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Draft Chapter

on

Illegality

by

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Article 1
Contracts contrary to fundamental principles

(1) A contract is illegal if, whether by its terms, performance or otherwise, it is contrary to principles widely accepted as fundamental in legal systems throughout the world.

(2) If only part of the contract is illegal under paragraph 1 the remaining part is not illegal unless giving due consideration to all the circumstances of the case it is reasonable to hold otherwise.

Comment

All developed legal systems have rules treating some contracts as unacceptable because of their subject matter. A classic example would be a contract to pay X money in return for his murdering Y. Such deals are often made but are unlikely to be the subject of litigation or arbitration. The cases which are so subject will be more sophisticated.

The content, terminology and conceptual structure of such rules vary widely. The present article is limited to principles which are very widely accepted across a wide range of states. Such acceptance may be shown by widespread acceptance of relevant international conventions (see for instance the United Nations Convention against corruption) but this is not essential.

These principles are undoubtedly in a state of permanent evolution. What is acceptable in one generation becomes unacceptable in the next and vice versa. Some principles are universal; others are widely accepted in many parts of the world. If the contracting parties all come from an area where something is unacceptable, it should be treated as unacceptable even though a different view would be taken in other parts of the world. It is not necessary to show that the transaction attacked is unacceptable in all countries. This would often be impractical or unduly expensive.

Examples which are practically important in the context of international commercial contracts include corruption, money laundering, trading in goods at prices which can only be achieved by unacceptable labour practices and trafficking in people.

In practice what is unacceptable will often not make up the whole of the contract. In such a case the effect of the unacceptable part on the remainder will depend upon what is reasonable.

National systems have another source of rules in statutory provisions which forbid particular contracts or require them to be made in a particular way. Unidroit has not created such rules as it has no legislature. Such mandatory rules are treated for the purpose of these principles by Article 1.4 and by Articles 3 and 4.

Contracts can come into conflict with principles in a variety of ways.

- a. It may be a contract whose performance will violate a relevant principle.
- b. The contract may require one person not to act in circumstances where a relevant principle although not requiring action, disapproves of promises not to act.

- c. The contract may tend to encourage behaviour which is contrary to a relevant principle.
- d. The contract is to do something in itself permissible but intended by one party as a preliminary to some act which compromises a relevant principle.
- e. The contract thus lawfully made has been illegally performed.

Not all illegality in performance would make the contract illegal. A contract of carriage would not become illegal because the lorry carrying the goods exceeds the speed limit. The key lies in the underlying purpose of the rule which has been broken.

Example 1

Contractor A of Utopia hires the Agent B of Ruritania. It is B's task under the agency agreement to pay \$ 10 million provided by A to C, a high ranking official in Ruritania's Ministry of Economics and Development, if the Ministry awards the contract to construct a new power plant in Ruritania to A. The agency contract is illegal in its entirety.

Example 2

Gray Boots is a major international manufacturer of sports shoes. It purchases large numbers of shoes from suppliers in Ruritania and Utopia. In both countries workers work 18 hour day under conditions of forced labour. This is contrary to an international convention which is widely accepted. The convention has been ratified by Ruritania but not by Utopia. The contract is illegal.

Example 3

Contractor A has been awarded by Official C, acting on behalf of Ruritania, the contract to build a new power plant after C has received \$ 10 million from A via B. The power plant is constructed, trial-runs have satisfactorily demonstrated that it is capable as was required to deliver 50% of the electricity needed for the capital city of Ruritania. The contract to build the power plant is only in part illegal.

Example 4

A is the owner of a large car showroom in Zenda, the capital of Ruritania. B, a Utopian national, agrees to buy 10 Rolls Royce cars to be delivered to St. Thomas, the capital of Utopia in one week for \$1,000,000. A stipulates for payment in advance. B pays in cash, using money which to A's knowledge is the product of drug smuggling. The contract is illegal.

Example 5

A, in Ruritania, enters into a contract to supply to B in Utopia quantities of semtex, a material useful for the manufacturer of bombs but also useful for peaceful purposes. A knows that B is a front for a terrorist organization. The contract is illegal.

Article 2

Effects of contracts contrary to fundamental principles

(1) Where each party knows, or ought to have known, of facts which make the contract illegal under Article 1, neither party has the right to exercise remedies under the contract.

