THE OBJECTIVE PRINCIPLE AND MISTAKE AND INVOLUNTARINESS IN CONTRACT AND RESTITUTION

Introduction

The purpose of this article is to examine some aspects of the objective principle in contract and the fundamental difference between the law of mistake and other defects of the will in contract and in restitution. Stated succinctly the law of contract, which regulates the "acquisition" of the right to the promised performance, is predicated on the objective principle under which the existence and extent of contractual obligations are to be ascertained from the parties' words and conduct even if they do not reflect their genuine (subjective) intentions. The objective approach, in its modern form, finds its roots in the broad principle relating to the protection of bona fide acquisition for value, as applied and adapted to the contractual setting.[1] The approach of the law of restitution, which governs the field of involuntary transfers, is utterly different. Such a transfer does not usually raise an issue of bona fide acquisition.[2] It is, therefore, founded on the subjective theory and looks to the actual intention of the party that made the transfer.

The article also points out that though the objective approach in its modern form has been considerably attenuated, there remains a wide gulf between the law relating to mistake and involuntariness in contract and that of mistake and involuntariness in restitution.

A Comment on the Objective and Subjective Theories

There are many models of objective and subjective approaches.[3] Under the extreme form of the objective approach the parties' rights and obligations are determined in accordance with their external conduct, and it is even

[1] The doctrine of bona fide acquisition for value generally applies in three parties situations in which there are two transactions, and the party to the second transaction claims the benefit of the doctrine. In this context "value" usually means value actually given and not merely promised: K. Barker, "Bona Fide Purchase as Defence to Unjust Enrichment Claims" [1999] R.L.R. 75. The objective theory of contract is based on an extended concept of good faith acquisition for value that applies in two party situations in which promise of value suffices to support the right to the other party's performance. *Cf.* the discussion in *Royal Bank of Scotland Plc v Etridge (No.2)* [2001] 3 W.L.R. 1021 at pp.1036 (Lord Nicholls of Birkenhead) and 1072 (Lord Scott of Foscote), of the equitable concept of constructive notice in the case in which a transferee of property claims a better title than the transferor had and constructive notice in a contractual setting.

[2] The question of bona fide purchase does however arise if the property was subsequently sold to a third party. In addition, where the property or the money transferred was accepted in discharge of a debt there arises the analogical issue of discharge for value. See A. Kull, "Defenses to Restitution: the Bona Fide Creditor" (2001) 81 Boston U.L. Rev. 919.

[3] W. Howarth, "The Meaning of Objectivity in Contract" (1984) 100 L.Q.R. 265. On the different meanings of subjectivity see Nicholas, *French Law of Contract* (2nd ed., 1992), p.85.

conceivable that a contract would be held to have been formed the contents of which does not correspond to the intention of either party.[4] The present position of Anglo-American law, in which the objective approach is firmly established, is more moderate. Its purpose is generally limited to protecting the performance interest of the party who acquired in good faith the other party's promise while being unaware that the promise is not in accord with the genuine will of the party who made it.

The objective principle does not apply where the wordings of the contract are not in line with the common intention of both parties, in which case rectification may be granted.[5] It also does not apply where the party who obtained the promise was aware that it does not reflect the other party's intention or that the will of the other party had been vitiated.[6] In addition, there are some exceptions, notably in American law, to the objective approach.[7]

The subjective approach considers that the party's will constitutes the creative source of the contractual obligation. Consequently, where the party's words or external conduct (usually termed in continental literature "declaration of the will") do not reflect his actual (internal) will, the "declaration" cannot provide a sufficient basis for contractual liability. This approach was adopted by the French legal system. In the nineteenth century the will theory was supported by some of Germany's leading jurists, including Savigny and Windscheid, but towards the last quarter of this century the opposite approach gained ground. The German civil code (BGB) seems to have taken the middle ground.[8] The topics of mistake, fraud and duress appear under the title "declaration of the will" (*Willenserklärung*) thus placing the emphasis upon the declaration, yet a number of specific sections show a clear inclination towards the subjective approach.[9] Yet it is clear that even the French legal system cannot unreservedly adhere to the subjective approach. Various techniques, based on the rules of evidence and interpretation, are applied to limit its

[4] Support for such an approach can be found in American case law and literature in the first part of the twentieth century. It is reflected in an often-quoted statement by Learned Hand J. under which "A contract has, strictly speaking, nothing to do with the actual intent of the parties. A contract is an obligation attached by the mere force of law to certain acts of the parties, usually words . . . ": *Hotchins v National City Bank* 200 F. 287 at p.293 (1911); affirmed 201 F. 664 (1912); affirmed 231 U.S. 50 (1913). See also O.W. Holmes, "The Theory of Legal Interpretation" (1899) 12 Harv.L.Rev. 417 at p.420.

[5] J. Beatson, *Anson's Law of Contract* (27th ed., 1998), pp.342–327.

[6] See *infra*, text after n.52 and text to nn.73–76.

[7] See the discussion of unilateral mistake, *infra*, text to n.57. See also Joseph M. Perillo, "The Origins of the Objective Theory of Contract Formation and Interpretation" (2000) 69 Fordham L.Rev. 427.

[8] *Münchener Kommentar BGB* (4th ed., 2001), Vol.1, pp.1059–1064 (E. Kramer) suggesting that the BGB adopted a pragmatic approach rather than decided between the two possibilities. The debate between the "will theorists" and the "objectivists" is discussed in Gordley, *The Philosophical Origins of Modern Contract Doctrine* (1991), pp.209–213.

[9] H. Kötz, *European Contract Law* (trans. by T. Weir, 1997), p.172, considers that in the context of mistake the BGB adopted the subjective approach.

application to the extent that French scholars speak of "*rapprochement*" of the two approaches.[10]

Of particular interest is the way in which the idea of *culpa in contrahendo* (fault in negotiation), that is highly developed in German law, can supplement the subjective approach. The party who, under the subjective approach, is entitled to avoid the contract on the ground of mistake of which the other party was unaware, is required to compensate the other party for his reliance losses.[11] The distinction between the objective and subjective approaches in this type of situation relates to the interest protected. The objective approach protects the performance interest of the party who concluded a contract on the basis of the external conduct of the mistaken party, by treating the contract as binding. The subjective approach merely protects the reliance interest of the party who concluded the contract on the basis of the mistaken party's declaration. It allows rescission, subject to payment of reliance damages.[12]

The Objective Theory and the Decline of Mistake in the Law of Contract

The objective theory of contracts became firmly established in English and American law in the second part of the nineteenth century. A number of leading scholars, including Grant Gilmore, Lawrence Friedman and Morton Horwitz,[13] conclude that the objective theory was actually invented at that time and replaced the subjective theory which was in effect in the eighteenth century and the early part of the nineteenth century. The objective theory reflecting the quest for certainty and stability thus gained preference over the hitherto prevalent subjective theory that was founded on communitarian notions of fairness and justice. However, in a recent article Joseph Perillo argued that this historical account is flawed and that objective approaches have predominated in the common law of contracts

[10] A. Weill and F. Terré, *Droit Civil—Les Obligations* (4th ed., 1986), pp.73–76. In addition; following the tradition of the Roman Law of mistake many legal systems limit the possibility of avoidance to certain types of mistake: see Kötz, *supra*; n.9 at p.178 *et seq*. The French legal system greatly expanded the categories of mistake for which rescission is available. See Nicholas, *supra*, n.3 at pp.85–95. But there are limitations. Rescission is not allowed for an inexcusable mistake (*erreur inexcusable*): Nicholas, *ibid.* at pp.94, 97.

[11] §122 of the BGB Liability does not depend on fault, but under Swiss law it does: Kötz, *supra*, n.9 at p.186. *Cf.* also s.14(b) of the Israeli Contracts (General Part) Law 1973 which grants the court discretion to rescind a contract on the ground of unilateral mistake. In such a case the court may require the mistaken party to pay reliance damages to the other party. French law did not adopt this concept of *culpa in contrahendo*, and liability in the pre-contractual stage is based on the general provision relating to delictual liability (CC, art.1382). If such liability is established the award of damages is not limited to reliance losses but covers the whole loss (*la réparation intégrale du prejudice*), which apparently includes the performance interest. Consequently, if the mistaken party's fault renders him liable in tort to the other party, the rescission of the contract on the ground of his mistake will serve no purpose, since his liability in tort would be similar to the contractual liability he is trying to avoid. See J. Ghestin, *Le Contrat: formation* (3ème éd., 1993), p.483. Indeed in such a case rescission is likely to be denied on the ground that the mistake is "inexcusable" (*supra*, n.10).

