

A Dog's Dinner?

Reconsidering Contractual Illegality in the Employment Sphere

Courts used to justify rejecting a claim on grounds of illegality on the basis that “the dirty dog gets no dinner here”¹. Following the approach of the Court of Appeal in *Enfield Technical Services Limited v Ray Payne*; *BF Components Limited v Ian Grace*², it would seem that precisely how dirty the dog is might determine whether or not he goes hungry. The Court’s recent judgment provides a suitable opportunity to reconsider whether, in reality, a more discretionary approach to the question of illegality has returned, notwithstanding its banishment by the House of Lords in *Tinsley v Milligan*³. Moreover, the Court’s judgment raises the issue of whether the time has now come to bite the bullet and adopt the Law Commission’s proposals for a structured statutory discretion.

1. Illegality and Employment Claims Generally

The general rules governing the application of the doctrine of illegality to claims based in contract apply equally when the contract concerned is one of employment⁴. Indeed, in the employment sphere, those rules apply not only to breach of contract claims, but also to claims enforcing statutory employment rights where the existence of a legally valid and enforceable contract of employment is a statutory pre-condition to the right. For example, under section 94 Employment Rights Act 1996 (“ERA”), an “employee” is entitled not to be unfairly dismissed; an “employee”, according to section 230(1), is “an individual who has entered into or works under (or where the employment has ceased, worked under) a contract of employment”. Where the contract of employment is tainted with illegality, a claim of breach of contract based on that contract will fail completely and a claim of unfair dismissal will meet a similar fate⁵. A distinction is, however, made between such claims⁶ and those which have been interpreted only to require a contract as a factual pre-condition to the claim, such as claims of discrimination. In the case of the latter, the Courts have decided⁷ that the tortious test of illegality is to be applied in place of the contractual rules, such that the claim will only be prevented where the claimant’s claim is “so closely connected or inextricably bound up with [his/her] criminal or illegal conduct that the court could not permit [him/her] to recover without appearing to condone that

¹ See, for example, *Tomlinson v Dick Evans U Drive Ltd* [1978] ICR 639; [1978] IRLR 77 at §8.

² [2008] IRLR 500; *The Times* (2 June 2008); [2008] EWCA Civ 393 (22 April 2008), upholding the judgment of the EAT, Elias P presiding, [2008] ICR 30; [2007] IRLR 840.

³ [1994] 1 AC 340.

⁴ See the instant case before the Court of Appeal, as confirmed by Lloyd LJ, *op. cit.* at §42: “It was also part of [the Appellant’s] argument that the EAT was wrong to add a requirement of misrepresentation because this only relates to fiscal illegality. [Counsel] argued that the principles as to the effect of illegality ought to be of general application. I agree with that proposition...”

⁵ See, *Tomlinson op. cit.* and other authorities, *post*.

⁶ Other such claims include claims for a redundancy payment pursuant to section 135 ERA; claims for unauthorised deductions from wages based on the particular contract pursuant to section 13 ERA. See generally *Illegality and Employment Law* (Law Commission Paper to the TUC Legal Officers Group, February 2005). As to National Minimum Wage claims, see Sarah Fraser and Adam Sher, *The National Minimum Wage: Under Threat From an Unlikely Source?* (2006) 35 *Ind Law J* 289-301; doi:10.1093/indlaw/dwl022.

⁷ See *Leighton v Michael* [1996] IRLR 67, *Hall v Woolston Hall Leisure Ltd* [2000] IRLR 578 and *Vakante v Addey & Stanhope School* [2004] 4 All ER 1056.

conduct.”⁸ Whilst there is ongoing debate as to whether domestic rules of illegality can defeat rights based on European measures at all⁹ and, in any event, whether the distinction drawn between different statutory claims can properly be maintained¹⁰, it is outside the scope of this article to consider those points further.

2. Illegality and Contractual Claims

The principles governing the operation of the illegality defence to contractual claims can be stated shortly. They were helpfully summarised by the Employment Appeal Tribunal¹¹ in the instant appeals.

The underlying principle of the doctrine of illegality stems from Lord Mansfield’s judgment in *Holman v Johnson*¹². It is a principle of policy which allows no room for the exercise of any discretion¹³. In *Hall*, the Court of Appeal approved a definitive¹⁴ three-category classification of cases where a contract may be tainted with illegality, thereby approving *St John Shipping Corp v Joseph Rank Ltd*¹⁵. The three categories are as follows:

⁸ *Hall*, op. cit. at §41 per Peter Gibson LJ, quoting from Beldam LJ in *Cross v. Kirby* unreported, 18th February, 2000.

⁹ For a detailed overview of that debate, see Simon Forshaw and Marcus Pilgerstorfer, *Illegally Formed Contracts of Employment and Equal Treatment at Work* (2005) 34 Ind Law J 158-177; doi:10.1093/indlaw/dwi009.

¹⁰ In *Chilton v HM Prison Service* (EAT, unrep., 15 July 1999), HHJ Clark voiced concern over the distinction drawn between how the illegality doctrine was applied in cases of unfair dismissal and discrimination. In his view, “Both statutory causes of action depend upon the contract as a prerequisite for the claim.” However, the Court of Appeal in *Hall* op. cit. ultimately rejected such criticism (see §§45-46).

