HOW ARE WE USING THE BLUE PENCIL? A CRITICAL ANALYSIS OF THE APPLICATION OF “BLUE PENCIL RULE” IN ILLEGAL CONTRACTS IN SRILANKA.

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Introduction

I. Introduction

A) Why are contracts enforced?

A contract is defined as “a promise, or promises mutually exchanged, setting up, against the promisor or promisors, duties of performance which the law will recognize or enforce at the instance or for the benefit of the promise or promises, or of a third party intended to be benefited.” According to C.G. Weeramantry, the law of contract is a branch of private law that regulates the relationships between individuals. Contracts are enforced through the courts of law on the basis that promises are sacred. This notion is further strengthened with the argument that mechanisms to secure reasonable expectations of individuals are necessary to maintain a rational society.

Modern law of contract, which dates back to the nineteenth century, is based on the philosophical foundations of wills and reliance theories. Charles Fried in “contract as promise” identifies the application of orthodox theory of wills and argues that the contractual obligations are virtues to the wills of the contracting parties. Modern welfare states’ laissez faire approach paves way for the operation of wills theory in contractual regimes. On the other hand, operation of reliance theory prevents unjust enrichment; a party who relied on the other’s promise needs to be compensated based on the value of expectancy. Reliance theory is favored in English Law rather than the Roman Dutch Law. English Law of contract is focused on wealth contracts that require monetary consideration as one of the essential elements to create binding contracts. In contrast, Roman Dutch Law accepts a good cause [i.e justa causa] to create a binding relationship. Causa does not necessarily require having a monetary value.

B) Vitiating factors - Illegality

Intruding of one or many vitiating factors may invalidate a contract that is otherwise valid. Illegality is one of the major vitiating factors that affect the validity of a contract. As a result, a contract may be entirely illegal or partially illegal. The Law of contract treats the entirely illegal contracts as void ab initio. The legal effect of partially illegal contracts is viewed from the perspective of severability. Severability means the rejection from a contract of objectionable promises or the objectionable elements of a particular promise, and the retention of those promises or of those parts of a particular promise that are valid. Accordingly, if the doctrine of Severability is employed in a given circumstance, the illegal parts can be removed and the rest of the contract will be given enforceability. Nevertheless, the severability principles cannot be applied to doctrine of consideration. Thus, if a promise is attached illegal consideration the entire contract is invalid in law.

Sri Lankan Contract law is a complex one, comprising of uncodified principles. The courts have been given discretionary power to act. Although the doctrine of severance is accepted and used in cases, there is no clear theoretical authority available to guide the judiciary in this regard. This study attempts to provide a holistic approach as to how, in future, the severance principles need to be used in Sri Lankan legal regime.

II. The Blue pencil rule

A) Evolution of the rule

The case of Attwood v. Lamont formulated a rule known as the “Blue Pencil Rule” to test the severability of contracts. The legal rule best known to the common law countries enables the legally valid – enforceable provisions of the contract to stand, despite the illegal provisions. Black’s Law dictionary defines the Blue Pencil Rule as “judicial standard for deciding whether to invalidate the whole contract or only the offending words”. Under this circumstance the offending clauses are invalidated by

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4 Hopkins v. Prescott (1847) 4 C.B 578
5 [1920] 2 KB 146
running a blue pencil where necessary. In the modern business world, entire illegality happens in rare circumstances and, thus the doctrine of severance and blue pencil rules’ usage is crucial.

The rule was initially used in the case of Nordenfelt v. Maxim Nordenfelt Guns and Ammunition Co Ltd, without naming it, to give the effect of a partial illegal contract. The Name of “Blue Pencil Rule” was given by Lord M.R Stemdale in the case of Atwood v. Lamont. 7

B) Theory of applicability of the rule

A threefold test to determine the applicability of the rule was pronounced in Beckett Investment Management Ltd & Ors v. Glyn Hall & Ors.8 Firstly, courts must look into explore whether the unenforceable part could be removed without the necessity of additions and modifications. Secondly, it needs to be checked whether the remaining parts could be adequately supported by consideration. Thirdly, it must be ensured that the severance doesn’t alter the original understandings of the related parties. However, the application of three fold test depends on the type of severability that is possible under the given circumstances. When textual severability is possible the three fold test could be applied as it is. However, if the textual severance is not possible, the courts must modify the agreement in a manner that enables severance.9 Therefore, it is clear that the blue pencil rule has been used by the courts for either severe the illegal parts of a contract or to modify the agreement between parties. In this regard, three schools of thoughts exist. The courts could take the approach of [1] all or nothing or [2] strict application of the rule or [3] liberal approach of the rule.