[12] But see *supra*, n.11 with regard to French law.

[13] *cf.* also P.S. Atiyah, *The Rise and Fall of Freedom of Contract* (1979), pp.434–438.

from early times. "There was a brief but almost inconsequential flirtation with subjective approaches in the mid-nineteenth century", but this flirtation "came to a decisive end when the legislatures enacted laws allowing parties to testify on their own behalfs".[14]

For our purpose it suffices to point out the impact that the objective theory had on the law of mistake as reflected in two nineteenth century leading cases. In the first case, *Kennedy v The Panama, New Zealand and Australian Royal Mail Co*,[15] the plaintiff was induced to buy shares in a company by a statement in its prospectus that it had a contract with the New Zealand government for a monthly mail service. It transpired that the contract was void as it was made with an unauthorised agent of the New Zealand Government. The shares lost much of their value and the plaintiff sought to rescind the contract, return the shares and recover the price. The judgment of the Queen's Bench was delivered by Blackburn J. who held that if the plaintiff had been induced to take the shares by fraud or deceit of the other party he was entitled to rescind the contract. But in that case the misrepresentation was innocent and "an innocent misrepresentation . . . does not authorize a rescission . . . "[16] The misrepresentation caused a mistake, which might affect the validity of the contract, an issue that was to be determined solely according to the rules relating to mistake. The fact that the mistake was caused by the other party's innocent misrepresentation was held to be irrelevant. This reasoning required a ruling on the law of mistake and Blackburn J. held that the principles of the common law were the same as those of the civil law. It was followed by a citation from the *Digest*[17] and a discussion of the case of a sale in which the vendor thought that he was selling the slave S while the buyer thought that he was buying the slave P. The contract is void because of *error in corpore*. Blackburn J. also adopted the distinction developed in Roman law between error in substance and error in quality. Where the parties agree upon the subject matter of the sale, but are mistaken as its substance, the contract is void. But if the mistake is merely as to its quality, the contract is binding. Blackburn J. concluded that the mistake in *Kennedy* related merely to the quality of the shares and held the contract to be binding.

The case of *Smith v Hughes*,[18] was decided some four years after *Kennedy*. It demonstrated that English law of mistake is subject to the objective theory, a limitation that was probably unknown to Roman law. The facts of the case are well known. It was concerned with a contract for the sale of oats of which the defendant received a sample. The defendant was only interested in buying old oats and claimed that the plaintiff

[14] Perillo, *supra*, n.7 at p.428.

[15] (1867) L.R. 2 Q.B. 580.

[16] *ibid.* at p.587.

[17] Lib.18, tit.4.

[18] (1871) L.R. 6 Q.B. 597.

described the oats as "good old oats", but the plaintiff denied this. The defendant refused to accept delivery of the oats on the ground that they were new oats and the plaintiff sued for the price. In the trial the defendant presented evidence that the price agreed upon was a very high price for new oats "such that a prudent man of business would not have given"[19] and the jury found for the defendant. The Court of Queen's Bench ordered a new trial on the ground that the trial judge had not properly directed the jury. Blackburn J. explained that the law of mistake is subordinate to the objective principle:

> "If, whatever a man's real intention may be, he so conducts himself that a reasonable man would believe that he was assenting to the terms proposed by the other party, and that party upon that belief enters into the contract with him, the man thus conducting himself would be equally bound as if he had intended to agree to the other party's terms."[20]

This obviously reflects a deviation of the common law from the Roman law of mistake, which Blackburn J. had purported to follow in the then recent case of *Kennedy*. For if, in the example discussed in *Kennedy*, the vendor intended to sell *e.g.* farm X while the buyer thought that he was buying farm Y, the contract would not necessarily be void. The common law subjects the issue to the objective test. If a reasonable man would conclude from the parties' words or conduct that the agreement related to farm X, the buyer is bound to buy it, despite the fact that this was never his intention.[21] It is only if under the objective test it is equally plausible that the reference was either to farm X or to farm Y that the contract would be void.[22]

The objective principle is subject to an important qualification which was already recognised in *Smith v Hughes*. This qualification derives from the very purpose of this principle which is to enable the party, who has reasonable grounds to assume that the other party agreed to certain terms, to rely on the existence of a valid contract. But if this party is aware of the other party's mistake he is precluded from relying on the objective test. Thus, where one party mistakenly offered to sell hare skins at a certain price per pound, while intending it to be the price per piece, the other party who was aware of the mistake could not accept the offer and claim that the contract is for a sale at that price per pound.[23]

In *Smith v Hughes* this qualification received a very narrow interpretation. It was clear that the jury concluded that the defendant mistakenly

[19] *ibid.* at p.602.
[20] *ibid.* at p.607. This passage has often been quoted. See, *e.g.* Treitel, *Law of Contract* (10th ed., 1999), p.1; Beatson, *supra*, n.5 at p.307; Cheshire, Fifoot and Furmston, *Law of Contract* (14th ed., 2001), p.272.
[21] *cf.* also *Tamplin v James* (1885) 15 Ch.D. 215.
[22] *Scriven Bros. & Co v Hindley & Co* [1913] 3 K.B. 564; *Raffles v Wichelhous* (1864) 2 H. & C. 906; 159 E.R. 375.
[23] *Hartog v Colin & Shields* [1939] 3 All E.R. 566.

believed that he was buying old oats and that the plaintiff knew of the defendant's mistake. It was also clear that the price agreed upon was that of old oats, which were much more expensive than new oats. But the Queen's Bench drew a distinction between two possibilities. One is that where the defendant believed that the oats were old but did not think that the plaintiff gave him a contractual promise to this effect. This is a mere mistake of motive,[24] which is understood to be any mistake inducing the formation of the contract, but one that does not relate to the contractual terms.[25] Such a mistake, even though it is known to the other party, does not affect the validity of the contract. "For, whatever may be the case in a court of morals, there is no legal obligation on the vendor to inform the purchaser that he is under mistake."[26]

The other possibility is that the defendant believed that the plaintiff gave a contractual promise that the oats were old. Such a mistake as to the contractual terms, which is known to the other party, prevents consensus *ad idem* and the contract is void. This conclusion does not necessarily follow. It is conceivable that in such a case the contract will be treated as binding on the terms as understood by the party who believed that the promise was given to him.[27] In the case of *Smith v Hughes* this means that the seller would be regarded as having promised that the oats were old (because he knew that the buyer believed that he made such promise). Consequently, the buyer would have been entitled to reject the delivery of the new oats,[28] and in addition would have been entitled to claim damages for breach of contract. A new trial was ordered on the ground that the distinction between these two possibilities was not explained to the jury. In fact one may wonder whether the parties themselves were aware of the fact that the very same mistake, which is known to the other party, can in one case constitute a mere mistake of motive, and consequently be irrelevant, whereas in another case it may relate to the contractual terms and render the contract completely void.

There is another point that deserves to be mentioned. Had the contract in *Smith v Hughes* been in force (a possibility that actually remained open) the defendant would have been required to pay for the oats an amount that greatly exceeded their value and as a result the other party would have been

[24] *ibid.* at p.606 (*per* Cockburn C.J.). *Cf.* also Savigny's theory of motive, that provides no ground for avoidance, discussed in Kötz, *supra*, n.9, at pp.179–181.
[25] See also Holmes, *The Common Law* (1881), p.314.
[26] *ibid.* at p.607 (Blackburn J.).
[27] For the approach under which if A mistakenly believes that B included a certain promise in his offer and B knows of A's belief, then there is a binding contract on the terms as understood by A, see *Restatement, Contracts (2d)*, §§20 and 166 and *Riverlate Properties Ltd v Paul* [1975] Ch. 133 at p.140 (*per* Russell L.J.).
[28] See Treitel, *supra*, n.20 at pp.279 and 283–284.

enriched at his expense.[29] This is typical of many mistake cases. From the parties' point of view this is usually the most important feature of the case and this is usually the factor that prompts the litigation. The paradox lies in the fact that the element that the parties (and possibly also the jury) usually consider to be the most important, is, under the common law, totally irrelevant. Indeed, the leading textbooks on contract that discuss *Smith v Hughes* in considerable detail, usually do not even mention this fact that the seller sued for a price that greatly exceeded the value of the oats he sought to supply.

