
ESTOPPEL AND ILLEGAL CONTRACTS

1. Introduction

Illegality is recognised as a difficult area of the law which sometimes produces harsh results. A few cases, however, seem extreme even by the standards of this field: innocent parties who have been tricked into illegal bargains and have transferred goods or paid money to rogues seem to end up with no recompense. The seeming injustice naturally spawns creative attempts to offset the perceived rigour of the doctrine of illegality and estoppel is frequently mentioned as a possible means to do this, though it is never explored more than cursorily. This paper attempts to outline the considerations relevant to estoppel in illegality and to sketch the bounds of its possible use, using the (relatively) familiar case of *In re Mahmoud v Ispahani*¹ to anchor the discussion.

2. *In Re Mahmoud*

In August 1919, an order was in force which provided that: "a person shall not either on his own behalf or on behalf of any other person buy or sell or otherwise deal in, any of the articles specified in the schedule ... except under and in accordance with the terms of a licence...". The parties entered into negotiations for the sale of linseed oil, a substance included in the schedule. The plaintiff had a licence; the defendant did not but said that he had applied for one. Later, the defendant told the plaintiff that he had acquired a licence for himself personally and for the company of which he was a director; the latter was true but the former was a deliberate lie. The parties contracted for the delivery of

¹*In re Mahmoud v Ispahani* [1921] 2 KB 716 (CA) (hereafter "*Mahmoud*").

oil in three monthly instalments, the defendant specifying that he was buying the oil personally. The defendant declined to accept delivery of any of the instalments. The plaintiff resold it at the best price obtainable and brought an action for the refusal to accept delivery, claiming the difference between the contract and resale prices.

The plaintiff succeeded in an arbitration but the defendant successfully appealed to an exceptionally strong Court of Appeal. Bankes LJ held that the language of the order “clearly prohibit[ed] the making of this contract”,² with the result that it was void *ab initio*. He held that the plaintiff’s action was brought on this contract and could not succeed, as the obligation for which compensation was sought was nullified along with the contract. Bankes LJ noted that the plaintiff had pleaded only actions on the contract and refrained from addressing actions outside it, including whether the plaintiff “may have a remedy in some other form of action against the appellant, who is said to have deceived him by making a deliberately false statement”.³ Scrutton LJ characterised the contract identically and construed the plaintiff’s contention as equivalent to asking the court to “enforce th[e] contract”. He held that a court would not “enforce” a contract once it knows it to be illegal, “whether its knowledge comes from the statement of the party who was guilty of the illegality, or whether its knowledge comes from outside sources” and considered that, since an estoppel would equally “enforce such a contract”, it equally would not lie.⁴

Atkin LJ, as he then was, referred at length to the plaintiff’s contention that “there is something in the nature of an estoppel”⁵ available. He held that the prohibition was intended to ensure that those left in possession of goods were licensed and that an estoppel would allow a deceived seller to “hand over the goods to that lying purchaser free from any restrictions whatever and leave him in control of the goods”, rendering the prohibition “absurd”; moreover, he extrapolated that result to posit that “if two rogues each mutually deceive one another, apparently the legislation would be given the go-

²*Ibid*, at page 724.

³*Ibid*, at page 726.

⁴*Ibid*, at page 729.

⁵*Ibid*, at page 732.

by altogether, and there would be unrestricted dealings in these particular commodities between such persons under contracts giving enforceable rights between one and the other."⁶

3. Analysis

Mahmoud has justly been seen as harsh. Glanville Williams has criticised it;⁷ Lord Denning would probably have refused to follow it;⁸ Bankes LJ was at pains to point out that the defence was *legally* available, "however shabby it may appear to be" for a party to raise it;⁹ and Scrutton LJ was quick to distinguish between the "legal" and the "commercial or business" merits of the parties.¹⁰ It is submitted that, while it is correct as far as it goes, the decision does not go so far as to foreclose the availability of an estoppel in some cases of illegal contracts.

