

CHAPTER FIVE

LEGALITY

5.1 Introduction

Legality is a basic requirement for valid contracts in free market jurisdictions. This was briefly explained in Chapter 1 ("Basic Aspects of Contract Law"). Courts generally will not enforce agreements that are illegal. Illegal offers cannot result in valid contracts. In fact, an "illegal contract" is a contradiction in terms, because by definition a contract is an agreement that the law will enforce. So it is more accurate to use the term "illegal agreements."

Agreements may be unenforceable for different reasons. Section 5.2 discusses the general reasons why agreements that violate the law are generally unenforceable.

Some agreements are illegal because they violate a specific statute. By "specific statute," this text means a statute that discusses the actual subject matter of the agreement, such as the sale of heroin. This text discusses how agreements may be illegal because they violate statutes regarding crimes or torts, gambling, usury, regulatory licensing requirements, and unreasonable restraints of trade. This kind of illegality is explained in Section 5.3 below.

Other agreements are illegal because they violate the more general principle of public policy, even if they do not violate specific statutes. "Public policy" basically means the promotion of the good of society. Principles of public policy may be stated in statutes, or they may be developed in court decisions, particularly in common law jurisdictions. This text discusses agreements that may violate public policy because they involve the commission of torts, harm the freedom of marriage, harm the administration of justice, harm public service or interfere in public affairs, unreasonably restrain trade, promote immorality, or contain improper exculpatory clauses. Agreements that violate public policy are discussed in Section 5.4.

An agreement may be illegal in some jurisdictions because it violates a specific statute, and illegal in other jurisdictions because it violates public policy. But whether agreements are illegal because of statutes or public policy, the effects on the agreement are generally the same.

The general effect of an illegal agreement is that it is void, and unenforceable by any party. And in general, courts will not give any remedy to parties to such agreements--even if the result is that one party profits and another has a loss! However, there are several limits on this rule. In a few special situations, one of the parties may actually be able to enforce the illegal agreement. And in a few other situations, one party can get restitution of what he has provided to the other party or possibly other remedies, even though the agreement is void. Also, if only part of an agreement violates the law, courts may “sever” that part and enforce the rest of the agreement. So such agreements might be considered partly void and partly valid. The effects of illegal agreements are discussed in Section 5.5.

As with other areas of law, the exact rules about legality vary in different jurisdictions. However, there are some basic principles about the kinds of agreements free market courts will not enforce because of illegality. This Chapter discusses many of these basic principles.

*** **ADDITIONAL REFERENCE:** Chapter 1 (“Basic Aspects of Contract Law”), Section 1.4d contains a more concise discussion of the formation requirement of legality.

5.2 Why Agreements That Violate the Law Are Generally Unenforceable

As noted in Section 5.1, courts in free market jurisdictions generally will not enforce agreements that violate the law. This is true even though the law generally wants to promote the enforcement of contracts, in order to protect the reasonable expectations of the parties, and promote economic activity.

The reasons the law will not enforce illegal agreements may seem obvious. But it may be useful to discuss them, in order to help think about which agreements should be considered “illegal.”

*** **WHY IS THIS IMPORTANT?** Why do courts in free market jurisdictions refuse to enforce agreements that violate the law?

There are several reasons courts generally will not enforce such agreements, despite the general policy to enforce real agreements. First, many laws are designed to protect the public. Enforcing contracts that violated such laws would hurt the public. An example would be an agreement to commit murder for money. To enforce such an agreement could encourage murder because, although the killer might risk going to jail, he might be more willing to take that risk if he knew his fee would wait for him when he was released from jail. And obviously, courts do not wish to actually order a party to perform an agreement that would mean committing a crime!

Second, the law wants to protect the integrity of the court system. In most societies, courts are the primary places where law is applied. Courts

should try to achieve justice, and to promote the rule of law, which will be discussed in more detail in Section 5.4a, below. In most cases, if courts enforced illegal agreements, they could not achieve justice or promote the rule of law.

Third, such agreements may be unenforceable because the law wishes to punish the parties who made the agreements for breaking the law, or agreeing to break the law. And the law wishes to deter such agreements. Of course, in some cases, one party to the agreement may be relatively “innocent” compared to the other party. An example would be agreements that violate laws designed to protect persons like one of the parties to the agreement, such as minimum wage laws. In limited situations like this, the law may allow some remedy for the more “innocent” party, but none for the more “guilty” party. This will be discussed in more detail in Section 5.5, which explains the effects of illegality.

5.3 Agreements Prohibited by Specific Statutes Are Generally Unenforceable

As noted in Section 5.1, agreements may be illegal because their performance violates a specific statute. There are many different kinds of statutes, criminal and civil, that agreements might violate.

In many jurisdictions, different government bodies--usually in the executive branch--issue detailed administrative regulations to help put statutes into practice. The legislature may not have the time or expertise to regulate by itself certain areas that are very complex--such as communications or health care--so executive bodies do so with regulations. As with statutes, courts will not generally enforce agreements that violate these regulations. For convenience in this Chapter, we will simply refer to statutes. But the same basic rules would apply to agreements that violated valid regulations.

In this Section, we will discuss some of the more important kinds of agreements that may be unenforceable because they violate specific statutes. These are agreements that violate:

- (1) criminal or tort statutes;
- (2) gambling statutes;
- (3) usury statutes;
- (4) regulatory licensing statutes; or
- (5) unreasonable restraint of trade statutes.

5.3a Agreements to Violate Criminal or Tort Statutes Are Not Enforceable

Courts will not enforce agreements to commit crimes or torts (non-contractual civil wrongs). Crimes are defined by statutes. In civil law

jurisdictions, all civil wrongs are also defined by statutes. Common law jurisdictions may define some kinds of torts in statutes, and define the rest in court precedent.