The law of mistake in contracts became subordinate to the objective principle and was almost completely whittled down. The narrow approach of the common law was strengthened by the decision of the House of Lords in *Bell v Lever Bros*.[30] So much so that the view was expressed that the common law has no doctrine of mistake vitiating a contract,[31] except where it disrupted the offer and acceptance process, as *e.g.* where one party offers one set of terms while the other party agrees to different terms and the objective test cannot determine which set of terms should govern.[32] The doctrine of mistake survived in some exceptional situations, which were akin to frustration or total failure of consideration, as in the case of a contract of sale of goods which unknown to the parties were lost before the conclusion of the contract[33] or where the sale related to property that already belonged to the purchaser.

The common law maintained a superficial resemblance to Roman law in that it organised the topic in two categories, mistake and fraud, and disregarded innocent misrepresentation. However, the rules within these categories were completely different. The category of mistake, which invalidated the contract, was fairly broad in Roman law while in the common law it became subordinated to the objective theory and was almost wiped out. The category of fraud that vitiated the contract was also broader in Roman law. Thus, in *Smith v Hughes* the court concluded that if the buyer's mistake did not relate to the terms of the contract, the seller

[29] This is unjust enrichment in the loose sense. Legally there is no unjust enrichment since the party to the contract, if it is binding, is legally entitled to receive that which was promised. See D. Friedmann, "Valid, Voidable, Qualified and Non-Existing Obligations: an Alternative Perspective on the Law of Restitution" in *Essays on the Law of Restitution* (A. Burrows ed., 1991), pp.247, 250–251.

[30] [1932] A.C. 161.

[31] C.J. Slade, "The Myth of Mistake in Contract in English Law" (1954) 70 L.Q.R. 385 and the references in Beatson, *supra*, n.5 at p.297.

[32] See the references *supra*, n.22. The offer and acceptance process also fails where one party intends to contract only with A and another person pretends to be A and purports to accept the offer made to A. On this topic of *error in persona* see Beatson, *supra*, n.5 at pp.311–318 and E. Stern, "Objectivity, Legal Doctrine and the Law of Mistaken Identity" (1995) 8 J.C.L. 154.

[33] *Couturier v Hastie* (1856) 5 H.L.C. 673; 10 E.R. 1065. An alternative approach would be to assume that the seller warranted the existence of the goods, in which case he would be liable in damages for the failure to deliver them. *Cf. McRae v Commonwealth Disposals Commission* (1950) 84 C.L.R. 377. For the approach under which the existence of specific property, which the parties erroneously assumed to exist, may be a condition precedent to the validity of the contract: see the decision of Steyn J. in *Associated Japanese Bank (International) Ltd v Credit du Nord S.A.* [1989] 1 W.L.R. 255.

was under no duty of disclosure and was in fact free to exploit the situation and sell the new oats at the high price of old oats. Roman law would have probably regarded this as a case of fraud.[34] Indeed, modern English law would in all probability also allow rescission.[35] The common law approach was enthusiastically adopted by O.W. Holmes. In his famous book *The Common Law* Holmes offered ideological support for the objective theory in its most extreme form stating that: "The law has nothing to do with the actual state of the parties' minds. In contract, as elsewhere, it must go by externals, and judge parties by their conduct."[36]

It is somewhat surprising to find such a generalisation in a book that clearly distinguishes between innocent and fraudulent misrepresentation, and discusses in considerable detail *mens rea* in criminal law.[37]

Holmes also offered theoretical explanation for the reason that innocent misrepresentation does not affect the validity of the contract:

> "The law does not go on the principle that a man is answerable for all consequences of all his acts . . . If a man states a thing reasonably believing that he is speaking from his knowledge, it is contrary to the analogies of the law to throw the peril of the truth upon him unless he agrees to assume that peril, and he did not do so in the case supposed, as the representation was not made part of the contract."[38]

This reasoning is doubly flawed. First, reference is made to the principle that a man is not "answerable for all consequences of all his acts", which reflects an objection to "absolute" or strict liability. Yet it does not explain the common law denial of rescission in cases of negligent misrepresentation. The second difficulty with this passage lies in its failure to distinguish between liability for a loss and the right to keep unjust profits obtained at another's expense. It is one thing to argue, vehemently as Holmes did, that "the general principle of our law is that loss from an accident must lie where it falls",[39] so that a person should not be liable for an act done without fault, though the act caused damage to others. It is a wholly different matter to suggest that a contract induced by innocent misrepresentation is valid, so that the party who by virtue of his misrepresentation obtained benefits that greatly exceeded the value of that which he gave, would be entitled to keep them.

Holmes' book was published in 1881. His analysis of misrepresentation became obsolete upon its publication, for in that very same year the Court

[34] W.W. Buckland and A.D. McNair, *Roman Law and Common Law* (2nd ed., F.H. Lawson ed., 1965), at p.203.

[35] See *infra*, text to nn.52–55.

[36] Holmes, *The Common Law* (1881), p.309.

[37] *ibid.* Chaps I and II.

[38] *ibid.* at p.323.

[39] *ibid.* at p.94.

of Appeal in England rendered the decision in *Redgrave v Hurd*,[40] that is discussed in the following section.

The Objective Theory and the Law of Misrepresentation

The Judicature Act 1873, which led to the fusion of the common law and equity, was enacted just two years after the decision in *Smith v Hughes*. A few years later the Court of Appeal rendered its decision in *Redgrave v Hurd*,[41] which revolutionised the law of induced mistake. In that case the plaintiff contracted to sell to the defendant his house and his practice as a solicitor after he had misstated the value of his practice. The plaintiff sued for specific performance and the defendant counterclaimed for rescission. The counterclaim was allowed and the defendant recovered his deposit. In his decision Jessel M.R. addressed the effect of the Judicature Act and stated that as regards rescission, there was a difference between the rules of equity and those of the common law. This difference "disappeared by the operation of the *Judicature Act*, which makes the rules of equity prevail".[42] He then stated that the equitable rule allowing rescission of a contract induced by innocent misrepresentation could be explained in two ways. One was that "a man is not allowed to get a benefit from a statement which he now admits to be false". The other way was this:

> "Even assuming that moral fraud must be shewn in order to set aside a contract, you have it where a man, having obtained a beneficial contract by a statement which he now knows to be false, insists upon keeping that contract. To do so is a moral delinquency: no man ought to seek to take advantage of his own false statements."[43]

It may be added that though rescission was granted, the defendant's claim for damages on the ground of deceit failed. A distinction was thus drawn between liability for a loss, which required pleading and proof of deceit, and preventing the retention of a benefit obtained by a false statement, even if innocently made. This is the very distinction which Holmes failed to perceive.[44] The decision in *Redgrave v Hurd* rendered obsolete the common law decision in *Kennedy*[45] as well as Holmes' analysis of innocent misrepresentation.

It may also be noted that the explanation offered by Jessel M.R. justifying rescission for innocent misrepresentation is characteristic of good faith argumentation. It is contrary to the principle of good faith to gain advantage at another's expense by misleading him, even if the act was

[40] (1881) 20 Ch.D. 1.
[41] *ibid.*, n.40.
[42] *ibid.* at p.12.
[43] *ibid.* at pp.12–13.
[44] *supra*, text to n.38.
[45] *supra*, text to n.15. The question whether rescission was available could however arise if the contract has been performed. This issue has been resolved by legislation. See *infra*, n.47.

innocently done. The principle of good faith has not been recognised by English law, but *Redgrave v Hurd* provides an example of an application of a similar idea.

Redgrave v Hurd also eroded the importance of the distinction between mistake as to the terms of the contract and mistake relating to a motive, namely an element not included in the contract but inducing its formation. In *Smith v Hughes* the distinction was considered crucial, but in *Redgrave v Hurd* rescission was granted although the misrepresentation and the ensuing mistake related to a fact regarding which there was no contractual undertaking (mistake in motive).[46]

This development led to a restructuring of the law of mistake in contract formation. As already indicated, *Smith v Hughes* maintained the basic categories, recognised by Roman law, namely the category of mistake and that of fraud. This remains to date the structure of the continental legal systems. But *Smith v Hughes* whittled down the contents of the mistake category so that possibility of avoiding a contract on the ground of mistake was almost completely excluded. However, *Redgrave v Hurd* opened a very broad and liberal avenue of rescission in cases in which the mistake was caused by the other party's misrepresentation. Consequently, for the purpose of rescission the distinction between fraud and innocent misrepresentation was almost completely blurred.[47] The result is reflected in the structure of English and American contract textbooks. Practically all of them have a large chapter on misrepresentation. There is no separate chapter on fraud, a topic that is usually discussed briefly within the chapter on misrepresentation. This remains the typical structure of topic although the Misrepresentation Act 1967 has given some substance to the once crucial distinction between innocent and fraudulent misrepresentation. Under section 2(2) of the Act the court has discretion, in cases of innocent misrepresentation, to award damages in lieu of rescission. This possibility is excluded where the misrepresentation has been fraudulent.[48]