3.1 Distinction Between Actions On and Outside the Contract

The court was correct to dismiss any action brought *on* the contract. It is undeniable that the language and intention of the statute meant to prohibit the contract: according to the principles first laid down by Parke B in *Cope v Rowlands*, it was the express purpose of the Order to forbid the contract and the type of dealing sued upon.¹¹ Such a prohibited contract is void regardless of whether the parties knew of the breach of the law; and there can be no actions for breach of a part of a non-existent contract.¹² Insofar as the plaintiff limited his claim for

⁶*Ibid*, at page 732.

⁷G.L. Williams, "The Legal Effect of Illegal Contracts" (1942) 8 *Cambridge LJ* 51.

⁸See example, *Shelley v Paddock* [1980] 1 QB 348, at pages 356-357 (CA).

⁹*Mahmoud*, *supra*, note 1, at page 724.

¹⁰*Ibid*, at pages 726-727.

¹¹*Cope v Rowlands* (1836) 2 M & W 150, at page 157; 150 ER 707, at page 710; *Sr John Shipping Corporation v Joseph Rank Ltd* [1957] 1 QB 267, at page 286 (QBD).

¹²*Waugh v Morris* (1873) LR 8 QB 202, at page 208; *Hughes v Asset Managers plc* [1995] 3 All ER 669, at page 674 (CA).

breach of contract, his action was correctly rejected. This does not, however, end the matter. There is a significant difference between contractual remedies and the restitutionary or equitable remedies arising out of a void contract. Contractual illegality is exhausted by finding a prohibition and making the contract void, but voidness sets the stage for a restitutionary remedy which may allow recovery of the reasonable value of goods transferred or work done - the old *quantum valebant* and *quantum meruit* claims - or for the return of money paid - the claim in money had and received.¹³ These are outside the contract though contingent on its voidness, arising from the transfer of value under a void contract.¹⁴ Equitable remedies are not even tied to the transfer of benefits under a void contract; a cause of action might begin to arise from the circumstances of the *making* - or attempted making - of the contract and crystallise when one party is harmed by its voidness. The plaintiff appears not to have properly raised, and the Court of Appeal thus did not address, this silent ground in which lies the seeds of an estoppel.

3.2 The Role of Illegality

The fate of these actions is governed by the doctrine of illegality. This writer's thesis is that illegality can be explained as a doctrine which attempts to prevent a civil action from undermining another part of the law; that it prevents the law "frustrating itself" when determining which civil actions may lie.¹⁵ Contractual illegality exists to stop the parties making bargains which are detrimental to society - which is why the courts will intervene even when the parties are unaware of the illegality of their bargain. Just as it invalidates a contract that would defeat

¹³Example, *Westdeutsche Landesbank Girozentrale v Islington LBC* [1996] AC 669, at page 688 (HL).

¹⁴*Taylor v Bhail* [1996] CLC 377 (CA); *Kleinwort Benson v Birmingham City Council* [1997] QB 380, at page 394 (CA).

¹⁵Fragments are found in example, *Boissevain v Weil* [1950] AC 327, at page 341 (HL); *Nelson v Nelson* (1995) 184 CLR 538, at pages 564-565; *Fitzgerald v FJ Leonhardt Pty Ltd* (1997) 143 ALR 569, at pages 576-577; G.H. Treitel, *The Law of Contract* (Ninth Edition), 1995, at page 448.

delegated legislation by leading to its breach, illegality will act as a defence to any other claim arising from that invalidation that would defeat the purpose of the contract being made void. Where those remedies would bring about the very mischief that the statute is trying to prevent, they will not lie. Thus, an action in money had and received will not lie on a contract of loan void for illegality when it would enable the lender to recover precisely what statute sought to prohibit him from recovering on the contract.¹⁶ This prevention of self-frustration by having regard to the mischief of the invalidating rule - "the policy of the Act"¹⁷ - extends throughout the law of obligations: a trust or contract in breach of statute cannot be enforced if it would defeat the purpose of the Act.¹⁸ It even extends to actions in negligence, which will not lie where recovery would defeat the normative force underpinning criminal law being breached when an accident occurred.¹⁹

This rule is not a rule against *recovery* but a rule against the *mischief*: recovery *will* be allowed where leaving the parties in the position they have placed themselves is against the policy of the rule breached. Actions may lie where a prohibition was enacted to protect a class of persons from a certain mischief at the hands of others, and the plaintiff is a protected party suffering that mischief;²⁰ borrowers may recover usurious interest from a money-lender in whose hands it

¹⁶*Boissevain v Weil* [1950] AC 327, at page 341 (HL).