(1) Crimes

Courts will not enforce agreements to commit or assist with crimes. Later, this Chapter will discuss a few important specific kinds of agreements that often violate criminal statutes, such as gambling agreements. But for now it is important to know this general rule.

For example, in Case Study 15 in Chapter 1 ("Basic Aspects of Contract Law"), two persons agreed to commit a robbery. This agreement was unenforceable, since robbery violates criminal laws. Courts will not enforce such agreements because it would probably encourage or even assist with the commission of crimes!

In addition, courts generally will not even award restitution of what parties have provided under such agreements. Courts do not wish to be involved in criminal activities even in that respect. So a party who transfers something under an illegal agreement to another party to that agreement generally cannot even recover what he has transferred!

CASE STUDY 116

FACTS Dara works as a night security guard at a bank. Narith says he will give Dara \$300 if Dara promises not to lock a back door leading to the bank vaults on a certain night. Dara agrees and takes Narith's money.

However, on the night of the planned robbery, Narith discovers that the door is locked and that he cannot get into the bank! Now Narith wants the court to enforce his agreement with Dara, and at least order Dara to return the \$300.

QUESTION OF LAW Is the agreement between Dara and Narith enforceable?

DECISION No. The agreement to leave the bank door open was an agreement to assist with a crime, and so the agreement is illegal and unenforceable.

Courts will not enforce agreements to commit or assist with crimes. In this case, Dara's agreement to assist in the robbery of the bank was an agreement to assist with a crime (the robbery). Therefore, a court will not enforce the agreement. In addition, the court will not order Dara to return the \$300 to Narith--even though Dara never performed his part of the agreement and Narith did perform his part.

Another important type of agreement that violates criminal statutes is an agreement to sell prohibited articles, such as illegal drugs or weapons. Where parties agree to sell articles prohibited by law, the court will not enforce the agreement.

CASE STUDY 117

FACTS Keary felt unhappy. So she went to a local drug dealer to buy some opium, even though it was a crime to buy or sell opium in her jurisdiction. The drug dealer sold Keary some opium. Keary took the drugs, but decided they were of poor quality. So she went to the drug dealer to demand part of her money back.

QUESTION OF LAW Can Keary enforce this agreement against the drug dealer?

DECISION No. Keary's agreement is void and unenforceable because it is an agreement for the sale of opium, which is prohibited by a criminal statute.

Agreements for the sale of articles prohibited by criminal statutes are unenforceable. In this case, Keary and the drug dealer made an agreement for the sale of opium. But the sale of opium is prohibited by a criminal statute. Therefore, this is an illegal agreement that cannot be enforced, and Keary cannot recover any of her money.

One limit on this rule about prohibited articles is that some jurisdictions say that, where one party to an illegal agreement is significantly less “guilty” of wrongdoing than the other party, and the less guilty party has done nothing seriously wrong, that less guilty party can get restitution, under quasi-contract. For example, it is a crime in many jurisdictions to sell cigarettes or alcohol to a minor. If an agreement to sell such articles to a minor was made, it would be void, and even the minor could not enforce it. But the minor might be able to get restitution of what she had already paid, as the minor could under the rules about disaffirmance of voidable contracts explained in Chapter 4 (“Capacity”), Section 4.4a. That is because the minor might be viewed as significantly less guilty than the adult who tried to sell him the prohibited articles. This limit on the general rule will be further discussed in Section 5.5a, below.

*** **ADDITIONAL REFERENCE:** Chapter 4 (“Capacity”), Section 4.4a contains further discussion of disaffirmance of voidable contracts by minors.

(2) Torts

Agreements to violate statutes that prohibit torts (non-contractual civil wrongs) are also void and unenforceable. In the civil law tradition, the rules about this kind of civil wrong are found in statutes.

In the common law tradition, torts are generally governed by court precedent, although some torts may be governed by statute. Court precedent is one source of public policy. In this Chapter, we will discuss in detail the legality of agreements to commit torts in Section 5.4, which is about agreements that violate public policy. But the status of such agreements is similar whether they are prohibited by statutes or public policy.

5.3b Many Gambling Agreements Are Not Enforceable

In many jurisdictions, courts generally will not enforce gambling agreements. Jurisdictions often prohibit or at least regulate gambling through statutes. This is because, though gambling may be popular, it is often considered to be a dangerous activity.

It appears that some jurisdictions will enforce gambling agreements where the gambling itself is legal. However, it appears that other jurisdictions refuse to enforce gambling agreements even if the gambling is allowed! Of course, that kind of refusal by the courts would be on the basis of public policy, since no statute in such jurisdictions prohibits the gambling. However, for convenience, we will discuss gambling agreements in some detail in this Section, rather than discuss them again in Section 5.4, which is about public policy.

Gambling can take many forms. These include bets on sporting events, lotteries, casino gambling, and bets on other future events. Perhaps because of this variety, gambling is hard to define. The following is an attempt to do so.

***** DEFINITION:** A **gambling agreement** is an agreement in which parties stand to win or lose some consideration based on the occurrence of some future event over which they do not have complete control, and which therefore contains an element of chance.

In some jurisdictions, courts will enforce certain special types of legal gambling agreements. In France and England, for instance, it appears that horse racing can give rise to legal gambling contracts. In addition, many jurisdictions have lotteries which create legal gambling contracts. In these situations, the government usually receives revenue from these activities, and uses the revenue to further the public welfare, like tax money. In this way, nations try to use a potentially dangerous activity in a way that benefits the public.

In addition, many other enforceable agreements may appear to contain an element of gambling. In these legal agreements, parties may gain or lose some consideration based on the occurrence of events they do not control. For example, insurance agreements are based on the unknown outcomes of future events the parties do not control, such as accidental fires. And many modern financial transactions, such as derivative transactions, are based on unknown future events in various markets. These types of transactions are

generally enforceable. If they were considered to be “gambling,” then they would be exceptions to the general rule that gambling agreements cannot be enforced. The law appears to believe the element of social benefit in these transactions outweighs the harm of the gambling element.