The development of the law of misrepresentation does not undermine the objective principle adopted in English law. The purpose of the objective principle is to enable a party to conclude a contract on the basis of the other

[46] The distinction remains however relevant for some purposes. Thus, where the misrepresentation relates to the terms of the contract it is possible to conclude that the contracts is valid and that its terms correspond to the intention of the party to whom the misrepresentation was made. See also *supra*, nn.27–28 and accompanying text.
[47] Some differences did however remain. In particular it was held in *Seddon v North Eastern Salt Co.* [1905] 1 Ch. 326 that a contract cannot be rescinded on the ground of innocent misrepresentation after it had been executed. The ambit of this rule is discussed in the Law Reform Committee, Tenth Report, Cmnd. 1782 (1962), §§6–10. This rule has been abolished by s.1(b) of the Misrepresentation Act 1967. Another difference between the two types of misrepresentation is evidentiary. In case of fraud the court is likely to conclude that it related to an important element that induced the contract. In the case of innocent misrepresentation the party making it has better prospects of convincing the court that it did not induce the contract. In addition, the distinction between innocent and fraudulent misrepresentation remained important for the purpose of a claim for damages.
[48] Beatson, *supra*, n.5 at pp.252–254.

party's words or conduct. It is meant to protect the *justified reliance* on the external appearance. But no such protection should be granted where the reliance is unjustified. The essence of Jessel M.R.'s decision in *Redgrave v Hurd* is that such reliance by the party who misled the other party is unjustified, even if the misrepresentation was innocent when made. Reliance on externals is similarly unjustified where the party knows that the other party's real intention does not correspond to the objective interpretation of his words or conduct.

The Objective Principle and Mistake in Equity

The decision of Denning L.J. in *Solle v Butcher*[49] was taken to establish that rescission in equity on the ground of common mistake relating to a basic assumption may be available with regard to contracts that were considered valid at law.[50] In order to test the compatibility of such rescission with the objective principle let us examine the following examples:

Example (1): S contracts to sell a house to B for £850. Both parties know that the house is occupied and believe that the person in possession is a protected tenant. It transpires that he is not and that he is leaving the house. The value of the vacant house is £2,250.

Example (2): Same facts as in example (1) except that that the buyer knows that there is no protected tenancy and he also knows that the seller mistakenly believes that the tenant is protected.

Example (1) is based, with a slight variation,[51] on *Grist v Bailey*[52] in which Goff J. ordered rescission subject to the condition that the seller agreed to enter into a new contract at the price which was proper for a vacant house. It is submitted that the decision does not conflict with the objective principle. Both parties erroneously believed that the house was occupied by a protected tenant. The mistake proved advantageous to the buyer and detrimental to the seller. But the objective principle does not mean that the buyer was entitled to take advantage of the situation. The mistake was common. The buyer was not misled by the conduct and appearance of the other party any more than by his own assumption as to the basis of the price agreed upon. The narrow approach of the common

[49] [1950] K.B. 671.

[50] *Solle v Butcher* was followed in a number of cases: see *Magee v Penine Insurance Co* [1969] 2 Q.B. 507, CA and Beatson, *supra*, 5 at pp.329–330. This is also the position of American law: *Restatement, Contracts (2d)*, §152.

[51] In *Grist v Bailey* the existence of the tenancy was mentioned in the contract, but nothing was said on its being protected. In the above examples it is assumed that the tenancy was not mentioned in the contract, but was known to the parties who calculated the price on the assumption that the tenancy is protected. The purpose of my variation is to emphasise the point that the rescission for mistake may be granted even when the mistake relates to an element that is not expressly referred to in the contract.

[52] [1967] Ch. 532.

law regarding mistake in contract was recently revived by the Court of Appeal in *Great Peace Shipping Ltd v Tsavliris Salvage (International) Ltd*[53] which held that there is no right in equity to rescind a contract, that is valid at common law, on the ground of common mistake. If indeed *Solle v Butcher* is no longer good law then the contract in example (1) will remain in force and the buyer would acquire the house for an amount well below its actual value.

Even if this is the result in example (1), it is submitted that in example (2) rescission ought to be allowed. In this example the buyer was not mistaken, yet he was aware of the seller's mistake. The case for rescission is much stronger than in example (1). The reason is obvious. While in example (1) there was nothing morally wrong in the buyer's conduct at the contract formation stage, in example (2) his moral conduct is not beyond reproach. In *Smith v Hughes* Blackburn J. considered that knowledge of the other party's mistake does not affect the validity of the contract, when the mistake does not relate to the terms of the agreement. However, equity allows rescission for innocent misrepresentation (which is actually a case of common mistake), although there was nothing morally wrong in the conduct of the party who made the misrepresentation. It suffices that he was in some respect responsible for the other party's mistake. Arguably, the case for rescission becomes stronger if one party is aware that the other party acts under mistake, and decides to take advantage of it. The point is strengthened by analogy to undue influence. Where a party enters into a contract under undue influence exercised by a third party, the contract is voidable if the other party is aware of it. The fact that the other party was not responsible for the undue influence does not preclude rescission. His knowledge of the fact suffices.[54] The position in case of mistake ought to be similar. Rescission on the ground of fundamental mistake of one party ought to be allowed, although the other party did not cause the mistake but was merely aware of it.[55] Again, this result does not conflict with the objective principle, which protects justifiable reliance on the words and conduct of the other party. Where one party is fully aware that the other party acts under a fundamental mistake, he should not be allowed to take advantage of the situation and his insistence upon the validity of the contract is unjustified.

If this analysis is correct it means that on the facts of *Smith v Hughes* a court would nowadays reach a different result. As will be recalled, the jury found that the seller was aware of the buyer's fundamental mistake. Nevertheless, the court in *Smith v Hughes* concluded that in order to relieve the buyer it is necessary that the jury should find not merely that the seller

[53] [2002] EWCA Civ 1407 affirming the decision of Toulson J. (2002) 151 N.L.J. 1696, noted by J. Cartwright in (2002) 118 L.Q.R. 196.

[54] See *infra*, n.73 and accompanying text.

[55] Constructive knowledge may suffice. See *infra*, n.73.

knew that the buyer mistakenly believed that he was buying old oats, but also that the seller knew that the buyer believed that it was a term of the contract that the sale related to old oats. It is however submitted that for the purpose of rescission in equity this additional requirement is unnecessary. It suffices that the seller knew of the buyer's fundamental mistake and took advantage of it, even if he did not think that the mistake related to a term of the contract.

Example (3): Same facts as in example (1) except that the buyer knows that there is no protected tenancy but does not know that the seller is mistaken, and simply believes that he is being offered a good bargain.

In this example the seller mistakenly believes that the person in possession is a protected tenant. The buyer knows that the tenant is about to leave the house, but he does not know of the seller's mistake and merely believes that for some reason he is getting a good offer which he accepts. Under the objective principle the contract is valid and there is no room for rescission. This is indeed the present position of English law.[56]

American law went a step further. Under s.153 of the *Restatement Contracts (2d)* a contract may be voidable on the ground of unilateral mistake that has a material effect on the agreed exchange that is detrimental to the mistaken party, if enforcement of the contract would be unconscionable and the other party had reason to know of the mistake or his fault caused it.[57] The section does not require actual knowledge of the mistake by the other party. It suffices if he "had reason to know of the mistake". American law did not stop there. Corbin states that decisions allowing rescission for unilateral mistake, the existence of which the other party neither knew nor had reason to know "are too numerous and too appealing to the sense of justice to be disregarded".[58] Calamari and Perillo add that "since these words were written, an increasing number of cases permitted avoidance where only one party was mistaken" if enforcement would be oppressive and avoidance does not impose substantial hardship on the other party.[59] The typical case is a mistake in the calculation of bid by a construction contractor. This means that at least in some situations the objective principle gave way to a subjective approach. Indeed it has been suggested that a rule which permits rescission on the ground of unilateral mistake, of which the other party was unaware and had no reason to suspect, "if liberally applied . . . would erode, if not totally deluge, the

[56] *Tamplin v James* (1885) 15 Ch.D. 215; *Riverlate Properties Ltd v Paul* [1975] Ch. 133, CA; Beatson, *supra*, n.5 at pp.331–332.

[57] It is also required that the mistaken party would not be regarded as the one who should bear the risk of the mistake: s.154 of *Restatement, Contracts (2d)*.

[58] Corbin, *Contracts*, vol.3, p.675.