¹⁷*Nelson v Nelson* (1995) 184 CLR 538; *Fitzgerald v FJ Leonhardt Pty Ltd* (1997) 143 ALR 569. It is not limited to statutory rules. Common law prohibitions are also imposed to address identifiable mischief: *Egerton v Brownlow* (1853) 4 HLC 1; 10 ER 359.

¹⁸So, the courts will not allow a party to assert beneficial ownership by a resulting trust when he has used it to evade statutory requirements concerning legal ownership: *Ex parte Yallop* (1808) 15 Ves Jun 60; 33 ER 677; *Dyer v Dyer* (1788) 2 Cox 92; 30 ER 42.

¹⁹*Gala v Preston* (1991) 172 CLR 243.

²⁰*Browning v Morris* (1778) 2 Cowp 790, at pages 792-793; 98 ER 1364, at pages 1364-1365; *Jaques v Golightly* (1775) 2 Black W 1073, at page 1075; 96 ER 632, at pages 632-633; which applied *Jaques v Withy* (1788) 1 H Bl 65; 126 ER 40.

already lies;²¹ and tenants may recover prohibited 'premiums' from their landlords.²² In some cases, however, the mischief may have occurred in a way that cannot be avoided or undone simply by granting or preventing recovery. Where a prohibited tenancy has been granted and enjoyed, or where a prohibited partnership has been carried on, actions between the parties to adjust their liabilities will not affect the targeted mischief having occurred.²³ The rationale reduces one form of deterrence and prevention to one of deterrence: illegality can now only attempt to prevent others from embarking on a similar course by refusing them to recover under their intended contractual arrangement. This deterrent policy will usually lead to non-recovery in the wake of a prohibited contract.

3.3 Competing Policies and the Tort of Deceit

However, this policy of deterring parties from entering into illegal contracts is not always the sole applicable policy. For example, where a party is forced into making an illegal contract, it is a well-recognised exception to the rule of non-recovery that he may recover back what he has transferred under it.²⁴ This is because, as Lord Ellenborough CJ once recognised, the policy against allowing parties to keep what they have received by fraud is a distinct consideration standing alongside illegality: it "is not a case of *par delictum*: it is oppression on one side, and submission on the other: it never can be predicated as *par delictum*, when one holds the rod, and the other bows to it."²⁵ It can be given effect to without undermining the prevention of the mischief.

²¹*Smith v Bromley* (1760) 2 Dougl 696; 99 ER 441 (n).

²²*Kiriri Colton Co Ltd v Dewani* [1960] AC 192 (PC).

²³*Marks v Jolly* (1938) 38 NSWSR 351 (NSWSC); *Mitchell v Cockburne* (1794) 2 H Bl 379; 126 ER 606; *Aubert v Maze* (1801) 2 Bos & Pul 371; 126 ER 1333; *Booth v Hodgson* (1795) 6 TR 403; 101 ER 619.

²⁴*Smith v Bromley*, above, note 21; *Clarke v Shee* (1774) 1 Cowp 197; 98 ER 1041.

²⁵*Smith v Cuff* (1817) 6 M & S 160, at page 165; 105 ER 1203, at page 1205.

Conversely, there are instances where a competing policy cannot be given effect to without bringing about the very mischief that was prohibited and *Mahmoud* is a case in point: despite his being defrauded, to allow the plaintiff to recover would effectively have enforced the prohibited contract.

