

I L L E G A L
C O N T R A C T S

REPORT OF THE CONTRACTS AND
COMMERCIAL LAW REFORM COMMITTEE
NEW ZEALAND

Presented to the Right Honourable the Minister
of Justice in October 1969

REPORT OF THE CONTRACTS AND COMMERCIAL
LAW REFORM COMMITTEE ON THE LAW GOVERNING
ILLEGAL CONTRACTS

To: The Right Honourable the Minister of Justice

Introductory

1. In 1966 the Minister of Justice referred to this committee for examination the results flowing from illegal contracts with a view to a restatement of the law which would produce the greatest measure of fairness. Although these terms of reference employ the expression "restatement" it is understood that this expression is to be taken as embracing the notion of ameliorative change.

2. The committee has found it possible to express its conclusions in the form of a relatively brief draft bill to be found in the Appendix to this report.

The Need for Reform

3. That there is need for change in the law relating to illegal contracts needs little argument. During the past two decades there have been repeated judicial expressions of concern at the harshness of the consequences which flow from illegality. In Todd v. Parker [1953] N.Z.L.R. 39, 47, 48, F.B. Adams J. said -

"There are some aspects of the law relating to illegal contracts which might well be borne in mind by those responsible for legislation. I say nothing in regard to any statute in particular, but the severity of the consequences which sometimes flow from the statutory invalidation of contracts is sometimes out of proportion to practical requirements."

The next judicial criticism was made by North J. (now North P.) in Griffiths v. Ellis [1958] N.Z.L.R. 840, 858 -

"A plea of illegality sounds ill from the lips of a person who brands himself to be a wrongdoer and then seeks to avoid an obligation solemnly entered into which has resulted in £250 reaching his pocket ... It may well be that in these days when citizens are faced with complicated legislation there is room in this field for the law reformer, at least in cases where a person has unwittingly involved himself in a contract prohibited by statute and has paid money to the other party."

The learned President repeated his opinion in Cotton v. Central District Finance Corporation Ltd. [1965] N.Z.L.R. 992, when he said at 997 -

"The result is most unfortunate, and this case may provide a further example of the need for law reform in the field of illegal contracts."

Finally we quote the comments of McCarthy J. in Carey v. Hastie [1968] N.Z.L.R. 276, 282 -

"There are few areas in the law of contract which cause more trouble than that of illegality, and it may be, as some writers urge, that the time has come when the Legislature might look carefully at this subject and consider doing something to remove the over-severe consequences which sometimes flow from a breach of one of the less important of the very large number of regulations which a managed welfare State seems to require."

As recently as May 1968, dissatisfaction at the present state of affairs was expressed by an audience representative of many interests at a session of the International Business and Law Symposium held at Auckland. That particular session dealt with the specific problem of the effect of regulation 53 of the Traffic Regulations 1956 (S.R. 1956/217) which requires the seller of a motor vehicle, upon delivery of the vehicle to the purchaser, to supply him with a warrant of fitness issued within the preceding thirty days. This requirement, which the audience was told was intended by its draftsmen to further the interests of road safety only, had been held in Dromorne Linen Co. Ltd. v. Ward

[1963] N.Z.L.R. 614 and in Berrett v. Smith [1965] N.Z.L.R. 460 to be of such a character that breach would disentitle the seller from recovering the purchase price under the contract of sale. While this view has since been rejected by Woodhouse J. in the recent case of Fenton v. Scotty's Car Sales Ltd. [1968] N.Z.L.R. 929 the history of the regulation does stand as an object lesson of the way in which breach of regulatory provisions can have quite drastic and even unintended effects upon the contractual rights of citizens.

Other contexts which have given cause for concern include the provisions of the Land Settlement Promotion and Land Acquisition Act 1952 and the local authority requirements relating to building permits. As section 25 of the Land Settlement Promotion and Land Acquisition Act 1952 was at one time interpreted, it would have been possible for someone holding under an agreement for the sale and purchase of land, in cases where the parties had failed within one month to apply for the consent of the Land Valuation Court, to lose not only his deposit but also the value of any improvements (and in one reported case, these were very substantial) notwithstanding that the failure to obtain consent was the result merely of ignorance, oversight or inadvertence.

The problem relating to building permits has arisen in some cases because of an apparent practice of some local authorities not to issue building permits until buildings have been completed, the reason being to avoid the necessity for issuing a series of permits covering variations to the building contract. The Court of Appeal recently held in Carey v. Hastie-[1968] N.Z.L.R. 276 that in such cases, the building contractor has no right to recover his contract price, even if the completed building complies entirely with the local authority's requirements.