¹¹ *Enfield Technical Services Ltd v Payne; Grace v BF Components Ltd* [2008] ICR 30; [2007] IRLR 840 (EAT) at §26 onwards, per Elias P.

¹² (1775) 1 Cowp. 341 at 343: “The objection, that a contract is immoral or illegal as between plaintiff and defendant, sounds at all times very ill in the mouth of the defendant. It is not for his sake, however, that the objection is ever allowed; but it is founded in general principles of policy, which the defendant has the advantage of, contrary to the real justice, as between him and the plaintiff, by accident, if I may so say. The principle of public policy is this; ex dolo malo non oritur actio. No court will lend its aid to a man who founds his cause of action upon an immoral or illegal act. If, from the plaintiff’s own stating or otherwise, the cause of action appears to arise ex turpi causa, or the transgression of a positive law of this country then the court says he has no right to be assisted. It is upon that ground the court goes; not for the sake of the defendant, but because they will not lend their aid to such a plaintiff. So if the plaintiff and defendant were to change sides, and the defendant was to bring his action against the plaintiff, the latter would then have the advantage of it; for where both are equally at fault, potior est conditione defendentis.”

¹³ See *Tinsley* op. cit. per Lord Goff at 363; per Lord Browne-Wilkinson at 369; and the extract which appears in *Hall* at §72. Also, more recently, *Moore Stephens (a firm) v Stone & Rolls Limited (in liquidation)* [2008] EWCA Civ 644 (18 June 2008) per Rimer LJ at §§4, 14, 15, 16, 92, 93, 106 and 107. This is discussed further below.

¹⁴ The categorisation was not only accepted by Peter Gibson LJ in *Hall* (see §§28-31) but also Mance LJ (see §71 and §74). Moore-Bick J agreed with both judgments. In later cases this categorisation has been approved: see, for example, *Colen & Another v Cebrian (UK) Ltd* [2004] IRLR 210 at §§21-22 per Waller LJ, quoting extensively (with approval) from Peter Gibson LJ’s judgment in *Hall* and also, in his own words, at §19. Further, the EAT (HHJ Ansell) in an earlier decision in *Grace v BF Components & Another* UKEAT/0006/05 (5 September 2005) accepted that *Hall* was the leading authority and adopted the categorisation and tests for illegality set out in *Hall* (see §13); see also *Daymond v Enterprise South Devon* (6 June 2007) UKEAT/0005/07 at §§16-17 and the Court of Appeal in *Enfield Technical Services Limited v Ray Payne; BF Components Limited v Ian Grace* op. cit. at §15.

¹⁵ [1957] 1 QB 267.

- (a) A contract entered into with the **intention of committing an illegal act**. In *St John Shipping*, Devlin J explained:

“The application of this principle **depends on proof of the intent**, at the time the contract was made, to break the law¹⁶; if the intent is mutual the contract is not enforceable at all, and, if unilateral, it is unenforceable at the suit of the party who is proved to have it.” (emphasis added)

- (b) A contract expressly or implicitly **prohibited by statute**. In *St John Shipping*, Devlin J said:

“If the contract is of this class it **does not matter what the intent of the parties is**; if the statute prohibits the contract, it is unenforceable whether the parties meant to break the law or not. A significant distinction between [the first and second categories of illegality is that i]n the former class one has only to look and see what acts the statute prohibits; it does not matter whether or not it prohibits a contract; if a contract is deliberately made to do a prohibited act, that contract will be unenforceable. In the latter class, one has to consider not what acts the statute prohibits, but what contracts it prohibits; but one is not concerned at all with the intent of the parties; if the parties enter into a prohibited contract, that contract is unenforceable.” (emphasis added)

- (c) Finally, a contract which was perfectly lawful when made, but has been **illegally performed** by one party in circumstances where the other party knowingly participated in that illegal performance. In *Hall*, the Court approved the statement of principle set out in *Ashmore, Benson Ltd v Dawson Ltd*¹⁷ per Lord Denning MR:

“Not only did [the plaintiff’s transport manager] **know of the illegality**. He **participated in it** by sanctioning the loading of the vehicle with a load in excess of the regulations. That participation in the illegal performance of the contract debars the [the plaintiff] from suing [the defendant] on it or suing [the defendant] for negligence”. (emphasis added)

And the dicta of Scarman LJ to similar effect:

“But knowledge by itself is not enough. There must be knowledge plus participation... For those reasons I think the performance was illegal.”

As such, in a case falling within that third *Hall* category, in order for the doctrine to act as a defence to the claim, there must be illegal performance of the contract by one party to the contract and knowledge of that illegal performance and participation in it by the other party to the contract¹⁸. In the employment context, the position will classically arise

¹⁶ In accordance with the principle that ignorance of the law is no defence, the intention to break the law that is required is the intention to do the act that the law prohibits as opposed to intend to do an act in the knowledge that behaving in this way is contrary to the law. This is made clear in the second extract from the *St John Shipping* case.

¹⁷ [1973] 1 WLR 828.