Equally, other forms of action may also not lead to the prohibited mischief. As hinted at in *Mahmoud*, an action in deceit in no way tends to enforce the prohibited contract nor cause property to pass to unlicensed buyers. It lies solely to avoid the wrongs of lying, fraud and sharp dealing; it is unconnected to the contractual dealings (except in point of time) and can exist even if no contract is concluded. Recovery is limited to the actual loss flowing from the fraud and, as Glanville Williams has demonstrated, it bears no necessary relation to the damages under contract.²⁶ Such an action was successful in *Saunders v Edwards*, where buyers were able to recover for the deceit of a vendor, notwithstanding their shared contractual machinations designed to defraud the Revenue.²⁷ Deceit would have been a sufficient remedy for the plaintiff in *Mahmoud* and would have overcome any normative cavils with non-recovery in contract. However, it is not a panacea, for it will not apply to all cases in which an innocent plaintiff might be misled: the requirement that there be a knowingly or carelessly false representation²⁸ leaves many situations not covered. Those situations in which there is no lie as to the circumstances that render the contract illegal or where the defendant simply acquiesces in the plaintiff's mistake as to the contract's legality²⁹ are still without remedy.

²⁶G.L. Williams, "The Legal Effect of Illegal Contracts" (1942) 8 CLJ 51, at pages 60-61.

²⁷*Saunders v Edwards* [1987] 1 WLR 1116 (CA). The injury caused by the deceit was "independent of, or unrelated to" the illegality: at page 1134.

²⁸*Derry v Peek* (1889) 14 App Cas 337 (HL).

²⁹Either as to the law or as to facts which, if truly known, would make the contract illegal.

4. The Role of Estoppel

4.1 Availability

A threshold question is whether an estoppel may lie in the face of illegality at all. The court correctly considered that if an estoppel simply precluded the defendant from stating the true state of affairs - preventing him saying that he had no licence - it could not be raised. As Scrutton LJ noted, a recurring theme in illegality is that a court will act on an illegality regardless of how it learns about it. It is only within the power of the parties to preclude raising the true state of affairs *inter se*; one cannot assert that the rights of the public at large have not been infringed when they have.³⁰ However, this is no bar to the proper view of estoppel as a doctrine which creates substantive rights and duties. Again, if its effect were truly confined to *enforcing* a contract, as Scrutton and Atkin LJJ seemed to view it,³¹ that contract's voidness would defeat it. But, it is submitted, it has a different effect: where the requisite elements of an estoppel exist, a competing policy factor – protecting reliance – will exist in addition to the doctrine of illegality's policy of deterrence by non-recovery; just as one exists in cases of oppression or in an action for deceit. If this competing policy of protecting reliance can be satisfied without leading to the prohibited mischief, it is submitted that an estoppel may lie alongside illegality, co-existing with and not 'trumping' it. It does not detract from deterrence

³⁰Illegality is "paramount to all obligations by which the parties to a contract can bind themselves, and is powerful enough to control it, and render it null and void in law": *Camden v Anderson* (1798) 1 Bos & Pul 272, at pages 272-273; 126 ER 900, at page 901. The analogous doctrine, expressed by Higgins J in *Davies v Davies* (1919) 26 CLR 348, at page 362 is that: "[a]nyone is at liberty to renounce a right conferred by law for his own sole benefit; but he cannot renounce a right conferred for the benefit of society."

³¹But *quaere* whether they misconstrued its effect to be something in the nature of specific performance.

aimed at parties who *knowingly* enter into illegal contracts to allow some relief to those who were tricked into or unwittingly forced to rely upon illegality.³²

4.2 The Nature of the Estoppel

The remaining issue is the nature of the estoppel that may lie. The great majority of situations involving some unconscientiousness will be dealt with at common law by deceit and, where it will not bring about the prohibited transaction, by remedies in restitution.³³ Had the roles in *Mahmoud* been reversed and a licensed purchaser paid his money to obtain goods from a lying, unlicensed vendor, the former could recover his payment as money had and received.³⁴ Even had the vendor in *Mahmoud* delivered his goods, he would be able to recover their reasonable value in a *quantum meruit* claim:³⁵ the mischief aimed at - the unlicensed defendant coming into possession of the goods - would have already occurred and preventing the innocent party bearing the loss does not aid the guilty party getting them. Moreover, it would induce, not deter, unlicensed parties to try to obtain such goods by false pretences to create a regime where they can take them and then refuse to pay their value.³⁶