While many of the provisions which have caused concern in recent years are susceptible to, and probably ought to be dealt with by, specific legislation, to deal

with every case in this way would be manifestly inconvenient. We have accordingly concentrated in this report on proposals for reforms of a general nature.

Types of Illegality

4. In the textbooks, illegal contracts are generally classified in three groups, viz. contracts illegal by statute, by law or regulation; contracts illegal at common law; and a third category of contracts comprising agreements in restraint of trade, agreements to oust the jurisdiction of the courts, and agreements tending to prejudice the status of marriage.

Restraint of Trade, etc.

5. The most important group of contracts falling within the third category described above are agreements in restraint of trade. The objective of the common law relating to them has been to ensure in the public interest that individuals are not unreasonably restrained from engaging in business enterprises or in following their chosen trades or professions. A contract which fails to comply with the common law requirements does not thereby become unenforceable as a whole. Only the offending portion is so affected, and then only if it is unreasonable.

There is a difficulty, however, that turns on a merely verbal distinction between differing restraints. If the court should decide that a restraint as it stands is unreasonable it may, if it can do so by merely cutting out the offending portions, make it reasonable and thereafter enforce it. On the other hand, if to make the restraint reasonable would involve the alteration of words, the whole clause will be struck out and no restraint at all will be enforced. Assuming, to take an example, that a restraint limited to the North Island were reasonable, and a clause contained a restraint expressed to extend to "the North and South Islands of New Zealand", the offending reference to the South Island would be struck out by the court and the restraint over the North Island would be enforced. However, were the clause to be

expressed to cover simply "New Zealand" it would have to be held to be entirely void. A recent illustration is the Australian case of Papastravou v. Gavan [1968] 2 N.S.W.R. 286.

We consider this difference unjustifiable and we accordingly recommend (clause 8 of the draft statute) that the courts be given power in all cases to enforce restraints of trade so far as they are reasonable, even if this does involve a redrafting of offending portions.

The other two classes of contract within this category are of little significance in practice and require no separate treatment.

Contracts Illegal at Common Law

6. A much larger and more important class of case is contracts illegal at common law. This class comprehends such contracts as those to commit immoral or illegal acts, torts and fraud; agreements contrary to public policy, such as those tending to promote corruption in public life, agreements with enemy aliens in time of war and agreements prejudicial to public policy; agreements prejudicial to the administration of justice, and agreements to defraud the revenue.

It is generally fair to say that, in cases of this character, the reasons for treating the contracts as illegal are readily understandable and in most cases there seems little need to waste sympathy on those who, having knowingly entered on such dealings, have their fingers burned.

For parties with a guilty intention, the consequences are severe. The court simply refuses to entertain or enforce the contract and the loss lies where it falls. An innocent party is, however, in some circumstances, differently treated and even where the contract itself cannot be enforced, may be allowed restitution of any property transferred, or to recover on a quantum meruit or quantum valebant for work done or materials supplied.

Even a guilty party may not be without remedy if he repents before the illegal purpose has been effected. While, however, in the case of contracts falling under this head, the need for reform may not be as urgent as it is in the category we discuss next, we have not forgotten that there can be degrees of "guilt" and that in some cases even a "guilty" party may be called upon to suffer consequences quite disproportionate to his offence. We do not think, therefore, that contracts illegal at common law should be excepted from the general reforms we propose in this report.

Contracts Illegal by Statute

7. The type of illegality which today gives most cause for concern is that brought about by the effect of statutes, regulations and bylaws. The trend in modern times towards increasing the degree of control exercised by the State and local government over the every day concerns of the community has led to a wide proliferation of possible offences and a consequent growth in the number of ways in which, potentially, contracts may be effected by illegality. Measures to control dispositions of land, safety on the highways, the construction of buildings, the sale of such commodities as food, tobacco and fertilizers and the loading of ocean-going vessels have all had the effect of rendering contracts illegal.