*** **WHY IS THIS IMPORTANT?** Why do many free market jurisdictions prohibit gambling, and say gambling agreements are not enforceable?

Most jurisdictions do not wish to encourage gambling agreements. There are a number of reasons for this. First, many persons appear to view gambling as an immoral way to make money. This may be because the money does not seem to be earned primarily through labor or merit, but instead through chance or luck.

In addition, although gamblers are encouraged to think they have a good chance to win, it appears that most gamblers lose more money than they win. The reason is that many parties involved in gambling, such as casinos, are very sophisticated. Usually, these parties have already calculated the chances of winning--and made sure that eventually the average gambler will lose and the sophisticated gambler will win! Some say this can harm society. Some people are desperate to escape poverty, and they may lose what little money they have by gambling. Others may become addicted to gambling, which can also lead to financial losses. This can also hurt family relationships.

Moreover, gambling in many forms has long been associated with crime. Indeed, some casinos have been used to launder money from crimes, such as extortion or drug dealing. So in some cases money made from gambling may actually be tainted by crime. And some of those who benefit from the activity may be criminals.

On the other hand, it may be argued that when courts refuse to enforce gambling agreements, it actually encourages gambling creditors to try to enforce such debts in other ways--such as violence or blackmail. Organized gambling also creates jobs in casinos and other gambling organizations, and may assist development to some extent.

In addition, governments can gain funds from legal gambling. Taxes on gambling institutions like casinos increase government revenue. In fact, governments may actually arrange organized gambling to raise revenue, such as through government-run lotteries.

So societies usually try to balance the potential benefits of gambling with the potential harm. But the result is that most free market jurisdictions do not encourage most forms of gambling. If governments do allow gambling, it is usually only in limited situations. And governments often regulate such gambling heavily, in order to control possible criminal activity.

CASE STUDY 118

FACTS Thim is a cyclo driver. After work, he relaxes with colleagues by playing cards for money. All the players agree that they will pay any debts they incur, although this kind of gambling is prohibited by a statute in their jurisdiction. Last week, Thim was very lucky and now his three gambling partners owe him 17,000 riels. However, none of them wants to pay his debts.

QUESTION OF LAW Can Thim enforce his agreement in court?

DECISION No. Thim's agreement with the other gamblers is void and cannot be enforced.

In many jurisdictions, gambling agreements are not enforceable. In this case, the agreement Thim made with the other card players was a gambling agreement. The agreement was illegal under a statute. So Thim cannot enforce it, and cannot collect the 17,000 riels.

Sometimes people bet about the occurrence of other future events. Such gambling agreements may also be unenforceable.

CASE STUDY 119

FACTS Sarakhan and Narong were farmers in the northwest. One evening, Sarakhan told Narong that Sarakhan believed his rice harvest would be larger than Narong's harvest. They decided to bet about Sarakhan's rice yield. They agreed that if Sarakhan's harvest yielded less than 13 tons, then Sarakhan would pay Narong 50,000 riels. However, if Sarakhan's harvest was 13 tons or more, then Narong would pay Sarakhan 50,000 riels. This kind of gambling agreement was illegal in this jurisdiction.

The rainy season that year was poor, and both men's crops suffered from a drought. Sarakhan's rice harvest yielded only 10 tons. When Narong went to claim his 50,000 riels from Sarakhan, Sarakhan said: "Sorry, Narong, but this drought has hit me very hard, and I cannot afford to pay you." But Narong had also been hurt by the drought, and he asked the court to enforce the agreement.

QUESTION OF LAW Will the court enforce Narong's agreement with Sarakhan?

DECISION No. The agreement about the outcome of Sarakhan's rice harvest is an illegal gambling agreement.

In many jurisdictions, gambling agreements generally cannot be enforced. In this case, the agreement Sarakhan made about the rice yield was a gambling agreement, because the parties were to win or lose money based on the outcome of a future event over which they did not have control.

This agreement was illegal under a statute. Therefore, the agreement cannot be enforced. The court will not order Sarakhan to pay Narong the 50,000 riels.

In some jurisdictions, loans made to enable someone to gamble are not considered gambling agreements, so it appears they can be enforced. For example, if Chhieng lends Rotana 5,000 riels so Rotana can continue gambling with him, that is not a gambling agreement. The reason seems to be that the loan is considered to be separate from the gambling. However, it could be argued that such a loan agreement promotes immorality (gambling), as discussed in Section 5.4h below, and that it should not be enforced for that reason. And it appears that other jurisdictions will not enforce such loan agreements.

5.3c Usurious Loan Agreements Are Not Enforceable Beyond the Legal Interest Rate

In most free market jurisdictions, loans with interest are generally legal. However, loan agreements are illegal if the rate of interest charged is higher than the rate allowed by the law of the jurisdiction. Such agreements are called usurious agreements. They are generally not enforceable beyond the legal rate.

In addition to repaying the money loaned, debtors are often required by the loan agreement to pay creditors an extra sum of money called interest. Interest is usually a certain percentage of the money loaned, although it may be expressed in other ways. So if 100 riels is loaned at 10% interest, then the debtor will have to repay the creditor 110 riels. The interest is like a fee to compensate the creditor for having lent some of his money to the debtor, instead of putting it to some other use.

***** DEFINITION:** A **usurious agreement** is a loan agreement in which the amount of interest charged is higher than the rate allowed by law.

Usury laws forbid the lender to charge more than a certain interest rate. The actual limits on interest vary greatly. In fact, many Muslim nations forbid lenders to charge any interest, although it appears such nations may have other ways to structure loan contracts in order to compensate lenders. In addition, many jurisdictions have different limits for different types of transactions, and many say the limits do not apply to loans to corporations. In general, usury statutes are intended to protect the individual borrower from excessive interest.