All or nothing approach, also known as “no modification rule,” precludes the application of the blue pencil rule. Accordingly, if any part of the contract seems to be illegal, the entire contract is declared void. In the modern business world, contracts absorbs wealth of the nation where entire illegality happens in rare circumstances and, thus the doctrine of severance and blue pencil rules’ usage is needed mostly. When courts try to modify the terms of the agreement for the purpose of applying the blue pencil rule, it affects the applicability of wills theory. There is room for instances where the court’s modification could impose a different kind of liability on the parties that contradicts the original will of the parties.

Approach of strict application allows the courts only to strike down the illegal parts. It doesn’t permit any additions or modifications. On the other hand, the liberal approach permits the removal, additions and modifications. When the courts try to modify the terms of the agreement for the purpose of applying the blue pencil rule, it affects the applicability of wills theory. There is room for instances where the court’s modification could impose a different kind of liability on the parties that contradicts their original will. This paper mainly focusses to analyses the Sri Lankan perspective with regard to the application of the blue pencil rule in illegal contracts while comparing with the jurisdictions of England, India and South – Africa.

C) Applicability of the blue pencil rule

1. English Law

In the English Law doctrine of severance used in the circumstances where contracts are void at the common law on public policy and void by statute. The doctrine of severance is used for two purposes. First is to cut down the offending part of a contract and make the rest to operate as it is. Second is to modify an offending part in the manner, making the whole agreement enforceable. It is claimed that the tests of severance differ according to the purpose.

The test laid down in Goodinson v. Goodison10 is used to achieve the first purpose. In the circumstances of illegal consideration, if the illegality supports the substantial portion of the consideration the contract is void. However if it goes to a subsidiary part of the contract the severance is permissible.

In the second scenario, the courts look for textual severability. Thus, the courts firstly look into the contract as to whether the contract as framed by the parties could be divisible into independent parts. If it so, the blue pencil rule is used to sever the offending parts. English Law is not permitting any aspects of modification on the court’s discretion. Therefore, it is evident that the English law adapts the strict approach of the blue pencil rule.

2) India

The Indian contract law is statutorised during the British colonial period. The Indian Contract Act 1872 is based on the English common law principles. Section 2411 of the Act embodies the Blue Pencil Rule. The Supreme court of India has described the blue pencil rule in the case of Beed District Central Coop Bank Ltdv. State of
In the case of Sunil Kumar Singhal and another v. Vinod Kumar, it was held:

“Applying the test of severability, as laid down in the afore stated decision to the facts of the present case, the agreement between the parties, the italic part as demonstrated in the arbitration agreement, already quoted above, can be severed or marked with “blue pencil”. The remaining part of the arbitration agreement survives and there is no infirmity of any kind whatsoever. It does not amount rewriting the contract nor is it in the nature of de novo contract. The intention of the parties is explicitly clear that they have agreed that the dispute, if any, would be referred to an arbitrator. To that extent, therefore, the agreement is legal, lawful and binding. The offending part of the said agreement already delineated above, can be separated and severed by using “blue pencil” on the principle of law as propounded by the Apex Court in the afore stated decision”

In Babasaheb Rahimsahed v. Rajaram Raghunath case it was held that “in an agreement if different clauses are separable, the fact that one clause, is void does not necessarily cause the other clauses to fail”. Thus, it becomes clear that the Indian courts are not in favour to the “no modification rule”.

In D.S Nakara v. Union of India the court said “If removal of arbitrariness can be brought about by severing the mischievous portion, the discriminatory part ought to be removed retaining the beneficial portion” and made the pension scheme applied in liberalized manner. In the above mentioned case court used the liberal approach of the blue pencil rule and modified the original policy to achieve justice and fairness.

In the recent case of Shin Satellite Public Co Ltd v. Jain Studios Ltd court invoked the principle of severability and give effect to the arbitration agreement. In this case the Supreme Court of India cited the judgments of English courts in the cases of Goldsoll v. Goldman, Atwood v. Lamont, Leases Manprop Ltd v O’Dell & Ors, and Kall – Kwik Printing v. Frank Clearance Rush and arrived to the point that the legal position in India is not different to the English Law. While holding as that the substantial severance was possible in the given circumstances, C.K Thakkar J, applied the liberal approach of the blue pencil rule. Justice Thakkar placed the judgment following the precedents established in the cases of Babasaheb Rahimsahed v. Rajaram Raghunath and Union Construction Co (P) Ltd v. Chief Engineer, Eastern command, Lucknow & Anr. This is the benchmark decision that stands as authoritative up to today. Based on the above case analysis it is evident that the substantial severance test and liberal blue pencil rule is used in India.

