an illegal express trust is invalid. We tentatively indicated that it may be, if the default beneficiary would be the settlor;[98] and asked consultees whether they considered that it would be appropriate to deal with such cases by conferring a discretion on the courts.[99] We also suggested that consistency arguably requires courts to have a further power to order a settlor who declares him or herself trustee of property on an illegal trust to transfer the property to the Crown.[100]

8.73 In our provisional view, if such a discretion to invalidate a default interest were to be introduced, the factors which should be relevant to, and structure, it should be similar[101] to those which are relevant to, and structure, our proposed discretion to invalidate an "illegal trust".[102] But for several reasons, default trust cases cannot be

[97] See para 8.26 above.

[98] See para 8.70 above.

[99] See para 8.71 above.

[100] See para 8.69 above.

[101] The "knowledge and intention of the beneficiary" will need to be read as the "knowledge and intention of the default trust beneficiary" rather than the "knowledge and intention of the illegal trust beneficiary".

[102] See paras 8.53 to 8.62 above.

dealt with by the same discretion that we propose for illegal trusts; a separate power is required. First, the power must enable a court to do more than simply invalidate a settlor's default trust interest. Such a power is adequate where a settlor transfers property on an illegal trust; however, an additional power is needed to deal with situations in which the settlor declares him or herself trustee of property on illegal trust. The court will need the power to compel the settlor to transfer the trust property to which he or she would, on ordinary principles, be absolutely entitled. Secondly, it would be clearer and simpler if two questions are firmly separated: (i) is an express illegal trust invalid?; and (ii) if it is invalid, and the settlor would be entitled to the property under ordinary principles, should he or she ever be denied that entitlement?

8.74 **We ask consultees whether they agree with our provisional view that, if there should be a discretion to invalidate a "default trust", it should be (a) a separate discretion, but (b) be structured by similar factors to those which structure our provisionally proposed discretion to invalidate an "illegal trust".**

(6) Who should be entitled to the trust property if a resulting trust, constructive trust or "default trust" is held to be invalid under our provisionally proposed discretion?

(a) Can a trustee take the benefit of property if a resulting trust, constructive trust or "default trust" is invalid, or is the property bona vacantia?

8.75 It may happen that the beneficiary of an "illegal trust" is the settlor (or, in the case of an illegal resulting trust the transferor of, or contributor to the purchase of, trust property). This could arise where one person transfers property to another in order to achieve some fraudulent purpose; as the transfer was voluntary, a resulting trust may arise in his or her favour. Who is entitled to the property if the trust is declared to be "invalid" because of the illegality, so that the settlor (or transferor/contributor) cannot claim any interest in the property? A similar question could arise if courts were given a power to invalidate a "default trust" in favour of a settlor.[103]

8.76 There appear to be two alternatives. One possibility is that the property is "ownerless" and, as *bona vacantia*, belongs to the Crown. The second is that the trustee becomes effective owner by default, on the basis that he or she has legal title and that no other person can assert an outstanding and superior equitable title to the property.

8.77 It is not clear which of these two approaches would be adopted by the common law. At present, if a resulting trust is unenforceable because it cannot be shown without the transferor relying on the fraudulent purpose of the transfer, the law apparently follows the second approach. The trust is valid so the property cannot be said to be "ownerless". But as the trust cannot be enforced against the trustee, he or she becomes effective owner by default. It is not clear whether the common

[103] See paras 8.64 to 8.71 above.

law would take any different view if the trust was invalid so that it became at least arguable that the property is "ownerless".

8.78 The choice is important and, because the common law offers no clear answer, will probably have to made by legislation. Unfortunately the proper approach, as a matter of policy, is not obvious. On the one hand, "trustee ownership" awards the "trustee" a windfall gain. This may appear particularly inappropriate where he or she was a knowing and active participant in the illegal scheme; *a fortiori* where he or she instigated, and/or directly profited from, the scheme. At least to this extent, the *bona vacantia* solution appears to be the preferable one. It avoids giving the trustee a windfall gain and renders the property available for a socially beneficial purpose. However, the *bona vacantia* solution is problematic because it could look like the state expropriating property as punishment for the settlor's "wrongdoing", in an analogous manner to the enforcement of criminal fine. And in any case, it is possible to address the windfall concerns. Courts could be directed to take into account the fact that the "trustee" will benefit if the illegal trust is invalid, as well as the "trustee's" involvement in the illegal scheme, in deciding whether the trust should be valid or invalid.[104] They could also reduce the windfall to the "trustee" by means of a power to order that he or she pay sums (whether as compensation or as restitution) to the settlor (or transferor/contributor).

8.79 **We would be grateful for consultees' views on whether, if a resulting trust, constructive trust or "default trust" of property in favour of a settlor (or transferor/contributor) is held to be invalid under our provisionally proposed discretion, and the property is not subject to any other express trust, the property (a) should be regarded as ownerless and fall to the Crown as *bona vacantia*; or (b) should be the trustee's by default. Further, if "trustee ownership" is preferred, how (if at all) should the windfall concern be addressed?**

(b) A possible additional consideration if a trustee is ever allowed to take the benefit

8.80 We noted above that where property is held on an illegal trust in favour of a settlor (or in the case of a resulting trust, the transferor/contributor) and that trust is held to be invalid, it is not easy to decide who should own the trust property.[105] We asked consultees whether the property should be considered to be (i) "ownerless", and therefore the Crown's or (ii) the trustee's by default.[106] If the trustee-ownership solution is preferred, it may be appropriate for one further factor to be added to the "core list" of factors which we provisionally propose should structure the discretion:[107] whether invalidity would unjustly enrich the trustee.

8.81 We have not found it easy to decide whether this additional consideration is either necessary or appropriate. In Part VII we have not required courts to consider the fact that, if the claim to restitution of benefits conferred pursuant to an illegal

[104] See further paras 8.80 to 8.82 below.

[105] See paras 8.75 to 8.79.

[106] See para 8.79 above.

[107] See paras 8.53 to 8.62 above.

contract was disallowed, the defendant would be unjustly enriched. However, we anticipate that courts will have a strong predisposition against denying a claimant his or her ordinary remedies, since that would leave work unremunerated, losses uncompensated and/or another unjustly enriched. We anticipate that courts would begin with a comparable predisposition against invalidating a trust where that would enrich an intended trustee; *a fortiori* where he or she instigated, and/or was actively involved in, and/or profited from the illegality.[108] On this basis, even if appropriate, no specific reference to this factor may be necessary.

8.82 **We also ask consultees whether they consider that it is necessary to add, as a factor to be taken into account in exercising the court's discretion, that invalidity would unjustly enrich the trustee.**

(7) What should be the starting point of the provisionally proposed discretion?

8.83 An initial question is whether the starting point of the provisionally proposed discretion should be that the illegal trust is *prima facie* valid, or invalid. In Part VII we have asked the same question in relation to claims that may be brought under or pursuant to an illegal contract.[109] We have already noted that this choice should not produce different results.[110] But the choice is still important. It ought to reflect the result which an open balancing of all relevant considerations can be expected to produce in most cases. It thereby highlights, for potential litigants and for courts adjudicating their claims, the need for particularly weighty reasons to exist in support of the opposite result.

8.84 On that basis, it seems to us that many of those types of illegal trust which we have proposed should be subject to a statutory discretion[111] should rarely be invalid and unenforceable. Not only would this reflect the conclusions which, we anticipate, an open balancing of all relevant considerations will produce in the great majority of cases; it is also possible that it most closely represents the present common law approach to the respective forms of illegal trust. But it would seem that some trusts, such as those which require a trustee to perform a legal wrong or require a beneficiary to do so as a condition of his or her entitlement should rarely, if ever, be valid. Because we do not regard the issues as being clear-cut, we would like to ask consultees for their views.

8.85 **Accordingly we ask consultees whether they consider that the starting point of the provisionally proposed discretion should be:**
(a) validity;
(b) invalidity; or

[108] To ask whether a trustee should benefit in these circumstances is not the same as asking whether a person who was involved in the illegality should be permitted to take a benefit under the intended illegal trust (see para 8.55 above) or under any default trust (see paras 8.72 to 8.74 above). In such a case, the objection is not one of unjust enrichment, for he or she would be entitled to the property under ordinary principles.