¹⁸ See *Hall* at §38 per Peter Gibson LJ and at §71 and §80A per Mance LJ. The test has regularly and consistently been applied in accordance with these judgments: see, by way of example, *Wheeler v Quality Deep Ltd T/A Thai Royale Restaurant* [2004] EWCA Civ 1085 at §§28-29 per Hooper LJ with whom the other members of the Court agreed; the earlier EAT decision in *Grace v BF Components & Another* op.

out of an employee's knowledge and participation in the illegal performance of the contract of employment by the employer. "Knowledge", in this context, requires the employee to have knowledge of the facts which renders the performance illegal as opposed to knowledge that the performance is contrary to law – ignorance of the law is no defence¹⁹. "Participation" requires some active participation²⁰; knowledge without participation will not suffice²¹. Where the underlying contract of employment is illegally performed and the employee has the requisite knowledge and participation, a claim for unfair dismissal cannot proceed by operation of public policy: *Tomlinson v Dick Evans U Drive Ltd*²². Moreover, an employee cannot count any period during which s/he is employed under an illegal contract as part of his/her period of continuous employment for the purposes of section 108 ERA, thus such periods can break continuity: *Hyland v JH Barker (North West) Ltd*²³. Whether there is knowledge or participation in a particular case is a matter of fact for the Tribunal or Court of first instance²⁴.

3. The Facts and Relevant Statutory Provisions

Both claimants in the joined cases before the Court of Appeal in *Enfield Technical Services Limited v Ray Payne; BF Components Limited v Ian Grace* advanced claims of unfair dismissal in which the status of the relevant claimant was in dispute. The claimants sought to establish that they were employees in order to qualify for the right not to be unfairly dismissed, and the respondents advanced a case that they were, in fact, independent contractors. The Tribunals ultimately found for the claimants and determined conclusively that they were, as a matter of law, to be classified as employees within the meaning of s230 ERA²⁵. There were no appeals against those decisions.

The consequence of these rulings was that the contractual provisions of the contracts as to remuneration had not been performed in accordance with the statutory enactments concerning the payment of taxes and national insurance contributions. The relevant statutory provisions merit closer consideration.

cit., in which HHJ Ansell and members accepted the submission that knowledge plus participation was required (see §13 to §16); *Souteriou v Ultrachem Ltd* [2004] IRLR 870 (HC) at §53; and *Daymond* op. cit. at §§16-17 and §23(3). See further the Court of Appeal in *Enfield Technical Services Limited v Ray Payne; BF Components Limited v Ian Grace* op. cit. at §15.

¹⁹ See *Miller v Karlinski* (1945) 62 TLR 85 (CA), *Salvesen v Simons* [1994] IRLR 52 and *Daymond* op. cit. See further the Court of Appeal in *Enfield Technical Services Limited v Ray Payne; BF Components Limited v Ian Grace* op. cit. at §15.

²⁰ See *Hall* per Peter Gibson LJ at §38.

²¹ See, in particular, *Hall* per Mance LJ at §80A, remarking upon dicta emanating from *Newland v Simons & Willer (Hairdressers) Ltd* [1981] IRLR 359 (EAT).

²² [1978] IRLR 77. See also *Davidson v Pillay* [1979] IRLR 279 at §3: "...[the EAT in Tomlinson] held that even when the right which it was sought to enforce was one which arose under statute, the employee could still not recover, because the basis of the claim, despite its statutory context, was a contract which was illegal. We follow and accept the decision in that case as properly stating the law where both employer and employee are a party to the illegality and have knowledge of it."; further see *Hyland v J H Barker (North West) Ltd* [1985] IRLR 403 at §§20-22; *Newland v Simons* op. cit. at §§19-20; and *Hall*, supra, at §§44-46 (dealing with the distinction between cases of unfair dismissal and discrimination).

²³ [1985] ICR 861.

²⁴ See *Hall* at §38 per Peter Gibson LJ.

²⁵ Section 230 ERA provides: "(1) In this Act "employee" means an individual who has entered into or works under (or, where the employment has ceased, worked under) a contract of employment. (2) In this Act "contract of employment" means a contract of service or apprenticeship, whether express or implied, and (if it is express) whether oral or in writing."

The rules relating to the charging and calculation of income tax are now contained in two Acts: the Income Tax (Earnings and Pensions) Act 2003 (“ITEPA”) and the Income Tax (Trading and Other Income) Act 2005 (“ITTOIA”)²⁶. The two acts encompass the distinction between the employed and self-employed: whereas ITEPA imposes a charge to tax on employment income (income from a contract of service)²⁷, ITTOIA deals with income from a contract for services²⁸.

The concept of “a contract of service” under s4(1)(a) ITEPA²⁹ is identical to the concept of “a contract of service” under s230(2) ERA. Appeals to the Special Commissioners on employee status under s4(1)(a) ITEPA apply precisely the same principles as those applied by Employment and Employment Appeal Tribunals when determining the question of employee status under the ERA³⁰. Thus, having found the claimants to be employees under s230 ERA, it follows that income earned in that employment ought to have been subject to tax collection under the PAYE scheme under Part 11 of ITEPA³¹. This would have involved tax being paid to the Revenue sooner. Instead, the employees benefited by paying tax under self-assessment at a later time. Further, the employees ought to have been restricted by the very limited ability to set off expenses against income under ITEPA as opposed to having the ability, as a self-employed person, to set off a wider range of expense incurred, and to carry forward losses. Finally, the employees (and, indeed, the employers) ought to have paid class 1 National Insurance Contributions (NICs) on employment income³² as opposed to class 2 and 4 NICs paid by self employed people.