11 “Agreements void, if considerations and objects unlawful in part.—If any part of a single consideration for one or more objects, or any one or any part of any one of several considerations for a single object, is unlawful, the agreement is void. —If any part of a single consideration for one or more objects, or any one or any part of any one of several considerations for a single object, is unlawful, the agreement is void” – Section 24, The Indian Contract Act, 1872


13 In Halsbury’s Laws of England, (4th Edn., Vol.9) p.297, para 430, it is stated; contract will rarely be totally illegal or void and certain parts of it may be entirely lawful in themselves. The question therefore arises whether the illegal or void parts may be separated or severed from the contract and the rest of the contract enforced without them. In P. Ramanatha Aiyars Advanced Law Lexicon, 3rd Edn. 2005, Vol. 1 pp 553-54, it is stated: A judicial standard for deciding whether to invalidate the whole contract or only the offending words. Under this standard, only the offending words are invalidated if it would be possible to delete them simply by running a blue pencil through them, as opposed to changing, adding, or rearranging words. (Black, 7th Edn., 1999) This doctrine holds that if courts can render an unreasonable restraint reasonable by scratching out the offensive portions of the covenant, they should do so and then enforce the remainder. Traditionally, the doctrine is applicable only if the covenant in question is applicable, so that the unreasonable portions may be separated” – 2006 8 SCC 514.

14 2007 Indlaw ALL 2702
15 (1931) 33 BOMLR 260
16 1983 AIR 130
17 2006 AIR 963
18 1914 2 Ch. 603
19 supra note 3
20 (1969) 2 All ER 849
21 1996 FSR 114
22 supra note 11
23 1960 AIR 72
24 Cilpa Ltd v. Anant Ganpat Patil and Ors 2008 (1) BomCR 78, Rakesh Jain v. M/S Wellwon Builders India – on 18th of February 2011/Allahabad High Court, Jashdan v. Sonaben 11th of March 2011/Gujarat High Court
3) South Africa


“With respect to partial illegality, the real issue is whether partial enforcement is possible without injury to the public and without injustice to the parties themselves. It is believed that such enforcement is quite possible in the great majority of cases.”

Thus, it becomes evident that the doctrine of severability is being used in South Africa in the name of “divisibility”. Further, it becomes clear through Botha J.’s words that the South African courts use the liberal approach of the blue pencil rule.28 “From the point of view of sound jurisprudence I do not see why this consideration should enter into the picture at all. If a restraint has been couched in unreasonably wide terms, but a court is prepared to enforce it to the extent that it is reasonable, there is no question, to my mind of the court making a new agreement for the parties.”

This view was accepted in the judgments of National Chemsearch v. Borrowman29, Freight Bureau (Pty) Limited v Kruger30, David Wuhl (Pty) Ltd and others v. Badler and another31, Bonnet and others v Schofield32 and Den Braven S.A (PTY) Ltd v. Yoganathan pillay, Gracehaven Industries.33

4) Sri Lanka

The Sri Lankan Law of Contract absorbs the English Law, Roman Dutch Law, statute law and personal Laws of Muslims, Kandians, and Tamils into application.34 The case of Kandiah v. Thambipillai35 pronounced the applicability of the severance principles in Sri Lanka. In this case Horward C.J cited Anson, Law of Contract and accepted the view of English Law as follows:

“Where you cannot sever the illegal from the legal part of a covenant the contract is altogether void, but where you can sever them, whether the illegality is created by statute or common law, you may reject the bad part and retain the good.”

The Court of Appeal in the case of Ratnavale v. Appuhamy36 used the severability principles to give effect to a non-notorially executed contract on sale of land. It was held: “Although the main agreement of sale is of no force or avail in law because it was not notorially executed still the subsidiary parts of the agreement that are severable from the agreement to sell the land can be considered and given effect to”.37

In Bastiampillai v. Rasalingham37 it was held that there can be no severance of the legal from the illegal part of consideration.

There are few reported cases supports the view that if the consideration is illegal the principles of severability would not be applied.38 However, none of the cases dealt with other types of illegality expressly talked about the blue pencil rule. Based on the above mentioned two cases, it could be argued that the blue pencil rule is part of the law of the country even if it is not expressly used with its name in the court of law.