[109] See paras 7.44 to 7.57 above.

[110] See para 7.51 above.

[111] See paras 8.22 to 8.32 above.

(c) one which varies according to the form of illegal trust in question. Alternatively, we ask consultees whether they consider that it would be preferable to express no starting point.

(8) Should the court have a discretion to recognise the validity of an illegal trust on terms that the beneficiary makes a payment or transfers property to a third party?

8.86 When considering reform of the law in relation to illegal contracts, we asked for consultees' views on whether the court should be able to make an award which recognises the plaintiff's usual contractual, restitutionary or proprietary remedies only on condition that the plaintiff pay a sum or transfer property to a third party, such as the State.[112] Such a condition might be imposed to punish the plaintiff for his or her involvement in the illegal transaction, or to strip away any gains that have been made at the expense of the third party. We also need to consider whether the court should have the power to recognise the validity of an illegal trust on such terms. So, for example, in *Tinsley v Milligan*,[113] had Miss Milligan not already made reparation with the DSS, the recognition of her equitable interest could have been made conditional on her repaying to the DSS the benefits which she had fraudulently claimed.

8.87 While recognising the benefits of such a power, we also pointed out the difficulties that it would involve. First, we suggested that using the illegality rules to punish the plaintiff in such an overt manner might be seen as blurring the distinction between the civil and criminal law. Secondly, we pointed out that where illegal gains had been made at the expense of the third party, that third party would generally have a right to intervene and recover the gains in any event. One might argue that it should be at the discretion of that third party to choose whether, how and when to seek recovery. For the court to make such an award while adjudicating on a dispute between the illegal trust beneficiaries and trustee might be seen as a usurpation of that third party's role.[114]

8.88 **Accordingly, we ask consultees whether they consider that the courts should be given a discretionary power to recognise the validity of an illegal trust only on terms that require the trust beneficiary to make a payment or transfer property to a person (such as the State) who is not a party to the action. If so, we ask consultees on what basis they consider such an award should be made.**

(9) How should the provisionally proposed discretion interact with the equitable maxim that "he who comes to equity must come with clean hands"?

8.89 Closely related, and potentially overlapping, with the doctrine of illegality, is the equitable maxim of "clean hands".[115] This maxim means that where a plaintiff

[112] See paras 7.88 to 7.93 above.

[113] [1994] 1 AC 340.

[114] See P Pettit, "Illegality and repentance" (1996) 10 TLI 51, 52.

[115] For a detailed discussion, see P H Pettit, "He Who Comes to Equity Must Come With Clean Hands" [1990] Conv 416.

whose conduct has been improper in a transaction seeks relief in equity, such relief will be refused.[116] The application of the maxim is uncertain. In some respects its ambit is wider than the illegality rules, in that it will apply where the plaintiff's behaviour is "improper" though not necessarily unlawful or falling within any recognised head of conduct contrary to public policy. On the other hand, it has been suggested that it is only applicable where the plaintiff seeks some form of discretionary equitable relief,[117] such as specific performance or an injunction, and does not apply to deny the existence of an equitable title. While the minority in *Tinsley v Milligan*[118] argued that Miss Milligan should be denied relief under the clean hands doctrine,[119] we have already seen that the majority rejected this approach.[120] It has been suggested that the maxim should be regarded as a "last resort defence",[121] which will be inapplicable where the illegality rules are in play.

8.90 How should this doctrine interact with our provisionally proposed discretion? We provisionally recommend that it should have no role to play in relation to the effect of illegality on a trust which is within the sphere of operation of our proposed discretion. In other words, it would be "swallowed up" within our discretion. It would be unfortunate indeed if, under the proposed discretion, the court decided that it would not be in the public interest to deny the plaintiff his or her equitable title, but the defendant was able to invoke the "clean hands" maxim in order to defeat the exercise of that discretion. So, for example, if the plaintiff has transferred legal title to his assets to the defendant in an attempt to defeat his creditors, should the court decide under our provisionally proposed discretion that it would not be contrary to the public interest to uphold the validity of the resulting trust in the plaintiff's favour, it would seem odd if, despite this finding, the defendant were able to go on to defeat the plaintiff's claim by alleging that the plaintiff came to equity "without clean hands". While we have already provisionally suggested that the behaviour of the plaintiff should be one relevant factor which the court should take into account in deciding whether to recognise the plaintiff's equitable interest, we do not believe that it should be the overriding one.

[116] R P Meagher, W M C Gummow and J R F Lehane, *Equity: Doctrines and Remedies* (3rd ed 1992) p 82; P H Pettit, "He Who Comes to Equity Must Come With Clean Hands" [1990] Conv 416, 418.

[117] See, in particular, the comments of Mummery LJ in *Dunbar v Plant* [1998] Ch 412, 422. He distinguishes the illegality rules from the clean hands maxim. The former, he says, is a principle of public policy, which may produce unfair consequences in some cases, whereas the latter is a principle of justice, designed to prevent those guilty of serious misconduct from securing a discretionary remedy, such as an injunction. See also Lord Goff of Chieveley and G Jones, *The Law of Restitution* (4th ed 1993) p 502; and G Virgo, "The Effect of Illegality on Claims for Restitution in English Law" in W Swadling (ed), *The Limits of Restitutionary Claims: A Comparative Analysis* (1997) 141, 176.

[118] [1994] 1 AC 340.

[119] Lord Goff, with whom Lord Keith agreed, said at [1994] 1 AC 340, 358: "[O]nce it comes to the attention of a court of equity that the claimant has not come to the court with clean hands, the court will refuse to assist the claimant". See para 3.11 n 36 above.

[120] See para 3.11 above.

[121] P H Pettit, "He Who Comes to Equity Must Come With Clean Hands" [1990] Conv 416, 424.

8.91 **Accordingly we are of the provisional view that the equitable "clean hands" maxim should have no role to play in cases which fall within the sphere of operation of our proposed discretion. If consultees do not agree with this provisional view, we ask how they consider the maxim should interrelate to our proposed discretion.**

(10) What should be the effect of the invalidity of the illegal trust in relation to acts carried out pursuant to that trust?

8.92 In this section we deal with several issues relating to the wider consequences of the decision that an illegal trust may be invalid. They include: the liability of trustees of illegal trusts;[122] the title and liabilities of illegal trust beneficiaries who wrongly[123] receive illegal trust property;[124] and the title and liabilities of third parties who deal with illegal trust property.[125] An important initial issue, which we have not yet addressed, is whether a court's decision that an illegal trust is invalid (or valid) should have retrospective or merely prospective effect. This choice can have a significant impact on the position of illegal trustees, beneficiaries and third parties.

8.93 On the face of it, prospective invalidity would have the following consequences. First, the trustee would not commit a breach of trust if he or she administered the trust on the basis that the illegal trust was valid. Secondly, a beneficiary of the illegal trust would obtain good title to any property which he or she had received before the court's decision and would not be liable in respect of his or her receipt. Thirdly, third parties who dealt with a beneficiary of the illegal trust would be similarly secure.

8.94 But it is our provisional view that prospective invalidity is not the right approach. Although it ensures a substantial degree of security for trustees, beneficiaries and third parties, the costs are high. For example, a trustee of an illegal trust would have no incentive to seek a legal opinion or a court decision as to whether the trust was illegal and invalid, and could freely execute the illegal trust, even if it was clear that a court would hold the trust to be invalid. And an illegal trust beneficiary could retain property which he or she had thereby received from the illegal trustee, even though that might hinder the purpose of rule which rendered the trust illegal.

8.95 An appropriate reconciliation of the competing considerations could, of course, be achieved by a form of qualified prospective invalidity. That would require specific statutory provision. However, in our provisional view, an appropriate reconciliation might be more simply achieved by a principle of retrospective invalidity and existing general principles. Thus the following paragraphs proceed on the basis that a court's decision will be retrospective, and not just prospective, in effect.

[122] See paras 8.96 to 8.100 below.

[123] They "wrongly" receive the property where the trust is invalid and, in that event, some other person becomes entitled to the property.

[124] See paras 8.101 to 8.107 below.

[125] See paras 8.108 to 8.115 below.