(2) Where one party neither knew nor ought to have known of facts which make the contract illegal under Article 1 it has the right to exercise such remedies under the contract as in all the circumstances are reasonable.

(3) Where it is held that a contract is partially illegal under Article 1 paragraph 2 each party has the right to exercise such remedies as in all the circumstances of the case are reasonable.

Comment

This article deals with the effects of the contract failing foul of Article 1. The basic rule is that neither party acquires any right to exercise remedies under the contract but this is subject to an important exception based on knowledge.

There will be situations where one party does not know key facts, which make the contract illegal. This can happen, for example, where one party has made the contract for an improper purpose which is neither obvious nor known to the other party. In such a case the innocent party should have the normal rights of a contracting party.

Even where both parties know or ought to know there may be cases where it is appropriate to grant a restitution remedy. This is dealt with by Article 5.

Example 6

A is a major defence contractor in Ruritania. It is keen to sell numbers of its new Eurobomber airplane to the Utopian air force. It enters into an agreement with B, a senior officer of the Utopian Ministry of Defence to pay him a facilitation fee of 5% of the price paid for each aircraft. The Utopian air force orders 100 Eurobombers at \$100,000,000 each, deliverable at the rate of 20 a year starting on 1 January 2006. 30 Eurobombers have been delivered. B has been paid his fee in respect of the first 20 and Utopia has paid for 25 planes. The Peace Party came to power at the last Utopian election. They would be glad not to have to pay for any more planes. They have also discovered that the maximum speed of the planes is 1,000 km/hour and not 1,500 km/hour as had been claimed during the original negotiations. In this case the fee offered is clearly so large that it must be a bribe. B cannot sue for the unpaid part of the bribe. There may be situations where B is so senior that his acts ought to be treated as those of the government but if not the Utopian government ought to be able to recover damages for defects in the planes delivered and to refuse to take any more.

Example 7

A, a national of Ruritania, runs a business whose main object is to provide prostitutes to work in brothels in Utopia. He procures girls by telling them that he will find jobs for them as waitresses or secretaries in Utopia. He has a contract with the X bus company to drive the girls in buses from Zenda to St. Thomas. He does not tell X what his purpose is but X has good reason to suspect it. X is not entitled to payment. One, of X's buses crashes on the journey owing to the negligence of the driver and some of the girls are injured. X is not liable to A for A's consequential financial loss.

Example 8

Contractor A has promised in the agency agreement to pay to Agent B \$ 1 million, if A is awarded by Official C, acting on behalf of Ruritania, the contract to build the power plant. C, having received \$ 10 million as a bribe from A via B, has awarded the contract to A on behalf of Ruritania. B requests now from A the promised payment of \$ 1 million for agency services rendered. The arbitral tribunal will dismiss his claim for remuneration.

Example 9

Official C had received a letter of credit \$ 10 million issued in his favour by A's bank. Ruritania's secret service had discovered the intended bribery scheme. Ruritania had therefore obtained an injunction against C's bank in Narnia forbidding it to draw the letter of credit to the benefit of C's bank account there. C now sues A before an arbitral tribunal for \$ 1 million to have the promise remuneration paid to him. The arbitral tribunal should dismiss the claim.

Example 10

The contract between A and Ruritania to build the power plant for \$ 110 million has been held to be partly illegal by an arbitral tribunal because of the \$ 10 million bribe paid by A via his agent B to C, an official of Ruritania. A now wants to have the money back he has paid to B for the service rendered by B (\$ 1 million) and the bribe he has paid to C (\$ 10 million) and sues B and C accordingly before an arbitral tribunal. The arbitral tribunal should dismiss both claims.

Example 11

Ruritania's anti corruption authority had dutifully supervised all officials in the procurement department in its Ministry of Economics and Development, including official C. Since Ruritania's government did not and could not know of the corrupt actions, it may exercise all remedies available.

Example 12

The contract to have a power plant built for \$ 110 million had been signed by Ruritania's Minister of Economics and Development himself, whose wife had received a \$10 million bribe from Contractor A in her bank account in Narnia. Trial runs of the power plant had been successfully completed, thereby the last 25% of the purchase price still outstanding becoming due. The Minister had been sacked in the meantime because of corruption with the entire government of Ruritania. The new government refuses to pay the outstanding amount because of the bribe paid by A to its former minister. A therefore sues Ruritania before an arbitral tribunal for the balance outstanding, and citing the principle of international public law of state responsibility for acts of its government as a factor reasonably to be considered by the tribunal. If the tribunal deems it fair that Ruritania recovers the bribe from its former minister, it may award to A the remaining outstanding purchase price of \$22,5 million in full.

