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Chapter 3

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Illegality

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Section 3

Illegality

Article 3.3.1

(Contracts infringing mandatory rules)

(1) Where a contract infringes a mandatory rule, whether of national, international or supranational origin, applicable under Article 1.4 of 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 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 one or both parties knew or ought to have known of the infringement;**
- (f) whether the performance of the contract necessitates the infringement;**
- and**
- (g) the parties' reasonable expectations.**

COMMENT**1. Scope of the Section**

Despite its paramount importance (see Article 1.1), freedom of contract is under these Principles not without limit. Not only must parties conclude the contract without error and without constraints, but the contract must also in other respects not violate the applicable mandatory rules. While defects of consent are dealt with in Section 2 of this Chapter, this Section is concerned with a contract that infringes, whether by its terms, performance, purpose or otherwise, mandatory rules. More precisely, it deals with the effects of such infringement on the contract by laying down the criteria to be followed in determining whether, despite the infringement, parties may still be granted remedies and if so, whether remedies under the contract (Article 3.3.1) or restitution (Article 3.3.2).

2. Only mandatory rules applicable under Article 1.4 of the Principles relevant

For the purpose of this Section only mandatory rules, whether of national, international or supranational origin, applicable under Article 1.4 of the Principles are relevant (see Comments 1 and 2 to Article 1.4). In other words it is concerned only with a contract infringing mandatory rules – be they specific statutory provisions or unwritten general principles of public policy – which are applicable in accordance with the relevant rules of private international law. Which mandatory rules will be applicable in a given case basically depends on whether the dispute is pending before a domestic court or an arbitral tribunal, and on whether the parties' reference to the Principles is considered to be only an agreement to incorporate them in the contract or whether the Principles are applied as the law governing the contract (see Comments 3, 4 and 5 to Article 1.4). Note that the Illustrations below do not address these questions and are based on the assumption that the mandatory rules referred to apply in the case at hand.

3. Ways in which a contract may infringe mandatory rules

A contract may infringe mandatory rules, first of all, by its very terms. As shown by the following Illustrations concerning corruption and collusive bidding, mandatory rules may be specific statutory provisions or unwritten general principles of public policy.

Illustrations

1. Contractor A of Country X enters into an agreement with Agent B ("the Commission Agreement") according to which B, against a fee of US \$1,000,000, would pay US \$10,000,000 to C, a high ranking procurement advisor of D, the Minister of Economics and Development of Country Y, in order to induce D to award A the contract for the construction of a new power plant in Country Y ("the Contract"). In both Countries X and Y bribery of public officials is prohibited by statute. The Commission Agreement infringes the statutory prohibitions in question by its terms. As to the Contract see Illustration 7.

2. Contractor A of Country X enters into an agreement with Agent B ("the Commission Agreement") to pay 100,000 Euro to C, a high ranking officer of Corporation D of Country Y, in order to induce D to award A the contract for the installation of a sophisticated IT system. Neither in Country X nor in Country Y is bribery in the private sector prohibited by statute but in both countries it is anyhow considered contrary to public policy. The Commission Agreement violates the principles of public policy in question by its terms.

3. Bidders A and B of Countries X and Y respectively enter into an agreement ("the Collusive Bidding Agreement") according to which in a series of public tendering proceedings for the procurement of construction contracts in Country Z, they would collude so that A would get some of the contracts and B the others. A statutory regulation of Country Z prohibits collusive bidding in public tendering proceedings. The Collusive Bidding Agreement infringes the statutory prohibition in question by its terms.

4. Bidders A and B of Countries X and Y respectively enter into an agreement ("the Collusive Bidding Agreement") according to which in a series of public tendering proceedings for the procurement of construction contracts in Country W, they would collude so that A would get some of the contracts and B the others. In Country W there is no statutory regulation prohibiting collusive bidding in public tendering proceedings, but collusive bidding is anyhow considered contrary to public policy. The Collusive Bidding Agreement violates the principle of public policy in question by its terms.

A contract may also by its performance infringe mandatory rules.

Illustrations

5. A, a large scale retailer in Country X, enters into an agreement with B, a manufacturer in Country Y, for the manufacture of toys according to its specifications ("the Manufacture Agreement"). A knew or ought to have known that the toys ordered would be manufactured by child labourers. In both Country X and Country Y child labour is considered contrary to public policy. The Manufacture Agreement violates the principles of public policy in question by its performance.