(a) The liability of the trustee for acts of administration occurring before any court order

8.96 A trustee of an "illegal trust" faces a dilemma. He or she may administer the trust as if it was fully valid; but a court may later declare the trust invalid under our provisionally proposed discretion. This could mean that the trustee holds the property on different trusts, in favour of another. The earlier acts of administration will be *prima facie* breaches of trust, so that (for example) if any property is wrongly distributed to the beneficiary of the illegal and invalid trust, the trustee may be liable to the beneficiary of the default trust for losses thereby caused to the trust estate. The same risk of liability arises in reverse if the trustee instead acts as if the trust was invalid,[126] but a court later declares the trust to be valid. The trustee appears to be in a "no win" situation.

8.97 No serious risk of injustice arises if it is, or should reasonably be, clear to the trustee that the trust is invalid (or valid); the trustee should act on that basis. However, it is arguable that the introduction of a discretion to decide whether any illegal trust is valid or invalid would create such a risk. A trustee of an illegal trust could never be sure, without obtaining a court declaration, whether the trust was "illegal" and, if so, on that ground "valid" or "invalid".

8.98 Courts already have the general power to relieve a trustee from personal liability for any breach of trust (wholly or in part), if he or she acted honestly and reasonably, and ought fairly to be excused for the breach of trust and for omitting to obtain the directions of the court in the matter in which he or she committed such breach. That power arises under section 61 of the Trustee Act 1925.[127] Courts insist that the jurisdiction must not be narrowly construed.[128] It can, in particular, apply to cases where a trustee pays money to the wrong person, whether because of a misinterpretation of the trust instrument,[129] or because of a mistake as to the law, according to which the trust in favour of that person was void[130] or the interest of that person was by statute vested in another.[131] The maxim *ignorantia iuris non excusat* is no bar to relief under section 61.[132]

[126] For example, by conveying property to the person who would be absolutely entitled thereto, under an automatic resulting trust, if the illegal trust was invalid.

[127] Section 61 of the Trustee Act 1925:

> If it appears to the court that a trustee ... is or may be personally liable for any breach of trust ... but has acted honestly and reasonably, and ought fairly to be excused for the breach of trust and for omitting to obtain the directions of the court in the matter in which he committed such breach, then the court may relieve him either wholly or partly from personal liability for the same.

See, for discussion, Fiduciary Duties and Regulatory Rules (1995) Law Com No 236 pp 90-96 and P Pettit, *Equity and the Law of Trusts* (8th ed 1997) pp 501-503.

[128] See, in particular, *Re Allsop* [1914] 1 Ch 1 (CA).

[129] See, for example, *Re Allsop* [1914] 1 Ch 1 (CA).

[130] See, in particular, *Re Wightwick's Will Trusts* [1950] Ch 260, 266, in which property was settled on trust for an anti-vivisection society and the trust was administered on the basis that it was a valid charitable trust. This was a reasonable analysis of the law at that time, but subsequently the House of Lords held that such trusts are not charitable and are therefore void. The earlier payments to the society were therefore made in breach of trust.

8.99 This jurisdiction could no doubt be used to relieve trustees of illegal trusts from liability for breach of trust in the circumstances outlined above. We anticipate that a trustee who did not and could not reasonably know of the facts which rendered the trust "illegal" (and thus potentially invalid) would be relieved under this section if he or she erroneously acts on the assumption that the trust is valid. We also anticipate that a trustee who obtains and acts on adequate legal advice as to the validity of the trust could be relieved under the section if the advice turns out to be wrong.[133] Any case law which develops around the discretion should provide important guidance for trustees and their advisors as to the likely validity of an illegal trust, without the need in every case to seek the directions of a court.

8.100 **Our provisional view is that section 61 of the Trustee Act 1925 could provide an appropriate level of protection for trustees of illegal trusts. We ask consultees whether they agree, and if not, what additional protections they consider are necessary.**

(b) The effect of dispositions by trustees occurring before a court order and the recipient's title and liability

8.101 A trustee of an illegal trust may assume that the trust is valid and convey property to a beneficiary under the trust. It may later transpire that the trust is invalid, and that that beneficiary should not have received the property. Conversely, a trustee may assume that the trust is invalid and convey property to a person who would be entitled to it on that basis. Again, it may later transpire that the trust is in fact valid, and that the recipient should not have received the property. What effect (if any) should such erroneous dispositions have in law? Should the recipient be liable to restore the property received to the person who should have received it, or to a personal restitutionary liability and/or to pay compensation to that person? These issues are not easy ones to resolve: there are a number of relevant and competing policies to be reconciled.

8.102 In either case the recipient receives property that he or she should not have received. To allow the recipient to retain it could enrich him or her; it could be unfair to the person who should have received it instead of the actual recipient;[134] and it could be contrary to the public interest, as (for example) it could tend to further, rather than prevent and/or discourage, the illegal purpose. But such considerations must be weighed against others. The recipient may be "innocent"; the recipient may have altered his or her position on the faith of his or her receipt of the property; and third parties may subsequently have acquired an interest in the property.

[131] See *Holland v German Property Administrator* [1937] 2 All ER 807 (CA), in which (however) it was held that the relevant statute did not assign the beneficiary's interest to the Adminstrator of German Property by operation of law.

[132] *Holland v German Property Administrator* [1937] 2 All ER 807 (CA).

[133] See, for example, *Re Allsop* [1914] 1 Ch 1 (CA) (legal advice as to the effect of trust instrument).

[134] Cf if he or she has a claim against the trustee for breach of trust.

8.103 We provisionally reject any suggestion that a "wrongful" recipient of illegal trust property who receives property which he or she should not have received, should always obtain good title to it and should never be liable to return it or to account for it to the person who should have received it. This would place all wrongful recipients of property that was settled on an illegal trust in a much better position than other persons who receive property from a second person to which a third person is entitled in equity. If a court decides that it is in the public interest that a particular disposition of property be invalid, it would be incoherent if the court was compelled, in every case, to accept the validity of acts giving effect to that disposition simply because they occurred before the court decision and thus before it was absolutely clear that the trust was invalid. That would place a severe limitation on the courts' ability to advance, sensitively and effectively, the public policies which justified invalidating the trust. It might promote, rather than prevent or discourage, the mischief.

8.104 There would appear to be two main options. First, a recipient's title and his or her liabilities could be decided in accordance with the rules which generally apply where one person receives property from another which is owned in equity by a third person. Secondly, a scheme of special statutory rules relating only to illegal trusts found to be invalid under the proposed discretion could be devised in order to determine who should own the property and subject to what conditions.

8.105 We are at least initially attracted to the first option. We recognise that the relevant equitable principles are complex[135] and remain in need of simplification and rationalisation in the light of, in particular, modern developments in the law of restitution.[136] Nevertheless, we are reluctant to introduce special statutory rules into this limited area of illegality, if special provision is not clearly justified. We are concerned that special provision could produce anomalous distinctions and stifle (or otherwise adversely affect) the judicial development of the equitable principles.

[135] The major forms of claim which may, on current authorities, be available to a beneficiary of a trust against a person who has received property transferred in breach of trust appear to be (i) an equitable proprietary claim; (ii) a personal claim in equity, which is now widely considered to be restitutionary, for "knowing receipt" of property transferred in breach of trust; and (iii) liability for the equitable wrong of dishonestly procuring or assisting a breach of trust. On (i) see, eg, J Martin, *Hanbury & Martin, Modern Equity* (15th ed 1997) pp 656-684; A J Oakley, *Constructive Trusts* (3rd ed 1997) pp 12-18; and P Pettit, *Equity and the Law of Trusts* (8th ed 1997) ch 24. On (ii) and (ii), see, eg, A J Oakley, *Constructive Trusts* (3rd ed 1997) ch 4, section II (dishonest assistance) and III (knowing receipt). Cf the view that (ii) is better viewed as a liability for an equitable wrong akin to the common law wrong of conversion: L Smith, "W(h)ither Knowing Receipt?" (1998) 114 LQR 394. There are other equitable claims of more limited availability and/or foundation in authority, such as a direct personal claim by a legatee against a person who has mistakenly been paid money by a personal representative (exemplified by *Re Diplock* [1948] Ch 465). See, in particular, C Harpum, "The Basis of Equitable Liability" in P Birks (ed), *The Frontiers of Liability: Volume 1* (1994) esp pp 21-24; see also Lord Goff of Chieveley and G Jones, *The Law of Restitution* (4th ed 1993) ch 29.

