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Draft Chapter
on
Illegality

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discussions of the Working Group at its 3rd session held in Rome, 26-29 May 2008

Comments prepared by the UNIDROIT Secretariat

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 the circumstances it is reasonable to hold otherwise.

COMMENT

1. “Illegality” and “illegal contracts” under these Principles

As ample as freedom of contract is under these Principles (see Article 1.1), it is not without limit. Not only must parties enter into their agreement without error and unconstrained, but also the content they agree upon must respect basic principles of law and justice and not infringe relevant mandatory rules. While defects of consent are dealt with in Articles 3.4 and following, the substantive validity of contracts or their individual terms is, apart from sporadic provisions throughout the Principles (see e.g. Articles 1.7, 1.8, 3.19, 7.1.6, 7.4.13 and 10.3), addressed in this Section dealing with “illegality” and “illegal contracts” in general.

2. Contracts contrary to fundamental principles

According to the seriousness of the infringement the Principles distinguish between “contracts contrary to fundamental principles” and “contracts infringing mandatory rules”. The former are defined in Article 1 and the latter in Article 3.

a) Only “principles widely accepted as fundamental in legal systems throughout the world” relevant

Given the universal sphere of application of the Principles, in order for a contract to be illegal under Article 1, not all principles of good morals and public policy considered fundamental at domestic level are relevant but only those that are “widely accepted as fundamental in legal systems throughout the world”. Exactly which principles fall in that category cannot be determined with absolute certainty. Not only do such principles evolve in time but they may also vary from one geographical region to another and/or among different ethnic and religious groups. In this latter case such principles may become relevant only if the contract involves parties belonging to the same region or group.

Illustrations

1. A, a major Health Care Provider situated in non-EU Country X, enters into an agreement with Insurance Companies B and C, situated in EU Countries Y and Z, to provide them with the health care records of its patients. The agreement, though being contrary to Article 8 of the European Union Charter on Fundamental Rights on the protection of personal data, is not illegal under Article 1 because in Country X it is permitted to transmit such data to third parties.
2. Seller A enters into an agreement with Buyer B for the sale of merchandise. The date of conclusion of the contract falls on a day of the week which for a certain religious group is a day of rest on which certain activities, including negotiating and concluding business transactions, are rigorously prohibited. The contract between A and B is illegal under Article 1 only if both parties belong to the religious group in question.

A clear indication of a truly universal acceptance of a particular principle is its condemnation by international conventions especially where signed or even ratified by a significant number of States. A particularly important example in the context of international commercial contracts is the prohibition of corruption firmly stated in a number of international instruments (see the 2003 United Nations Convention Against Corruption, the 1999 OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions and the 1997 Inter-American Convention Against Corruption). Other examples are the prohibition of money laundering (see the Recommendations against money laundering of the Financial Action Task Force, an intergovernmental body with 34 member States), the prohibition of child and compulsory labour (see the 1998 ILO Declaration on Fundamental Principles and Rights at Work). More in general see also the ten fundamental principles in the areas of human rights, labour, environment and anti-corruption set forth by the United Nations Global Compact, a policy initiative with currently over 5100 corporate adherents from over 130 countries.

b) Ways in which a contract may violate fundamental principles

The most frequent case of illegality under this Article is that in which a contract violates a fundamental principle by its very terms.

Illustrations

3. Contractor A of Country X enters into an agreement with Agent B of Country Y (“the Agency Agreement”) to pay 10 million Euro to C, a high ranking official of D, the Ministry of Economics and Development of Country Y, in order to induce D to award A the contract to construct a new power plant in Country Y (“the Contract”). According to the Agency Agreement A will transfer to B the 10 million Euro at the latter’s request, while B will be paid a fee of 1 million Euro as soon as the Contract is awarded to A. The Agency Agreement is illegal because it is contrary to the fundamental principle prohibiting corruption.