One problem which may occur in calculating interest is how the percentage rate is calculated over time. It is necessary to know this in order to know how much interest is really being charged. Usury statutes specify the highest rate that can be charged for a certain time period, such as “20% per year.” And usually the interest rate part of an agreement will also show this. For example, an agreement may say “interest at 5% per year,” which would

mean that a principal of 100 riels would accrue 5 riels in interest at the end of one year. But if the agreement said “5% interest per month,” then a 100 riels principal would accrue 5 riels each month--or 60 riels per year (5 riels x 12 months). This would be the same as 60% interest per year!

In addition, for some loans, compound interest is charged. This is really interest upon interest. It means that, at a specified time, the accrued interest is added to the principal sum. The total result is treated as a new principal for the calculation of the interest for the next period. For example, a loan of 100 riels at 5% interest per month, compounded monthly, would mean that at the end of the first month, the new principal would become the original 100 riels plus the 5 riels in interest that had accrued over that first month. So at the end of the first month, the new principal would be 105 riels. At the end of the second month, the debtor would owe a principal of 105 riels plus 5% interest on that 105 riels--a total of 110.25 riels. The effect of the compounding may be small at first, but over time it makes the total amount owed grow much larger.

The effect of a usurious loan agreement is different in different jurisdictions. The statutes that define the maximum interest rate generally say that any higher rate is illegal and cannot be enforced. For example, a statute may say that no loan agreement may charge over 5% per year in interest. This means that any rate over 5% is illegal, and a court will not enforce a loan agreement beyond that rate, no matter what the agreement says. Many jurisdictions will enforce a usurious loan agreement as if it charged interest at the statutory limit. For example, if a loan agreement charged 10% interest, but 5% was the maximum allowed by law, these courts would enforce the contract as if it said 5%! Of course, these courts would also order the lender to return any amount of interest already paid that is higher than the legal rate. Other jurisdictions say that usurious agreements are enforceable, but only to the extent that the borrower must repay the principal. In other words, the lender cannot recover any interest, as a penalty for charging an illegal rate. And other jurisdictions will not enforce such agreements at all, and not even allow the lender to recover any principal still owed by the debtor!

CASE STUDY 120

FACTS Bora and Sarith lived in a jurisdiction where a statute said 20% per year was the maximum rate of interest that could be charged on loans, with a few exceptions. Bora borrowed \$100 from Sarith, with 10% interest to be repaid with the principal in three months. This meant that, at the end of the three months, Bora would owe Sarith \$110.

However, when it was time for Bora to repay the loan, Bora gave Sarith only \$105. Bora said he found out that the legal rate of interest was 20% per year, and so he was not obligated to pay Sarith any more than \$105.

QUESTION OF LAW Can Sarith recover the remaining \$5 from Bora?

DECISION No. The loan agreement between Bora and Sarith charged a usurious rate of interest, and it is not enforceable at that rate.

Lenders can recover no more than the legal rate of interest on their loans. In this case, the loan agreement between Sarith and Bora did not seem usurious, because 10% is less than the 20% legal limit on interest. But that 10% rate was only for three months. In reality, the interest rate on Bora's loan was 40% per year--because if the loan period had been for one year instead of three months, the 10% per three months interest rate would have resulted in 40% per year! The highest rate allowed in this jurisdiction is 20% per year, or 5% per three months. Five per cent of \$100 is \$5. So in this case, Sarith cannot recover more than \$105 from Bora.

In many jurisdictions, courts will enforce agreements like this at the legal rate (in this case 20% per year). Other jurisdictions might enforce the agreement but allow no interest to be charged, or refuse to enforce the agreement at all.

Some usurious agreements are disguised by money lenders in the hope that the borrower or the courts will not be able to tell that they are usurious. And sometimes this is hard for courts to detect, because there are so many ways to do it! Examples of ways to disguise usurious agreements include requiring the borrower to sell the lender something at a price below its market value; to buy something from the lender at a price higher than its real value; or to antedate the loan agreement--to state that the borrower received the money earlier than he actually did--so it looks like the interest is being charged for a longer period than it really is. These methods are usurious if the real effect is that the borrower must pay more interest than the law allows. Of course, to find out whether that is happening, courts must look carefully at all the facts surrounding the loan agreement.

5.3d Certain Agreements Made by Those Who Have Violated Regulatory Licensing Statutes Are Not Enforceable

When persons or businesses fail to comply with licensing statutes that apply to their work, and then make agreements as part of that work, those agreements may not be enforceable. For example, a government body may require that veterinarians get a license in order to practice. When parties who fail to meet such requirements make business agreements, the general rule is that they cannot enforce agreements made after they have violated statutes that mainly protect the public's health or welfare. But they can enforce agreements made after they violate statutes that mainly raise money for the government.

***** DEFINITION:** A **licensing statute** is a statute which requires that some competent authority (generally a government body) formally give permission--a license--in order for someone to do something.

Often, such statutes require licenses for persons to do certain business activities or professions. In general, licensing statutes are divided into two categories:

- (1) regulatory statutes that mainly protect the public's health or general welfare; and
- (2) revenue statutes that mainly raise revenue for the government.

These two categories are discussed below.

(1) Regulatory statutes primarily protect the public's health, safety, or general welfare. Licensing requirements in regulatory statutes usually say that certain types of workers must meet certain standards of competence before they are permitted to do their work. Examples of such workers include: nurses, doctors, dentists, lawyers, builders, architects and public accountants. Courts will not enforce an agreement for such work made by a party who has broken a regulatory requirement. If such persons have no licenses, it appears that they cannot collect fees for their services. In fact, they may even be guilty of crimes!

CASE STUDY 121

FACTS Tech studied architecture at university. However, he failed his qualifying examinations. So he did not become legally licensed to practice as an architect. Nevertheless, he opened an office in Phnom Penh.

One day, Sophea asked Tech to draw up plans for a new mansion in Prey Veng province. They signed an agreement under which Tech charged Sophea a \$500 fee. But after Tech did the work, Sophea refused to pay the fee.

