

Recent Developments in European Contract Law
Winter term 2007/08
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Illegality and Immorality

Introduction; Situation in the national laws:

Examples: German & Dutch Law

§ 134 BGB Statutory prohibition

A legal transaction which violates a *statutory prohibition* is void unless a different consequence is to be deduced from the statute.

Art. 3:40 BW

(2) Violation of an *imperative statutory provision* entails nullity of the juridical act;

if, however, the provision is intended solely for the protection of one of the parties to a multilateral juridical act, the act may only be annulled;

in both cases this applies to the extent that the necessary implication of the provision does not produce a different result.

(3) Statutory provision which do not purport to invalidate juridical acts contrary to them are not affected by the preceding paragraph.

§ 138 BGB Immoral legal transaction; extortion

- (1) A legal transaction which violates *good morals* is void.
- (2) In particular a legal transaction is void by which someone through *exploitation of the predicament, inexperience, lack of judgement or significant weakness of will* of another person *causes to be promised* or granted to himself or a third party in return for a performance economic advantages which are *conspicuously disproportionate* to the performance.

Art. 3:40 BW

- (1) A judicial act which by its content or necessary implication is contrary to *good morals* or *public order* is null.

Example: French Law

Art. 1131 code civil

An obligation without *cause* or with a false cause, or with an unlawful cause, may not have any effect.

Art. 1133

A cause is unlawful where it is *prohibited by legislation*, where it is *contrary to public morals or to public policy*.

New case-law in France relating to gifts to a "concubine":

- Cour de cassation (Assemblée Plénière) 29 October 2004
- Cour de cassation 3e chambre civil, 3 February 1999 (Rec. Dall. 1999 p. 267)

See: *ERPL 2005, 232*

Art. 27 ZGB (Swiss Civil Code)

- (2) No one can dispose of his freedom or limit its exercise to a degree inconsistent with the law or ethics.

**§ 90 a HGB (German Commercial Code (=Handelsgesetzbuch)
Agreement prohibiting competition**

- (1) An agreement by which a commercial agent is restricted in his commercial activity following termination of the contractual relationship (agreement prohibiting competition), must be in writing, ... The agreement may run for no longer than two years following the termination of the contractual relationship. The agreement may cover only the geographical area or group of customers assigned to the commercial agent, and may only refer to the type of business for which the commercial agent was responsible to conclude transactions. The principal is obligated to pay reasonable compensation to the commercial agent for the duration of the prohibition of competition. ...
- (4) Agreements deviating from these provision to the disadvantage of the commercial agent cannot be made.

Case 1:

The Murgitroyd Company (M) is engaged in the provision of intellectual property services, having eight offices spread throughout Europe. The company hired Mr. Purdy (P) who is a European patent agent to work out of the plaintiffs Dublin office. In the service agreement the following clause was provided:
"Undertaking The Executive (P) will not within the Republic of Ireland during the period of 12 months following determination of his employment hereunder on his account and in competition with the company carry on any business which competes with the business of the company (M) or any associated company having intellectual property work as one of its principal objects existing as of the date of termination of the executive's (P's) employment hereunder and with which the executive shall have been directly or indirectly concerned PROVIDED THAT ... nothing in this Agreement will affect the Executive's (M's) right to accept employment as an employee in another firm of patent attorneys".
Is this clause enforceable? [see Irish High Court, *MURGITROYD v. PURDY*, 1st June 2005 (ERPL 2005, 912)]

House of Lords in *Mason v. Provident Clothing & Supply Co. Ltd.*
[1913] A.C. 724:

“It would in my opinion be *pessimi exempli* if, when an employer had exacted a covenant deliberately framed in unreasonably wide terms, the Courts were to come to his assistance and, by applying their ingenuity and knowledge of the law, carve out of this void covenant the maximum of what he might validly have required. ... The hardship imposed by exaction of unreasonable covenants by employers would be greatly increased if they could continue the practice with the expectation that, having expose the servant to the anxiety and expense of litigation, The Court would in the end enable them to obtain everything which they could have obtained by acting reasonably.”