4. Bidders A and B of Countries X and Y respectively, participating in a bidding process for the award of a construction contract (“the Contract”) called for by C, a governmental agency of Country Z, agree to collude in the bidding for the purpose of raising the price with a view to sharing the surplus profit (“the Collusive Bidding Agreement”). The Collusive Bidding Agreement is illegal by its terms.

Yet a contract may violate a fundamental principle also in its performance.

Illustration

5. A, a large scale retailer in Country X, enters into an agreement with B, a manufacturer in Country Y, for the manufacture and supply of toys according to its specifications (“the Sales Agreement”). A knows or ought to have known that the toys it orders will be manufactured by minors. The Sales Agreement is illegal because the way in which the goods will be manufactured is contrary to the fundamental principle prohibiting child labour.

Moreover a contract may violate a fundamental principle in other ways.

Illustrations

6. The facts are the same as in Illustration 3, except that B pays C the ten million Euro bribe and D, which is aware of this payment or at least ought to have been aware of it, awards the Contract to A thanks to the intervention of C. The Contract is illegal because it is contrary to the fundamental principle prohibiting corruption.

7. In an international tender process for the construction of a new power plant (“the Contract”) opened by D, the Government of Country Z, Contractor B from Country Y makes an offer which is 40% below the offer made by Contractor A from Country X. The difference in price is due not only to the considerably lower labour and energy costs in Country Y but also to the fact that A’s offer includes the cost of a 10 million Euro bribe A has promised to C, a high ranking official of D. C suppresses B’s offer and D, which is aware or at least ought to have been aware of it, awards the Contract to A at the higher price offered by A. The Contract is illegal because it is contrary to the fundamental principle prohibiting corruption.

8. The facts are the same as in Illustration 4, except that the Contract is awarded to A at an inflated price. The Contract is illegal on account of collusive bidding.

9. A, a manufacturer of plastic explosives situated in Country X, enters into an agreement with B, a trading company situated in Country Y, for the supply of quantities of semtex, a material useful for peaceful purposes as well as for the manufacture of bombs (“the Supply Agreement”). It is understood between A and B that goods will ultimately be forwarded to a terrorist organization. The Supply Agreement is illegal because the goods are intended to be used for criminal purposes.

3. Contracts only in part contrary to a fundamental principle

If only part of the contract is illegal under paragraph 1 of this Article, as is the case e.g. if only one of its terms or part of its performance violates a fundamental principle, the question arises as to whether the remaining part of the contract can be upheld or whether the contract is to be considered invalid in its entirety. Paragraph 2 of this Article establishes a presumption in favor of the first solution by providing that the remaining part of the contract is not illegal unless in the circumstances it is reasonable to hold otherwise. A reason for not upholding the contract would be the fact that the contract is not divisible or that the illegal part of it is of such importance as to affect also the remaining part.

Illustrations

10. The facts are the same as in Illustration 5, except that only one specific type of toy ordered by A is manufactured by minors in their homes, while all the other types are manufactured by workers lawfully employed by B in its factory. The Sales Agreement between A and B is illegal only with respect to the toys manufactured by the minors.

11. A, an aircraft manufacturer located in Country X, knowing that C, the Ministry of Defence of Country Y, intends to purchase a number of military aircraft, enters into an agreement with B, a consultancy firm located in Country Y, whereby B is to negotiate the possible purchase by C of the aircraft manufactured by A (“the Consultancy Agreement”). The agreement establishes in favour of B a remuneration equivalent to 8% of the total sale price A and C may eventually agree on. The exceptionally large remuneration is intended to cover also any “gifts” B may have to make to its counterparts in the negotiation process. The Consultancy Agreement is illegal in its entirety because it is not possible to separate the legal from the illegal part of it.