²⁶ Note that although ITEPA came into force on 6 April 2003 and ITTOIA on 6 April 2005, they are restatement Acts which do not change the underlying law. The Explanatory Notes to ITEPA record, at §§3-4: “3. The main purpose of the Income Tax (Earnings and Pensions) Act 2003 is to rewrite tax legislation relating to income from employment, pensions and social security so as to make it clearer and easier to use. 4. The Act also makes some minor changes to the legislation. These are within the remit given to the Tax Law Rewrite project and the Parliamentary process for the Act.” Similarly, the Explanatory Notes to ITTOIA record, at §§5-6: “5. The purpose of the Income Tax (Trading and Other Income) Act is to rewrite income tax legislation relating to trading, property and investment income so as to make it clearer and easier to use. 6. The Act does not generally change the underlying law when rewriting it. The only changes to the law which it does make are minor ones which are within the remit of the Tax Law Rewrite Project and the Parliamentary process for the Act.”

²⁷ ITEPA s1(1)(a): “(1) This Act imposes charges to income tax on— (a) employment income (see Parts 2 to 7)...”

²⁸ ITTOIA s1(1)(a): “(1) This Act imposes charges to income tax under—(a) Part 2 (trading income)...”

²⁹ Section 4 ITEPA provides: “(1) In the employment income Parts “employment” includes in particular— (a) any employment under a contract of service, (b) any employment under a contract of apprenticeship, and (c) any employment in the service of the Crown. (2) In those Parts “employed”, “employee” and “employer” have corresponding meanings.”

³⁰ By way of mere recent example, see *Parade Park Hotel & Anor v Revenue & Customs* [2007] UKSC SPC00599 (05 March 2007), decision of Special Commissioner John Clark, citing many of the familiar judgments on the issue; *Lewis (t/a MAL Scaffolding) v Revenue & Customs* [2006] UKSPC SPC00527 (27 March 2006), decision of Special Commissioner Dr Williams; and *Demibourne Ltd v HM Revenue and Customs* [2005] UKSPC SPC00486 (23 June 2005), decision of Special Commissioner John Clark.

³¹ Section 683(2) ITEPA defines “PAYE employment income” as meaning “income which consists of— (a) any taxable earnings from an employment in the year (determined in accordance with section 10(2))...” Section 684 gives validity to the Income Tax (Pay as You Earn) Regulations 2003 SI 2003/2682. Regulation 21(1) of those Regulations provides: “(1) On making a relevant payment to an employee during a tax year, an employer must deduct or repay tax in accordance with these Regulations by reference to the employee's code, if the employer has one for the employee.”

³² The Social Security Contributions and Benefits Act 1992 sets out six classes of NICs at s1(2). Primary class 1 contributions under s1(2)(a)(i) are “contributions from employed earners” and are payable under s6 of that Act. “Employed earners” are defined in s2(1) of the Act to mean “...a person who is gainfully employed in Great Britain either under a contract of service, or in an office (including elective office) with

In *Payne*, the employee had been paid as a self-employed person, albeit subject to 18% deductions for tax under the Construction Industry Scheme. In *Grace*, the employee had received full gross payments upon him submitting an invoice and, at the time of his dismissal, was (that month) due to pay his tax and national insurance contributions under the self-assessment scheme (having previously accounted under that regime).

At the outset of the relationship in *Payne*, the employee had told the employer that he wanted to be hired on a sub-contract basis because he (rightly) considered that this would be more beneficial for tax purposes. Further, during the employment relationship, the Inland Revenue held an enquiry as to whether Mr Payne's status had been correctly assessed; in the course of that, Mr Payne made submissions in support of maintaining his self-employed status, a position which the Revenue eventually accepted (although the inspector remarked that the position was not "clear cut"). The claimant's evidence to the Tribunal was that, at the time of the enquiry, he considered himself to be an employee but because he wanted to retain more of his money, he made representations to the contrary. When Mr Payne was dismissed in March 2006, he brought a claim of unfair dismissal. Following the determination of the status dispute, the employer argued that the contract had, for its duration, been illegally performed and that the claim should fail.

The *Grace* case was slightly more complicated. Mr Grace began working for the employer in June 2002. From then until mid-September 2003 he was paid gross at a rate of £120 per day, upon him submitting an invoice. Ten weeks into his employment, Mr Grace was told that the company would like to keep him on and they offered to put him on the books on a salary of £18,000 plus commission payments. Mr Grace refused, perceiving this as a pay-cut, and continued working at the rate of £120 per day, paid gross. In mid August 2003, the company told Mr Grace that they were liable for his tax and national insurance since he was, in reality, an employee and would be so regarded by the Revenue. Mr Grace consulted ACAS and other 'legal advisory services' and he disclosed to the Tribunal that they, too, had told him that he was, in law, an employee. Mr Grace was told to sign a contract of employment or he would be dismissed. After a while, in mid September 2003, Mr Grace signed that contract under which he was entitled to an annual salary of £25,000. Mr Grace was then dismissed for redundancy on 12 January 2004 and claimed unfair dismissal. In order to establish one year of continuous service³³, he had to rely on the period of service prior to mid-September 2003. The employer contended that during that period the contract had been illegally performed and thus no reliance could be placed upon it: Mr Grace could not, therefore, establish one year of continuous service.

As can be seen from this overview, it was an important feature of both cases that it had been the employee in question who had insisted upon entering (or maintaining) the self-employed arrangement.