QUESTION OF LAW Would a court enforce Tech's agreement with Sophea?

DECISION No, in many jurisdictions. Tech will not be able to recover his \$500 fee from Sophea, because he is not licensed as an architect.

In many jurisdictions, courts will not enforce professional agreements where the professional has failed to get the license required by law for him to practice. In this case, Tech failed to get the architect's license required by law. So he cannot enforce his agreement with Sophea. And this is true no matter how good a job Tech has done!

WHY IS THIS IMPORTANT? Why do many jurisdictions say that unlicensed workers cannot enforce agreements with their clients?

Although this rule may seem harsh, there are several possible reasons for it. Professional licenses are usually given only to persons who have shown they meet a certain standard of competence. Often that competence

is measured through difficult qualifying examinations. An unqualified professional (like an unqualified architect) could make a mistake that would cost lives. This rule tries to deter unqualified persons from posing as skilled workers, and possibly harming the public.

Of course, qualified persons are not perfect, and they also can make mistakes. But at least their qualifications prove that they are able to achieve a certain standard. Moreover, skilled workers are sometimes required to be insured. If something does go wrong, anyone harmed may be more likely to get compensation. Unlicensed workers may be less likely to have such “safety nets.”

(2) Revenue statutes impose requirements primarily as a means of raising money for the government, and not as a way to assure competence. A party who has violated a revenue-raising statute--such as by failing to get a license not related to qualifications, or failing to pay a fee--may still enforce a contract for his work.

For example, if a market stall holder forgets to pay his annual registration fee to the government, he can still enforce his business contracts, such as contracts to sell fruit or get supplies. The reason is that such revenue statutes do not relate to competence. So there is less harm to the general public than with regulatory statutes. A vegetable seller is generally just as capable of selling a tomato whether he has paid such a fee or not. And the same would be true of a licensed architect who forgets to pay an annual license renewal fee, since that does not relate to competence. The only potential harm to the public in these situations is that the government has lost some tax revenue. Of course, the stall holder or architect may still be required to pay some penalty to the government for failing to pay the fee.

5.3e Agreements That Unreasonably Restrain Trade Are Generally Not Enforceable

Agreements that unreasonably restrain trade are generally void and unenforceable in many free market jurisdictions. Many jurisdictions have statutes that forbid unreasonable restraints of trade. Agreements that unreasonably restrain trade may also be unenforceable because they violate public policy, even if they do not violate a specific statute. Such agreements will be discussed in Section 5.4f, below.

***** DEFINITION:** **Agreements that unreasonably restrain trade** are basically those that harm competition or unreasonably restrict a party’s freedom to conduct his trade or business as he chooses.

Of course, this is a very general definition. The exact definition depends on the actual statutes in each jurisdiction.

Generally, restraint of trade means restricting the freedom of a person or business to conduct a trade or business. In a way, all business agreements restrain trade to some extent, because they require the parties to do something, and so limit their freedom.

However, agreements that unreasonably restrain trade conflict with the goals of free market jurisdictions to encourage competition and promote efficient economic activity. This is because, if competitors are “free” to make contracts that actually hurt competition, there will eventually be less “free trade” in the entire market! So the courts and legislators of many jurisdictions look carefully at agreements to make sure they do not unreasonably restrain trade. For instance, an agreement to allow only one brand of computer into a nation would eliminate competition in that nation. Such an agreement would probably restrain trade unreasonably, and be unenforceable, in many jurisdictions.

However, it is important to remember that free market law does not protect individual competitors--only competition. So if a particular competitor loses business--or even loses his entire business--because of fair competition, the laws about trade restraints do not protect him.

Agreements that “unreasonably restrain trade” may take many forms, and this area of law can be very complex. Therefore, we will only discuss a few important types of trade restraints briefly and in a general way. Depending on local law, some types of such agreements are always unenforceable, while others might be unenforceable only in certain situations.

(1) Agreements to Fix Prices -- Agreements to fix (or set) prices so that prices of products will be the same among different competitors are often unreasonable restraints of trade. The reason is that such agreements may cause consumers to lose the benefits of free market competition. When competitors fix prices, the prices are usually unreasonably high. If the price fixers are an important part of the market, consumers may be forced to pay the high prices, because they may have few other choices. So there is less competition about price--which usually means high prices--and less choice for the consumer.

An example of a price fixing agreement would be if the two main bicycle manufacturers in a nation agreed to charge the same high prices for their bicycles, in order to increase the profits they made on each bicycle. If there were few other bicycles for consumers to buy, competition and choice would decrease, and consumers would be forced to pay too much for these products. So such an agreement might be an unreasonable restraint of trade.

(2) Agreements to Divide Territory and Exclude Competitors -- Other agreements to unreasonably restrain trade may divide the territory of a given market among sellers and exclude competitors. This also hurts competition and can encourage a monopoly. Very basically, a monopoly occurs where

one firm is the dominant seller of a particular product or service in a particular market. This may enable the firm to charge high prices for low quality products and exclude competition. In such cases, where consumer choice is restricted, there is less incentive for prices to be reasonable and quality to be good. So consumers may suffer.

CASE STUDY 122

FACTS Yummy and Scummy, the two dominant manufacturers of instant noodle soup in a particular nation, agreed to divide that nation's soup market. They agreed that Yummy would distribute his soup only in the east and north of the nation, and Scummy would distribute his soup only in the west and south. They also agreed to use their market power to keep all other competitors out of the market. A statute in the nation prohibited unreasonable restraints of trade.

One day, Yummy went to visit his aunt in the north of the country. She told Yummy that one of her few pleasures in life was her daily bowl of Spicy Snake soup. Yummy told her that his firm did not manufacture Spicy Snake soup. His aunt showed him a packet of Scummy Spicy Snake soup that she had bought at the local market. When Yummy saw his competitor's product, he became very angry. He went to the market and found that almost every stall holder was selling Scummy soup products. Yummy now had proof that Scummy's products were being sold in the north--a violation of their agreement. Yummy rang his lawyer that evening and asked him to prepare a case against Scummy.

