



INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW
INSTITUT INTERNATIONAL POUR L'UNIFICATION DU DROIT PRIVE

**Working Group for the preparation of
Principles of International Commercial Contracts (3rd)
Drafting Committee
Third session
Hamburg, 25 – 28 January 2010**

UNIDROIT 2009
Study L – WP 25 Add.
English only
December 2009

**Draft [Chapter][Section]
on
[Illegality][Infringement of Mandatory Rules]**

A Reporter's Note

by

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1. The Working Group, when adopting at its 4th session in May 2009 the two Articles on “Infringement of Mandatory Rules” and on “Restitution” as reproduced in UNIDROIT 2009 – Study L - WP 25, did not take any decision as to the final placement of these two provisions in the forthcoming 3rd edition of the Principles.
 - 1.1. Two solutions may be envisaged: either having the two provisions in a separate chapter or having them in a second section of the present Chapter 3 on Validity.
 - 1.2. The new Chapter/Section will in any case have to be given a title. Within the Working Group arguments were put forward in favour of both “Illegality” and “Contracts Infringing Mandatory Rules” as possible titles¹ (the corresponding Section 3 of Chapter 7 of the DCFR is entitled “Infringement of Fundamental Principles or Mandatory Rules”; the corresponding Chapter 8 of the Restatement 2nd is entitled “Unenforceability on Grounds of Public Policy”).
2. If the two provisions were to be in a second section of Chapter 3 on Validity, the following questions arise:

¹ Cf. UNIDROIT 2008 – Study L - Misc. 28: “[...] 241. Furmston pointed out that what was important was that the notion of illegality appeared in the title of the chapter because at least in English, Australian or Canadian texts books this was the title under which the kinds of situation dealt with in Articles 1 and 3 were normally addressed [...]”; cf UNIDROIT 2009 – Study L - Misc. 29: “[...] 457. Finn questioned the very title of the draft chapter. The notions of “illegality” and “illegal” had been extirpated from the black letter rules so why keep them in the title? A possibility would be to replace it by “Contracts infringing mandatory rules” though he admitted that this title could be equally questionable in view of the fact that the Principles themselves contained mandatory provisions. - 458. Bonell recalled that the chapter under discussion had from the outset been entitled “Illegality” and thought that also in order to accommodate the views expressed by those members and observers who would have preferred keeping the old Article 1 instead of having only a reference to unwritten principles of international public policy in the comments to Article 1.4 it would be wise to keep the original title. - 459. Gabriel agreed that the original title was “Illegality” but pointed out that in the meantime the scope of the chapter had been substantially reduced. Or, better say, while it still covered contracts that may be considered illegal because they infringe fundamental principles applicable under Article 1.4, it referred also and above all to contracts infringing statutory prohibitions such as the carrying out of certain professional activities without the necessary permission to do so which nobody would consider as illegal. He therefore suggested changing the title in order to avoid any misunderstanding as to the real scope of the chapter. - 460. Bonell noted that precisely for the reasons indicated by Gabriel also the alternative title “Contracts infringing mandatory rules” could be misleading. He therefore thought that unless other alternative proposals were put forward the original title which had been used over the last four years should be kept for the time being. After all, one thing was the notion of “illegal contracts” which no longer appeared in the black letter rules and another thing was “Illegality” as an overall title of the entire chapter which as far as he could recall was commonly used in the same context at least in English textbooks. - 461. Date-Bah suggested as an alternative title “Non-compliance with applicable law” [...].

- 2.1. Should the title of the entire Chapter 3 remain “Validity”? (the corresponding Chapter 7 of the DCFR is entitled “Grounds of Invalidity”)
- 2.2. What should be the title of Section 1? One may think of “Defects of consent” (the corresponding Section 2 of Chapter 7 of the DCFR is entitled “Vitiating Consent or Intention”).
- 2.3. What about present Article 3.1? Article 3.2? Article 3.3? Article 3.19? (in the DCFR the provisions corresponding to Articles 3.1 and 3.3, i.e. Articles II.-7:101 and II.-7:102, are in a separate section, i.e. Section 1 entitled “General Provisions”; the provision corresponding to Article 3.2, i.e. Article II.-4:101, is in the chapter on formation; the provision corresponding to Article 3.19 is Article II.-7:215).
3. What about present Article 3.17? Article 3.17(2) is now contained in Article 3.18 of Prof Zimmermann’s draft Rules on Restitution, but what about Article 3.17(1)? (the corresponding provision in the DCFR is Article II.-7:212(1)).
4. As a point of substance, should in the Chapter/Section on Illegality/Infringement of Mandatory Rules a provision on damages be added along the lines of what Article 3.18 provides in the context of avoidance of contracts for defects of consent? (this is the approach adopted in the DCFR: see Articles II.-7:214 and II.-7:304, respectively).