Example 13

The facts are as in example 5 but A has no reason to suspect that B has terrorist connections. A can enforce the contract but B cannot.

Article 3

Contracts infringing mandatory rules

(1) A contract is illegal if, whether by its terms, performance or otherwise, it infringes a mandatory rule applicable under Art. 1.4 under these Principles.

(2) If only part of the contract is illegal under paragraph 1 the effect will be determined by the mandatory rule infringed and in the absence of express guidance by Article 4 (2) and (3).

Comment

In domestic systems it is common to find contracts struck down by general principles and by specific prohibitions, usually statutory. These principles do not contain independent statutory prohibitions but the choice of the Unidroit Principles should not be a means of sidestepping national rules which are applicable under Article 1.4.

The presumption in such cases is that where the mandatory rule applies only to part of the contract, the rest of the contract will usually be valid.

Article 4
Effects of contracts infringing mandatory rules

1) The effects of any infringement of a mandatory rule upon a contract are those expressly prescribed by that rule.

(2) Where the mandatory rule does not expressly prescribe the effects of an infringement upon a contract, the parties have the right to exercise such remedies as in all the circumstances are reasonable.

(3) In determining what is reasonable regard is to be had in particular to:

- (a) the purpose of the rule which has been infringed;**
- (b) the category of persons for whose protection the rule exists;**
- (c) any sanction that may be imposed under the rule infringed;**
- (d) the seriousness of the infringement;**
- (e) whether the infringement was intentional; and**
- (f) the closeness of the relationship between the infringement and the contract.**

Comment

National rules may prohibit a contract without going on to state the effects of the prohibition. In that case it will be necessary to consider what is reasonable taking into the factors set out in paragraph (3). It would be appropriate to take into account solutions arrived at by national case law.

Example 14

X, a Utopian company, enters into a contract with Y to erect a building in Ruritania. The contract contains a provision for dispute-settlement by arbitration which can only be initiated after the work has been completed. Ruritanian law has a mandatory provision that either party is entitled to have any dispute settled by neutral adjudication at any time during the contract. This provision prevails but does not affect the validity of the remainder of the contract.

Example 15

A, a Ruritanian merchant, contracts to sell 100 tons of coffee beans to B, a Utopian merchant, on 28 days credit. He delivers the coffee beans but B now refuses to pay on the ground that he does not have, as Utopian law requires, a license to buy coffee. Enquiry shows that the Utopian rule is in effect a tax on importers. A can recover the price.

Example 16

The facts are as in 15 but enquiry shows that the Utopian government has adopted a fair trade policy designed to make sure that Utopians only drink coffee imported from approved countries and that the licensing scheme is an essential part of this policy. A can not sue for the price though he may have a restitutionary remedy. In neither case could specific performance be obtained.

Article 5
Restitution

(1) Where there has been performance under an illegal contract, restitution may be permitted where in all the circumstances of the case this would lead to a reasonable result.

(2) Where restitution is granted it may take the form of return of property, the repayment of money, or payment of an allowances for property transferred or services supplied, whichever is appropriate.

Comment

Many national systems have rules which deny restitutionary relief in relation to illegal contracts which have been performed. Although this result is defensible as discouraging the making of illegal contracts, it goes too far and should be subject to some exceptions and qualifications where a rigid rule produces an unacceptable result. Where the illegal contract has been performed, the fact that there are no contract remedies may mean that one party may receive an undeserved benefit for instance by having received the illegal performance without paying for it. Sometimes the illegality may be so awful that this is an appropriate result but this will not always be so. The present rule is designed to be flexible.

Example 17

In example 5 although the contract is illegal, it may be that it is not reasonable for Utopia to keep the 5 planes for which it has not paid. This would involve a careful examination of all the surrounding circumstances. It might be relevant, for example, that Utopia has been lamentably lax in the supervision of its purchasing officers or that B has been promoted to a new and even more senior position in Utopia.