[59] Calamari and Perillo, *Law of Contracts* (4th ed., 1998), p.355. See also A. Farnsworth, *Contracts* (3rd ed., 1999), pp.631–636.

prevailing objective theory of contracts".[60] But if this approach is adopted it should be supplemented by a rule imposing liability on the party who seeks rescission on the ground of his unilateral mistake, for the reliance losses of the other party, when the other party was not responsible for the mistake and had no reason to know of its existence.[61]

Fraud, Misrepresentation, Duress and Undue Influence Exercised by a Third Party

Under the objective principle the apparent assent of one party to the terms agreed to by the other party suffices in order to create a binding contract, even if the apparent assent does not correspond to the actual (subjective) intention of that party. This approach also applies where the intention of one party was vitiated by fraud, misrepresentation, duress or undue influence exercised by a third party. If the other party to the contract is unaware of it, he is entitled to rely on the apparent consent of the party with whom he contracts and insist upon the validity of the contract.

This basic rule does not apply in the extreme case in which the act of the third party completely deprived the party of his will, so that act ostensibly of that party is no longer attributed to him. From his point of view it is "*non est factum*". This is a very narrow category and modern developments tend to narrow it even further.[62] The typical case is that in which a person is fraudulently induced to sign a document which turns out to be essentially different from that which he intended to sign. No difficulty arises if the claim is brought by the person who committed the fraud. The transaction, even if it is not void, is voidable and the deceived person can escape liability. The difficulty arises where the document signed embodied a transaction with another party who acted in good faith and was unaware of the fraud. The modern position of English law, as reflected in the decision of the House of Lords in *Saunders v Anglia Building Society*,[63] is that even if the document is essentially different from that which the person intended to sign, the plea of *non est factum* is unavailable if the person who signed acted negligently. In such a case the contact remains valid and is unaffected by the fraud exercised by the third party, so that the performance interest of the other party to the contract is fully protected.

The result can be compared to that which obtains in legal systems that follow the subjective approach, supplemented by liability for fault in negotiation (*culpa in contrahendo*). Under German law a contract cannot be rescinded on the ground of fraud exercised by a third party, if the other party to the contract was unaware of it.[64] It seems, however, clear that since

[60] Calamari and Perillo, *ibid.*

[61] See *supra*, n.11 and accompanying text.

[62] *Saunders v Anglia Building Society* [1971] A.C. 1004; Beatson, *supra*, n.5 at pp.318–320.

[63] *supra*, n.62.

[64] §123(2) of the BGB. The position under French law is similar. See Kötz, *supra*, n.9 at p.208.

the deceived party acted under mistake, he can seek a remedy under the provision relating to avoidance on the ground of mistake,[65] provided of course that the mistake, caused by the third party's fraud, is one for which rescission is available. Rescission on the ground of such unilateral mistake may entail liability to pay for the other party's reliance losses.[66] The other party who acted in good faith thus gains a measure of protection. Under English law, which follows the objective principle and does not allow rescission on the ground of unilateral mistake, the position of this party is stronger, since his performance interest is fully maintained.[67]

Analogous questions arise in cases of duress or undue influence exercised by a third party. In exceptional situations, in which the pressure exerted upon the person who signed the document was so extreme that it deprived him of any choice, he can claim that "it is not his" document.[68] But in most cases duress and undue influence do not completely negate consent. The contract is voidable by the victim if the other party to the contract is responsible for the duress or undue influence. However, if the duress or undue influence was exercised by a third party, the objective principle applies. The contract is valid since the party to the contract, who is unaware of the duress, is entitled to rely on the apparent consent of the other party, although the latter's consent was improperly obtained by the act of a third party. It is however clear that the contract can be avoided if the third party who exercised misrepresentation, duress or undue influence acted on behalf of the other party to the contract and can be regarded his agent.[69] The contract can also be set aside if one party was a privy to the wrong exercised on the other party or had knowledge of it. In such a case the objective principle does not apply and the contract is voidable by the party whose consent was wrongfully obtained.[70] The leading case of *Barclays Bank Plc v O'Brien*[71] has further attenuated the objective principle by introducing the concept of constructive notice into the contractual setting. This concept was traditionally applied to determine

[65] §119 BGB.

[66] §122 BGB and *supra* n.11.

[67] Except in the rare case of *non est factum*.

[68] In most English cases the issue arose in the context of documents mistakenly signed, and consequently English textbooks discuss the topic of *non est factum* in the chapter on mistake. See Beatson, *supra*, n.5 at pp.318–320; Treitel, *supra*, n.20 at pp.301–304; Cheshire, Fifoot and Furmston, *supra*, n.20 at pp.284–289. But see Goff and Jones, *Law of Restitution* (5th ed., 1998), at pp.307–308 in which *non est factum* is also discussed in the context of duress. See also *Restatement, Contracts (2d)*, §174 dealing with physical duress that prevents the formation of a contract, and Farnsworth, *supra*, n.59 at p.264. The possibility that duress would render the contract void is discussed in Cheshire, Fifoot and Furmston, *supra*, n.20 at p.337. See also Treitel, *supra*, n.20 at p.375; D.J. Lanham, "Duress and Void Contracts" (1966) 29 M.L.R. 615 and *Barton v Armstrong* [1976] A.C. 104.

[69] *Avon Finance Co v Bridger* [1985] 2 All E.R. 281, CA (in the context of undue influence). *Cf.* also *Kings North Trust Ltd v Bell* [1986] 1 W.L.R. 119.

[70] *Royal Bank of Scotland plc v Etridge (No.2)* [2001] 3 W.L.R. 1021 at p.1036 (Lord Nicholls of Birkenhead).

[71] [1994] 1 A.C. 180.

whether a purchaser of property was bound by a pre-existing right in the purchased property of which he could be deemed to have notice.[72] The transplantation of this concept into the law of contract means that in certain circumstances a contracting party may be "put on inquiry" and deemed to know that the assent of the other party has been vitiated by the misconduct of a third party. In such a case constructive knowledge excludes the application of the objective principle in much the same way as actual knowledge does. The question usually arose in cases in which the debtor used undue influence to induce his wife or a close relative to guarantee a loan that he received from a bank or another financial institution. The contract was set aside where the lender knew of circumstances that raised an inference of undue influence, notably the relations of the debtor and the guarantor and the fact that the transaction is highly disadvantageous to the guarantor.[73] This approach has been extended to other situations, including the case in which a junior employee was convinced by her employer to guarantee the employer's overdraft,[74] and it now seems that the bank is "put on inquiry" in every case in which the relationship between the debtor and the surety is non-commercial.[75] §175(2) of the *Restatement, Contracts (2d)* has also adopted the concept of constructive notice. It provides that when the manifestation of assent is induced[76] by a third party the contract is voidable by the victim "unless the other party to the transaction in good faith *and without reason to know of the duress* gives value . . . "[77] (emphasis added). Comment *e* to this section explains that "value" includes a performance or a return promise that constitutes consideration. The close connection between the objective principle and good faith acquisition is thus highly conspicuous.[78]

[72] *Etridge*, *supra*, n.70 at pp.1036–1037 (Lord Nicholls of Birkenhead), 1072 (Lord Scott of Foscote).

[73] See the references *supra*, nn.70–71, and Treitel, *supra*, n.20 at pp.387–388; Beatson, *supra*, n.5 at pp.286–287.

It is submitted this approach ought to apply, by way of analogy, to unilateral mistake of one party that is known or ought to be known to the other party, even if the mistake does not relate to the terms of the agreement. See also *supra*, text to nn.54–55.

[74] *Credit Lyonnais Bank Nederland NV v Burch* [1997] 1 All E.R. 144, CA.

[75] *Etridge*, *supra*, n.70 at p.1048 (Lord Nicholls of Birkenhead).

[76] Under American law the test of inducement is subjective: comment *c* to §175 of the *Restatement, Contracts (2d)*. This means that if a wrongful threat induced a timid person to make the contract, the contract is voidable, even if such a threat would not have been taken seriously by a reasonable person. It has been suggested that this reflects a victory of the subjective approach: Perillo, *supra*, n.7 at pp.466–472. In my view this test of inducement is not incongruous with the objective test in the sense described in this article. A party who induces a contract by a wrongful threat is not in the position of a good faith acquirer and is not entitled to the benefit of the objective principle, even if the threat would not have been effective against a reasonable person.

[77] A question does however arise regarding the consistency of American law to the subjective approach. American law allows, in certain situations, rescission on the ground of unilateral mistake (*supra*, text to nn. 57–60). There is no reason to adopt a different approach if the "defect in the will" of the party stems not from mistake but from duress or undue influence of a third party. In other words, if rescission for unilateral mistake is allowed, it should also be allowed for duress exercised by a third party.