QUESTION OF LAW Is the agreement between Yummy and Scummy enforceable?

DECISION No. The agreement between Yummy and Scummy to divide the national soup market would probably be illegal and unenforceable because it unreasonably restrains trade.

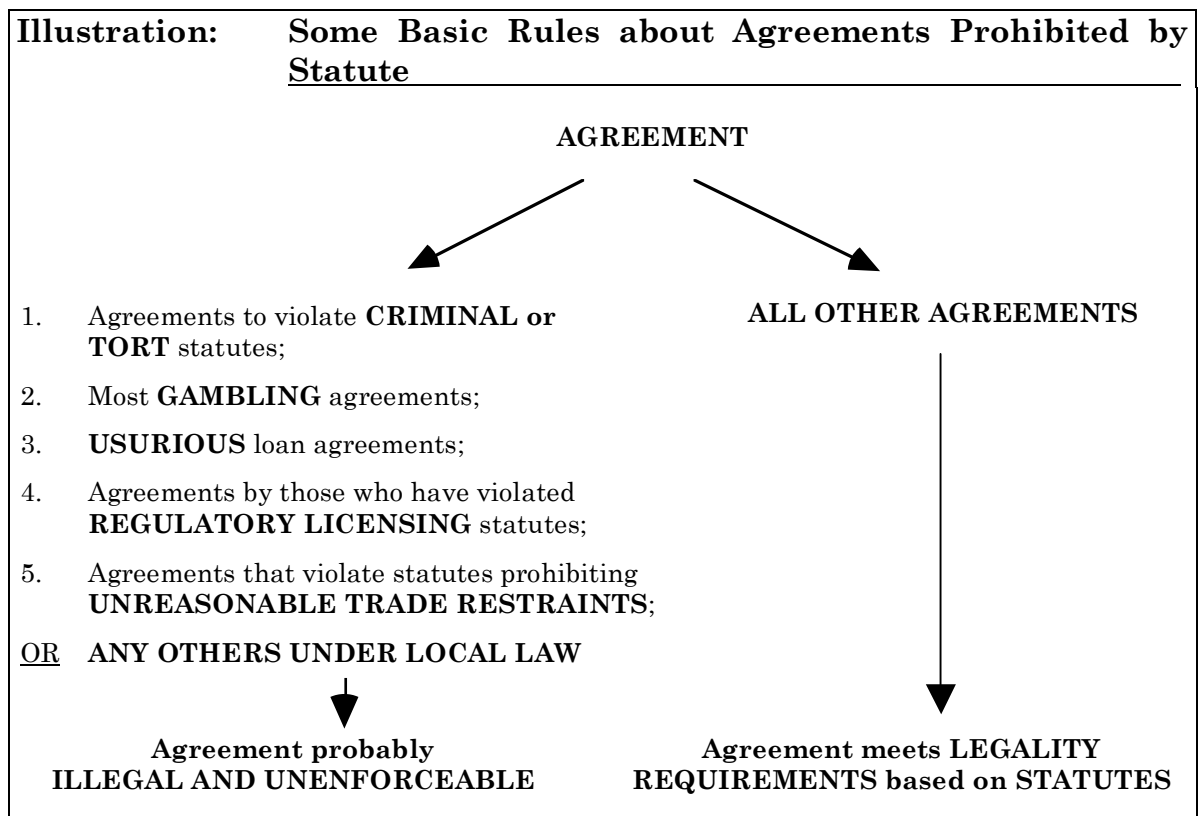
In many jurisdictions, statutes prohibit unreasonable restraints of trade, including agreements to divide territory and exclude competition. In this case, Yummy and Scummy divided their nation's territory and agreed to keep other competitors out. By making this agreement, Yummy and Scummy prevented consumers from benefiting from a wide choice of soup products--and from competition in general. Under this arrangement, the two soup manufacturers would also be able to fix the prices of the soup products. That would probably mean the prices would be unreasonably high. This agreement is probably an unreasonable restraint of trade, which is prohibited in this jurisdiction. So it is probably unenforceable.

(3) Agreements to Limit Production -- Another type of agreement which might unreasonably restrain trade is one that would limit production of a certain product. For instance, two bicycle manufacturers might agree

to produce only 50% of their normal output, in order to make bicycles more rare on the market, and so allow them to charge higher prices. In this situation, the bicycle makers might make greater profits on each bicycle sold. But consumers would suffer. This is because if the supply of bicycles is low, consumers may be willing to pay more for a bicycle. So a manufacturer might make more profit on the sale of one bicycle at a high price than he would if he sold two bicycles at a more competitive price! This kind of agreement would restrict free trade, and prevent normal economic forces from giving consumers a variety of quality goods at reasonable prices.

5.3f Summary of Some Basic Rules about Agreements Prohibited by Statutes

As discussed above in Sections 5.3a-e, many types of agreements are prohibited by statutes, and so are generally unenforceable, in many free market jurisdictions. The chart below summarizes some basic rules about such agreements.



5.4 Agreements Contrary to Public Policy Are Generally Unenforceable

Many jurisdictions say agreements in limited situations are illegal and unenforceable, even though no specific statute forbids them, because

they violate “public policy.” Public policy is difficult to define, but it basically means the good of society.

In some jurisdictions, especially civil law jurisdictions, agreements that violate public policy actually violate statutes--general statutes that simply prohibit any agreements violating “public policy,” or “public order,” as is the case in France. In common law jurisdictions, such agreements may violate rules about public policy developed in court decisions. Whether such agreements are prohibited by “public policy” statutes, or by rules about public policy developed in court decisions, courts in many free market jurisdictions will not enforce them.

