

Illegality in the Law of Contract (*Giao dịch Dân sự Vô hiệu Do Vi phạm Điều cấm*)

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The Origin of the Illegality Doctrine

- *Pacta sunt servanda*: 'agreements should be kept' or the principle of binding force i.e., if the parties have concluded a contract freely and with adequate information, then the contract should be treated as binding on them
- *Ex turpi causa non oritur action*: no action arises from a disgraceful cause
- *In pari delicto, prior est conditio possidentis*: in shared guilt the defendant's position is stronger (i.e., no recovery for the claimant)
- *Legal doctrine of 'Ex turpi causa'*: the courts may refuse to enforce a claim arising out of the claimant's own illegal or immoral conduct or transactions

Illegality Doctrine under the Common Law

- *"No court will lend its aid to a man who founds his cause of action upon an immoral or illegal act" (Holman v Johnson (1775) 1 Cowp 341 (Lord Mansfield))*
- *"the illegality defence operates as a rule of policy and is not designed to achieve justice between the parties (Holman v Johnson (Lord Mansfield))*
- *"one cannot judge whether allowing a claim which is in some way tainted by illegality would be contrary to the public interest, because it would be harmful to the integrity of the legal system, without considering [...]. We are, after all, in the area of public policy. That trio of necessary considerations can be found in the case law." Patel v Mirza [2017] AC 467*
- *the relevant issue is "not whether the contract should be regarded as tainted by illegality, but whether the relief claimed should be granted" Patel v Mirza*
- *John Stuart Mill's famous "harm principle" permits the use of state power only to prevent harm to others. Legal paternalism and legal moralism should be avoided; the state (through its laws) should not impose its view of the good, but should remain neutral between different understandings of the good.*

Goals and Nature of the Illegality Doctrine

Law Commission of the United Kingdom, Consultative Report, Consultation Paper No.189, The Illegality Defence (2009):

- (1) furthering the purpose of the rule which the claimant's illegal behavior has infringed;
- (2) consistency;
- (3) the need to prevent the claimant profiting from his or her own wrong;
- (4) deterrence;
- (5) maintaining the integrity of the legal system; and
- [(6) punishment]

Development of the illegality test under the common law

- “*Public conscience test*” or the ‘shocking the public conscience’ test: the discretionary test of whether in all the circumstances it would be an ‘*affront to the public conscience*’ to afford the claimant the relief sought (*Howard v Shirlstar Ltd* [1990] 1 WLR 1292).
- “*Rules based approach*” (*Tinsley v Milligan* [1994] 1 AC 340): If the formation, purpose or performance of a contract involves conduct that is illegal or contrary to public policy, a party cannot enforce the contract if he has to rely on that conduct to establish its claim – Andrew Burrows, *A Restatement of the English Law of Contract* (Oxford University Press, 2nd ed, 2016).
- “*Factors-based approach*” (*Patel v Mirza*) the aim is to provide structured and clear principles to answer the question whether it would be arbitrary, unjust or disproportionate to deny the claimant a remedy.

The Policy-based Approach under English law

- Courts have the discretion to decide whether or not illegality should act as a defence to a claim for contractual enforcement
- But the discretion should be structured by requiring the court to take account of specific factors:
 - (1) the seriousness of the illegality involved;
 - (2) the knowledge and intention of the party seeking enforcement;
 - (3) whether denying relief will act as a deterrent;
 - (4) whether denial of relief will further the purpose of the rule rendering the contract illegal; and
 - (5) whether denying relief is proportionate to the illegality involved.

The Policy-based Approach under English law

- *“The public interest is best served by a principled and transparent assessment of the considerations identified, rather than by the application of a formal approach capable of producing results which may appear arbitrary, unjust or disproportionate.” Patel v Mirza*
- *‘Thus the law in illegality in contract is no longer a prescriptive, mechanical rule but rather involves a determination of whether the policy underlying a particular rule would be advanced or frustrated by the application of the rule. The court granted restitutionary recovery to prevent the unjust enrichment of the defendant’. Chitty on Contracts, Chapter 16 (Illegality and Public Policy)*

Illegality Test under English Law

Andrew Burrows, *A Restatement of the English Law of Contract* (Oxford University Press, 2nd ed, 2020)

If the formation, purpose or performance of a contract involves conduct that is illegal or contrary to public policy, the contract is unenforceable by one or either party if enforcement would be harmful to the integrity of the legal system taking into account the following considerations:

- (a) the purpose of the rule which the conduct has infringed;
- (b) any policies that may be rendered ineffective or less effective by denying enforcement;
- (c) the need to ensure that a denial of enforcement is not a disproportionate sanction for the conduct.

In applying subsection (1)(c), more specific factors that may be taken into account include:

- the seriousness of the conduct;
- the centrality of the conduct to the contract;
- whether the conduct was intentional;
- whether there was a marked disparity in the parties' respective culpability.