[136] See, in particular, the recognition of the defence of change of position in *Lipkin Gorman v Karpnale Ltd* [1991] 2 AC 548, which, it has been predicted, leaves the way "open to simplify and rationalise both the *in personam* and *in rem* remedies that exist for the recovery of trust property transferred in breach of trust": see C Harpum, "The Basis of Equitable Liability" in P Birks (ed), *The Frontiers of Liability:Volume 1* (1994) p 9 at p 18.

8.106 It is clearly difficult to make a choice between the options without adopting a position in the more general debate about the standard of restitutionary liability in analogous cases.[137] We do not consider that that is an appropriate choice for us to make in this limited project (albeit that we think it likely that the "strict liability subject to defences" approach will ultimately triumph). We are therefore provisionally attracted to the view that the liability of a person who receives trust property to which another is entitled in equity should be decided on general principles. Courts would not be precluded from developing those principles in favour of stricter (or strict) liability to restitution.

8.107 **We ask consultees whether they agree that a person who received property which was held on illegal trust, from the trustee of such a trust, and where the property was owned by another in equity, should not be dealt with under our proposed statutory discretion but:- (a) should only receive such title as he or she would receive under general principles; and (b) should be liable to restitutionary claims in respect of his or her receipt in accordance with general principles.**

(c) The effect of dispositions by beneficiaries to "third parties" occurring before a court order

8.108 What should the position be if the illegal trust beneficiary transfers his or her interest under the illegal trust to a third party or transfers property which he or she has received from the trustee pursuant to the illegal trust, and the illegal trust is subsequently declared invalid under our provisionally proposed discretion?[138] We do not accept that a third party should always obtain good title or be immune from restitutionary (or other) claims when the third party (i) acquires an equitable interest from the beneficiary of an illegal trust; or (ii) acquires property which has been absolutely transferred to the beneficiary of such a trust. It is not generally the case that C will acquire from B good title to property when B's title is defective (because it is owned at law and/or in equity by another, A). There can be no justification for treating a third person so favourably, just because the explanation for the defect in B's title is that it arises out of an illegal and invalid trust.

8.109 We are therefore attracted to the view that the rationality of the law demands that the title of a third party, and his or her liability to restitution, should be decided in accordance with general principles - unless the case for special treatment is clear.

[137] See, for example, P Birks, "Persistent Problems in Misdirected Money: a Quintet" [1993] LMCLQ 218; C Harpum, "The Basis of Equitable Liability" in P Birks (ed), *The Frontiers of Liability:Volume 1* (1994) p 9; Lord Nicholls, "Knowing Receipt: the Need for a New Landmark" in W R Cornish *et al* (eds), *Restitution: Past, Present & Future* (1998) ch 15. Even if liability is "strict subject to defences", the fault of the recipient will remain important to his or her liability, in particular because the change of position defence is not available to a "wrongdoer" (see *Lipkin Gorman v Karpnale Ltd* [1991] 2 AC 548). Thus, for example,
Mr Harpum has proposed that the defence should not be available to a recipient with constructive notice: C Harpum, " The Basis of Equitable Liability" in P Birks (ed), *The Frontiers of Liability:Volume 1* (1994) p 9 at pp 24-25.

[138] The same problems arise if the "default beneficiary" purports to assign his or her interest under the default trust and/or property which he or she has received from the trustee pursuant to the default trust, and the primary illegal trust is later declared to be valid.

At present, the rules regarding the acquisition of title to property which is owned by another in equity differ according to the nature of the property, and the nature of the interest in it (legal and/or equitable) which the third party has purported to acquire. We now consider what the impact of those rules would be.

8.110 It is arguable that a third party who acquires a *legal interest* in property from the beneficiary of an illegal (and invalid) trust is appropriately protected by ordinary principles. Where the property is personal property or unregistered land, such a third party can obtain an overriding equitable title to the property if he or she is a *bona fide* purchaser for value without notice of the defect in the beneficiary's title. Provided that courts interpret and apply this principle straightforwardly,[139] we consider that the title of third parties would not be rendered unacceptably insecure by our proposals. Where the property is a registrable interest in real property, the principles of land registration replace the common law rules (including the equitable doctrine of notice).[140] If a third party purchases a registrable freehold or leasehold interest in land, then once that interest is registered, he or she will usually[141] acquire absolute title,[142] subject only to minor interests protected on the register and overriding interests. In practice, the title of such third parties is most unlikely to be subject to the claims of another who, under common law principles, would have been the equitable owner (in place of the transferee).

8.111 On the other hand, a third party who purports to acquire the *equitable interest* of a beneficiary under an illegal (and invalid) trust can never acquire a "good" interest, *even where he or she is a bona fide purchaser for value without notice*, if the effect of invalidity is that the beneficiary does not have the interest in question.[143] Some might consider this unfair.

8.112 In our view, there is an arguable case of injustice only if the third party does not know and could not reasonably know that the transferee's equitable interest arose under an "illegal trust". However, it is vital to see that this arguable "injustice" is not limited to cases in which the cause of the defect in the transferor's equitable interest is that it arose under an illegal trust which the court invalidates under our proposed discretion. A similar risk might arise in any case where a third party purports to acquire an interest under a trust which is subsequently found to be invalid by virtue of a statutory or common law rule other than illegality.

8.113 Thus it is arguable that the reform which we provisionally propose (a discretion to invalidate an illegal trust) does not *itself* demand that the "injustice" be addressed. It should not extend the ambit of the category of "illegal trusts" which are, or are likely to be, invalid for illegality. As a result, it does not extend the area of risk for

[139] We would hope, in particular, that courts would not struggle to find that a third party has "constructive notice" of the defect.

[140] See the Land Registration Act 1925.

[141] It is different if he or she is registered with some lesser title.

[142] It is possible that a *personal* claim might still lie against the purchaser, but such claims are likely to require a relatively high degree of fault on the purchaser's part.

[143] This is because: (i) the assignor did not have any interest to transfer, and therefore *prima facie* could not transfer such an interest; and (ii) the third party does not acquire a legal estate, and therefore cannot rely on the plea of *bona fide* purchaser.

third parties, who under the present law may be confronted with a potentially invalid interest, whose invalidity they could not reasonably anticipate.

8.114 **We therefore provisionally conclude that the rights and liabilities of third parties who acquire "illegal trust property" from the beneficiary of an illegal trust, or from someone who would be entitled to the property if an illegal trust was invalid, should not be dealt with under our provisionally proposed discretion. Instead they should be decided in accordance with the standard principles which govern whether a third party (C) can obtain from another (B) a superior equitable title to property to which another person (A) was previously entitled in equity, and whether C is liable to restitutionary (or other) claims.**

8.115 However, we recognise that there might be circumstances where the third party (C) was the main culprit behind the establishment of the illegal trust and the trust beneficiary (B) was simply an innocent conduit of the trust property. In such cases it might be appropriate that the court should have a discretion to recognise any title of C's only subject to terms, in a manner similar to that which we have considered in relation to the recognition of the trust beneficiary's interest.[144] **We ask consultees whether they consider that there might be circumstances in which it would be appropriate for the court to have a discretion to recognise the third party's (C's) title subject to terms.**

(11) Severance

8.116 So far, we have only considered the effect of illegality on a trust as a whole. In many cases, however, it may be that only one term (or a number of terms) are tainted by illegality and that that term (or terms) can be "severed" from the remaining terms of the trust, leaving it valid. For example, where property is held on trust subject to several conditions, only some of which are illegal, then the illegal conditions may be severed and the trust remain valid subject only to the valid conditions.[145] And a discretionary trust for a variety of objects, some legal and some illegal, depending on the trustees' selection, is valid so far as respects the legal objects and the trustees may exercise their discretionary selection in respect of these objects, but they cannot validly do so in respect of those which are illegal.[146] We have also suggested that where a term in a trust requires the trustee to commit a legal wrong, such as an unlawful investment, in many cases that term could be severed, without affecting the validity of the beneficial interests.[147] For the avoidance of doubt, we should make clear that where severance of an illegal term (or illegal terms) is permitted, leaving the remainder of the trust valid, we do not intend that our provisionally proposed discretion should apply. **Accordingly, our provisional view is that where (under general principles) it is possible to sever the term(s) tainted by illegality from the trust, leaving the remaining terms of the trust valid, our provisionally proposed discretion**

[144] See paras 8.86 to 8.88 above.