The small kernel of cases susceptible to equitable relief are those where the defendant has induced the plaintiff to believe, or refrained from correcting the belief,³⁷ that he is entitled to some executory benefit under a contract which the defendant has caused to be illegal. These executory rights do not exist because the contract is void, and the

³²M. Spence, *Protecting Reliance: The Emerging Doctrine of Equitable Estoppel* (Hart, 1999), at pages 72-76.

³³*Hughes v Liverpool Victoria Legal Friendly Society* [1916] 2 KB 482.

³⁴*Shelley v Paddock*, above, note 8.

³⁵*Reynell v Sprye* (1851) 1 De GM&G 656; 42 ER 708; *Blossome v Williams* (1824) 3 B & C 232; 107 ER 720.

³⁶*Shelley v Paddock*, above, note 8.

³⁷*Thompson v Palmer* (1933) 49 CLR 507.

plaintiff cannot enforce them nor obtain damages for non-performance. As Heath J posited in *Mitchell v Cockburne*,³⁸ a good example is where the plaintiff contracts for insurance which is void due to the conduct of the defendants. He may recover his premium as money had and received before or after the risk eventuates.³⁹ In the former case he may be able to re-insure but in the latter he cannot; and in most cases the illegality comes to light only when the risk eventuates and the defendant refuses to pay. It is submitted that, in such a case, a clear loss occasioned by the reliance upon the assumption of the contract being legal can be identified: the failure of the plaintiff to be able to enter into an equivalent, lawful contract. This lost chance to obtain a similar but valid executory benefit from another would be compensable in deceit, at its market value, as part of "his negative interest",⁴⁰ and there is no principled reason it should not also be repaired in estoppel when deceit is unavailable - it is the extent of his detrimental reliance.⁴¹ There is old authority for the proposition that an innocent assured may indeed do just this in answer to his insurer's attempt to avoid a contract of insurance on the grounds of the illegality of his partnership;⁴² however, this issue is now moot for insurance contracts themselves, given that legislation following the *Phoenix* case⁴³ has obviated the need for estoppel by allowing the assured to enforce the contract itself. If

³⁸*Mitchell v Cockburne*, above, note 23, at page 382; ER at page 608.

³⁹*Lowry v Bourdieu* (1780) 2 Dougl 468, at page 471, 99 ER 299, at pages 300-301 per Buller J; *Hughes v Liverpool Legal Friendly Society*, above, note 33.

⁴⁰Being put "into the position he would have been in if no false representation had been made": *Smith New Court Securities Ltd v Scrimgeour Vickers* [1997] AC 254; *Gates v The City Mutual Life Assurance Society Limited* (1986) 160 CLR 1 and a case cited therein: *Parker v Co-operative Insurance Society* (1945) IACRep (1938-39). It would be measured by the plaintiff's ability to have entered into an equivalent lawful contract or contracts, at the market value of the premium and policy.

⁴¹*Commonwealth v Verwayen* (1990) 170 CLR 394, at pages 428-429.

⁴²*Booth v Hodgson* (1795) 6 TR 405; 101 ER 619; *Sullivan v Greaves in Park on Insurance*, noted *arguendo* in *Armstrong v Lewis* (1834) 2 C & M 274, at page 288; 149 ER 763, at page 769.

⁴³*Phoenix Insurance v Halvanon Insurance* [1988] 1 QB 216 (CA); section 132 of the Financial Services Act 1986.

anything, this shows that allowing recovery is often desirable on policy grounds. However, it is submitted that identical reasoning ought to apply to other contracts which do not have the benefit of specific legislation.

