Illegality in contracts

As a general rule, the English courts will not enforce an illegal contract or provide for any other remedies that arise out of it. However, in determining the consequences of illegal acts carried out pursuant to a contract, the courts will distinguish between those contracts that are said to be illegal at their formation, and those that are illegal through performance.

Contracts considered illegal at formation

A contract will be considered illegal at its formation when it is incapable of performance without an illegal act. Contracts falling into this category cannot be enforced. Where a contract is illegal when formed, neither party will acquire rights under that contract, regardless of whether there was any intention to break the law. The contract will be void and treated as if it was never entered into.

The case of David Taylor & Son v Barnett Trading Co [1953] provides us with an example of a contract that was deemed illegal at its formation. In that case, Barnett Trading agreed to sell David Taylor Irish steak for delivery between April and July for a set price. At the date the contract was entered into, an order was in force preventing the buying or selling of meat over a certain price (which the contract exceeded). When Barnett Trading did not make delivery, Mr Taylor claimed damages. At first instance, the arbitrators ordered that Barnett Trading pay Mr Taylor compensation for non delivery. On appeal, the Court of Appeal held that the contract had been illegal at its formation due to the provision of set prices that exceeded the legal limits.
and accordingly set aside the award as it was based on an illegal contract.

In the case of **Anderson Ltd v Daniel** [1924], the Fertiliser Act 1906 required every person that sold for use as a fertiliser any soil that had been subject to an artificial process, to provide the purchaser with an invoice stating the respective percentages of certain chemicals. The court held that the effect of non compliance did not merely render the vendor liable to pay a penalty, but made the sale illegal and precluded the vendor for suing for the price of the contract.

**Contracts illegal as performed**

A contract which need not necessarily be performed in an illegal manner, but which is ultimately performed illegally by one of the parties, will be considered slightly differently from those that are illegal at formation. In these circumstances, all rights are withheld from the party that committed the illegal act, but the appropriate remedies will still be available to an innocent party that was not aware of the illegality. If, however, the innocent party has been privy to, or taken part in, the illegality they will not be able to enforce or rely on the contract.

In **Colen v Cebrian** [2003], a husband and wife claimed commission that was owed prior to their dismissal from the company for whom they worked. The husband had evaded tax, by giving to his wife commission to which he alone was contractually entitled. The company claimed that they should not have to pay the commission because the contract was tainted by illegality and the employment tribunal ruled that they did not have to pay the commission. The Court of Appeal, however, overturned the tribunal’s decision, ruling that there was a clear distinction between the method of calculating the commission and the ultimate destination of that commission. The Court of Appeal upheld the contract, providing that illegality as to performance will not always result in the unenforceability of the contract. Lord Justice Carnwath said that:

‘... if at the date of the contract the contract was perfectly lawful and it was intended to be performed lawfully, the effect of some illegal performance is not automatically to render the contract unenforceable’.

**Law Commission Report**

In March 2010, the Law Commission published its final report and draft bill on illegality. The report held that it was not possible to lay down strict rules on illegality, but judges should consider the underlying policy and facts of each case. A new law was proposed in relation to illegality and trusts. However, when considering illegality in the context of contract law, recent case law was said to be bringing in the changes that the Law Commission was looking for, which was to take account of the underlying policy grounds behind the defence and to examine each case on its facts, rather than applying a mechanical approach. For example:

- In **Nayyar v Denton Wilde Sapte** [2010], a breach of contract and negligence claim, Mr Justice Hamblen considered the underlying principle of the illegality defence; that the court will not enforce a contract forbidden by statute or entered into with the intention of an illegal act, nor will it assist a claimant to recover the benefit of their wrongdoing. In this case the claimant travel agents had made a payment in order to become the global sales agent for an airline. This payment was found to be a bribe and therefore the travel agents could not pursue their action based on their own illegal act.

- In **K/S Lincoln v CB Richard Ellis Hotels Ltd** [2010], the Court said that the underlying principle is one of
deterrence, that the courts will not encourage illegal acts by allowing claims based upon them.

The Law Commission said these cases demonstrate that the courts are now looking at underlying policy reasons and statutory reform of the law was not necessary.

**When will a contract tainted by illegality be enforceable?**

The case of *Coral Leisure Group Ltd v Barnett* [1981] demonstrates that an illegal act carried out in the course of an otherwise lawful contract will not always prevent a party being able to enforce the contract. In this case, the illegal act was quite separate from the main contract, and it was held that although the mode of performance was unlawful, the contract itself was not and was ultimately upheld.

*Waugh v Morris* (1873) confirmed that a contract can be rescued if the parties are content that, going forward, the contract can be performed in a legal manner within its terms. If this is the case, parties should act promptly to rectify the illegality as soon as they are made aware of it.