Example 18

During the international tender process for the new power plant opened by Ruritania, its official C had suppressed an offer by Contractor D from Narnia which was 40% below the offer from contractor A mainly for two reasons: (1) The price asked for did not contain the compensation of the bribe of \$10 million calculated by Contractor A to be paid by A to Official C and \$1 million to be paid to Agent B. (2) The labour costs in Narnia are considerably lower than in Contractor A's Utopia. In addition Narnia's energy costs are much lower, because 90% of its electricity comes from hydro-electric power plants, whereas Utopia's electricity comes from plants using fuel and gas.

In the arbitration initiated by Contractor A on the last part of the outstanding purchase price the government of Ruritania request the arbitral tribunal to reduce the agreed purchase price of \$110 million by 40% to \$ 56 million only, which was the purchase price asked for

by contractor D from Narnia.

The arbitral tribunal held it to be reasonable to apply the principle known from anti-trust violations to take all profits away from the participants in the anti-trust violation. After requesting from Contractor A to reveal his costs, excluding all costs related to bribery, it reduced the contractual purchase price from originally \$110 million to \$56 million under Art. 2 (5) and therefore dismissed Contractor A's claim for \$25 million.

(Ruritania may claim back any payment it has made exceeding \$56 million as restitution under Art. 5 see the illustration there).

Principles of European Contract Law

CHAPTER 15 – ILLEGALITY

Article 15:101: Contracts Contrary to Fundamental Principles

A contract is of no effect to the extent that It is contrary to principles recognised as fundamental in the laws of the Member States of the European Union.

Article 15:102: Contracts Infringing Mandatory Rules

- (1) Where a contract Infringes a mandatory rule of law applicable under Article 1:103 of I these Principles, the effects of that infringement upon the contract are the effects, if any, expressly prescribed by that mandatory rule.
- (2) Where the mandatory rule does not expressly prescribe the effects of an infringement upon a contract, the contract may be declared to have full effect, to have some effect, to have no effect, or to be subject to modification.
- (3) A decision reached under paragraph (2) must be an appropriate and proportional response to the infringement, having regard to all relevant circumstances, including:
 - (a) the purpose of the rule which has been infringed;
 - (b) the category of persons for whose protection the rule exists;
 - (c) any sanction that may be imposed under the rule Infringed;
 - (d) the seriousness of the infringement;
 - (e) whether the infringement was intentional; and
 - (f) the closeness of the relationship between the infringement and the contract,

Article 15:103: Partial Ineffectiveness

- (1) If only part of a contract is rendered Ineffective under Articles 15:101 or 15:102, the remaining part continues In effect unless, giving due consideration to all the circumstances of the case, it is unreasonable to uphold it.
- (2) Articles 15:104 and 15:105 apply, with appropriate adaptations, to a case of partial ineffectiveness.

Article 15:104: Restitution

- (1) When a contract is rendered ineffective under Articles 15:101 or 15:102, either party may claim restitution of whatever that party has supplied under the contract, provided that, where appropriate, concurrent restitution is made of whatever has been received.
- (2) When considering whether to grant restitution under paragraph (1), and what, concurrent restitution, if any, would be appropriate, regard must be had to the factors referred to in Article 15: 102(3).
- (3) An award of restitution may be refused to a party who knew or ought to have known of the reason for the ineffectiveness.
- (4) If restitution cannot be made in kind for any reason, a reasonable sum must be paid for what has been received.

Article 15:105: Damages

- (1) A party to a contract which is rendered ineffective under Articles 15:101 or 15:102 may recover from the other party damages putting the first party as nearly as possible into the same position as if the contract had not been concluded, provided that the other party knew or ought to have known of the reason for the ineffectiveness.
- (2) When considering whether to award damages under paragraph (1), regard must be had to the factors referred to in Article 15:102(3).
- (3) An award of damages may be refused where the first party knew or ought to have known of the reason for the ineffectiveness.

Draft Common Frame of Reference

II. – 7:301: *Contracts infringing fundamental principles*

A contract is void to the extent that:

- (a) it infringes a principle recognised as fundamental in the laws of the Member States of the European Union; and
- (b) nullity is required to give effect to that principle.