4. The Court of Appeal's Judgment

The lead judgment in the Court of Appeal was given by Pill LJ. He accepted that both employees had knowledge of the facts and had participated in the schemes under

general earnings...". The primary contribution is the liability of the employee, although it is collected through the PAYE scheme: see s6(4) and paragraphs 3, 3A and 3B of Schedule 1.

³³ As was required for his claim of unfair dismissal by section 108 ERA.

consideration sufficient to satisfy the test confirmed in *Hall* and set out above³⁴. Pill LJ considered that the issue in the case was, however, "...whether there was, on the facts, an illegal performance".

In the present case, it was submitted that non-compliance with the Revenue statutes set out above constituted the necessary illegality in law. As Lloyd LJ put it:

"for the Appellants [it was] submitted, correctly, that the employer, in paying the employee his remuneration under the contract gross rather than subject to deduction of tax under PAYE, was in breach of its statutory obligations in respect of tax, and [counsel] is entitled to submit that the different (and incorrect) treatment of the tax liability was a consequence of the treatment of the employee as self-employed which was known and intended by both parties. On that basis, [counsel] submitted that the contract between the parties was illegal, in the sense that it was performed illegally, and that the consequence is that the employee cannot enforce it by a claim for unfair dismissal."³⁵

The Court held, however, that this was 'insufficient' illegality. The Court instead endorsed the approach of the EAT, Elias P presiding, in which it was said that: "...the essential feature of all the cases where there has been found to be illegality is that the parties having knowingly entered into arrangements which have to their knowledge represented the facts of the employment relationship to be other than that they really were."³⁶ Further, the Court of Appeal depreciated the width of the comments of Underhill J in an earlier EAT decision, *Daymond v Enterprise South Devon*, that "...where an employee has made a positive choice to operate arrangements which have the effect of depriving the Revenue of payment to which it is entitled, contracts giving effect to those arrangements will be unlawful notwithstanding that the employee may genuinely have believed them to be lawful."³⁷

The Court was clearly concerned that in many cases the categorisation of a relationship as either one of employment or self-employment can be legally uncertain³⁸. Pill LJ therefore held:

³⁴ Op. cit. §§15, 23.

³⁵ Op. cit. at §36.

³⁶ EAT decision, op. cit. at §43 (see also §§46, 49); CA decision, op. cit. at §§25, 49.

³⁷ See *Daymond*, op. cit. at §§12, 23 and the CA in *Enfield*, op. cit. per Pill LJ at §§18, 25 and per Lloyd LJ at §41.

³⁸ This view has also been expressed by the editors of *Harvey on Industrial Relations* at Division A, 1. Categories of Workers, A. Servants, (10) Illegality, §137: "If both parties honestly consider the contract to be one for services (independent contractor), it cannot be contended that it is illegal as being a fraud on the Revenue merely because a court or tribunal later holds that in truth the worker was a servant (cf *Young and Woods Ltd v West*, above). ..." A more up to date edition now cites the *Enfield* case as additional authority for this proposition. With respect to the learned editors of *Harvey*, it is difficult to derive support for this proposition from *Young and Woods v West* [1980] IRLR 201. The question in that appeal, as clearly set out in §5 of the judgment, simply related to whether the claimant was an employee or an independent contractor. No illegality argument was advanced; rather the focus was on an estoppel type argument that having agreed to be self-employed, the claimant ought not to be able to deny that status when seeking unfair dismissal compensation. The Court of Appeal rightly held that when deciding the true status of the employee, the label the parties attached to the arrangement was not determinative. At §18, Stephenson LJ referred to the judgment of Lord Denning MR in *Massey v Crown Life Insurance Co* [1978] IRLR 31 in which he commented that he considered an arrangement between two parties to put forward a dishonest description of their relationship so as to deceive the Revenue would be illegal an unenforceable. It is, in our view, rather excessive extrapolation of that dicta to go on to say that which appears in *Harvey*.

“A contract of employment may, as the cases show, be unlawfully performed if there are misrepresentations, express or implied, as to the facts. An obvious example occurs when what is in fact taxable salary is claimed to be non-taxable expenses. That is, however, distinguishable from an error of categorisation (as in the present cases) unaccompanied by such false representations, even if the employee had claimed the advantages of self-employment before the dispute arose. I accept that there are limits to that principle and that the circumstances in which a miscategorisation is made may amount to misrepresentation and bad faith which would deprive the employee of the right subsequently to claim the benefits of employment.”³⁹

Lloyd LJ, whilst accepting the need for the illegality doctrine to be of general application⁴⁰, put it this way:

“I agree with Pill LJ that the EAT, chaired by Elias J, President, was correct to hold that it is not sufficient, in a case of this kind, to show that the employer’s fiscal obligations were not complied with, and that the employee knew of the facts which led to this, namely the mischaracterisation of the relationship as being not one of employment, and participated knowingly and actively in that mischaracterisation. In a case of this kind there must in addition be a misrepresentation, express or implied, to the Revenue as to the facts if the contract is to be tainted by illegality of performance. That was the case in *Miller v Karlinski* (1945) 62 LT 85 and in *Salvesen v Simons* [1994] IRLR 52, as well as in other cases cited to us.”⁴¹

5. Analysis

The Court’s endorsement of the proposition that before the illegality doctrine can bite, there must be some misrepresentation designed to conceal the true facts of the relationship sits awkwardly with previous authority binding on the Court. The test insists on a particular type of knowledge and participation on the part of the claimant. In *Miller v Karlinski*⁴², a previous division of the Court of Appeal emphasised that it is irrelevant whether the parties knew or were ignorant that what they were doing was illegal⁴³. The Court’s judgment in the instant case, by contrast, requires not only knowledge of the facts: the parties must have knowingly entered into arrangements which have to their knowledge represented the facts of the employment relationship to be other than that they really were. Further, insisting upon a misrepresentation in bad faith is to require a particular type of participation; yet a further prior division of the Court in *Hall* had emphasised that the assessment of participation was a matter to be left for the Tribunal at first instance⁴⁴.