(Similar: BGH NJW 1986, 2944)

Lord Justice Kerr in *Phoenix General Insurance Co. v. Administratia Asigurariilor de Stat* [1987] 2 All ER 152, 176):

“Where a statute merely prohibits one party from entering into a contract ... it does not follow that the contract itself is impliedly prohibited so as to render it illegal and void. Whether or not a statute has this effect depends on considerations of public policy in the light of the mischief which the statute is designed to prevent, its language, scope and purpose, the consequences for the innocent party, and any other relevant consideration.”

Case 2:

The owner of a house contracted an insurance to cover the risk of destruction by fire. The house was destroyed in a fire, but it became clear afterwards the house had been built illegally, without building permit. The insurance company argued that it was not obliged to make the payment, as the insurance agreement had an illegal object.

Was the company right?

Belgian Cour de Cassation, 19 May 2005 (See ERPL 2005, 896)

- Do bribes that have been paid for obtaining a contract render that contract void by reason of illegality?

(See Swiss Bundesgericht, 21 February 2003, ERPL 2003, 558)

- Company C is established by one of its founders and registered for VAT, as a part of a fraud aimed at avoiding VAT payments. It sells and delivers computer units to M. Later M refuses to pay the price and argues that the contract is unenforceable because the company entered into it with the aim of defrauding the tax authorities.

Is M right?

(See: English High Court, 17 February 2004, ERPL 2005, 231: *21st Century Logistic Solutions Ltd v. Madysen Ltd* [(2004) EWHC 231 (2004) 2 Lloyd's Rep. 92])

Unified Laws:

Article 4 CISG

This Convention governs only the formation of the contract of sale and the rights and obligations of the seller and the buyer arising from such a contract. In particular, except as otherwise expressly provided in this Convention, it is not concerned with:

- (a) the validity of the contract or of any of its provisions or of any usage;
- (b) the effect which the contract may have on the property in the goods sold.

PECL

CHAPTER 4 : VALIDITY, Article 4:101: Matters not Covered

This chapter does not deal with invalidity arising from illegality, immorality or lack of capacity.

UNIDROIT Principles:

Article 3.1 (Matters not covered)

These Principles do not deal with invalidity arising from

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

UNIDROIT Principles:**Article 3.10 (Gross disparity)**

- (1) A party may avoid the contract or an individual term of it if, at the time of the conclusion of the contract, the contract or term unjustifiably [2] gave the other party an excessive advantage [1].
Regard is to be had, among other factors, to
- (a) the fact that the other party has taken unfair advantage of the first party's dependence, economic distress or urgent needs, or of its improvidence, ignorance, inexperience or lack of bargaining skill [2.a.]; and
- (b) the nature and purpose of the contract [2.b.].



Requirements: 1. Excessive advantage

2. Unjustifiably advantage

a. Unequal bargaining position

b. Nature and purpose of the contract

c. Other factors

Illustration (to 2.a.)

A, the owner of an automobile factory, sells an outdated assembly line to B, a governmental agency from a country eager to set up its own automobile industry. Although A makes no representations as to the efficiency of the assembly line, it succeeds in fixing a price which is manifestly excessive.



According to the UNIDROIT Principles (Art. 3.10) B may, after discovering that it has paid an amount which corresponds to that of a much more modern assembly line, be entitled to avoid the contract.

PECL:

Article 4:109: Excessive Benefit or Unfair Advantage

- (1) A party may avoid a contract if, at the time of the conclusion of the contract:
- (a) it was *dependent* on **or** had a relationship of *trust* with the other party, *was in economic distress or had urgent needs*, was *improvident, ignorant, inexperienced or lacking in bargaining skill*, and
 - (b) the other party *knew or ought to have known* of this and, given the circumstances and purpose of the contract, took advantage of the first party's situation in a way which was grossly unfair or took an excessive benefit.

...

Illustrations to the requirement of "Excessive Advantage" (PECL):

Illustration 1:

During a sudden cold snap during early summer the price of tomatoes suddenly increases dramatically. B agrees to buy tomatoes from A at the increased price.

Can B avoid the contract under Art. 4:109 PECL?

Illustration 2:

X, an uneducated person with no business experience, I left some property. He is contacted by Y who offers to buy it for a sum much less than it is actually worth, telling X that he must sell it quickly or he will lose the chance. X agrees without consulting anyone else.

Illustration 3:

U and her family are on holiday abroad when they are involved in a car crash and U's husband is badly hurt. He urgently needs medical treatment which is not locally available. V agrees to take the man by ambulance to the nearest major hospital, charging approximately five times the normal amount for such a journey. U is so worried that she agrees without getting other quotations; she does not discover until later that she has been overcharged.