UNIDROIT Principles 2004

CHAPTER 3 — VALIDITY

ARTICLE 3.1

(Matters not covered)

These Principles do not deal with invalidity arising from

- (a) lack of capacity;
- (b) immorality or illegality.

ARTICLE 3.2

(Validity of mere agreement)

A contract is concluded, modified or terminated by the mere agreement of the parties, without any further requirement.

ARTICLE 3.3

(Initial impossibility)

(1) The mere fact that at the time of the conclusion of the contract the performance of the obligation assumed was impossible does not affect the validity of the contract.

(2) The mere fact that at the time of the conclusion of the contract a party was not entitled to dispose of the assets to which the contract relates does not affect the validity of the contract.

[...]

ARTICLE 3.17

(Retroactive effect of avoidance)

(1) Avoidance takes effect retroactively.

(2) On avoidance either party may claim restitution of whatever it has supplied under the contract or the part of it avoided, provided that it concurrently makes restitution of whatever it has received under the contract or the part of it avoided or, if it cannot make restitution in kind, it makes an allowance for what it has received.

ARTICLE 3.18

(Damages)

Irrespective of whether or not the contract has been avoided, the party who knew or ought to have known of the ground for avoidance is liable for damages so as to put the other party in the same position in which it would have been if it had not concluded the contract.

ARTICLE 3.19

(Mandatory character of the provisions)

The provisions of this Chapter are mandatory, except insofar as they relate to the binding force of mere agreement, initial impossibility or mistake.

Draft Common Frame of Reference

[...]

CHAPTER 4: FORMATION

Section 1: General provisions

II. – 4:101: *Requirements for the conclusion of a contract*

A contract is concluded, without any further requirement, if the parties:

- (a) intend to enter into a binding legal relationship or bring about some other legal effect; and
- (b) reach a sufficient agreement.

II. – 4:102: *How intention is determined*

II. – 4:103: *Sufficient agreement*

II. – 4:104: *Merger clause*

II. – 4:105: *Modification in certain form only*

[...]

CHAPTER 7: GROUNDS OF INVALIDITY

Section 1: General provisions

II. – 7:101: *Scope*

(1) This Chapter deals with the effects of:

- (a) mistake, fraud, threats, or unfair exploitation; and
- (b) infringement of fundamental principles or mandatory rules.

(2) It does not deal with lack of capacity.

(3) [...]

II. – 7:102: *Initial impossibility or lack of right or authority to dispose*

A contract is not invalid, in whole or in part, merely because at the time it is concluded performance of any obligation assumed is impossible, or because a party is not entitled to dispose of any assets to which the contract relates.

Section 2: Vitiating consent or intention

II. – 7:201: *Mistake*

II. – 7:202: *Inaccuracy in communication may be treated as mistake*

II. – 7:203: *Adaptation of contract in case of mistake*

II. – 7:204: *Liability for loss caused by reliance on incorrect information*

II. – 7:205: *Fraud*

II. – 7:206: *Coercion or threats*

II. – 7:207: *Unfair exploitation*

II. – 7:208: *Third persons*

II. – 7:209: *Notice of avoidance*

II. – 7:210: *Time*

II. – 7:211: *Confirmation*

II. – 7:212: *Effects of avoidance*

(1) A contract which may be avoided under this Section is valid until avoided but, once avoided, is retrospectively invalid from the beginning.

(2) The question whether either party has a right to the return of whatever has been transferred or supplied under a contract which has been avoided under this Section, or a monetary equivalent, is regulated by the rules on unjustified enrichment.

(3) The effect of avoidance under this Section on the ownership of property which has been transferred under the avoided contract is governed by the rules on the transfer of property.

[...]

II. – 7:214: *Damages for loss*

(1) A party who has the right to avoid a contract under this Section (or who had such a right before it was lost by the effect of time limits or confirmation) is entitled, whether or not the contract is avoided, to damages from the other party for any loss suffered as a result of the mistake, fraud, coercion, threats or unfair exploitation, provided that the other party knew or could reasonably be expected to have known of the ground for avoidance.

(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, with the further limitation that, if the party does not avoid the contract, the damages are not to exceed the loss caused by the mistake, fraud, coercion, threats or unfair exploitation.

(3) In other respects the rules on damages for non-performance of a contractual obligation apply with any appropriate adaptation.

II. – 7:215: *Exclusion or restriction of remedies*

(1) Remedies for fraud, coercion, threats and unfair exploitation cannot be excluded or restricted.

(2) Remedies for mistake may be excluded or restricted unless the exclusion or restriction is contrary to good faith and fair dealing.

[...]

Section 3: Infringement of fundamental principles or mandatory rules

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

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

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

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.

[...]