6. 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 an embargo on the importation of such equipment in Country X. Nevertheless B delivers the equipment. The agreement between A and B violates the embargo in question by its performance.

Moreover a contract may infringe mandatory rules also in other ways, for example by the way in which it is formed or by its purpose.

Illustrations

7. The facts are the same as in Illustration 1, except that B pays C the US \$10,000,000 bribe and D awards the Contract to A. The Contract violates the statutes prohibiting corruption by the way in which it is formed.

8. 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"). A knew or ought to have known that B would ultimately forward the goods to a terrorist organization. The Supply Agreement violates the fundamental principle of public policy prohibiting the support of terrorist activities by its purpose.

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

Sometimes the mandatory rule itself expressly states which contractual or restitutionary remedies, if any, are available to the parties

in case of its infringement. Thus for instance Article 81(2) of the Treaty of Lisbon (former Article 85(2) of the Treaty of Rome) 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". On its part the UNIDROIT Convention on Stolen or Illegally Exported Cultural Property provides that "[a] Contracting State may request [...] the return of a cultural object illegally exported from the territory of the requesting State" (Article 5) and that "[t]he possessor of a cultural object who acquired the object [...] illegally exported shall be entitled [...] to payment by the requesting State of fair and reasonable compensation, provided that [it] neither knew nor ought reasonably to have known at the time of acquisition that the object had been illegally exported " (Article 6).

5. 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 used is sufficiently broad to permit a maximum of flexibility. Thus, notwithstanding the infringement of the mandatory rule, one or both of the parties may, according to the circumstances of the case at hand, be granted the ordinary remedies available under a valid contract, including the right to performance, or other remedies such as the right to treat the contract as being of no effects, the adaptation of the contract or its termination on terms to be fixed. The latter kind of remedies may be particularly appropriate where as a consequence of the infringement only part of the contract becomes ineffective. As to the granting of restitution of the performances rendered under a contract infringing a mandatory rule, see Article 3.3.2.

6. Criteria for determining what is reasonable in the circumstances

Given the great variety of mandatory rules which may be relevant under this Article, 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 contractual remedies, if any. The list is not exhaustive. In many cases more than one of the criteria will be relevant and the decision will involve a balancing process.

a) Purpose of the rule infringed

Among the most important factors to be taken into account is the purpose of the mandatory rule and whether its achievement would or would not be affected by granting at least one of the parties a remedy under the contract.

Illustrations

9. The facts are the same as in Illustration 1, except that even though B paid C A's bribe, D does not award the Contract to A. Since the purpose of the relevant statutory prohibitions of bribery would be frustrated by granting A and B any remedy under the Commission Agreement, B may not request from A the payment of the US \$1,000,000 fee nor may A recover from B the US \$10,000,000 B has paid to C.

10. 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. Since the purpose of the statutory prohibition of the employment of intermediaries is to fight corruption, neither A nor B should be granted any remedy under the Agency Agreement.

11. The facts are the same as in Illustration 6. Since the purpose of the embargo is to impose a sanction on Country X following X's violation of international law, the achievement of that purpose requires that all contracts concluded or performed in violation of the embargo have no effects and that parties be denied any remedy under such contracts.

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

Another important factor to be taken into consideration is whether the mandatory rule infringed 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

12. 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, who does not have the necessary license, delivers plans that are in part based on erroneous calculations causing a delay in the restructuring work. Requested by A to pay damages for the loss caused by the delay, B refuses to pay on the ground that the Engineering Contract was invalid as he lacked the required license. Since the purpose of the license requirement is the protection of the clients, A may be granted the right to damages.

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. When such a regulation expressly states the effect of violation on contractual rights or remedies, that statement controls as noted in Comment 4. When the regulation is silent as to that effect, however, the existence and nature of the criminal or administrative sanctions can provide important insight into the purpose of the rule that has been violated, the category of persons for whose protection the rule exists, and the seriousness of violation. Accordingly, the existence and nature of such sanctions should be taken into account in determining the effect of such a violation on contractual rights and remedies.

13. 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 ("the Contract"). A statutory regulation in Country X imposes limits on the loads ships may carry. The statutory regulation provides for a fine in the case of its violation but says nothing about the effects a violation would have on the individual contracts of carriage. B overloads the ship and A, claiming the invalidity of the Contract, refuses to pay the freight notwithstanding the fact that the goods had arrived safely. Since the aim of the statutory regulation is to prevent, in the interests of the safety of the ship and its crew, overloading and not to prohibit contracts, and this aim is sufficiently achieved by the fining of B, B may be granted the right to be paid the agreed

freight for the carriage of the goods.

d) Seriousness of infringement

Another factor to be taken into account is the seriousness of the infringement. Thus remedies under the contract may be granted where the mandatory rule is of a purely technical nature and its infringement has no impact on the other party.