[78] But see *supra*, n.1.

It may also be noted that the concept of constructive notice as developed in *O'Brien*[79] and *Etridge*[80] does not merely impute knowledge but actually requires a contracting party who is "put on inquiry" to take reasonable steps to ensure that the consent of the other party is properly obtained and thus to reduce the risk of wrongful pressure or undue influence. The requirement to take active steps by the lender goes beyond that which was required under the traditional doctrine of constructive notice, and it was actually pointed out that the constructive notice terminology was a misnomer.[81]

The objective principle has thus been considerably diluted. But it continues to apply in instances in which a party has neither actual nor constructive knowledge that the will of the other party has been vitiated by misrepresentation, duress or undue influence of a third party. In such an instance the party, who acquired his contractual right in good faith and for value, is entitled to enforce the contract despite the defect in the other party's will.[82]

By way of comparison it may be noted that both the French and the German legal systems allow rescission for duress by a third party even if the other party to the contract neither knew nor should have known of it.[83] The result is in line with the subjective approach. Yet, neither German nor French law allow avoidance on the ground of fraud exercised by a third party, when the other party was unaware of it.[84] It has been suggested that this indicates that these legal systems regard duress as having a stronger vitiating effect on the party's will than deceit.[85] Another possible explanation is that deceit by a third party leads to mistake, which provides an independent ground of avoidance. The victim can thus resort to the law of mistake, provided of course that the mistake is of the type for which avoidance is allowed.

Mistake and Involuntariness in the Law of Restitution

It is not the purpose of this article to examine the vast case law and literature relating to recovery of money paid (or property transferred[86])

[79] *supra*, n.71.
[80] *supra*, n.70.
[81] *Etridge*, *supra*, n.70 at p.1037 (Lord Nicholls of Birkenhead).
[82] See, *e.g. Coldunell Ltd v Gallon* [1986] 1 Q.B. 1184, CA; *Goldsworthy v Brickell* [1987] Ch. 378, CA; N. Andrews, "Undue Influence by a Third Party" [1986] C.L.J. 194.
[83] This is expressly provided in art.111 of the French CC. See also Kötz, *supra*, n.9 at p.273.
[84] Kötz, *supra*, n.9 at p.206.
[85] *ibid.* p.273.
[86] The issues relating to mistaken transfer of property are in many respects similar to those of mistaken payment. For the sake of simplicity the discussion will concentrate on the latter category. However the case of services mistakenly provided (*e.g.* A paints a car owned by B erroneously believing that it belongs to A) raises the issue of unsolicited benefits that cannot be returned *in specie* and in which the recipient may not have been interested. This issue is briefly referred to *infra*, text to nn.108–109.

under mistake. Rather it is to point out the fundamental difference between mistake and involuntariness in the law of restitution as distinguished from that relating to contract formation.

The law relating to mistaken payment is concerned with the recovery of payment that was not due. This is the first and foremost condition for restitution. Even if the payor acted under the most serious mistake, he is not entitled to restitution if it transpires that he actually owed the money to the payee. Indeed it seems that the existence of a mere moral duty suffices to exclude restitution.[87] However, under Anglo-American law, this basic condition, namely that payment was neither legally nor morally due, is insufficient to ground liability. The law relating to mistake and involuntariness is concerned with the additional element required to complete the payor's cause of action to recover his payment. This additional element, when it is based on the payor's involuntariness, is concerned solely with the payor's mental state. The test is entirely subjective.[88] Recovery does not depend on fraud or misrepresentation on the part of the recipient, and the question whether the recipient shared the same mistake or was aware of it, has no bearing on the right to restitution.[89]

It is obvious that policy considerations underlying involuntariness in restitution are totally different from those relating to contract formation, which, as already indicated, are concerned with good faith acquisition of a legal right (the right to the other party's performance). The crucial point for the purpose of restitution, namely that the payor was not legally obligated to make the payment, usually does not arise at the stage of contract formation, in which both parties are interested in creating new rights and obligations.[90] On the other hand, questions relating to the creation and acquisition of new rights, which lie at the heart of contract formation and underlie the objective theory in contract, do not arise in the context of mistaken payment that was not due.

Yet, the fact that the term mistake is used both in the context of contract formation and restitution of payment that was not due has often led to confusion. *Norwich Union Fire Insurance Society v Price*[91] is a classical

[87] Thus, *e.g.* a person who pays a debt that is time barred is not entitled to restitution even if the payment is made because he mistakenly believes that the period of limitation has not yet expired. He will however be entitled to restitution if his mistake was induced by the fraud or misrepresentation of the recipient. See *Restatement, Restitution (1st)*, §61 and *cf. Bize v Dickason* (1786) 1 T.R. 285; 99 E.R. 1097 (Lord Mansfield).
[88] The position and the basic considerations are similar with regard to mistake in gifts: *Lady Hood of Avelon v MacKinnon* [1909] 1 Ch. 476; Goff and Jones, *supra*, n.68 at pp.188–191.
[89] This proposition is subject to a number of qualifications that are examined *infra*, text to nn. 108–117.
[90] Such questions may however arise in contracts dealing with compromises and other arrangements regarding pre-existing debts.
[91] [1934] A.C. 455.

case of a mistaken payment, made under an insurance policy which covered a shipment of lemons on a voyage to Sydney. The lemons were ripening on the way and were sold at Gibraltar. The insurers mistakenly concluded that the lemons had been damaged by a peril insured against and paid for the loss, which was not covered by the policy. The claim to recover the amount paid under mistake was rightly allowed. But the fact that such a clear case went to up to the House of Lords as well as some of the statements in the decision, indicate the difficulty. Lord Wright observed that

> "The facts which were misconceived were those which were essential to liability and were of such a nature that on well-established principles any agreement concluded under such mistake was void at law[92] . . . It is true that the general test of intention in the formation of contracts and transfer of property is objective; that is, mistake is to be ascertained from what the parties said or did. But proof of mistake affirmatively excludes intention . . . "[93]

The misconceived assimilation of mistake in payment and mistake in contract formation and the reference to the objective principle created an almost insurmountable difficulty. Mistake in contract formation was governed by *Smith v Hughes*[94] and the narrow approach of *Bell v Lever Bros*.[95] decided just two years earlier. Lengthy and detailed opinions were therefore required to explain why recovery should nevertheless be allowed.[96] However, once it is realised that the objective principle is inapplicable and that cases dealing with mistake in contract formation are irrelevant, the right of restitution in this rather simple situation becomes evident.[97]

Since we are dealing with situations in which *ex hypothesi* the recipient was not entitled to the payment, there is no reason to confine the right of restitution to a specific type of mistake such as fundamental mistake or mistake that leads the payor to erroneously believe that he is under liability to pay. It should suffice that the mistake has caused the payor to make the

[92] *ibid.* at p.461.
[93] *ibid.* at p.463.
[94] *supra*, n.18.
[95] *supra*, n.30.
[96] The reasoning in *Norwich Union* is also criticised in Goff and Jones, *supra*, n.68 at pp.178–79 and A. Burrows, *The Law of Restitution* (1993) at pp.106–107. The distinction between mistake in contract formation and in the payment of money was already pointed out in a note by P.A. Landon on *Bell v Lever* (1935) 51 L.Q.R. 650. The other points made in this note are not however convincing.
[97] Atiyah, *supra*, n.13 at pp.436–437 provides a more recent example of assimilating mistake in formation of contract and mistake in performance of an existing contract. He criticises the distinction that developed between money paid under mistake of fact and mistake in an executory transaction, stating "obviously the two types of case raise, at least in some cases, virtually identical issues". The issues are however totally different.

payment.[98] This indeed is the modern approach.[99] The test is wholly subjective. Recovery is allowed even if the recipient was unaware of the payor's mistake. In addition it is not required that the mistake would have influenced a reasonable person to make the payment. It suffices that it influenced the person who made it.[100] The seriousness of the mistake is only relevant for evidentiary purposes. The more serious was the mistake the better are the payor's prospects of convincing the court that but for the mistake he would not have made the payment.