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 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 under the contract as in the circumstances are reasonable.]^(*)

^(*) *Note by the Rapporteurs:*

Paragraph 3 of Article 2 has been put in square brackets on the ground that there seems not yet to be sufficient support for it. The addition of this new paragraph was proposed at the 2008

COMMENT

1. Contracts illegal under Article 1 as a rule invalid in all respects

Where each party knows or at least ought to have known of the facts which make their contract illegal under Article 1, the contract is in all respects invalid and, irrespective of whether it has not yet been performed, has been partially performed or has been fully performed, neither party may exercise any of the remedies available under the contract (paragraph 1).

Illustrations

1. The facts are the same as in Illustration 3 in the Comments to Article 1, except that A has transferred the 10 million Euro to B and D, thanks to the intervention of C, has awarded the Contract to A. B may not sue A under the Agency Agreement for the payment of the 1 million fee nor may A sue B under the Agency Agreement for the recovery of the ten million Euro bribe B has paid to C.

2. The facts are the same as in Illustration 4 in the Comments to Article 1, except that after A has paid B part of its share of the surplus profit, C discovers that there was collusive bidding and invokes the illegality of the Contract. B may not sue A for payment of the remaining part of its share of the surplus profit nor may A sue B for the refund of the part already paid

3. The facts are the same as in Illustration 5 in the Comments to Article 1, except that B has delivered the first consignment of toys and A, having discovered defects in the goods, wants to put an end to the Sales Agreement and invokes its illegality. A may not sue B under the Sales Agreement for damages for the defects in the goods nor may B sue A under the Sales Agreement for the payment of the price of the goods supplied.

session of the Working Group in order to take into account the view of those Members who had advocated flexibility as to the remedies to be granted when a contract is partially illegal under Article 1 (cf. Summary Records, Doc. 28, para. 197). However, already on that occasion it was objected that to this effect there was no need of a special black letter rule but a reference in the Comments would be sufficient (cf. ibidem, para. 168). In deciding whether to keep Article 2(3) or to delete it, the Working Group may wish consider the following:

- (1) If the partial illegality under Article 1(2) leads to the illegality of the entire contract, the effects are already covered by Article 2 (1) and (2).*
- (2) If the remaining part of the contract is upheld, both parties can rely on that part of the contract and have all the remedies normally available under a valid contract.*
- (3) The only question that arises in the situation sub (2) relates to the illegal part of the contract, i.e. whether and to what extent the parties may exercise any remedy under it.*
- (4) Since with respect to contracts that are totally illegal under Article 1(1) or 1(2), Article 2(2) already provides maximum flexibility, it may be sufficient to mention in the Comments to Article 2(2) that the same flexible approach applies in case of partial illegality with respect of the illegal part of the contract.*
- (5) Should the Working Group decide to keep Article 2(3), it might wish to consider whether it was justified to provide different solutions according to whether or not both or only one of the parties knew or ought to have known of the illegality only in cases of total illegality and not in case of partial illegality.*

4. The facts are the same as in Illustration 6 in the Comments to Article 1, except that A has commenced the construction of the plant and D made a first down payment when a new government comes into power in Country Y and invokes the illegality of the Contract. A may not sue D under the Contract for damages for lost profit nor may D sue A under the Contract for the refund of the down payment made.

5. The facts are the same as in Illustration 7 in the Comments to Article 1, except that after completion of the work A requests D to pay the outstanding purchase price and D refuses payment. A may not sue D under the Contract for the payment of the outstanding purchase price.

6. The facts are the same as in Illustration 9 in the Comments to Article 1, except that B refuses to pay the price for the goods delivered. A may not sue B under the Supply Agreement for payment of the price.

2. Exception where one of the parties neither knew nor ought to have known of the illegality

Where, despite the seriousness of the violation, one of the parties was neither aware nor ought to have been aware of the illegal nature of the contract, paragraph 2 provides for an exception to the general rule laid down in paragraph 1 insofar as that party may exercise “such remedies under the contract as in the circumstances are reasonable”. The formula used is sufficiently broad to permit a maximum of flexibility. Thus, according to the circumstances of the case at hand the innocent party (or the court) may resort not only to the ordinary remedies available under a valid contract such as the right to performance, termination and damages, but also to other remedies, such as the right to request renegotiation, adaptation of the contract or termination on special terms, which under the Principles are available only in special situations (e.g. hardship: see Article 6.2.3).