The Court in the instant appeals viewed both *Salvesen* and *Miller* as cases which would satisfy the test it adopted⁴⁵, yet in neither was there a finding of an express misrepresentation to the revenue with the objective of concealment of the true factual position. Misrepresentations in those cases can only be derived by implication from the

³⁹ Op. cit. at §28.

⁴⁰ See §42.

⁴¹ Op. cit. at §27.

⁴² Op. cit.

⁴³ Du Parcq L.J., in the leading judgment, held: “In truth, it makes no difference whether or not the parties were ignorant that what they were doing was illegal. Ignorance of the law cannot excuse them.”

⁴⁴ See *Hall* §38.

⁴⁵ See Lloyd LJ at §37.

way the taxation affairs of the parties were reported and declared to the Revenue. Whilst Lloyd LJ acknowledged that an implied misrepresentation could suffice for the purposes of the test⁴⁶, it is difficult to see how, in the two appeals under consideration, there were not similar implied misrepresentations to the Revenue of type seen in *Miller, Salvesen* and, indeed, *Daymond*.

In fact, in the *Payne* case⁴⁷, it is somewhat puzzling that the facts did not satisfy the Court of Appeal's own test, given the way that the Employment Tribunal recorded a submission detailing Mr Payne's own evidence: "The Claimant had given evidence at the time the Inland Revenue were investigating that he considered himself to be an employee and because he wanted to retain more of his money, made representations to the contrary"⁴⁸. Clearer evidence of a misrepresentation designed to conceal the true facts is, we would suggest, hard to imagine.

For these reasons, the Court's passing criticism of Underhill J's decision in *Daymond* was, we would suggest, misplaced. The facts of that case were at one with those before the Court: when Ms Daymond was invited to work for her employer, she was given the option of being paid through the payroll or by invoicing the respondent through one of her own companies. She chose the latter option. Subsequently the position was altered and she accepted a formal contract of employment. She was later dismissed. In her unfair dismissal claim, Ms Daymond contended she had been an employee throughout the period in question and the Tribunal agreed. Nevertheless, like in *Grace*, she needed to rely on the entire period to establish one year of continuous service. Underhill J upheld the Tribunal's judgement that the contract was tainted with illegality, finding that "...the arrangements for payment [in the earlier period] involved a breach of the parties' obligations under the Taxes Acts"⁴⁹. There was no finding of an express misrepresentation – all that was present was an implied misrepresentation by virtue of the self-assessment accounting that had taken place in the early period. It is surprising, too, that given the parallels to be drawn between the facts of *Daymond* and the instant appeals, the Court resisted declaring that case wrongly decided⁵⁰.

Thus on a strict application of authority, we would suggest that Underhill J's analysis is legally correct and that he was right to say that where an employee has made a positive choice to operate arrangements which have the effect of depriving the Revenue of payment to which it is entitled, contracts giving effect to those arrangements will be unenforceable notwithstanding that the employee may genuinely have believed them to be lawful. He considered there was nothing objectionable in the law taking the view that workers who actively chose to employ sophisticated arrangements of this kind must take the consequences of their actions whether they appreciated those consequences or not.⁵¹

Irrespective of the correctness of the decision in the instant cases, there is a more important issue of principle which flows from the Court's judgment. The decision has potentially wide implications, extending beyond employment cases to all cases of

⁴⁶ *Op. cit.* at §37.

⁴⁷ Which could, perhaps, alternatively be analysed as a case falling within the first *Hall* category as set out above.

⁴⁸ *Payne v Enfield Technical Services Limited* (Case No. 2701233/2006) Judgment of the Employment Tribunal (Chairman: Mr J R Hardwick), promulgated 8 November 2006 at §10.

⁴⁹ *Op. cit.* at §3.

⁵⁰ *Op. cit.* at §41 per Lloyd LJ.

⁵¹ See *Daymond*, *op. cit.* at §12 and §23(3).

contractual illegality⁵². It is now open to a Court to decide that a transgression of a positive law is “insufficient illegality” for the doctrine to bite. Quite when and how the Courts should do this was not discussed in any detail by the members of the Court of Appeal.