Precisely this approach was very recently applied in respect of a void - though not prohibited - contract by the Court of Appeal in *Yaxley v Gotts*.⁴⁴ There, the plaintiff had orally agreed with the defendant to acquire the ground floor of a house in return for conducting building work on other floors and acting as an agent for the tenants it housed. Under section 2 of the Law of Property (Miscellaneous Provisions) Act 1989, the absence of writing made the contract void. The plaintiff performed the work under the agreement and sought an interest in land, the defendant conceding only that a *quantum meruit* for the services rendered was payable. The Court unanimously affirmed the decision of the trial judge to grant the plaintiff a long lease on the ground floor via a proprietary estoppel. Beldam LJ, with whom Clarke LJ agreed, held that the "general principle that a party cannot rely on an estoppel in the face of a statute depends upon the nature of the enactment, the purpose of the provision and the social policy behind it", and that the policy behind section 2 was to reduce the complexities of the old section 40 of the Law of Property Act 1925 (which itself codified and replaced section 4 of the Statute of Frauds 1677) in setting up a regime where minimum levels of formalities were introduced in order to encourage "certainty as to the formation of contracts of this type".⁴⁵ The policy of the Act was not impaired, because the remedy was not, as Clarke LJ noted, to "render valid a transaction which the legislature, on grounds of general public policy, has enacted is to be invalid or void"; it did not bring about in any way "the mischief which the Act is designed to cure". Rather, it was to do the minimum required to fulfil the discrete policy to prevent

⁴⁴*Yaxley v Gotts*, *The Times*, July 8 1999.

⁴⁵Similar legislation has also been considered to have the purpose of preventing "spurious claims" against the landowner: *Pavey & Matthews Pty Ltd v Paul* (1987) 162 CLR 221, at pages 228-229.

unconscientious retention of benefits by invoking a statute in a way smacking of equitable fraud. Beldam LJ did "not think it inherent in a social policy of simplifying conveyancing by requiring the certainty of a written document that unconscionable conduct or equitable fraud should be allowed to prevail" and Robert Walker LJ came to the same conclusion in finding that the "the parliamentary purpose" was not "frustrated".

5. Conclusion

Provided one remains conscious that illegality will never allow an action to effect prohibited mischief, it is submitted that there is a definite role for estoppel to play in protecting parties to some illegal contracts. The protection of detrimental reliance is a discrete policy factor which can be given effect to - in certain instances - without upsetting the doctrine of illegality, just as actions in deceit protect against lying and fraudulent conduct. If the proper role and scope of each doctrine is retained in mind, harsh results may be avoided in many seemingly hard cases. Suppleness of mind can prevent the doctrine of illegality itself being used as a tool for one party to oppress another; equity, at least, may intervene to protect a party unwittingly straying, or being duped, into an illegal contract, perhaps with the attachment of conditions, "lest there be 'no redress at all against the fraud nor any body to ask it' ".⁴⁶

Ben Kremer*

* MSc candidate
University of Sydney and
DPhil candidate
Magdalen College
Oxford

⁴⁶*Nelson v Nelson* (1995) 184 CLR 538, at page 559.

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THE DEVELOPMENT OF PROMISSORY ESTOPPEL

The obsession of the common law courts with the doctrine of consideration delayed the development of the equitable doctrine of promissory estoppel. Gradually, the courts realised the harshness which resulted from the indiscreet adherence to the requirement of consideration in contracts, in their making and discharge. Eventually, promissory estoppel was born.

Requirements of Promissory Estoppel

Under the principle of promissory estoppel, a promisor would be estopped from going back on his representation whereby he has waived his legal rights against the promisee, in reliance upon which the latter has altered his position, so that it would be inequitable to change that position. The traditional requirements of promissory estoppel include the pre-existing contractual relationship between the parties, a clear undertaking that the legal rights under the contract would not be enforced or would be held in abeyance, alteration of the promisee's position in reliance upon the representation and the inequity that would result if the promisor is allowed to resile from his promise. The promissory estoppel is said to only avail as a defence and not as the sole cause of action. Further, the doctrine is said to apply to representations relating to the past or present events and not to the future events and that it only suspends the legal rights without extinguishing them.

The doctrine of promissory estoppel has gradually shorn itself of almost all limitations which were placed on it in its formative period.