In the above mentioned cases the courts attempted to use the strict approach of the blue pencil rule. Thus, the offending parts were removed without any alterations in the agreement. Accordingly, it is worthy to note Horward C.J’s statement in Kandiah v. Thambipillai39

“If the promise is a separate promise and valid, the Court will enforce it. Whether it is separate or not depends on the language of the document. Severance, as it seems to me, is the act of the parties, not of the Court.”

This approach of the Sri Lankan courts strengthens the use and applicability of wills theory. It should be noted that even though the courts had the opportunity to invoke modifications in the above mentioned circumstances the courts didn’t

26 1979 (3) SA 1092 (T) at 1108 D-G
28 Botha J in National Chemsearch (SA)(Pty) Limited v. Borrowman and another 1979 (3) SA 1092 (T) at 1108 D-G.
29 supra note 26
30 1974 (4) SA 337
31 1984 (3) SA 427
32 1989 (2) SA 156
33 CC 2899/2008, 2008 3 All SA 518
35 (1943) 44 NLR 556
36 1978-79 2 SLR 389
37 38 NLR 89
38 Ismail v. Carlis Appu (1911) 15 NLR 94, Swaminathan Chetty v. Douglas (1931) 32 NLR 293
39 Supra note 35
attempt to do so. On the other hand, it might be the concern when it comes to restrain of trade contracts. There are little reported judgments available in relation to restrain of trade contracts.

Even there, none of the cases dealt with severability. Therefore the question as to how the severability principles will be used in the restraining contracts remains open before the apex court of the land. Based on the above case law analysis, it is evident that in the Sri Lankan context, guidance on as how to use the rule effectively is needed. The evolving nature of the Sri Lankan Contract Law warrants clear authorities in relation to the common law principles that are vividly used across the other common law countries.

III. Conclusion

It is now become clear that the purpose of and approach to blue pencil rule differs from State to State. The biggest criticism against the use of blue pencil rule is that it enables the courts to arbitrarily modify the agreements between the parties, while attempting to use the blue pencil to severe the illegal parts and thereby, making liable the parties to agree on terms which differ from their original will. Based on this argument, there are proposal put forward to adapt the no modification approach in the Western countries.\textsuperscript{40} The western countries have different opinion, whether to achieve it via legislation or not.\textsuperscript{41}

The socio economic conditions in the developing countries, especially in Asia and Africa, are quite different from the west. The recommendations of this study is subjected to the limitation of the study. This study is limited with the scope of considering the severability in terms of other illegal factors other than the consideration. Most of the developing economies are facing challenges in relation to wealth management. Thus, it would be the best choice for Sri Lanka to come up with a statute on commercial contracts that gives room for the courts to adapt the liberal approach of the blue pencil rule being in mind the evolving and complex nature of business transactions. The experience gained through having a general law statute to regulate the marriage relationships, while giving a choice of law to the persons, could be used in the sphere of Contract Law. In my opinion, at least the Apex courts should have jurisdiction to intervene in contractual matters which carry vast amount of national wealth into it for the purpose of proper administration of wealth management. Giving powers in the hand of the judiciary would keep a bird eye view on the parties whoever deals with contractual relationships that potentially could have illegal parts in it. The Indian experience on statutorizing the Law of contract could be looked upon for guidance.

Policy makers should consider the ambiguity of the prevailing system in contract law creates. Mostly, the Sri Lankan contract law responds in a reactive manner. We respond to the challenges only after crisis arises and thus creating the judicial precedent later. Introducing a statute would enable the state to respond to the needs in proactive manner while giving room for judicial innovation and creativity to settle the issues in acceptable manner.

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\textit{Hopkins v. Prescott} (1847) 4 C.B 578.

\textit{Attwood v. Lamont} [1920] 2 KB 146.


\textit{Beed District Central Coop Bank Ltd v. State of Maharastraand Ors} 2006 8 SCC 514.


\textit{41} “There should be no legislative reform in relation to contract and tort. We have reached the conclusion that it is not possible to lay down strict rules about when the illegality defence should apply instead, the courts should consider the policy rationales that underlie the defence and apply them to the facts of the case. Policy rationale includes these: 1) Furthering the purpose of the rule which the illegal conduct has infringed. 2) Consistency 3) that the claimant should not profit from his or her own wrong. 4) Deterrence; and 5) maintaining the integrity of the legal system. – Consultation Paper 2009 ,The Law Commission of England \textit{<http://www.lawcom.gov.uk/project/illegalitly/>} accessed 25\textsuperscript{th} of June, 2016.
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