The Law Commission continues with its long running review of the operation of the doctrine of illegality. From its Consultation Papers⁵³, the proposal provisionally favoured by the Commission was to confer a statutory discretion on the Court to decide whether illegality should bar a claim in a particular case⁵⁴. That proposed statutory discretion was carefully structured⁵⁵, requiring the Court to consider the following factors:

- the seriousness of the illegality (including considering whether the behaviour has been stigmatised as criminal, what sanctions might be invoked, and the manner in which the illegality was committed or intended);
- the knowledge and intention of the claimant (as the defence operates to deprive the claimant of rights, it should only do so where the claimant’s conduct relating to the illegality makes such a result imperative in order to protect the public interest. The guilt or innocence of the defendant should have no bearing);
- whether denying relief will act as a deterrent to others;
- whether denying relief will further the purpose of the rule which renders the contract illegal;
- whether denying relief is proportionate to the illegality concerned (including considering any other punishment that the claimant has received in respect of the illegality);
- the degree of connection between the illegal act and the facts giving rise to the claim;
- whether the court allowing the claimant to prosecute the claim would involve an inconsistency in the law as between the law prohibiting certain types of activity but allowing recovery notwithstanding a breach of the said prohibition.⁵⁶

It is difficult to escape the conclusion that the Court’s decision, in effect, applied a discretion, albeit without it being structured or directed. Of course the Court did not overtly do so (nor could it have) in light of the binding judgment of the House of Lords

⁵² As accepted by Lloyd LJ at §42.

⁵³ See *Illegal Transactions: the Effect of Illegality on Contracts and Trusts* (Consultation Paper No 154 (1999)); *The Illegality Defence in Tort* (Consultation Paper No 160 (2001)); and *Illegality and Employment Law* (Law Commission Paper to the TUC Legal Officers Group (February 2005)). A final report is expected during 2008.

⁵⁴ See, Consultation Paper No 154, op. cit. at Part VII, §§7.1 to 7.117.

⁵⁵ In accordance with the four policies which the Commission considered lay behind the illegality doctrine, namely: (i) upholding the dignity of the courts; (ii) preventing the claimant from profiting from his or her own wrongdoing; (iii) deterring illegality; and (iv) punishment. See further Consultation Paper No 154, op. cit. at §7.28.

⁵⁶ The final two factors were added to the Law Commission’s list of factors to be taken into account as part of the structured discretion in tort claims: *The Illegality Defence in Tort* (Consultation Paper No 160 (2001)); see §§6.23 and 6.25 to 6.45.

in *Tinsley v Milligan*⁵⁷. In that decision, Lord Goff⁵⁸ held: “it is by no means self-evident that the public conscience test is preferable to the present strict rules. Certainly, I do not feel able to say that it would be appropriate for your Lordships House, in the face of a long line of unbroken authority stretching back over 200 years, now by judicial decision to replace the principles established in those authorities by a wholly different discretionary system.”⁵⁹ More recently, the Court of Appeal has confirmed that there remains no discretionary basis for the application of the doctrine – *Moore Stephens (a firm) v Stone & Rolls Limited (in liquidation)* per Rimer LJ: “The House [in *Tinsley*] unanimously rejected the “public conscience” test, which was no more than the assumption of a judicial discretion as to whether or not in any particular case, despite the illegality or immorality, to grant or refuse relief.”⁶⁰

That said, the Court’s judgment in the present appeals thinly veils the exercise of a discretion: the Court accepted that the employers were in breach of the relevant tax legislation and that there was the requisite knowledge and participation elements on the part of the employees. However, the Court upheld the employees’ right to bring claims for unfair dismissal on the basis of a want of ‘sufficient’ illegality, even though it was clear that a positive statutory law of the country had been infringed in the performance of the contract⁶¹. The Court’s references to the notorious difficulty in categorising contracts as being *qua* employment or contractor⁶² indicate that it had real concerns about a harsh wider implication of a decision adverse to the claimants.

Due to the minor nature of the illegality in question in the present appeals, the draconian effect of a finding of a taint of illegality in the performance of the contract (the claims being completely barred), and the lack of any connection as between whether or not the tax legislation was complied with by the employer and the substance of the employees’

⁵⁷ Op. cit.

⁵⁸ Who, whilst in the minority on the disposal on the facts of that case, gave the unanimous view of the House on this issue.

⁵⁹ Op. cit. at 363. See also per Lord Browne-Wilkinson, giving the majority judgment, at 369: “My Lords I agree with the speech of my noble and learned friend, Lord Goff of Chieveley, that the consequences of being a party to an illegal transaction cannot depend as the majority in the Court of Appeal held, on such an imponderable factor as the extent to which the public conscience would be affronted by recognising rights created by illegal transactions”

⁶⁰ Op. cit. at §15. See also at §16: “The relevant question [the statement of principle] identifies is whether, to advance the claim, it is necessary for the claimant to plead or rely on the illegality. If it is, *Tinsley* decided that the axe falls indiscriminately and the claim is barred, however good it might otherwise be. There is no discretion to permit it to succeed. The absence of any such discretion emerges from all their Lordships’ speeches. Lord Goff of Chieveley, who was in the minority with Lord Keith of Kinkel, gave the leading speech for the rejection of the “public conscience” test, with which the majority agreed. The essential difference between the minority and the majority views was whether the touchstone for the application of the *ex turpi causa* maxim was the reliance test favoured by the majority or the wider test favoured by the minority and regarded as applicable to the particular facts before the court. But once the maxim is engaged, it applies indiscriminately.” And the discussion at §§92 and 93 (dealing with the judgment of Buxton LJ in *Reeves v. Commissioner of Police of the Metropolis* [1999] QB 169). In *Moore Stephens*, Rimer LJ’s judgment was agreed with by both Mummery and Keene LJ.