Illustration

14. Cattle Farmer A in Country X sells cattle to Cattle Farmer B in Country Y ("the Contract"). A statutory regulation in Country Y requires that incoming cattle must be properly tagged and that the information contained on the tags be set out also in accompanying documents. The cattle delivered is properly tagged but the accompanying documents are incomplete. A may nevertheless be granted the right to payment of the price.

15. 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 ("the Contract"). Country X has a statutory regulation requiring goods of the kind in question to be carried on a vehicle of a prescribed type. The statutory regulation provides a criminal sanction in case of violation but says nothing about the effects a violation would have on the individual contracts of carriage. B carries the goods on a vehicle that does not meet the prescribed safety requirements. A, claiming the invalidity of the Contract, refuses to pay the freight notwithstanding the fact that the goods arrived safely. Since the aim of the statutory regulations is the prevention of injury to third persons or damage to the environment, B, irrespective of the imposition of the criminal sanction, should not be granted the right to be paid the agreed freight.

e) Whether one or both parties knew or ought to have known of the infringement

Granting remedies under the contract may also depend on whether one or even both of the parties knew or ought to have known of the mandatory rule or of its infringement.

16. The facts are the same as in Illustration 1 except that B has paid the bribe to C and D awarded the Contract to A without knowing nor having ought to have known of the payment of the

bribe to C. If subsequently D becomes aware of the payment of the bribe, it may choose whether or not to treat the Contract as effective.

If D chooses to treat the Contract as effective, A will be obliged to perform and D will have to pay the price, subject to an appropriate adjustment taking into account the payment of the bribe. If, on the other hand, D chooses to treat the Contract as being of no effects, neither of the parties has a remedy under the Contract. This is without prejudice to any restitutionary remedy that may exist.

17. Contractor A of Country X enters into negotiations with D, the Minister of Economics and Development of Country Y, with a view of concluding an agreement on a large infrastructure project ("the Contract"). D requests the payment of a "commission" of 7,5% of the contract price in order to conclude the Contract. A pays the requested "commission" and the Contract is concluded. When A has already performed half of its obligations under the Contract, a new government comes to power in Country Y and the new Minister of Economics and Development, invoking the payment of the "commission", cancels the project and refuses to pay for the work already performed. A is not entitled to any remedy under the Contract. This is without prejudice to any restitutionary remedy that may exist.

f) Whether the performance of the contract necessitates the infringement

Another factor to be taken into account is whether the performance of the contract necessitates the infringement. Thus, 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

18. Company A of Country X enters into a contract with Company B of Country Y for the construction of a chemical fertilizer production plant in Country Y ("the Contract"). The Contract does not provide for the installation of the safety devices required by the environmental protection laws of Country Y and the parties deliberately agree on a price insufficient to cover the costs of the installation of the devices in question. Neither A nor B should be granted any remedy under the contract.

g) The parties' reasonable expectations

Where one of the parties on account of different legal or commercial culture could not have reasonably been aware of the infringement or, as is more often the case, one of the parties creates a legitimate expectation as to the enforceability of the contract and later invokes a statutory prohibition of its own law in order to nullify that expectation, it might be reasonable to grant the other party the remedies available under the contract.

Illustrations

19. Company A of Country X enters into an agreement with B, the Minister of Economics and Development of Country Y, concerning an investment project in Country Y ("the Agreement"). The Agreement contains a clause providing that all disputes arising out of the Agreement should be decided by arbitration to be held in Country Z in accordance with the UNCITRAL Arbitration Rules. If a dispute arises later and A commences arbitration proceedings, B cannot invoke a mandatory rule of Country Y according to which for disputes relating to contracts of the type of the Agreement the domestic courts of Country Y have exclusive jurisdiction which may not be contractually excluded by an arbitration agreement.

h) Other criteria

In addition to the criteria expressly listed in paragraph 3 of this Article there are others which may be taken into account for determining, in the circumstances, the available remedies, if any. One is the extent to which the contract infringes the mandatory rule. If the contract infringes the mandatory rule only in part, it may be reasonable to adapt the contract and grant the parties remedies under it.