8. On the authorities, it would appear that a contract can be affected by statutory illegality in one of five ways :-

- (i) The law may prohibit the very formation of the contract, in which case, neither party can enforce it. (E.g. In re Mahmoud and Ispahani [1921] 2 K.B. 716)
- (ii) The contract, while not ex facie prohibited, may be illegal because the parties intend by it to effect an illegal purpose. Again, neither party

may enforce it. (E.g. Miller v. Karlinski (1945) 62 T.L.R. 85)

- (iii) The contract, while ex facie legal, may become illegal because it is performed in a manner which is prohibited. In such cases, sometimes one, and sometimes both, parties will be unable to enforce it. (E.g. Carey v. Hastie (supra) and Anderson Ltd. v. Daniel [1924] 1 K.B. 138)
- (iv) The contract may remain at all times legal, but one of the parties may be unable to enforce it because of his illegal conduct in the course of performance. (This was the view taken of the effect of the illegality in Dromorne Linen Co. Ltd. v. Ward (supra) and Berrett v. Smith (supra))
- (v) The contract may be completely legal and enforceable by both parties, notwithstanding that one or both parties may have committed an offence in the course of performance. (E.g. St John Shipping Corporation v. Joseph Rank Ltd. [1957] 1 Q.B. 267).

9. Statutory illegality gives rise to two major difficulties. The first is that it is often very difficult to know into which of the above five categories a particular case should fall. The other is that the consequences for a defaulting party are often quite disproportionate to his offence. We deal with these two matters in turn.

Categorisation

10. Contracts expressly prohibited ought not to present any difficulties of categorisation. The trouble comes when the question is whether a prohibition should be implied. On this matter there is authority for two different kinds of approach. Under the one, in any case where the contract requires the performance of an illegal act, or where an illegal act is committed by a party in the course of performance, the contract will be illegal and the guilty party, or sometimes both parties, will be unable to enforce it. An example would be the approach of the New Zealand courts to the effect of breach of section 25 of the Land Settlement Promotion and Land Acquisition Act 1952, prior to the decision of the Court of Appeal in Joe v. Young [1964] N.Z.L.R. 24. Under the other approach, the requirement or commission of any illegal act does not of itself determine the fate of the contract. The statute, regulation or bylaw must still be construed to see whether its policy and purpose clearly require that breach should effect the legality of contracts. Examples of this approach are St. John Shipping Corporation v. Joseph Rank Ltd. (*supra*) and the New South Wales case, Hayes v. Cable (1961) 62 S.R. (N.S.W.) 1. It is perhaps fair to say that the second approach has gained greater favour with judges overseas than with those in this country.

The consequences of illegality being what they are, we believe they ought not unnecessarily to be visited on the parties to any contract. Accordingly we recommend in clause 5 of our draft statute what in effect would be an adoption of the second approach in this country.

The Consequences of Illegality

11. Ordinarily neither party to an illegal contract can enforce it. But there are cases where only the "guilty" party to such a contract loses his remedy and other cases where, though the contract has been held to be legal, a party who has committed a prohibited act in the course of

performance has been disqualified from obtaining any remedy.

Illegal contracts are frequently described as being void. There is room for argument whether this is in fact so. It appears, for example, that property can pass under an illegal contract. It is possible, in other words, that the effects of illegality are "procedural" in the sense that they make contracts not void, but merely incapable of enforcement. A result of this is that loss lies where it falls and there is not (except where a statute provides) any scope for the restitution of property illegally acquired or for striking a balance between the parties.

The harsh treatment of illegal contracts by the common law is not echoed in all other legal systems. Under Roman-Dutch law in force in South Africa and Ceylon it seems that restitution as distinct from enforcement may be granted in a much wider range of circumstances than our own law permits. Under the Roman-Dutch law the maxim in pari delicto is regarded as requiring the Court to consider the conduct of one party in relation to that of the other. The courts look at all the circumstances of the case in deciding whether or not relief should be granted and have often granted relief "wherever it is necessary to prevent injustice or to promote public policy", to quote from a South African decision, Jajbhay v. Cassein [1939] A.D. 537. There is a very helpful discussion of this approach in a recent book, Weeramantny, The Law of Contract, Vol. 1, pp. 397-400, to which we acknowledge our indebtedness.

Any general reform should, in our view, have the effect of making such contracts as are illegal, of no effect, so that no rights will pass under them and the position of the parties will be the same as if the illegal contract had never been entered into (clause 6 of the draft statute). We would qualify this rule, however, by giving to the courts a discretion to order that, notwith-

standing the illegality, the contract be enforced in whole or in part. We would make this exception because we recognise that there may be circumstances where it may be impossible or unjust that the parties should be restored to their original position. We therefore make the recommendations set out in clause 7 of the attached draft statute.