Illustrations

7. The facts are the same as in Illustration 3 above, except that A neither knew nor ought to have known that the toys have been manufactured by children. A may sue B under the Sales Contract for damages for the defects in the goods.

8. The facts are the same as in Illustration 6 above, except that A neither knew nor ought to have known that B would transfer the goods to the terrorist organization. A may sue B under the Sales Contract for the payment of the price.

9. The facts are the same as in Illustration 8 in the Comments to Article 1. C, which when awarding the Contract to A was neither aware nor could have been aware of the collusive bidding between A and B, may either avoid the Contract and claim damages that would put C in the same position in which it would have been if it had not awarded the Contract to A or, alternatively, request A to renegotiate the Contract and, in case of failure to reach an agreement, its adaptation by the court in order to reduce the price to the amount that would have been agreed upon in the absence of the collusive bidding between A and B.

3. Restitution unimpaired

Even where remedies under the contract are not available according to paragraphs 1 and 2 of this Article, restitution may be available (see Article 5).

Article 3

Contracts infringing mandatory rules

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

[(2) (*Alternative 1*) If only part of the contract is illegal under paragraph 1 the remaining part is not illegal unless giving due consideration to the circumstances it is reasonable to hold otherwise].^()**

[(2) (*Alternative 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)].^()**

^(**) *Note by the Rapporteurs:*

*Paragraph 2 of Article 3 is presented in two alternative versions. Alternative 1 is the text submitted to the Working Group at its 2008 session. On that occasion it was criticized by one Member on the ground that there was an inconsistency between Article 3(2) and Article 4(2) and it was suggested changing Article 3(2) so as to state that the effects of a partially illegal contract under Article 3 would primarily be determined by the mandatory rule infringed and that in the absence of such indication Article 4(2) and (3) would apply (cf. Summary Records, Doc. 28, para. 242). The proposal was strongly objected to by another Member on the ground that in reality there was no contradiction between Alternative 1 of Article 3(2) and Article 4 since the former only deals with the impact of partial illegality on the fate of the remaining part of the contract and had nothing to do with the effects, i.e. the available remedies, of a (partially) illegal contract dealt with in Article 4 (cf. *ibidem*, para. 247). The Group eventually agreed to adopt the proposed amendment which is now reflected in Alternative 2. In deciding which of the two Alternatives to adopt the Working Group might wish to consider that*

- *In Rome last year there was little if any discussion as to the merits of the arguments put forward in favor of and against Alternative 2.*

- *Alternative 1 was intended to parallel Article 1(2), on the understanding that both provisions only deal with the impact of a partial illegality on the fate of the remaining contract, while “the effects” of (total or partial) illegality, i.e. whether and if so what remedies would be available under a contract illegal under Article 1(1) and 3(1), respectively, would be dealt with exclusively by Article 2 and 4, respectively.*

- *If Alternative 2 were to be adopted the question may arise why the impact of partial illegality under Article 1 should be determined according to criteria substantially different from those to be used to determine the impact of partial illegality under Article 3.*

- *If Alternative 2 were to be adopted the question may arise how to ensure consistency between the wording of the new text of Article 3(2) and that of Article 4, given that both would refer to “the effects” of a contract (totally or partially) infringing a mandatory rule.*

COMMENT

1. Contracts infringing mandatory rules

Contracts, though not violating principles widely accepted as fundamental in legal systems throughout the world according to Article 1, may nevertheless be illegal because they infringe mandatory rules enacted by national, supranational or international legislatures for a variety of reasons of public policy (trade policy, public health and safety, regulation of professional activities, environmental protection, taxation, etc.). This Article addresses contracts infringing such mandatory rules.