⁶¹ At §40, Lloyd LJ pointed out that he found it unhelpful to resort “for points of detail” to Lord Mansfield’s reference in *Holman v Johnson* to “the transgression of a positive law of this country” and decided that it was “not sufficient... to show that the employer’s fiscal obligations were not complied with” (§37). Contrast *Daymond*, op. cit. It is notable that the Court was not able to rely on any previous authority adopting the course it took. Indeed, the previous authority in the employment field weighs heavily in support of the proposition that non-compliance with tax statutes can bring the illegality rules into play.

⁶² See, e.g. Pill LJ at §§26, 28.

claims for unfair dismissal, it is natural to have sympathy for the Court's concern. As the Law Commission has noted, "in some situations, we believe that the [claimant] is being unduly penalised by the present rules. This injustice would seem to be the inevitable result of the application of a strict set of rules to a wide variety of circumstances"⁶³.

That said, it is our view that an unstructured, judicially created, discretion as illustrated by the judgments in this case, pose their own significant dangers. Those dangers are exactly those which were apparent in the application of the old unstructured 'public conscience' test, namely that it was vague, imponderable and uncertain. It is of paramount importance in the area of employment law, where the existence of a legally enforceable contract of employment provides the gateway to a whole host of employment rights, that the parties to a contract are aware of, with some certainty, which enforceable rights that contract has given rise to. Neither the old 'public conscience' test nor the Court of Appeal's test based on whether or not there is 'sufficient illegality' provides that much needed certainty.

Far better, in our view, would be the overdue enactment of the Law Commission's proposals so that the structured statutory discretion is now introduced. That would facilitate the principled, transparent decision making in a way which will enable cases involving minor illegalities in performance to be decided justly and proportionately to the wrongdoing in question. In the present appeals, the majority of the factors suggested by the Law Commission point towards allowing the claims to proceed. Employment Tribunals and Courts are well used to applying such structured discretions: a very similar discretionary approach is applied by Tribunals when determining whether to extend the three month time limit in discrimination claims⁶⁴, and by Courts when extending time limits under section 33 Limitation Act 1980. Importantly, the structure of the proposed discretion strikes, in our view, the correct balance between the need for the Courts to respond justly and appropriately to an infinite variety of factual circumstances in which illegality can arise, and the need for a tolerable level of legal certainty in the outcome of disputes.

The final legislative proposal might also afford the Court or Employment Tribunal a parallel discretion to consider the recoverability of different heads of losses where it has been decided that the entire claim is not barred for illegality.⁶⁵ The Court could then

⁶³ Consultation Paper No 154, op. cit. at §7.2.

⁶⁴ See *British Coal Corporation v. Keeble* [1997] IRLR 434 where the EAT held that employment tribunals should apply the factors set out in section 33(3) of the Limitation Act 1980 in determining whether it would be "just and equitable" to extend time in a discrimination claim. Those factors are (a) the length of and reasons for the delay; (b) the extent to which the cogency of the evidence is likely to be affected; (c) the extent to which the party sued had cooperated with any requests for information (d) the promptness with which the plaintiff acted once he or she knew of the facts giving rise to the cause of action (e) the steps taken by the plaintiff to obtain appropriate professional advice once he or she knew of the possibility of taking action.

⁶⁵ A detailed consideration of this approach in the context of discrimination claims can be found in Simon Forshaw and Marcus Pilgerstorfer, *Illegally Formed Contracts of Employment and Equal Treatment at Work* (2005) 34 Ind Law J 158-177; doi:10.1093/indlaw/dwi009. See also *Hewison v Meridian Shipping PTE* [2003] ICR 766; and, in particular, Clarke LJ at §37, entirely agreeing with the judgment of Garland J in *Newman v Folkes*, unreported, 5 May 2001, at §47: "...In a non-dependence case if the claimant derives income from a lawful source even though there may be a collateral illegality in the performance of the contract (*Le Bagge v Buses*; *St John Shipping Corporation v Joseph Rank Ltd* [1957] 1 QB 267) he is entitled to rely on the loss of that source of income to found a claim although it may be necessary to make some financial adjustment for unpaid tax and national insurance. ...". The majority of the Court went on, however, to reject the entirety of the future loss of earnings claim in that case because, per Tuckey LJ at

make suitable adjustments to any damages awarded to ensure that the claimant received no benefit from illegal performance of a contractual obligation and indeed, where appropriate, the Court or Tribunal might deny recoverability for a head of claim altogether.

It follows that, although we consider that the Court of Appeal was absolutely correct to consider how dirty the respective dogs were before serving them up their dinner, we consider that in the interests of both integrity of approach and legal certainty, if such an approach is to be taken, it should be taken explicitly with an openly structured discretion as has been advocated by the Law Commission. The sooner this is done, the better!

MARCUS PILGERSTORFER⁶⁶
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§52, “The alleged illegality arises specifically in relation to his claim for future loss of earnings. This part of the appellant's claim can only be based on the assertion that he would have gone on working at sea by continuing to deceive his employers into believing that he was not suffering from epilepsy. Whether this would have amounted to one or more criminal offences does not really matter. The fact is that (however understandable) the appellant's future employment was dependent upon his continuing deceit of his employers. This deceit was not therefore collateral but essential to establish this part of the claim and could not possibly be described as insignificant in view of the risks involved to the appellant, those with whom he would work and his employers.”

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