The above approach is strengthened by reference to comparative law. As already indicated, even legal systems that follow the subjective approach in contract formation adopt measures that limit the possibility of avoiding the contract, *inter alia* by restricting the types of mistake that provide ground for rescission. These restrictions do not apply to the recovery of a payment that was not due. German law has even adopted a far-reaching approach according to which the very fact that the payment was not due provides ground for restitution. But recovery is excluded if it is shown that payment was made without mistake.[101] Mistake was thus turned into a defence. The defendant is required to prove its absence in order to escape liability. This is not an easy task since mere doubts on the plaintiff's part will not suffice to establish the "no mistake" defence.[102] Indeed, English law also recognises situations in which policy considerations justify recovery of payment that was not due, although there has been no mistake, duress or undue influence.[103]

FRAUD AND MISREPRESENTATION BY THE RECIPIENT

Rules as to fraud and misrepresentation are applied in order to grant a remedy for those situation for which mere mistake is insufficient to ground

[98] Correcting a mistake can entail costs, but in my view this consideration does not justify a limitation on the right to recover mistaken payment. Moreover, from an economic point of view, a rule that denies recovery will increase the precautionary costs required to prevent payments that are not due. For an economic analysis of this issue see J. Beatson, *The Use and Abuse of Unjust Enrichment* (1991), Chap.6, pp.137–176. See also H. Dagan, "Mistakes" (2001) 79 Texas L.Rev. 1795.
[99] *Barclays Bank Ltd v W. J. Simms Son & Cooke (Southern) Ltd* [1980] Q.B. 677; Goff and Jones, *supra*, n.68 at p.180 and the discussion of *Nurdin & Peackock Plc v D. B. Ramsden & Co Ltd* [1999] 1 W.L.R. 1249 in the 2000 supplement to Goff and Jones, pp.20–21; G. Virgo, *Principles of the Law of Restitution* (1999) 3 pp.151–162.
[100] A possible exception is the case of mistake relating to evidence. Suppose A demands payment of a debt from B. B knows that he already paid but he cannot find the receipt and decides to pay. Shortly afterwards B finds the receipt. Recovery may be denied on the ground that the mistake did not relate to the payment (B knew that he was not liable) but to the prospects of defending a potential claim and that the payor submitted to an honest claim (*infra*, n.112 and accompanying text). *Cf.* also *Marriot v Hampton* (1797) 7 T.R. 269; 101 E.R. 969. It seems that under French law recovery will be allowed: Weill and F. Terré, *supra*, n.10 at p.829. Under English law recovery will be allowed if the recipient did not act in good faith: *Ward and Co v Wallis* [1900] 1 Q.B. 675.
[101] BGB §814 first sentence.
[102] G. Dannemann, "Unjust Enrichment by Transfer" (1991) 79 Texas L.Rev. 1837 at p.1850.
[103] *Woolwich Equitable Building Society v Inland Revenue Commissioners* [1993] A.C. 70. But see *Nurdin & Peackock*, *supra*, n.99, at pp.1258–1259 in which Neuberger J. was not inclined to expand this approach.

recovery. But once it is accepted that any causative mistake suffices in order to recover payment that was not due, it becomes evident that except in some marginal situations, fraud and misrepresentation are no longer relevant for the purpose of restitution.[104] Misrepresentation is merely a potential source of the payor's mistake, but the source of mistake is of no moment. The only relevant factor is the very existence of mistake that led to the payment that was not due. In other words, the definition of mistake is so broad that it encompasses all causative mistakes without differentiating between mistakes that result from fraud or misrepresentation and any other mistakes.

The point can be further demonstrated by the rules relating to mistake of law. It was held in *Bilbie v Lumley*[105] that money paid under mistake of law is not recoverable. This rule, which was in force for nearly 200 years, did not apply where the payor's mistake was fraudulently induced by the recipient.[106] Consequently, the question whether the mistake of law derived from the payor's own sources or from the recipient's fraud became of the utmost importance. However, a recent decision the House of Lords abolished the old rule and held that payment under mistake of law is recoverable.[107] As a result the once crucial distinction between mistake of law induced by the recipient's fraud and other mistakes of law lost much of its significance.

This analysis is subject to the following qualifications:

(1) The recipient's fraud and misrepresentation is highly relevant in the case of services provided under mistake. In this type of situation the recipient can usually argue that he was not interested in getting the service from the plaintiff and that he was not actually enriched.[108] However, if the mistake was caused by the recipient's fraud or misrepresentation, the argument that the service was unsolicited will not be open to him and he will be liable for the service that was rendered.[109] This is the most conspicuous situation in which there is a major difference in the law of restitution between mere causative mistake and one for which the recipient is responsible.

[104] They remain of course highly relevant for other causes of action, notably in torts. Thus, suppose that A fraudulently induces B to pay money to C. B can recover his payment from C on the ground of mistake. But he can also sue A in torts in order to recover his loss, though he can obviously not recover twice.

[105] (1802) 2 East 469; 102 E.R. 448.

[106] *Ward & Co v Wallis* [1900] 1 Q.B. 675 at p.678; Virgo, *supra*, n.99 at p.137.

[107] *Kleinwort Benson Ltd v Lincoln City Council* [1999] 2 A.C. 349. See also *Nurdin & Peackock Plc.*, *supra*, n.99.

[108] Goff and Jones, *supra*, n.68 at pp.240 *et seq.* who also examine the possibility that this rule will not apply in where the benefit is incontrovertible.

[109] Indeed the recipient may be liable, by virtue of the equitable doctrine of acquiescence, even if he made no misrepresentation but was merely aware of the fact that the plaintiff is acting under mistake, and yet he failed to advise him: Goff and Jones, *supra*, n.68 at pp.241–243.

(2) Misrepresentation and in particular fraud may be relevant in the borderland of mistake, voluntary payment and compromise. The typical situation is that in which A demands payment from B. B doubts the validity of the claim but eventually decides to pay or reaches a compromise under which he pays part of the claim. It later transpires that B owed nothing. If B resolved the doubt and mistakenly concluded to accept the truth of the facts upon which the claim was founded, he should be entitled to restitution.[110] But if he decided to assume the risk of their falsity and to pay irrespective of whether they are true, recovery will be denied.[111] The line between these possibilities is rather thin, and in any event if the recipient acted fraudulently or in bad faith, recovery will be allowed.[112]

(3) Although misrepresentation and fraud do not constitute elements of the restitutionary cause of action to recover mistaken payment, they have evidentiary value. If fraud or misrepresentation is proved the court is more likely to conclude that the resulting mistake was an operative cause of the payment than in the case in which the recipient had nothing to do with the payor's mistake.

(4) The defence of change of position is not available if the defendant was aware of the payor's mistake and *a fortiori* if he fraudulently caused it.[113] The position in case of innocent misrepresentation is less clear.[114]

(5) Where the recipient successfully used the payment to obtain additional gains, as *e.g.* by acquiring property that appreciated in value,[115] the question arises whether the payor can trace his payment or otherwise recover these additional profits. I shall not

[110] *Restatement, Restitution (1st)*, §10.

[111] Goff and Jones, *supra*, n.68 at pp.54–55, 234–35. A compromise of a doubtful claim is a contract supported by consideration even if it later transpires that the claim was invalid: see Treitel, *supra*, n.20 at pp.83–84. Therefore, if a compromise was reached, its rescission can only be made in accordance with the rules relating to mistake and misrepresentation in contract formation.

[112] S. Arrowsmith, "Mistake and the Role of 'Submission to an Honest Claim'" in *Essays on the Law of Restitution* (A. Burrows ed., 1991), pp.17, 27–28; N. Andrews, "Mistaken Settlements of Disputed Claims" [1989] L.M.C.L.Q. 431. See also n.100, *supra*, with regard to mistake as to the availability of evidence required to prove that payment is not due. Another rare situation in which recovery will only be allowed if the mistake was caused by the recipient's fraud or misrepresentation is that of a mistaken discharge of a mere moral obligation: see *supra*, n.87.

[113] *Lipkin Gorman v Karpnale Ltd* [1991] 2 A.C. 548 at pp.579–580 (*per* Lord Goff); Goff and Jones, *supra*, n.68 at p.826 ("The defence is not open to one who has changed his position in bad faith"). Regarding the ambit of this defence see *Dextra Bank v Bank of Jamaica* [2002] 1 All E.R. (Comm.) 193, PC.

[114] If the misrepresentation was negligent, the payor may have an action in tort against which the defence of change of position is unavailable, but the defendant may try to show contributory negligence.