a) Only “mandatory rules applicable under Article 1.4 of these Principles” relevant

In order to determine whether a contract is illegal under this Article, obviously not all mandatory rules enacted worldwide are relevant but only those applicable in accordance with the relevant rules of private international law (see Article 1.4 of the Principles). Which mandatory rules will ultimately be applicable in the case at hand depends on whether the parties’ reference to the Principles is considered to be only an agreement to incorporate them in the contract or whether they are applied as the law governing the contract, and on whether the dispute is pending before a domestic court or an arbitral tribunal (see Comments 2, 3 and 4 to Article 1.4).

b) Ways in which a contract may infringe a mandatory rule

A contract may infringe a relevant mandatory rule by its very terms.

Illustrations

1. A, a law firm in Country X, enters into an agreement with B, a publisher of a newspaper in Country Y, for the publication in B’s newspaper of an advertisement publicizing A’s services. In country Y attorneys are prohibited by statutory regulation from advertising their services. The agreement between A and B is illegal by its terms.

2. A, an aircraft manufacturer in Country X, knowing that C, the Ministry of Defense of Country Y, intends to purchase a number of military aircraft, enters into an agreement with B, a consultancy firm located in Country Y, whereby B is to negotiate the possible purchase by C of the aircraft manufactured by A (“the Agency Agreement”). A statutory regulation of Country Y prohibits the employment of intermediaries in the negotiation and conclusion of contracts with governmental agencies. The Agency Agreement is illegal by its terms.

A contract may also infringe a relevant mandatory rule by its performance.

Illustrations

3. A, B and C, automobile manufacturers in Country X, enter into an agreement with D, an attorney in Country Y for carrying out a lobbying activity with members

of the Parliament of Country Y (“the Lobbying Agreement”). The Lobbying Act of Country Y requires registration of lobbyists before they carry out certain lobbying activities. D carries out one of these activities without having registered beforehand. The Lobbying Agreement is illegal by its performance.

4. Importer A from Country X enters into an agreement with Exporter B from Country Y for the supply of equipment. After the conclusion of the contract, the United Nations imposes a trade embargo on Country X. Nevertheless B delivers the equipment. The agreement between A and B is illegal by its performance.

Moreover a contract may infringe a mandatory rule in other ways.

Illustrations

5. Company A in Country X enters into an agreement with Engineer B in Country Y for the preparation of plans for the restructuring of A’s factory (“the Engineering Contract”). A statutory regulation of Country X requires that only licensed engineers may carry out such activity. B does not have the necessary license. The Engineering Contract is illegal because B is unlicensed.

6. Company A in Country X enters into an agreement with Builder B in Country Y for the restructuring of A’s factory (“the Restructuring Contract”). The stipulated price is much lower than the prices normally charged by B’s competitors in Country X because B, as A knows, is not registered and is therefore able not to pay taxes and security charges for him and for his employees. A statutory regulation of Country X prohibits contracts with unregistered builders and make it an offence for both the unregistered person to render a service and for the customer to pay for it. The Restructuring Contract is illegal because B is unlicensed.

2. Contracts only in part infringing mandatory rules

[...]

Illustration

7. A, a manufacturer of arcade games situated in Country X, enters into an agreement for the sale of arcade games to B, manager of an arcade in Country Y. Country Y’s gambling laws prohibit the installation of certain types of arcade games. Some of the games sold by A to B are of the types prohibited. The agreement between A and B is illegal only with respect to the sale of the prohibited games.

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 under the contract as in 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

1. Effects of infringement expressly prescribed by the mandatory rule infringed

Sometimes, although not too frequently, the mandatory rule itself expressly prescribes the effects of its infringement. Thus for instance Article 81(2) of the Treaty of Rome (as renumbered by the Treaty of Amsterdam) expressly states that the anti-competitive agreements between undertakings which may affect trade between member States of the European Union prohibited under Article 81(1) “shall be automatically void”. Likewise Article 5-511 of the New York General Obligations Law expressly declares “void” usurious contracts of the kind defined therein.