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 (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 and we have moreover provided some curbs on the exercise by the courts of the proposed powers.

12. At present, the courts have the power in certain cases to assist the parties to an illegal contract by severing and discarding the illegal portions of it, so that the legal parts remaining can be enforced. This power can sometimes work injustice in that the enforcement of only a part rather than the whole can have the effect of distorting the parties' bargain. It seems to us, however, that the need for the remedy will disappear if the larger reforms we recommend are adopted. Under these the courts will have a much wider discretion to enforce or not enforce the contract (including the illegal portions of it) whether in whole or in part. We therefore recommend in clause 3 of our draft statute that contracts should be treated as illegal whether the illegal provisions in them are severable or not.

13. We are anxious that in considering this branch of the law the deterrent effect of the present stringent rules

is not overlooked. Although the proviso to regulation 10 of the Hire Purchase and Credit Sales Stabilisation Regulations 1957 probably does less than justice between the parties, its swingeing effect has the consequence that these regulations are largely observed by retailers and finance companies despite minimal governmental policing. On the other hand, because, to take another example from the field of economic regulation, Regulation 12(4) of the Finance Emergency Regulations 1940 (No.2) provided that non-compliance did not invalidate a security, that regulation was in practice in many respects widely flouted. We have in our draft therefore required the courts to consider not only the situation inter partes but also the public interest.

14. The discretion conferred on the courts by clause 7 of our draft is therefore trammelled to the degree and for the reasons indicated in the above paragraphs.

15. We have extended the right to seek relief to third parties to cover the case of a third party who believes he has acquired rights to property from a party to an illegal contract which that party, because the illegality prevents the property passing to him, is in fact unable to grant. We have also had it in mind that questions of illegality may arise before a tribunal other than "the court" as defined, and that such a tribunal may for the determination of the matter before it, need to know how the court will exercise its discretion under clause 7.

For the Committee

Chairman

DATED at Wellington 24th October 1969.

Members

Mr M.F. Chilwell Q.C. (Chairman)

Mr B.J. Cameron

Professor B. Coote

Mr D.F. Dugdale

Professor E.P. Ellinger

Mr W. Iles

Mr C.I. Patterson

APPENDIXDRAFT ILLEGAL CONTRACTS BILL

ANALYSIS

- | | |
|--------------------------|---------------------------|
| Title | 6. Illegal contracts to |
| 1. Short Title | be of no effect |
| 2. Interpretation | 7. Court may grant relief |
| 3. "Illegal contract" | 8. Restraints of trade |
| defined | 9. Jurisdiction of |
| 4. Act to bind the Crown | Magistrates' Courts |
| 5. Breach of enactment | 10. Savings |

A BILL INTITULED

An Act to reform the law relating to illegal contracts
BE IT ENACTED by the General Assembly of New Zealand in
Parliament assembled, and by the authority of the same,
as follows:

1. Short Title - This Act may be cited as the
Illegal Contracts Act 1970.

2. Interpretation - In this Act, unless the
context otherwise requires, -

"Act" means any Act of the General Assembly;
and includes any Act of the Parliament of
England, of the Parliament of Great Britian,
or of the Parliament of the United Kingdom,
which is in force in New Zealand:

"Court" means the Supreme Court or a Magistrate's
Court that has jurisdiction under section 9 of
this Act:

"Enactment" means any provision of any Act,
regulations, rules, bylaws, Order in Council,
or Proclamation; and includes any provision of
any notice, consent, approval, or direction
which is given by any person pursuant to a
power conferred by any Act or regulations:

"Property" means land, money, goods, things in action, goodwill, and every valuable thing, whether real or personal, and whether situated in New Zealand or elsewhere; and includes obligations, easements, and every description of estate, interest, and profit, present or future, vested or contingent, arising out of or incident to property.

3. "Illegal contract" defined - Subject to section 5 of this Act, for the purposes of this Act the term "illegal contract" means any contract that is illegal at law or in equity, whether the illegality arises from the creation or performance of the contract; and includes a contract which contains an illegal provision, whether that provision is severable or not.

4. Act to bind the Crown - This Act shall bind the Crown.

5. Breach of enactment - (1) A contract lawfully entered into shall not become illegal or unenforceable by any party by reason of the fact that its performance is in breach of any enactment, unless the enactment expressly so provides or its object clearly so requires.

(2) A contract the object of which or of any provision of which is the doing of an act that is prohibited by any enactment shall be illegal, unless the enactment otherwise provides or its object otherwise requires.