Illustration

20. The facts are the same as in Illustration 5, except that only one specific type of toy ordered by A is manufactured by child laborers in their homes, while all the other types are manufactured by workers lawfully employed by B in its factory. Under the circumstances it may be reasonable to adapt the Manufacture Agreement accordingly and grant the parties the ordinary remedies under the revised Manufacture Agreement.

Another factor is timely withdrawal from the improper transaction. Thus, if a party to a contract infringing a mandatory rule repents of its

action before the unlawful purpose of the contract has been achieved, that party may be granted the right to recover what it has performed.

Illustration

21. The facts are the same as in Illustration 1, except that A, after having paid B the agreed fee of US \$ 1,000,000, but before B actually pays C the US \$ 10,000,000 bribe, decides to no longer pursue the illegal purpose and withdraws from the contract. A may be granted the right to recover from B the fee.

Article 3.3.2

(Restitution)

(1) Where there has been performance under a contract infringing a mandatory rule under Article 3.3.1, restitution may be granted where this would be reasonable in the circumstances.

(2) In determining what is reasonable, regard is to be had, with the appropriate adaptations, to the criteria referred to in Article 3.3.1(3).

(3) If restitution is granted, the rules set out in Article 3.2.15 apply with appropriate adaptations.

COMMENT

1. Restitution under contracts infringing mandatory rules to be granted where reasonable under the circumstances

Even where as a consequence of the infringement of a mandatory rule the parties are denied 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. According to Article 3.3.1 paragraph 1, the answer first of all depends on the mandatory rule itself which may or may not expressly address the issue (see also Comment 4 to Article 3.3.1).

If the mandatory rule infringed is silent on the issue, this Article, in line with the modern trend, adopts a flexible approach and provides that

where there has been performance under a contract infringing a mandatory rule restitution may be granted if reasonable in the circumstances (paragraph 1). In other words, contrary to the traditional view that, at least where both parties were aware or ought to have been aware of the infringement of the mandatory rule, they should be left where they stand, i.e. should not even be entitled to recover the benefits conferred, under these Principles restitution may or may not be granted 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.

2. Criteria for determining whether granting of restitution reasonable

The same criteria for determining what is reasonable under paragraph 3 of Article 3.3.1, apply to determine whether granting restitution under paragraph 1 of this Article is reasonable. Since the contractual and restitutionary remedies are different, the same criteria may lead to different results even in problems arising out of the same facts.

Illustrations

1. The facts are the same as in Illustration 1 in the Comments to Article 3.3.1, except that A, having been awarded the Contract, had almost completed construction of the power plant when in Country Y a new government comes to power which claims the Contract invalid on account of corruption and refuses to pay the outstanding 50% of the price. Under the circumstances it would not be fair to let D have the almost completed power plant for half the agreed price. A may be granted an allowance in money for the work done corresponding to the value the almost completed power plant has for D and D may be granted restitution of any payment it has made exceeding this amount.

2. Contractor A of Country X enters into negotiations with D, the Minister of Economics and Development of Country Y, with a view of concluding an agreement on a large infrastructure project ("the Contract"). D request the payment of a "commission" of 7,5% of the contract price in order to conclude the Contract. A pays the requested "commission" and the Contract is concluded. After A has fulfills all of its obligations under the Contract, a new government comes to power in Country Y and the new Minister of Economics and Development, invoking the payment of the "commission", refuses to pay the remaining contract price. A may

be granted an allowance in money for the work done corresponding to the value of the infrastructure project.

3. The facts are the same as in Illustration 15 in the Comments to Article 3.3.1, except that B, given that the goods arrived safely at destination, claims the recovery of at least the value of its service. Under the circumstances, i.e. in view of the seriousness of the violation and the necessity of preventing by all means the carriage of dangerous goods by vehicles lacking the required safety requirements, B should not even be granted the right to recover the value of its service.

3. Rules governing restitution if granted

If restitution is granted under this Article it is governed by the rules set out in Article 3.2.15 on restitution in the context of avoidance. These rules however need some adaptations, in the sense that in paragraph 1 of Article 3.2.15 the reference to avoidance is to be understood as reference to the case where the contract becomes ineffective as a result of the infringement of a mandatory rule, and the reference to avoidance of part of the contract as reference to the case where only part of the contract becomes ineffective as a result of the infringement of a mandatory rule. For further explanation of the rules on restitution referred to in this Article see the Comments to Article 3.2.15.