2. Effects of infringement to be determined according to what is reasonable in the circumstances

If the mandatory rule does not expressly provide for the effects of its infringement upon the contract, paragraph 2 provides that the parties may exercise “such remedies under the contract as in the circumstances are reasonable”. The formula which is the same as that used in Article 2(2) is sufficiently broad to permit a maximum of flexibility (see Comment 2 to Article 2).

3. Criteria for determining what is reasonable in the circumstances

Given the great variety of statutory regulations which may be relevant under Article 3, ranging from regulations of a merely technical nature to prohibitions for the purpose of preventing grave social harm, paragraph 3 provides a list of criteria for determining, in the circumstances, the available remedies, if any. The list is by no means exhaustive and the criteria listed should be weighed in relation to one another.

a) Purpose of the rule infringed

Absent an express provision in the mandatory rule itself as to the effects of its infringement, an important indication is the purpose of the rule and whether it requires that the contract be considered invalid in all respects or its achievement would not be affected by granting at least one of the parties a remedy under the contract.

Illustrations

1. The facts are the same as in Illustration 2 in the Comments to Article 3. Since the purpose of Country Y's prohibition of the employment of intermediaries is to combat corruption, A and B should be denied any remedies under the Agency Agreement.
2. The facts are the same as in Illustration 3 in the Comments to Article 3. Since the purpose of the registration requirement is to avoid abuses in the lobbying activity, neither party should be entitled to any remedy under the Lobbying Agreement.
3. The facts are the same as in Illustration 4 in the Comments to Article 3. Since the purpose of the trade embargo is to impose a sanction on Country X following X's violation of international law, its achievement requires that all contracts concluded or performed in violation of the embargo are considered invalid in all respects and that parties be denied any remedy under such contracts.
4. The facts are the same as in Illustration 6 in the Comments to Article 3, except that B, having completed the restructuring of the factory, requests A to pay the agreed price and A, having discovered defects in the work, requests B to repair the defects. Since the purpose of the statutory regulation prohibiting contracts with unregistered builders is to combat operations in the black economy, neither A nor B should be granted any remedy under the Reconstruction Contract.

b) Category of persons to be protected by the rule infringed

Another important factor to be taken into consideration is whether the statutory regulation is aimed at protecting the interests of the public in general or those of a specific category of persons. Licensing requirements are often of the latter type, i.e. are imposed by law on those carrying out certain activities for the protection of their customers or clients. If a contract is entered into by an unlicensed party it might be reasonable to grant its customer or client at least some remedies under the contract such as damages.

Illustration

5. The facts are the same as in Illustration 5 in the Comments to Article 3, except that B delivers plans that are in part based on erroneous calculations causing a delay in the restructuring work. Since the purpose of the license requirement is the protection of clients, A may be granted the right to damages for the loss caused by the delay.

c) Any sanction that may be imposed under the rule infringed

Statutory regulations prohibiting certain activities or imposing limitations to certain activities often provide criminal or administrative sanctions in case of violation. If a contract infringes such statutory regulations, the application of the criminal or administrative sanction may be considered sufficient to achieve the purpose of the statutory regulation in question, especially where such purpose is the protection of a particular category of persons or the government.

Illustrations

6. A, an exporter in Country X, enters into a contract with B, a ship owner in Country Y, to carry goods by sea from Country X to Country Y. A statutory regulation in Country X imposes, in the interests of the safety of the ship and its crew, limits on the load ships may carry. The statutory regulation provides a criminal sanction for its violation but says nothing about the effects a violation would have on the individual contracts of carriage. B overloads the ship and A refuses to pay the freight. Since the aim of the statutory regulation is sufficiently achieved by the imposition of the criminal sanction on B, B may be granted the right to recover the agreed freight.