6. Illegal contracts to be of no effect - (1) 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:

Provided that nothing in this section shall invalidate -

- (a) Any disposition of property by a party to an illegal contract for valuable consideration; or
- (b) Any disposition of property made for valuable consideration by -
 - (i) A person who became entitled to the property under a disposition by a party to the illegal contract; or
 - (ii) A person who became entitled to the property through a person to whom subparagraph (i) of this paragraph applies -

if the person to whom the payment or disposition was made was not a party to the illegal contract and had not at the time of the payment or disposition notice that the property was the subject of, or the whole or part of the consideration for, an illegal contract and otherwise acts in good faith.

(2) In this section the term "disposition" has the meaning assigned to that term by section 2 of the Insolvency Act 1967.

7. Court may grant relief - (1) Notwithstanding the provisions of section 6 of this Act, but subject to the express provisions of any other enactment, the Court may in the course of any proceedings, or on application made for the purpose, grant to -

- (a) Any party to an illegal contract; or
- (b) Any party to a contract who is disqualified from enforcing it by reason of the commission of an illegal act in the course of its performance; or

(c) Any person claiming through or under any such party -
such relief by way of compensation, variation of the contract, validation of the contract in whole or in part or for any particular purpose, or otherwise howsoever as the Court in its discretion thinks just.

(2) An application under subsection (1) of this section may be made by -

(a) Any person to whom the Court may grant relief pursuant to subsection (1) of this section; or

(b) Any other person where it is material for that person to know whether relief will be granted under that subsection.

(3) In considering whether to grant relief under subsection (1) of this section the Court shall have regard to -

(a) The conduct of the parties; and

(b) In the case of a breach of an enactment, the object of the enactment and the gravity of the penalty expressly provided for any breach thereof; and

(c) Such other matters as it thinks proper; but shall not grant relief if it considers that to do so would not be in the public interest.

(4) The Court may make an order under subsection (1) of this section notwithstanding that the person granted relief entered into the contract or committed an unlawful act with knowledge of the facts or law giving rise to the illegality, but the Court shall take such knowledge into account in exercising its discretion under that subsection.

(5) The Court may by any order made under subsection (1) of this section vest any property that was the subject of, or the whole or part of the consideration for, an

illegal contract in any party to the proceedings or may direct any such party to transfer or assign any such property to any other party to the proceedings.

(6) Any order made under subsection (1) of this section, or any provision of any such order, may be made upon and subject to such terms and conditions as the Court thinks fit.

8. Restraints of trade - (1) Where any provision of any contract constitutes an unreasonable restraint of trade, the Court may -

- (a) Delete the provision and give effect to the contract as so amended; or
- (b) So modify the provision that at the time the contract was entered into the provision as **modified would have been reasonable, and give effect to** the contract as so modified; or
- (c) Where the deletion or modification of the provision would so alter the bargain between the parties that it would be unreasonable to allow the contract to stand, decline to enforce the contract.

(2) The Court may modify a provision under paragraph (b) of subsection (1) of this section, notwithstanding that the modification cannot be effected by the deletion of words from the provision.

9. Jurisdiction of Magistrates' Courts - (1) A Magistrate's Court shall have jurisdiction to exercise any of the powers conferred by any of the provisions of sections 7 and 8 of this Act in any case where -

- (a) The occasion for the exercise of the power arises in the course of any civil proceedings (other than an application made for the purposes of subsection (1) of section 7 of this Act) properly before the Court; or

- (b) The value of the consideration for the promise or act of any party to the contract is not more than \$2,000; or
- (c) The parties agree, in accordance with section 37 of the Magistrates' Courts Act 1947, that a Magistrate's Court shall have jurisdiction to hear and determine the application.

(2) For the purposes of section 43 of the Magistrates' Courts Act 1947, an application made to a Magistrate's Court pursuant to subsection (1) of section 7 of this Act shall be deemed to be an action.

10. Savings - Except as provided in section 8 of this Act, nothing in this Act shall affect the law relating to:

- (a) Contracts, or provisions of contracts, which are in restraint of trade; or
- (b) Contracts, or provisions of contracts, which purport to oust the jurisdiction of any Court, whether that Court is a Court within the meaning of this Act or not.

(2) Nothing in this Act shall affect the right of any person to bring an action for breach of promise of marriage and every such action shall be heard and determined as if this Act had not been passed.