Illustration 4:

As the last Illustration. U realises that V is demanding an extortionate price but this is the only ambulance available.

⇒ Art. 4:109 PECL applies to illustrations 2-4.

Illustration to "Grossly Unfair Advantage" (PECL):

X, a widow, lives with her many children in a large but dilapidated house which Y, a neighbour, has long wanted to buy. X has come to rely on Y's advice in business matters. Y is well aware of this and manipulates it to his advantage: he persuades her to sell it to him. He offers her the market price but without pointing out to her that she will find it impossible to find anywhere else to live in the neighbourhood for that amount of money.

The 'Gross disparity' & 'Unfair surety agreements of family members'

= one of the areas of immoral contracts, with which the national laws have recently been occupied.

Art. 341-4 French Consumer Code states that:

- if surety is manifestly disproportionate to the guarantor's capital and income ...
- ... the lender cannot rely on the guarantee ...
- ... unless the guarantor's assets at the time the guarantee is called in, allow him to face his obligations.

German law:

§ 242 BGB Performance in accordance with good faith

A creditor is obliged to effect performance in the manner required by good faith, having regard to custom (Verkehrssitte).

⇒ (+) BGH 5 January 1995, NJW (Neue Juristische Wochenschrift) 1995 p. 592; 25 April 1996, BGHZ 132, 328.

§ 138 BGB Immoral legal transaction; extortion

(2) In particular a legal transaction is void by which someone through *exploitation of the predicament, inexperience, lack of judgement or significant weakness of will* of another person causes to be *promised* or granted to himself or a third party in return for a performance economic advantages which are *conspicuously disproportionate* to the performance.

⇒ (+) e.g. BGH 11 February 2003, ZIP (Zeitschrift für Wirtschaftsrecht) 2003, p. 796

For a recent overview (in German) of the German case-law see for ex.

- *Braun*, JURA (Juristische Ausbildung) 2004, p. 474 et seq. or
- *Krafka*, JA (Juristische Arbeitsblätter) 2004, p. 668 et seq. or

For a not so recent overview (in English) of the German case-law see for ex.

- *Habersack & Zimmermann*, 3 ELR (Edinburgh Law Review) 1999, p. 272 et seq. or
- *Kiefel*, 74 ALJ (Australian Law Journal) 2000, p. 692 et seq.

English Case-Law: 'Undue Influence' see: *Royal Bank of Scotland v. Etridge* (No. 2), House of Lords, 11 October 2001 [2001] UKHL 44

- ⇒ In the field of spouses' suretyships undue influence can be presumed a wife is able to establish that she had placed trust and confidence in her husband in the management of her financial affairs and that the impugned transaction was not 'explicable in the ordinary way'.
- ⇒ However no undue influence, when the lender fulfilled its obligation to take reasonable steps to satisfy himself that the wife had understood and freely entered into the transaction.

See for the Scottish Case-Law: *Smith v. Bank of Scotland*; *Mumfort v. Bank of Scotland*, 1996 SLTZ 392

Lord Denning in *Lloyds Bank v. Bundy* [1975] QB 326 at p. 337:

“There are cases in our books in which the courts will set aside a contract, or a transfer of property, when the parties have not met on equal terms – when one is so strong in bargaining power and the other so weak – that, as a matter of common fairness it is not right that the strong should be allowed to push the weak to the wall. But I think the time has come when we should seek to find a principle to unite them. ...

[T]hrough all these instances there runs a single thread. They rest on ‘inequality of bargaining power’. By virtue of it, the English law gives relief to anyone who, without independent advice, enters into a contract on terms which are very unfair or transfers property for a consideration which is grossly inadequate, when his bargaining power is grievously impaired by reason of his own needs or desires, or by his own ignorance or infirmity, coupled with undue influences or pressures brought to bear on him by or for the benefit of the other.”

But see: House of Lords, *National Westminster Bank v. Morgan* [1985] 1 All ER 821

Italian law:

There is no specific rule protecting non-professional sureties from disproportionate obligations.

See for an essay on this subject:

Ciacchi, ERPL 2005, p. 285 et seq.: “Non legislative Harmonisation of Private Law under the European Constitution – The case of unfair suretyships”.

Thank you for your attention!