Requirements for the Rule of Illegality

- Freedom, security, justice and efficiency
- Flexibility
- Certainty (or predictability)
- Proportionality

Freedom of Contracts under German Law

- *“Contractual obligations are self-imposed and therefore require that the ‘will’ of the respective contracting party be accurately reflected by the obligation undertaken”* (Savigny’s theory in his System des heutigen Römischen Rechts)
- *“The idea behind contract is that what has been agreed is binding because in making the contract the parties have agreed that it should determine their rights and liabilities”* (Flume, Allgemeiner Teil, vol 2, p 7)
- *‘A legal transaction is a private declaration of intention aiming at a legal consequence which the law sanctions because it is intended.’* (Motive vol 1, p 126)
- The doctrine of *laesio enormis* (allowing a contract to be avoided if the disparity between the values of what was exchanged was beyond a certain multiplier) was expressly rejected by the drafters of the BGB (Motive, vol 1 (1888))

Validity of Contracts under German Law

- **Procedural justice:** deficiencies in the contracting process e.g., incapacity, mistake, deception, coercion and some forms of 'misrepresentation'
- **Substantive justice:** the fairness of the exchange of values
 - *'The content of a contract as such was (except for the violation of statutory provisions or bonos mores) not to be regarded as sufficient ground to justify the intervention of a court. In terms of substantive and procedural justice, [...] if the requirements of the latter were fulfilled the former would not be questioned. The parties were the best guarantors of their respective rights and the contractual process was the epitome of fairness'. [The German Law of Contract: A Comparative Treatise, p46]*
 - Personal autonomy (the parties are best left to their own devices) v. the 'social' function or the element of 'social justice' of private law e.g., the correction of market failures, the need to protect the 'weaker' party
- **External, ie extra-contractual, justice**
 - a necessary device to ensure that the will of the legislator is applied also in relation to social ordering by contract
 - freedom of contract was balanced against some other basic right of the Constitution, e.g., the right of free marriage, the right to one's personality, freedom of expression, prohibition of slavery and forced labor, etc.

Illegality of Contracts under German law (the BGB)

- Conditions for the validity of a ‘legal transaction’:
 - legal capacity (§§ 104–13),
 - absence of mistake or vitiating factors (§§ 116–24),
 - compliance with form (§§ 125–9),
 - proper notification of the addressee of a declaration of intention inter absentes (§§ 130–2).
 - absence of a statutory prohibition (§ 134),
 - absence of violation of public policy (§ 138 I),
 - absence of a grossly inadequate and unduly obtained bargain (§ 138 II)
- Illegal contracts, or contracts contrary to public policy are void ab initio. In which case, the obligations between the parties are determined by the law of delict (§§ 823), the law of unjust enrichment (§§ 812 BGB), or the law of negotiorum gestio (§§ 677)

Illegality of Contracts under German law (the BGB)

Section 134 Statutory prohibition

A legal transaction that violates a statutory prohibition is void, **unless the statute leads to a different conclusion.**

Section 138 Legal transaction contrary to public policy; usury

(1) A legal transaction which is contrary to public policy is void.

(2) In particular, a legal transaction is void by which a person, by exploiting the predicament, inexperience, lack of sound judgement or considerable weakness of will of another, causes himself or a third party, in exchange for an act of performance, to be promised or granted pecuniary advantages which are clearly disproportionate to the performance.

Illegality under German Law

- § 134 BGB establishes consistency between the law of contract and the rest of the legal order. It ensures that the political will of Parliament cannot be called into question by the means of contract law.
- Statutory prohibitions in the sense of § 134 BGB often do not expressly concern the validity of contract. Generally speaking, they are not aimed at restricting freedom of contract as such but at banning a certain type of conduct irrespective of the legal form that it takes.
- The invalidity of the contract is thus merely a reflection, an indirect consequence, of the wish of the legislator that certain incidents do not occur
- This insight determines the conditions of application of § 134 BGB: it must be established that it is the will of the legislator that demands that the contract is void and this is something which is not easy to ascertain.

Illegality under German Law (cont)

- § 134 BGB presupposes that a statutory prohibition has been violated and that, if properly construed, the provision demands that the contract be declared void.
- § 134 BGB demand to inquire whether the invalidity was the purpose of the statutory prohibition.

Illegality under German Law (cont)

- Under the German law, selling in shops during certain hours (after 8pm) or on Sundays is prohibited. A contract of sale concluded during the prohibited periods of time violates the statute. However, the statute does not require the invalidity of such contracts. This consequence would clearly be excessive (RGZ 60).
- Under the German law, the provision of legal counsel is restricted to lawyers admitted to the Bar. Contracts which contravene this statute are treated as void (BGHZ 37, 262). Contracts with workmen or craftsmen who are not properly registered in are valid (BGHZ 88, 240 = NJW 1984).
- The court regarded the performance without authorization of one activity (the provision of legal advice) as more dangerous than the other (the services of a craftsman) for the individual customer.

Illegality under the Draft Common Frame of Reference (DCFR)

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.

Illegality under the DCFR (cont)

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.

Illegality under the DCFR (cont)

(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.

Illegality under the DCFR (cont)

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.

(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.

(3) This Article is subject to the powers of the court to modify the contract or its effects.

Illegality under the DCFR (cont)

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.

Takeaways

- Illegality may or may not result in invalidity (the civil law approach) or unenforceability (the common law approach)
- Illegality in the law of contract needs a test to determine in which cases illegality result in invalidity (the civil law approach) or unenforceability (the common law approach)
- The test must satisfy the requirements of
 - Freedom, security, justice and efficiency
 - Flexibility
 - Certainty (or predictability)
 - Proportionality

Thank you very much!



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