[145] *Re Hepplewhite Will Trusts*, *The Times* 21 January 1977 (at least where the gift involves personalty and the conditions are *malum prohibitum* only).

[146] *Re Piercy* [1898] 1 Ch 565.

[147] See para 3.39 above.

should not apply. We ask consultees whether they agree with this approach, and if not, to explain why not.

8.117 However, the above provisional recommendation assumes that the present law has correctly identified those cases in which it should be possible to sever an illegal term from a trust, leaving the remaining terms valid. In the case of the present rules which apply to determine the effect of an invalid condition on the interest to which it is attached we are concerned that this is not the case. It seems to us that, in principle, the rules which determine how the invalidity of a condition should affect the interest to which it is attached should follow the actual or likely intentions of the settlor, as far as it is reasonably possible, and not contrary to public policy, to give them effect.[148] Thus if a condition precedent is illegal, the question should be whether the settlor would prefer that the gift was absolute and that the beneficiary could take the interest even though the condition is not fulfilled, or would instead prefer the gift to fail completely if the condition is not fulfilled.[149]

8.118 We saw above that English courts have elaborated and applied general rules to determine the effect of an invalid condition on the interest to which it is attached.[150] They have not sought to ascertain the settlor's actual or probable intention.[151] And it is arguable that, in at least two respects, these rules produce results which cannot be justified as the "best" reflection of the settlor's intentions.

8.119 The general rule is that if a condition subsequent is illegal and invalid, the interest to which it is attached takes effect free of the invalid condition,[152] at least unless performance of the invalid condition was the sole motive for a bequest.[153] This rule is probably the most realistic reflection of a settlor's likely intentions that can, practically, be achieved. In our provisional view, it does not need to be altered. Since the severing of the illegal condition will leave the remaining terms of the trust valid, our provisionally proposed discretion would not apply.[154]

8.120 The general rule for conditions precedent which are illegal and invalid is not so obviously correct, however. That rule is that the interest will fail completely. It may be that the "explanation" for this rule is a technical one: the interest cannot vest unless and until the condition has been satisfied and since the condition is

[148] See, for a similar view, A W Scott & W F Fratcher, *The Law of Trusts* (4th ed 1987 and later supplements) vol 1A, § 65.3, p 382.

[149] Cf A W Scott & W F Fratcher, *The Law of Trusts* (4th ed 1987 and later supplements) vol 1A, § 65.3, p 382.

[150] See para 3.38.

[151] This contrasts with the "modern tendency" in United States case law to "give effect as far as possible to the intention of the settlor rather than to attempt to lay down artificial rules": see A W Scott & W F Fratcher, *The Law of Trusts* (4th ed 1987 and later supplements) vol 1A, § 65.3, p 382.

[152] *Re Beard* [1908] 1 Ch 383.

[153] C H Sherrin, R F D Barlow and R A Wallington, *Williams on Wills* (7th ed 1995) pp 340-341.

[154] See para 8.116 above.

invalid, it can never be satisfied.[155] We are not persuaded by this explanation. Nor are we confident that the rule is likely to best reflect the settlor's intentions. It is certainly plausible that the fact that a condition is a condition precedent, rather than a condition subsequent, makes it more likely that the settlor would have preferred the gift to fail.[156] But it is not obvious that that fact alone can justify an absolute rule of invalidity. It is arguable that, in so far as an absolute or *prima facie* rule is required, a better one would be that the interest will take effect free of the invalid condition.[157] Indeed, it appears that courts may incline to construe a condition as a condition subsequent, rather than precedent, in order to uphold a disposition, if that construction is possible.[158]

8.121 The general rule for illegal conditions precedent is, as we have already noted,[159] also subject to an anomalous exception. If the condition is attached to an interest in personalty, and is *malum prohibitum* rather than *malum in se*, the interest will not fail, but will take effect free of the invalid condition.[160] The distinction is an obscure one.[161] It is often criticised[162] and has not been accepted elsewhere.[163] It is

[155] See, for this suggestion, C H Sherrin, R F D Barlow and R A Wallington, *Williams on Wills* (7th ed 1995) p 340.

[156] The argument would be that the fact that the beneficiary was never intended to acquire an interest unless the condition was satisfied may be taken as a reasonable indication that fulfilment of the condition was so vital to the settlor's intention to benefit the other that the interest must fail completely.

[157] Cf A W Scott and W F Fratcher, *The Law of Trusts* (4th ed 1987 and later supplements) vol 1A, § 65.3, p 383 ("[i]nsofar as there is any inference either way, we believe that the inference is that the settlor would have intended that the gift should be absolute rather than that it should fail altogether; that the gift is absolute unless it appears from all the circumstances that the settlor would probably have desired that if the condition should be illegal the gift should fail altogether"). Cf *Re Blake* [1955] IR 89 which took the contrary view.

[158] See, for example, *Re Borwick* [1933] Ch 657, cited in A W Scott and W F Fratcher, *The Law of Trusts* (4th ed 1987 and later supplements) vol 1A, § 65.3, p 386.

[159] See para 3.38 above.

[160] See *Re Moore* (1888) 39 Ch D 116, and for cases in which the exceptional rule has been applied: *Re Piper* [1946] 2 All ER 503; *Re Elliott* [1952] Ch 217. In *Re Piper*, a trust was declared in favour of such children of a man as should reach 30 and not reside with their father before attaining that age. The residence condition was held to be an illegal (and therefore invalid) condition precedent. However, because the bequest was of personalty, and the court treated the illegality as *malum prohibitum*, the interest took effect free of the invalid condition. Any of the children who reached 30 could therefore take an interest.

[161] It is extremely unclear what illegality is *malum prohibitum* rather than *malum in se*. The case law provides some illustrations, but not enough to draw any general conclusions. See, in particular, *Re Piper* [1946] 2 All ER 503 (condition as to residence is *malum prohibitum*) and *Re Elliott* [1952] Ch 217 (condition violating rule against perpetuities is *malum prohibitum*). Cf P Pettit, *Equity and the Law of Trusts* (8th ed 1997) pp 197-198.

[162] See eg D J Hayton, *Underhill and Hayton, Law of Trusts and Trustees* (15th ed 1995) p 202 ("[i]t is high time these archaic, illogical and anomalous rules were reformed"); N Enonchong, *Illegal Transactions* (1998) pp 171-172; *Re Blake* [1955] IR 89, 100, *per* Dixon J; R Keane, *Equity and the Law of Trusts in the Republic of Ireland* (1988) para 14.05.

[163] See eg *Re Blake* [1955] IR 89 (Ireland) and A W Scott & W F Fratcher, *The Law of Trusts* (4th ed 1987 and later supplements) vol 1A, § 65.3 (United States).

impossible to justify in terms of the settlor's likely intentions, or rationally to justify in terms of the policies which justify special illegality rules.

8.122 Our firm provisional view is that the distinction between the effect of conditions precedent which are *malum prohibitum* and those which are *malum in se* must be eliminated. But we have found it more difficult to decide what rule should be preferred for the future. There are four options. The principle could be that where a condition precedent is void because it is "illegal", the interest to which it is attached will (i) always fail; (ii) always take effect free of the condition; (iii) fail, unless it appears probable that the settlor did or would have preferred the interest to take effect if the condition was invalid; or (iv) take effect free of the condition, unless it appears probable that the settlor did or would have preferred the interest to fail if the condition was invalid. The first option represents the general rule in England at present;[164] the second appears in the American Restatement of Property.[165] As absolute rules, they offer greater certainty, but pose the risk that courts will sometimes be forced to reach conclusions that the settlor or testator is unlikely to have desired. The third and fourth options avoid this difficulty, as they allow the court to disapply the general rule, if that can be demonstrated to be a better reflection of what the settlor did or would have intended. However, they avoid the difficulty only at the price of some uncertainty.