7. A, a tax inspector employed by a governmental agency of Country X, agrees to carry out a consultancy service for B, a company in Country Y which is interested in investing in Country X. A statutory regulation of Country X prohibits tax inspectors from rendering remunerated private consultancy services and provides for disciplinary sanctions if they do so. A actually renders B the agreed services and is dismissed from its position. A may still be entitled to sue B for payment of the agreed fee for services rendered.

d) Seriousness of infringement

Another factor to be taken into account is the degree of seriousness of the infringement. If the infringement is only a minor one, it might be reasonable to grant the parties remedies under the contract.

Illustration

8. The facts are the same as in Illustration 6 above, except that the overloading arises because the master of B's ship has overlooked that the ship will in the course of the voyage move from the summer to winter limits and consequently the load limit will be slightly exceeded. This would be an additional factor in favour of not denying B the right to recover from A the agreed freight.

e) Whether infringement was intentional

Granting remedies under the contract may also depend on whether one or even both of the parties intentionally violated the statutory regulation or, on the contrary, one or even both parties were unaware of the statutory regulation.

Illustrations

9. A, an exporter in Country X, enters into a contract with B, a carrier from Country Y, for the carriage of dangerous goods from Country X to Country Y. Both countries have statutory regulations requiring goods of the kind in question to be carried on a vehicle of a prescribed type. Both A and B are aware of these regulations at the time of the conclusion of the contract and that B does not have any vehicles of the prescribed type. B successfully completes the carriage but neither B nor A should be granted any remedy under the contract.

10. The facts are the same as in Illustration 6 above, except that B was neither aware nor ought to have been aware of the statutory regulation of Country X imposing limits on the load ships may carry. This would be an additional factor in favour of not denying B the right to recover from A the agreed freight.

f) Closeness of relationship between infringement and contract

Yet another criterion to be taken into account is the relationship between the infringement of the mandatory rule and the contract. If, by its very terms, the contract provides for, or even only implicitly involves, the violation of a statutory regulation it might be reasonable not to grant the parties any remedy under the contract.

Illustration

11. A, an exporter in Country X, enters into a contract for the sale of goods with B, an importer in Country Y (“the Sales Contract”). Both parties know that the price stipulated is realistic only if the customs duties imposed by the statutory regulation of Country Y are evaded. Neither A nor B should be entitled to any remedy under the Sales Contract.

4. Restitution unimpaired

Even where remedies under the contract are not available according to paragraphs 1 and 2 of this Article, restitution may be available (see Article 5).

Article 5
Restitution

(1) Where there has been performance under an illegal contract, restitution may be granted where in the circumstances this would be reasonable.

[(2) (*Alternative 1*) In determining what is reasonable regard is to be had in particular to:

- (a) the purpose of the fundamental principle or mandatory rule which has been infringed;**
- (b) the category of persons for whose protection the fundamental principle or the mandatory rule exists;**
- (c) any sanction that may be imposed under the fundamental principle or mandatory 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.]**

[(2) (Alternative 2) In determining what is reasonable, regard is to be had, with the appropriate adaptations, to the criteria referred to in Article 4 (3).]^(*)**

[(3) Where either party may claim restitution of whatever it has supplied under the contract, or the part of it that is illegal, such party concurrently must make restitution of whatever it has received under the contract or the part of it that is illegal.

(4) If restitution in kind is not possible or appropriate, an allowance has to be made in money whenever reasonable.

(5) The recipient of the performance does not have to make an allowance in money if the impossibility to make restitution in kind is attributable to the other party.