**A recent example of an enforceable contract tainted by illegality**

Recent case law has confirmed the principle referred to above: that an element of illegality in the course of a contract will not necessarily result in the whole contract being rendered unenforceable. In *Parkingeye Ltd v Somerfield Stores* [2012], the Court of Appeal was asked to considered whether a party was able to rely on illegality as a defence to a claim for the payment of contractual fees. In doing so, it examined when illegality would render the contract void and when illegality was found to be so minor that it would not destroy the contract.

**The facts**

In this case, the defendant, Parkingeye had entered into a 15-month contract to install and operate a monitoring system in Somerfield’s car parks (the claimant). Parkingeye’s system read the registration plates of cars that overstayed the free parking time and levied a charge on those that overstayed. Parkingeye then sent out a series of *pro forma* letters demanding payment of the charge to Somerfield’s customers.

Somerfield terminated the contract early, claiming that the third letter sent by Parkingeye was deceptive and used illegal means to induce people to pay and therefore amounted to a tort. On this basis they said that the illegality rendered the whole contract unenforceable. The judge at first instance rejected this defence of illegality. Somerfield, in terminating the contract, was held to be in repudiatory breach. Parkingeye was able to claim damages for lost revenue during the unexpired term of the contract. Somerfield appealed.

**The principles**

In *Parkingeye*, Lord Justice Laws said that the ‘law was not in a straightjacket’. Illegality of any sort would not immediately render the contract unenforceable and each case must be considered on its facts. He then set out a number of factors that had to be considered:

1. The object and intent of the party seeking to enforce the contract – if one party intends to perform the contract in a way that involves the commission of an illegal wrong at the time of entering the contract, they will not be able to enforce the contract. Therefore, if the parties were not aware at the outset that the contract was illegal and the parties had no ‘fixed intention’ of acting unlawfully, the contract may be upheld.
The centrality and gravity of the illegality – if the illegality is not central to the contract and is merely a minor aspect, it may be held to be too remote to render the contract unenforceable.

3. The nature of the illegality – in Parkingeye, the performance of the contract involved a tort (of deceit) and therefore the gravity of this illegality was not sufficient to make the contract unenforceable.

**Court of Appeal decision**

The issue on appeal was whether Somerfield had a complete illegality defence. Laws LJ held that the misleading third letter (which contained a tort of deceit) was collateral and distinct from the main contract, which was itself free from illegality.

Laws LJ recognised that illegality and the law of contract was a ‘notoriously knotty territory’. At common law a distinction previously had been drawn between cases where the guilty party intended from the time of entering the contract to perform unlawfully and cases where the intention to perform unlawfully was only made subsequently.

In determining the intention of the parties, the Court will examine the facts and severity of any illegality on a case-by-case basis. Laws LJ doubted that Parkingeye had appreciated the implication of the draft letters: if someone had pointed out the potentially objectionable aspects of these letters, he was sure they would have been rectified. Therefore, Laws LJ concluded that Parkingeye did not have an intention to deliberately break the law in this instance and the contract was upheld.

The Court of Appeal found that Parkingeye had no ‘fixed intention’ of acting unlawfully, and that illegality was incidental to part of the performance of the contract but far from central to it. A contract creating a long-term relationship would be examined as a whole, so that where, as in Parkingeye, there was a chance to remove the illegality from future performance the contract could remain in force. On the other hand, there was less scope to rectify a one-off contract so it was more likely to be held unenforceable.

Furthermore, the Court of Appeal held that a crude application of the general contractual illegality rules could lead to harsh decisions and that was why the severity, centrality and nature of the illegality must be considered in each case on its facts.

In conclusion, it will generally be found that illegality will render a contract void or unenforceable. However, the decision in Parkingeye demonstrated a qualification to this rule, whereby if the intention was limited to a partial and minor mode of performance and this could be changed at any time, the contract may be upheld regardless. The application of this principle depends upon proof of intent. The method of performance chosen and the degree of participation in that illegal performance can be such as to turn the contract into an illegal contract. Therefore, the court will consider each case on its facts.

**Commercial impact**

The decision in Parkingeye serves as a reminder that a contract could be rendered void if it contains an element of illegality, or was entered into with the intention to perform it illegally. It remains important that parties entering into a contract ensure that no aspect of the contract could contravene public policy or contain an element of illegality.

However, the decision in Parkingeye demonstrates that the courts will take a commercial and pragmatic approach to matters when considering illegality, and if it appears that there was no intention to perform the contract illegally from the outset, an illegal act will not automatically render the contract unenforceable. Any
party considering using illegality as a grounds for termination or non-performance of a contract should first consider whether the illegality is a minor part of the contract and whether it could be rectified. Failing to do so will mean a party runs the risk of themselves committing a repudiatory breach if they subsequently terminate it. In \textit{Parkingeye}, it was particularly relevant that Somerfield had been shown copies of the offending letter and should have drawn the illegality to the attention of Parkingeye, which would have allowed the issue to be rectified.