8.123 We are provisionally attracted to the fourth option. We consider that a general rule that the interest will take effect free of the invalid condition precedent is the most appropriate general inference; that a qualified rule is preferable to an absolute rule; and that a qualified rule need not lead to unacceptable uncertainty. The fourth option would in practice mean that a trust interest would take effect free of an invalid illegal condition, whether the condition was subsequent or precedent, and whether the property was real or personal, unless, where the condition is precedent, it is probable that the settlor would have preferred the interest to fail.[166] Our one concern is that it might not be appropriate to introduce a new rule for conditions precedent which are invalid pursuant to illegality without at the same time adopting a similar rule for *all* types of invalid conditions precedent (whether they are invalid on grounds of illegality, impossibility or certainty).

8.124 **We ask consultees whether they agree with our provisional view that if a condition precedent is invalid because of illegality, the interest to which it is attached should take effect free of the condition, unless it is probable in all the circumstances that the settlor or testator did or would have preferred the interest to fail if the condition was invalid.**

[164] See para 8.120 above.

[165] American Restatement of Property § 424 (see comment d, which takes the position that, whether the condition be precedent or subsequent, whether the property be real or personal, if the condition is illegal the gift is absolute); Restatement (Second) of Property (Donative Transfers) § 5.1 (1980); and Simes & Smith, *The Law of Future Interests* § 1520 (2nd ed 1956), cited in A W Scott & W F Fratcher, *The Law of Trusts* (4th ed 1987 and later supplements) vol 1A, § 65.3, fn 1, p 381.

[166] Where the interest would fail, the trust would then be an "illegal trust" (see para 8.22 above) and therefore subject to our provisionally proposed discretion.

8.125 **If consultees do not agree, would they prefer a rule whereby the interest will (a) always fail, (b) always take effect, or (c) fail unless it is probable in all the circumstances that the settlor or testator did or would have preferred the interest to take effect if the condition was invalid?**

3. THE EFFECT OF OUR PROVISIONALLY PROPOSED DISCRETION

8.126 We have already provided examples of how our provisionally proposed discretion would operate in relation to contracts. In the following paragraphs we do the same for trusts. We would also make the same general point which we made there:[167] that is, that we believe that under our provisional proposals, illegality would less frequently operate to deny the plaintiff his or her usual beneficial entitlement. The examples which we provide here focus on the area which in practice has caused the most difficulty: that is trusts which are entered into to facilitate fraud, or which arise out of transactions with that purpose.

8.127 Under our provisionally proposed discretion we believe that the same outcome would have been reached in *Tinsley v Milligan*.[168] However, the court could have reached its decision using much more principled reasoning, rather than relying on the fortuitous result obtained under the reliance principle. The illegality involved was not regarded as serious;[169] Miss Milligan had already admitted and made amends for her unlawful behaviour; and denying Miss Milligan her beneficial interest would not have furthered the purpose of the social security legislation and would have been clearly out of all proportion to the offence which she had committed. The only factor suggesting that recovery should be denied is therefore the deterrence of others, but even the minority seemed to doubt that it would be efficacious in this type of case.[170]

8.128 Say that the facts of *Tinsley v Milligan*[171] were to recur, but that the parties were husband and wife, and legal title to the house was put in the wife's name. The presumption of advancement would apply, and, in order to rebut it the husband would have to plead the underlying illegal purpose of the arrangement.[172] The reliance principle would not allow him to do so, and his claim would therefore fail. Under our provisionally proposed discretion, however, the husband could lead evidence of the illegal arrangement in order to rebut the presumption of a gift to his wife, and could plead that despite the involvement of illegality, the resulting trust should be valid. The court would look at the same factors as those we have outlined in paragraph 8.127 above, and the husband's claim would therefore be likely to succeed.

[167] See para 7.107 above.

[168] [1994] 1 AC 340.

[169] [1994] 1 AC 340, 362, *per* Lord Goff.

[170] See Lord Goff [1994] 1 AC 340, 363 citing a passage from the dissenting judgment of Ralph Gibson LJ in the Court of Appeal [1992] Ch 310, 334: "Lawyers have long known of the [*ex turpi causa* defence] and must have advised many people of its existence. It does not stop people making arrangements to defraud creditors, or the revenue, or the DSS."

[171] [1994] 1 AC 340.

[172] [1994] 1 AC 340, 372, *per* Lord Browne-Wilkinson.

8.129 Say that in *Tinsley v Milligan*[173] the parties had given their arrangement some formality, so that Miss Tinsley had expressly declared herself to be trustee of the house for the benefit of herself and Miss Milligan. What the approach of the present law would be to such an express trust entered into for the purpose of facilitating a fraud is not clear, although it seems likely that the express trust would be valid but its enforcement would be subject to the reliance principle.[174] Under our provisionally proposed discretion, the court would be able to take into account the same factors as those we have outlined in paragraph 8.127 above, and would seem likely to reach the conclusion that the express trust would be valid.

4. ILLEGAL TRANSACTIONS THAT ARE NEITHER CONTRACTS NOR TRUSTS

8.130 So far, we have concentrated solely on how illegality affects contracts or trusts. However, there is a range of other transactions that may also be tainted in some way by illegality. One example is a "gift" (other than under a trust).[175] It seems that under the present law, the general rule that property passes under an illegal contract[176] also applies where there is a transfer of legal title by way of a gift.[177] But more difficult questions may be raised when considering whether there are any circumstances in which the donor can recover the property so transferred. Say, for example, that an uncle gives £100 to his niece when he hears of her forthcoming marriage, expressly to help her and her husband begin their married life together.[178] If the marriage is called off, the niece must return the money which was given on the basis of a non-contractual consideration[179] which has failed. But what if the basis of the gift had been an illegal consideration? Say that the niece had been about to embark on some terrorist campaign of which her uncle approved, and expressly to mark his support for her new venture he gave her £100. If she pulled out, could the uncle still recover his money on the basis of a failure of consideration? It seems to us, that it would be sensible if the discretionary approach which we have provisionally proposed should govern the effect of illegality on contracts and trusts, should also apply to this type of

[173] [1994] 1 AC 340.

[174] See paras 3.55 to 3.56 above.

[175] Another example might be a non-contractual bailment.

[176] See para 2.57 above.

[177] See, for example, *Bowman v Secular Society Ltd* [1917] AC 406, 436, *per* Lord Parker: "At common law the conditions essential to the validity of a gift are reasonably clear. The subject-matter must be certain; the donor must have the necessary disposing power over, and must employ the means recognised by common law as sufficient for the transfer of, the subject-matter; and, finally, the donee must be capable of acquiring the subject-matter. ... The common law takes no notice whatever of the donor's motive in making the gift or of the purposes for which he intends the property to be applied by the donee, or of any condition or direction purporting to affect its free disposition in the hands of the donee. It is immaterial that the gift is intended to be applied for a purpose actually illegal - as, for example, in trade with the King's enemies - or in a manner contrary to the policy of the law - as, for example, in paying the fines of persons convicted of poaching. In either case, the essential conditions being fulfilled, the gift is complete, the property has passed, and there is an end of the matter."

[178] The example is taken from P Birks, *An Introduction to the Law of Restitution* (revised ed 1989) pp 223-226.

[179] The niece did not promise her uncle that she would marry.

transaction. However, we would be very grateful to receive the views of consultees as to whether this is a practical approach to take and as to what is the range of illegal transactions that are neither contracts nor trusts.

8.131 **We ask consultees whether the same discretionary approach which we have provisionally proposed should govern the effect of illegality on contracts and trusts should also apply to govern the effect of illegality on other types of illegal transactions. We would also be grateful for consultees' help in identifying the range of illegal transactions that are neither contracts nor trusts.**

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PART IX
SUMMARY OF PROVISIONAL RECOMMENDATIONS AND CONSULTATION ISSUES

9.1 Subject to the views of consultees, our general provisional recommendation in this paper is that the current complex and technical rules relating to the effect of illegality on contracts and trusts should be replaced by a discretion. We set out below a summary of our questions and provisional recommendations on which we invite the view of consultees.

(1) Introduction

9.2 Do consultees agree with our provisional view (a) that the law on the effect of illegality in relation to contracts and trusts is in need of reform; and (b) that legislative reform is to be preferred to leaving "reform" to the judiciary through development of the common law? If consultees do not agree, is there any limited area of the law on the effect of illegality which they consider is in need of legislative reform? (paragraph 5.13).