This Section discusses agreements that may violate public policy. Section 5.4a explains in more detail what public policy is. The remaining Sections discuss some particular kinds of agreements that may violate public policy.

5.4a Public Policy Is Basically the Promotion of the Good of Society

The law tries to promote the good of society and avoid harming it. In contract law, this generally means that courts will not enforce an agreement if its effect would be contrary to the good of society.

***** DEFINITION:** Very generally, **public policy** is the promotion of the common good and well-being of society.

Courts refuse to enforce agreements because of public policy only in limited situations. Public policy must be clear and widely recognized in a jurisdiction for a court to refuse to enforce an agreement on that basis. Perhaps the most reliable way to determine public policy is through the statutes and other activities of the legislative branch of government. Court decisions and executive branch actions are also important sources of public policy. Public policy can sometimes be measured in other ways, such as the acts of religious figures, scholars, or public interest groups.

As noted above, public policy is very difficult to define. It may change from one jurisdiction to the next, and from one generation to the next. However, public policy does not develop quickly. This is because it takes time for a new idea of the common good to be accepted by society, and to appear in legislation, court decisions, or other sources of public policy. And what one jurisdiction or generation considers to be the common good may not be true of another jurisdiction or generation.

For example, in some jurisdictions, it was for a long time considered contrary to public policy for legislatures or courts to recognize certain rights of unmarried couples who lived together in long-term unions, particularly homosexual couples. This was because such activity was considered immoral.

Now many unmarried couples live together, and it has become more accepted in some jurisdictions. So legislatures and courts in such jurisdictions may now recognize certain rights of such couples. That indicates that public policy in those jurisdictions has changed to some extent. Of course, other jurisdictions may not agree.

***** WHY IS THIS IMPORTANT?** Why do some courts refuse to enforce certain agreements on the basis of “public policy,” even though no specific statute prohibits those particular agreements?

When courts refuse to enforce agreements on the basis of “public policy,” it may appear to conflict with the idea of freedom of contract. Some might argue that courts should only refuse to enforce agreements when the legislature has indicated, through a specific statute, that that kind of agreement should not be enforced. In addition, it might be argued that “public policy” is a vague idea, and it might give courts too much discretion to refuse to enforce agreements they do not like. This might also harm “the rule of law.” People may not agree about what the rule of law means. Basically, many consider it to be the idea that law should be applied fairly and consistently, based on well understood rules--not based on the personal feelings or arbitrary decisions of powerful officials or judges. Some believe the “rule of law” can exist even where legal rules do not reflect the will of the people, since arguably even a dictator can enforce his rules fairly and consistently. Others say that if even a “fair dictator” can change the rules without the people’s consent, then it is still that dictator who rules--not the law. In any case, these are legitimate concerns, and courts that apply the “public policy” rules may have problems because of them.

On the other hand, in jurisdictions where courts refuse to enforce contracts because of public policy, it appears that the courts are trying to remain flexible enough to handle situations the legislature may not have envisioned, or may not have addressed clearly. For example, if two parties agree to start a prostitution agency, that agreement would probably be viewed as against public policy by courts in many societies. And it might be against public policy for a company to agree to dispose of dangerous chemical waste by dumping it on the ground in a populous area. Agreements like that might be void and unenforceable--even if the legislature had passed no statute specifically forbidding such activities. Of course, in many jurisdictions, there is at least some legislation indicating that prostitution and pollution are against public policy. And in common law jurisdictions, there is a long tradition of the development of legal rules through court decisions, where legislation does not exist or is not clear in a particular legal area. The idea is that courts should carefully supplement the legislature’s role in promoting the rule of law--not create uncertainty, or violate the will of the legislature, or harm the legitimate intentions of the parties.

In deciding whether to refuse to enforce an agreement because of public policy, courts try to balance the interests of parties to a contract against the

interests of society as a whole. When the interests of society in not having the agreement enforced outweigh those of the parties in having the agreement enforced, the courts may refuse to enforce the agreement based on public policy. It is also important to remember that such situations are rare. They only occur when it is clear that the agreement is harmful to the good of society.

There are several types of agreements which are considered to be contrary to public policy in many jurisdictions. We will discuss seven types of such agreements, though there may be others in different jurisdictions. The seven we will discuss are agreements which:

- (1) involve the commission of torts;
- (2) harm the freedom of marriage;
- (3) harm the administration of justice;
- (4) harm public service or interfere in public affairs;
- (5) unreasonably restrain trade;
- (6) promote immorality; or
- (7) contain improper exculpatory clauses.

These types of agreements are discussed in the following Sections.

5.4b Agreements to Commit Torts Are Not Enforceable

Courts will not enforce agreements to commit torts, because enforcing such agreements would be contrary to public policy. For example, common law courts will not enforce an agreement between private parties to falsely imprison someone, even if no statute prohibits it, because this is a tort under rules developed by courts. As explained in Section 5.3a above, courts will also not enforce agreements to commit torts defined by statute.

***** DEFINITION:** A **tort** is basically a non-contractual civil wrong for which the wronged party--not society--can seek compensation.

Some torts are also crimes. But the basic difference is that tort lawsuits are brought by private parties, whereas criminal actions are brought by the government on behalf of society.

In common law jurisdictions, torts are primarily defined by legal rules developed by courts, although some torts are defined by statutes. So even where no statute specifically prohibits such wrongs, courts will not enforce agreements to commit them. The reason for this rule is that if courts enforced such agreements, it might encourage parties to commit torts--and actually involve the courts in committing the wrongs!

CASE STUDY 123

FACTS Puth decides he wants to destroy the reputation of a certain politician who has said things Puth dislikes. So Puth and Sarvy agree that Puth will pay Sarvy \$10,000 to publish an article in her newspaper which falsely accuses the politician of doing specific acts which are treasonous.

However, just before the date for publication, Sarvy decides that it would be wrong to publish these false statements. So she refuses to publish them. Puth asks the court to enforce the agreement.