II. – 7:302: *Contracts infringing mandatory rules*

- (1) Where a contract is not void under the preceding Article but infringes a mandatory rule of law, the effects of that infringement on the validity of the contract are the effects, if any, expressly prescribed by that mandatory rule.
- (2) Where the mandatory rule does not expressly prescribe the effects of an infringement on the validity of a contract, a court may;
 - (a) declare the contract to be valid;
 - (b) avoid the contract, with retrospective effect, in whole or in part; or
 - (c) modify the contract or its effects.
- (3) A decision reached under paragraph (2) should be an appropriate and proportional response to the infringement, having regard to all relevant circumstances, including:
 - (a) the purpose of the rule which has been infringed;
 - (b) the category of persons for whose protection the rule exists;
 - (c) any sanction that may be imposed under the rule infringed;
 - (d) the seriousness of the infringement;
 - (e) whether the infringement was intentional; and
 - (f) the closeness of the relationship between the infringement and the contract.

II. – 7:303: *Effects of nullity or avoidance*

- (1) The question whether either party has a right to the return of whatever has been transferred or supplied under a contract, or part of a contract, which is void or has been avoided under this Section, or a monetary equivalent, is regulated by the rules on unjustified enrichment. [Book VII].
- (2) The effect of nullity or avoidance under this Section on the ownership of property which has been transferred under the void or avoided contract, or part of a contract, is governed by the rules on the transfer of property.

II. – 7:304: Damages for loss

(1) A party to a contract which is void or avoided, in whole or in part, under this Section is entitled to damages from the other party for any loss suffered as a result of the invalidity, provided that the first party did not know and could not reasonably be expected to have known, and the other party knew or could reasonably be expected to have known, of the infringement.

(2) The damages recoverable are such as to place the aggrieved party as nearly as possible in the position in which that party would have been if the contract had not been concluded or the infringing term had not been included.

Restatement, Second, Contracts

CHAPTER 8 – UNENFORCEABILITY ON GROUNDS OF PUBLIC POLICY

TOPIC 1. UNENFORCEABILITY IN GENERAL

§ 178 (When a Term Is Unenforceable on Grounds of Public Policy)

- (1) A promise or other term of an agreement is unenforceable on grounds of public policy if legislation provides that it is unenforceable or the interest in its enforcement is clearly outweighed in the circumstances by a public policy against the enforcement of such terms.
- (2) In weighing the interest in the enforcement of a term, account is taken of
 - (a) the parties' justified expectations,
 - (b) any forfeiture that would result if enforcement were denied, and
 - (c) any special public interest in the enforcement of the particular term.
- (3) In weighing a public policy against enforcement of a term, account is taken of
 - (a) the strength of that policy as manifested by legislation or judicial decisions,
 - (b) the likelihood that a refusal to enforce the term will further that policy,
 - (c) the seriousness of any misconduct involved and the extent to which it was deliberate, and
 - (d) the directness of the connection between that misconduct and the term.

[...]

§ 184 (When Rest of Agreement is Enforceable)

- (1) If less than all of an agreement is unenforceable under the rule stated in § 178, a court may nevertheless enforce the rest of the agreement in favor of a party who did not engage in serious misconduct if the performance as to which the agreement is unenforceable is not an essential part of the agreed exchange.
- (2) A court may treat only part of a term as unenforceable under the rule stated in Subsection (1) if the party who seeks to enforce the term obtained it in good faith and in accordance with reasonable standards of fair dealing.

[...]

TOPIC 5. RESTITUTION

§ 197 (Restitution Generally Unavailable)

Except as stated in §§ 198 and 199, a party has no claim in restitution for performance that he has rendered under or in return for a promise that is unenforceable on grounds of public policy unless denial of restitution would cause disproportionate forfeiture.

§ 198 (Restitution in Favor of Party who Is Excusably Ignorant or Is Not Equally in the Wrong)

A party has a claim in restitution for performance that he has rendered under or in return for a promise that is unenforceable on grounds of public policy if

(a) he was excusably ignorant of the facts or of legislation of a minor character, In the absence of which the promise would be enforceable, or

(b) he was not equally in the wrong with the promisor.

§ 199 (Restitution Where Party Withdraw or Situation Is Contrary to Public Interest)

A party has a claim in restitution for performance that he has rendered under or in return for a promise that Is unenforceable on grounds of public policy if he did not engage In serious misconduct and

(a) he withdraws from the transaction before the improper purpose has been achieved,

or

(b) allowance of the claim would put an end to a continuing situation that is contrary to the public interest.