9.3 Do consultees agree with our strong provisional view that it would not be appropriate to adopt the radical approach of dispensing with all special illegality rules and that a distinction should continue to be drawn between illegal transactions and valid transactions? If consultees do not agree, please would they give their reasons. (paragraph 6.12).

(2) Illegal Contracts

The proposed discretion

9.4 Do consultees agree with our provisional view that a court should have a discretion to decide whether or not illegality should act as a defence to a claim for contractual enforcement where the formation, purpose or performance of the contract involves the commission of a legal wrong (other than the mere breach of the contract in question)? If consultees do not agree, we would ask them to explain why not. (paragraph 7.10).

9.5 Do consultees agree with our provisional recommendation that the equitable "clean hands" maxim should have no role to play in cases within the sphere of operation of our provisionally proposed discretion? If consultees do not agree, we would ask them to explain why not. (paragraph 7.12).

9.6 Do consultees agree with our provisional view that a court should not be given a discretion to enforce contracts which do not involve a legal wrong but which the court declares to be otherwise contrary to public policy? That is, the question of the enforcement of such contracts should continue to be governed by the common law. In addition, do consultees agree with our provisional view that a legislative provision should make it clear that the courts are to judge whether a contract is contrary to public policy in the light of policy matters of the present day and that contracts which were previously considered to be contrary to public policy may no

longer be so and *vice versa*? If consultees do not agree, please would they explain why not. (paragraph 7.16).

9.7 Do consultees agree with our provisional view that a court should have a discretion to decide whether or not illegality should be recognised as a defence to a claim for the reversal of unjust enrichment in relation to benefits conferred under a contract which is unenforceable for illegality? If consultees do not agree, please would they explain why not. (paragraph 7.22).

9.8 Do consultees agree with our provisional view that (a) a court should have a discretion to decide whether illegality should act as a defence to the recognition of contractually transferred or created property rights where the formation, purpose or performance of the contract involves the commission of a legal wrong (other than the mere breach of the contract in question) or is otherwise contrary to public policy; but (b) that illegality should not invalidate a disposition of property to a third party purchaser for value without notice of the illegality? (paragraph 7.26).

Structuring the discretion

9.9 Do consultees agree with our provisional view that the proposed discretion should be structured so that the court should be required to take into account specific factors in reaching its decision; and that those factors should be: (1) the seriousness of the illegality involved; (2) the knowledge and intention of the plaintiff; (3) whether denying relief will act as a deterrent; (4) whether denying relief will further the purpose of the rule which renders the contract illegal; and (5) whether denying relief is proportionate to the illegality involved? We also ask consultees whether there are any other factors which they consider the courts should take into account in exercising the discretion. If consultees do not agree with our provisional view, we would ask them to explain why not. (paragraph 7.43).

The starting point of the discretion

9.10 Do consultees consider that the starting point of the provisionally proposed discretion should be:

(a) that illegality will act as a defence unless the court declares otherwise;

(b) that the plaintiff's claim will be allowed unless the court decides that because of the involvement of illegality it would not be in the public interest to allow the claim;

(c) one which varies according to whether the claim is for contractual enforcement; restitution pursuant to a contract which has failed for illegality; or the recognition of contractually transferred or created property rights; or

(d) that a claim by a party who has neither carried out nor intends to carry out the illegality will be allowed, unless the court declares otherwise; but a claim by a party who has carried out or intends to carry out the illegality will be refused, unless the court declares otherwise?

Alternatively we ask consultees whether they consider that it would be preferable that no starting point should be expressed. (paragraph 7.57)

Illegality as a restitutionary cause of action: the doctrine of locus poenitentiae

9.11 Do consultees agree with our provisional proposal that:
(a) a court should have a discretion to allow a party to withdraw from an illegal contract, and to have restitution of benefits conferred under it, where allowing the party to withdraw would reduce the likelihood of an illegal act being completed or an illegal purpose being accomplished: but that
(b) to succeed in a withdrawal claim the plaintiff must first satisfy the court that the contract could not be enforced against him or her? (paragraph 7.69).

9.12 Do consultees agree with our provisional proposal that in deciding whether or not to allow a party to withdraw and have restitution a court should consider (i) whether the plaintiff genuinely repents of the illegality (albeit that this should not be a necessary condition for the exercise of the discretion); and (ii) the seriousness of the illegality? (paragraph 7.69).

If consultees disagree with these provisional proposals, we ask them whether they regard withdrawal and restitution on the basis of a "*locus poenitentiae*" as a needless complication that could happily be done away with.

The scope of the provisionally proposed discretion

9.13 Do consultees agree with our provisional recommendation that our proposed statutory discretion in relation to:
(a) contractual enforcement should apply to all contracts which in their formation, purpose or performance involve a legal wrong (other than a mere breach of the contract in question);
(b) the reversal of unjust enrichment should apply to all contracts which are unenforceable for illegality; and
(c) the recognition of contractually transferred or created property rights should apply to all contracts which in their formation, purpose or performance involve a legal wrong (other than a mere breach of the contract in question) or conduct which is otherwise contrary to public policy?[1]
If consultees do not agree, please would they explain what they consider the scope of our proposed discretion should be. (paragraph 7.72).

A discretion to go beyond treating illegality as a defence to standard rights and remedies

9.14 Do consultees agree with our provisional view that (with the exception of the *locus poenitentiae* doctrine) illegality should continue to act only as a defence to claims for standard rights and remedies and that, in particular, the courts should not be specially empowered to apportion losses under illegal contracts? If consultees do not agree, do they consider that a court should have an open-ended discretion to grant any relief that it considers just in relation to illegal contracts? (paragraph 7.87).

[1] Although note that we have excluded from the scope of this project contracts which are rendered ineffective by statute but which do not involve any conduct which is expressly or impliedly prohibited (para 1.10 above), and contracts which are in restraint of trade (para 1.11 above).

A discretion to make an award on terms that the plaintiff makes a payment of transfers property to a person who is not party to the illegal contract

9.15 Do consultees consider that in contractual disputes involving illegality the courts should be given a discretionary power to allow the plaintiff's claim only on the condition that the plaintiff makes a payment or transfers property to a person (such as the State) who is not a party to the illegal contract? If so, we ask consultees on what basis (that is, punishment or disgorgement of gain or both) they consider such an award should be made. (paragraph 7.93).

The interaction of our provisionally proposed discretion and statutory provisions which deal with the effects of illegality

9.16 Do consultees agree with our provisional view that where a statute expressly lays down what should be the consequences for a contract, of the contract involving a breach of the statute's provisions, our proposed discretion should not apply? If consultees do not agree, do they consider that a court should be able to use our proposed discretion in order to override the provisions of the statute? (paragraph 7.102).

Severance

9.17 Do consultees agree with our provisional view that where (at common law) part of a contract is severed so that the remainder no longer falls within our broad definition of illegality, our proposed discretion should not apply? If consultees do not agree, please would they give their reasons. (paragraph 7.103).

Tainting

9.18 Do consultees agree with our provisional view that the tainting principle is a sensible one and should be retained? If not, do consultees consider that the tainting principle should be abandoned? (paragraph 7.104).

Changes in the law

9.19 Do consultees agree that where a change in the law means that (a) previously lawful conduct becomes unlawful, then the enforcement of any contract involving such conduct should be governed by the rules relating to frustration, rather than our proposed discretion; or (b) previously unlawful conduct becomes lawful (and is not otherwise contrary to public policy), any contract involving such conduct should be enforceable? If consultees do not agree, do they consider that in either case our proposed discretion should apply? (paragraph 7.106).

General question on discretionary approach

9.20 Having set out the details of our provisional proposals, we would ask those consultees who object to any discretionary approach to set out and explain what reforms, if any, they would prefer to make to the rules on illegality in relation to contracts. (paragraph 7.117).

(3) Illegal Trusts

Abandonment of reliance principle

9.21 Do consultees agree with our provisional proposal that the reliance principle should be abandoned as a test of enforceability of a trust? If consultees do not agree, do they consider that the reliance principle is operating satisfactorily, or should be in any way reformed? (paragraph 8.12).