(6) Compensation may be claimed for the reasonable expenses linked to the performance received.]^(**)**

COMMENT

1. Restitution under illegal contracts to be granted where reasonable under the circumstances

Even where as a consequence of the illegal character of the contract parties are denied, in accordance with Articles 2 and 4, any remedies under the contract, it remains to be seen whether they may at least claim restitution of what they have rendered in performing the contract. Contrary to the traditional view that, at least where both parties were aware or ought to have been aware of the infringement of a fundamental principle or mandatory rule, they should be left where they stand, i.e. should not even be entitled to recover the benefits conferred, the Principles, in line with the modern trend, adopt a more flexible approach and provide that where there has been performance under an illegal contract restitution may be granted whenever reasonable in the circumstances (paragraph 1 of this Article). In other words, restitution may or may not be granted

^(***) *Note by the Rapporteurs:*

Paragraph 2 of Article 5 is presented in two alternative versions. Alternative 1 literally corresponds to Article 3(3), the only change being the addition of a reference to the principles that might be infringed under Article 1. Alternative 2 corresponds in substance to Article 3(3) and the wording “with the appropriate adaptations” should allow sufficient flexibility in adopting the criteria set forth in Article 3(3) in the case of infringement of a mandatory rule under Article 2 also in the case of a contract contrary to a fundamental principle under Article 1.

^(****) *Note by the Rapporteurs:*

Paragraphs 3, 4, 5 and 6 set forth the rules governing restitution if granted and correspond, with minor changes, to Article 1 of the draft Chapter on Unwinding of Failed Contracts. If the Working Group agrees on the substance of these rules, it may wish to decide whether to keep them in Article 5 of the draft Chapter on Illegality or to have in that chapter a mere reference to the corresponding rules in the draft Chapter on Unwinding of Failed Contracts.

depending on whether, in the case at hand, it is more appropriate to allow the recipient to keep what it has received or to allow the performer to reclaim it.

Illustrations

1. The facts are the same as in Illustration 6 in the Comments to Article 1, except that A has almost completed construction of the power plant. Under the circumstances it would not be fair to let D have the power plant for nothing. A may be granted an allowance in money for the work done corresponding to the value it has for D and D may be granted restitution of any payment it has made exceeding this amount.

2. The facts are the same as in Illustration 5 in the Comments to Article 2. Under the circumstances A may be granted an allowance corresponding to the price offered by B and D may be granted restitution of any payment it has made exceeding this amount.

2. Criteria for determining whether granting of restitution reasonable

As to the criteria for determining whether the granting of restitution under paragraph 1 is reasonable, paragraph 2 refers to the same criteria set out in Article 4(3) for determining, in case of a contract infringing mandatory rules, whether it is reasonable to grant remedies under the contract, and if so, what those remedies are. While these criteria should also for the purpose of paragraph 1 of this Article be weighed in relation to one another, given the different nature of remedies under the contract and restitution, they may well lead in one and the same case to different results, i.e. to denying parties the former but granting the latter.

Illustrations

3. The facts are the same as in Illustration 1 in the Comments to Article 4, except that B has properly negotiated the purchase of A's aircraft by C. Under the circumstances, i.e. taking into account the purpose of the prohibition of the employment of intermediaries and the fact that B has lawfully performed its task, it may be reasonable to grant B the right to recover the costs of its service.

4. The facts are the same as in Illustration 4 in the Comments to Article 4. Under the circumstances, i.e. taking into account the purpose of the prohibition of contracts with unregistered builders and that B has been punished and paid back the taxes owed, it may be reasonable to grant B an allowance in money for the work done corresponding to its objective value less the expenses A incurs in repairing the defects.

5. The facts are the same as in Illustration 5 in the Comments to Article 4. Under the circumstances, i.e. taking into account that A is granted the right to damages under the Engineering Contract, it may be reasonable to grant B the right to recover the costs of its service.

6. The facts are the same as in Illustration 9 in the Comments to Article 4. Under the circumstances, i.e. taking into account that the purpose of the infringed regulation is to ensure security in transportation and that both parties have intentionally infringed the regulation, it may be reasonable not to grant either party restitutionary remedies.

3. Rules governing restitution if granted

[...]

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.