[115] This case is the opposite of change of position discussed under (4) above. Change of position usually means change for worse. The present case is concerned with change for the better.

enlarge on this point. It suffices to point out that at least under the *Restatement, Restitution (1st)* there is, for the purpose of tracing, a fundamental difference between the case in which the recipient acted fraudulently and that in which he acted in good faith.[116]

(6) Fraud remains highly relevant in other areas of the law of restitution that are not directly concerned with recovery of mistaken payment. A possible example is fraudulent appropriation of another's prospects of gain.[117]

Duress and Undue Influence Exercised by the Recipient

In the case of a contract, if the improper pressure is exerted by the other party the objective principle does not apply. It might therefore be considered that the test of determining whether the pressure constitutes duress or undue influence should be similar in the case of such a contract and in restitution. A distinction needs however to be drawn between an imbalanced contract in which the cost to one party greatly exceeds the benefit that he receives, and a balanced contract in which the consideration given by one party is about equal in value to that given by the other. It is clearly arguable that the requirement of duress and undue influence should be less stringent in the case of an imbalanced contract than in the case of a balanced one. The restitutionary claim to recover a payment that was not due is of course analogical to that of the imbalanced contract.

It seems however that as a matter of substantive law English law does not distinguish between the two categories described above. But the distinction is clearly reflected in evidentiary rules, as is most conspicuous in the context of undue influence. Where it is shown that the plaintiff reposed trust and confidence in the defendant and that the transaction or the payment that was not due is manifestly disadvantageous to the plaintiff, the burden of proof shifts to the defendant.[118] It is then incumbent upon him to prove that the unfair contract or the payment to which he was not entitled was not procured by undue influence, and the burden is a heavy one. This approach can be compared to that adopted by German law, regarding a wide spectrum of restitutionary claims, according to which in the case of

[116] §§202 and 203 of the *Restatement* and illustration 7 to §202 (at p.823) dealing with fraud.

[117] Consider the following example: A and B are interested in buying a certain painting at an auction. A fraudulently tells B that that the auction has been cancelled. A then goes to the auction and buys the painting. *Cf. Harper v Adametz* 113 A. 2d 136, 55 A.L.R. 2d 334 (1955). See also D. Friedmann, "Restitution of Benefits Obtained Through the Appropriation of Property or the Commission of a Wrong" (1980) 80 Col.L.Rev. 505 at pp.513, 548–549, in which this example is discussed and it has been suggested that B would have no right of action if it can be proved that in any event he would not have bought the painting. I am not now sure that considerations of deterrence would not justify restitution even in such a case. But clearly in the absence of such proof B should have a right to receive the painting from A, subject to his paying the price A paid for it at the auction. For another approach to this type of situation that bases restitution on breach of competition rules see O. Grosskopf, "Protection of Competition Rules via the Law of Restitution" (2001) 79 Texas L.Rev. 1981.

[118] *Etridge*, *supra*, n.70, at pp.1032–1034 (Lord Nicholls of Birkenhead).

payment without legal ground the recipient is required to prove absence of mistake, or in other words to show that the payment was voluntarily made.[119]

There seems to be in English law no parallel rule regarding duress, but it is obvious that the fact that the contract was completely imbalanced or that the defendant received a very substantial payment to which he was not entitled and which cannot be accounted for on justifiable grounds, is likely to provide strong evidentiary support to a claim based on duress.

Fraud, Duress and Undue Influence Exercised by a Third Party

As already indicated, a contract cannot be rescinded on the ground of fraud, duress or undue influence exercised by a third party, if the other party to the contract neither knew nor had reason to know about it.[120] This result follows the objective principle in contract law. The situation regarding the recovery of payment that was not due is entirely different. Restitution is governed by the subjective principle and the payor is entitled to restitution. In the case of fraud by a third party recovery is predicated on the ground of mistake. The test is subjective and the fact that the recipient is not responsible for the mistake does not prevent recovery. However, if the recipient was unaware of the fraud and the ensuing mistake, he may rely on the defence of good faith acquisition for value or that of change of position, if the necessary requirements for the application of these defences are met.

The situation is similar in case of duress or undue influence by a third party. The payment which was not due was vitiated by the unlawful pressure or influence and the payor is entitled to restitution. Again, the test is subjective and the mere fact that the recipient was neither responsible for the unlawful pressure nor aware of it is no defense.[121] But he may avail himself of the defence of acquisition for value or change of position if the conditions required for their application are satisfied.[122]

Conclusion: the Effect of the Objective and Subjective Approaches on the Organisation of the Law of Contract and the Law of Restitution

The objective theory in contract, coupled with the distinction between mistakes relating to the contractual terms and other mistakes (mistakes in

[119] *supra*, n.102 and accompanying text.

[120] *supra*, text after n.61. This rule is qualified by the rule on constructive notice, *supra*, nn.70–73 and accompanying text.

[121] *Pope v Garrett* S.W.2d 559 (1948); G. Palmer, *Law of Restitution* (1978), Vol.1, pp.221–24; Friedmann, *supra*, n.117 at pp.549–551.

[122] These defences may be excluded in the case of constructive notice; *cf. supra* nn.70–73 and accompanying text.

motive), has in the second part of the nineteenth century marginalised the role of mistake as an independent ground for contract avoidance.

This narrow approach has been circumvented by the development of the law of misrepresentation that deals with mistakes induced by the other party. Rescission within this category is most liberally granted and the category of mistakes, for which rescission is allowed, even in case of innocent misrepresentation, has been expanded so as to include almost any causative mistake.[123] Consequently, traditional distinctions between various types of mistake, such as mistake in substance and mistake in quality, became irrelevant within this category.

The result is clearly reflected in practically every English and American textbook. The historical division of the subject included a major chapter on mistake supplemented by a chapter or sub-chapter on fraud. Modern English and American textbooks adopt a classification reflecting the change that occurred. Each has an extensive chapter on misrepresentation, which is in fact the main chapter dealing with rescission on the ground of mistake. This chapter deals with both innocent and fraudulent misrepresentations, since the type of mistake for which a remedy is granted (*i.e.* causative mistake) is similar in both categories.[124]

The position of the mistake chapter in contract books, which deals with mistakes that were not induced by the other party, reflects the decline and the uncertain position of the once dominant topic in contract law. A number of books maintain the traditional approach and open the part dealing with vitiated consent with a chapter on mistake.[125] But a variety of other approaches can be discerned. These include the placing of the mistake chapter after those dealing with misrepresentation and duress[126] and even the splitting of the topic so that one part of it is discussed within the chapter on offer and acceptance and the other part within the chapter on construction of the contract.[127]

There is no such divergence in the literature on restitution. Practically all English textbooks include a chapter on mistake in payment and other transfers. None of them has a separate chapter on misrepresentation or fraud affecting such payments, though some authors refer briefly to the

[123] But in the case of innocent misrepresentation the court has now discretion to grant damages in lieu of rescission: see *supra*, text to n.48. In addition for the purpose of damages there is a difference between non-negligent innocent misrepresentation and negligent and fraudulent misrepresentations.

[124] But see *supra*, n.100 and nn.108–112 and accompanying text. In addition, the type of remedy may differ: see n.123, *supra*.

[125] Chitty, *Contracts* (28th ed., 1999, H. Beale ed.), Chap.5; Treitel, *supra*, n.20, Chap.8; Cheshire, Fifoot and Furmston, *supra*, n.20, Chap.8. This position can be justified in view of the possibility of obtaining equitable relief on the ground of mistake.

[126] Beatson, *supra*, n.5, Chap.8.

[127] P.S. Atiyah, *An Introduction to the Law of Contract* (5th ed., 1995), Chap.3, sub-s.5 and Chap 12, sub-s.2.

possibility of misrepresentation in the chapter of mistake.[128] This structure follows the substantive law. The test for recovery of a mistaken payment is subjective, and restitution is usually allowed even in the absence of fraud or misrepresentation by the recipient. Fraud and misrepresentation are only relevant in some exceptional situations that do not justify a separate chapter.

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[128] See Goff and Jones, *supra*, n.68, Chaps 4–8 (misrepresentation is discussed mainly in Chap.9 in the context of rescission of contracts); A. Burrows, *supra*, n.96, Chap.3 (misrepresentation is discussed in s.3 in the context of mistake in contract formation); P. Birks, *Introduction to the Law of Restitution* (rev. ed., 1989) also discusses misrepresentation, under the title "induced mistake" within the chapter on mistake (pp.168 *et seq.*) suggesting that "when the mistake is induced the category of operative mistakes expands". But the cases discussed in the text deal with misrepresentation in contract formation. Virgo, *supra*, n.99, has a broad chapter on mistakes (Chap.8). Misrepresentation is discussed in the context of rescission of contracts (pp.175–187). There is however a very brief mention of "induced payment" in the context of mistake in restitution (p.143) suggesting that different tests apply to spontaneous and induced mistakes. P. Jaffey, *The Nature and Scope of Restitution* (2000) has a section on mistake in transfer (pp.166–177) but no separate section on misrepresentation.

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