The proposed discretion

9.22 Do consultees agree with our provisional view that, once the reliance principle is abandoned, the creation of a statutory discretion to decide the effect of illegality on some or all trusts is the right way forward? If consultees do not agree, do they consider that (a) future development of this area of the law should be left entirely to the courts; or (b) legislative reform should introduce a set of statutory *rules* governing the effect of illegality on some or all trusts? (paragraph 8.20).

9.23 Do consultees agree with our provisional view that the illegal trusts made subject to a statutory discretion should be limited to:[2]
(i) trusts which it would be legally wrongful to create or impose;
(ii) trusts which are created to facilitate a fraud or which arise from a transaction or arrangement with that objective;
(iii) trusts which are created to facilitate some other legal wrong or which arise from a transaction or arrangement with that objective;
(iv) trusts created in return for the commission of a legal wrong or the promise to commit a legal wrong (an "illegal consideration");
(v) trusts which expressly or necessarily require a trustee to commit a legal wrong or which tend or are intended to do so;
(vi) trusts which expressly or necessarily require a beneficiary to commit a legal wrong or which tend or are intended to do so; and
(vii) trusts which are otherwise contrary to public policy at common law?[3] (paragraph 8.40).

If consultees do not agree, please would they explain which trusts, if any, they consider should be made subject to our provisionally proposed statutory discretion. (paragraph 8.41).

9.24 Do consultees agree with our provisional view that where a statute expressly lays down what should be the consequences for a trust, of the trust involving a breach of the statute's provisions, our proposed discretion should not apply? If consultees do not agree, we ask them to explain why not. (paragraph 8.43).

Invalidity or unenforceability?

9.25 Do consultees agree with our provisional view that courts should have a discretion to declare an illegal trust to be invalid or valid (rather than unenforceable or

[2] And not including "default trusts" arising on the invalidity of an express illegal trust (see para 8.23 above).

[3] Although note the doubts about the inclusion of this category which we raise in para 8.32 above.

enforceable)? If consultees do not agree, do they consider (a) that the courts should have a discretion to declare an illegal trust to be unenforceable or enforceable (rather than invalid or valid); or (b) that the courts should have a discretion to declare a trust to be invalid, unenforceable or valid and enforceable? (paragraph 8.49).

Structuring the discretion

9.26 Do consultees agree with our provisional view that the proposed discretion should be structured so that a court should be required to take into account specific factors in reaching its decision; and that those factors should be: (a) the seriousness of the illegality; (b) the knowledge and intention of the illegal trust beneficiary; (c) whether invalidity would tend to deter the illegality; (d) whether invalidity would further the purpose of the rule which renders the trust "illegal"; and (e) whether invalidity would be a proportionate response to the claimant's participation in the illegality? We also ask consultees whether there are any other factors which they consider the courts should take into account in exercising their proposed discretion. If consultees do not agree with our provisional views, we ask them to explain why not. (paragraph 8.63).

"Default trusts" which take effect in the event that an express illegal trust is invalid on grounds of illegality

9.27 We would be grateful for consultees' views on whether courts should have:
(a) a discretion to invalidate a default trust in favour of a person who transfers property on an illegal and invalid express trust; and/or

9.28 (b) the further discretion to order that a person who has declared him or herself trustee of an illegal and invalid express trust should transfer the trust property to the Crown. (paragraph 8.71).

9.29 Do consultees agree with our provisional view that, if there should be a discretion to invalidate a "default trust", it should be (a) a separate discretion, but (b) be structured by similar factors to those which structure our provisionally proposed discretion to invalidate an "illegal trust"? If consultees do not agree, please would they give their reasons. (paragraph 8.74).

Trustee's entitlement to property if a resulting trust, constructive trust or "default trust" trust is invalid

9.30 We would be grateful for consultees' views on whether, if a resulting trust, constructive trust or "default trust" of property in favour of a settlor (or transferor/contributor) is held to be invalid under our provisionally proposed discretion, and the property is not subject to any other express trust, the property (a) should be regarded as ownerless and fall to the Crown as *bona vacantia*; or (b) should be the trustee's by default. Further, if "trustee ownership" is preferred, how (if at all) should the windfall concern be addressed? (paragraph 8.79)

9.31 If the trustee-ownership solution is preferred, we ask consultees whether they consider that it is necessary to add, as a factor to be taken into account in exercising the court's discretion, that invalidity would unjustly enrich the trustee. (paragraph 8.82).

The starting point of the discretion

9.32 We ask consultees whether they consider that the starting point of the provisionally proposed discretion should be:
(a) validity;
(b) invalidity; or
(c) one which varies according to the form of illegal trust in question?

9.33 Alternatively we ask consultees whether they consider that it would be preferable to express no starting point. (paragraph 8.85).

A discretion to make an award on terms that the beneficiary makes a payment or transfers property to a third party

9.34 Do consultees consider that the courts should be given a discretionary power to recognise the validity of an illegal trust only on terms that require the trust beneficiary to make a payment or transfer property to a person (such as the State) who is not a party to the action? If so, we ask consultees on what basis they consider such an award should be made. (paragraph 8.88).

The interaction of the provisionally proposed discretion and the equitable maxim "he who comes to equity must come with clean hands"

9.35 Do consultees agree with our provisional view that the equitable "clean hands" maxim should have no role to play in cases which fall within the sphere of operation of our proposed discretion? If consultees do not agree, how do they consider the maxim should interrelate to our proposed discretion? (paragraph 8.91).

The effect of the invalidity of the illegal trust in relation to acts carried out pursuant to the trust

9.36 Do consultees agree with our provisional view that section 61 of the Trustee Act 1925 could provide an appropriate level of protection for trustees of illegal trusts? If consultees do not agree, what additional protections do they consider are necessary? (paragraph 8.100).

9.37 Do consultees agree that a person who received property which was held on illegal trust, from the trustee of such a trust, and where the property was owned by another in equity, should not be dealt with under our proposed statutory discretion but:- (a) should only receive such title as he or she would receive under general principles; and (b) should be liable to restitutionary claims in respect of his or her receipt in accordance with general principles? (paragraph 8.107).

9.38 Do consultees agree with our provisional conclusion that the rights and liabilities of third parties who acquire "illegal trust property" from the beneficiary of an illegal trust, or from someone who would be entitled to the property if an illegal trust was invalid, should not be dealt with under our provisionally proposed discretion, but should be decided in accordance with the standard principles which govern whether a third party (C) can obtain from another (B) a superior equitable title to property to which another person (A) was previously entitled in equity, and whether C is liable to restitutionary (or other) claims? (paragraph 8.114).

9.39 Do consultees consider that there might be any circumstances in which it would be appropriate for the court to have a discretion to recognise the third party's (C's) title subject to terms? (paragraph 8.1115).

Severance

9.40 Do consultees agree with our provisional view that where (under general principles) it is possible to sever the term(s) tainted by illegality from the trust, leaving the remaining terms of the trust valid, our provisionally proposed discretion should not apply? If consultees do not agree, please would they explain why not. (paragraph 8.116).

9.41 Do consultees agree with our provisional view that if a condition precedent is invalid because of illegality, the interest to which it is attached should take effect free of the condition, unless it is probable in all the circumstances that the settlor or testator did or would have preferred the interest to fail if the condition was invalid? (paragraph 8.124).

9.42 If consultees do not agree, would they prefer a rule whereby the interest will (a) always fail, (b) always take effect, or (c) fail unless it is probable in all the circumstances that the settlor or testator did or would have preferred the interest to take effect if the condition was invalid? (paragraph 8.125).

Illegal transactions that are neither contracts nor trusts

9.43 We ask consultees whether the same discretionary approach which we have provisionally proposed should govern the effect of illegality on contracts and trusts should also apply to govern the effect of illegality on other types of illegal transactions. We would also be grateful for consultees' help in identifying the range of illegal transactions that are neither contracts nor trusts. (paragraph 8.131).

(4) Question from Part I

Compatibility of our provisional proposals with the European Convention on Human Rights

9.44 We would be very grateful if consultees with the relevant expertise could let us know whether they agree with our view that our provisional recommendations do not infringe the European Convention for the Protection of Human Rights and Fundamental Freedoms, and, if they do not agree, to explain their reasoning. (paragraph 1.23)