QUESTION OF LAW Can Puth enforce his agreement with Sarvy?

DECISION No. Puth cannot enforce this agreement because it is an agreement to commit a tort: defamation.

Courts will not enforce agreements to commit torts, even where no statute specifically prohibits them, as often occurs in common law jurisdictions. In this case, Puth and Sarvy agreed to defame a politician by publishing harmful statements about that person which they knew were false. This is not a crime in most jurisdictions, but it is a tort or civil wrong. Therefore, Puth cannot enforce the agreement.

5.4c Agreements That Harm the Freedom of Marriage Are Not Enforceable

In many jurisdictions, agreements which harm the freedom of marriage are not enforceable because they violate public policy. Most jurisdictions want to encourage good marriages, and maintain what many view as their sacred nature. In order to promote good marriages, many jurisdictions wish to protect the individual's right to freely choose who the individual will marry, and to protect that choice after the marriage occurs. So many agreements that interfere with those rights are unenforceable. Some jurisdictions also have statutes that protect the freedom of marriage.

Several types of agreements are unenforceable in many jurisdictions because they harm the freedom of marriage. Three of these types are discussed below.

(1) Agreements to Marry -- Many jurisdictions will not enforce agreements to marry, or at least will not order the parties to marry each other. In Australia and England, for example, courts will no longer enforce promises to marry. In the past, agreements to marry were valid contracts in many jurisdictions. This may have been because such agreements were like commercial agreements, to some extent. But many jurisdictions will no longer enforce such agreements. This is an example of a change in public policy. It may seem odd that some courts now promote marriage by not enforcing agreements to marry! But many jurisdictions want to promote good, voluntary

marriages--not just any marriages. And in many jurisdictions, the freedom of marriage includes a person's freedom to change his mind before the marriage.

However, it also seems likely that a party could at least get restitution of what he had transferred to the other party because of a marriage agreement, under quasi-contract--as long as what was transferred was actually part of the marriage agreement, and not a gift. It also appears that some jurisdictions might compensate a party who changed his position in reliance on such a marriage agreement, such as by spending money to prepare for a wedding, even if the agreement is not enforceable. In that kind of situation, a court might consider awarding a party his reliance damages, under a theory of promissory estoppel. These potential remedies will be discussed in Section 5.5a, on the effect of illegal agreements.

CASE STUDY 124

FACTS Bunny agreed to marry Samnang in exchange for his promise to marry her and give her one damlung of gold. Samnang gave her the gold, but on the day before the marriage, Bunny decided she did not wish to get married. Samnang asks the court for help.

QUESTION OF LAW Can Samnang enforce his agreement with Bunny?

DECISION Perhaps. Courts will not order Bunny to marry Samnang, but courts in some jurisdictions would order her to return the gold.

Many modern courts will not enforce marriage agreements, and those that will are likely to award only compensation--not order a marriage to occur. In this case, Bunny broke her marriage agreement with Samnang. Although courts in many jurisdictions would not enforce this agreement, some courts would order Bunny to provide restitution of the gold Samnang had given her under the agreement. It appears that some jurisdictions would say they were enforcing the agreement and awarding restitution damages to Samnang. Others might say they were not enforcing the agreement, but only giving Samnang restitution under quasi-contract.

In many jurisdictions, agreements to marry are also unenforceable when they are made by persons who are already married. The reason appears to be that, if such agreements were enforceable, it might lead to immorality or criminal activity. Such agreements probably weaken the existing marriage. They could also lead to bigamy--having more than one spouse at a time--which is illegal in most free market jurisdictions. And they might even lead to harm to the spouse who is not a party to the agreement.

*** **ADDITIONAL REFERENCE:** Chapter 1 ("Basic Aspects of Contract Law"), Section 1.5 contains further discussion of quasi-contract; Chapter 6 ("Formality"), Section 6.3d contains further discussion of agreements to marry and related formality requirements; Chapter 7 ("Other Contract Formation

Problems"), Section 7.8 contains further discussion of promissory estoppel; and Chapter 10 ("Remedies"), Section 10.4 contains further discussion of restitution.

(2) Agreements Not to Marry -- Agreements in which a party promises not to marry at all; not to marry particular persons; not to marry anyone except a particular person; or not to marry for a particular period of time are void in many jurisdictions. However, some jurisdictions say an agreement is not void if it deters marriage but does not prevent it. For example, under this rule, an agreement to live or work far away from a potential spouse might be enforceable, since it would deter marriage, but not prevent it.

CASE STUDY 125

FACTS Colonel Monocle, leader of the Blue political party, has a 20-year-old daughter named Liberty. Liberty is madly in love with Freeman. However, Freeman's father is Koolman, leader of the Pink political party. Because the Blue Party dislikes the Pink Party, Colonel Monocle is horrified that his daughter loves Koolman's son. The Colonel wants Liberty to marry Vuth, the son of a friend of his.

The Colonel asks Liberty to agree not to marry anyone except Vuth. In return, the Colonel promises to buy her a stallion from the Hotblood Stud Farm. Liberty agrees. But after meeting Vuth, she decides she wants to marry Freeman.

QUESTION OF LAW Can the Colonel enforce his agreement with his daughter?

DECISION No. The Colonel's agreement with his daughter restricts the freedom of marriage, so it is void and unenforceable.

In many jurisdictions, agreements not to marry are generally unenforceable because they violate public policy. In this case, Liberty agreed not to marry anyone but Vuth. But Liberty is an adult who has the right to marry anyone she chooses. This agreement clearly restricts Liberty's right to do that. So the Colonel cannot enforce it.

(3) Marriage Brokerage Agreements -- Marriage brokerage agreements are void in many jurisdictions. These agreements occur where one party promises to find a spouse for another party in exchange for a fee. The reason these agreements are unenforceable in many jurisdictions is that it violates public policy in such jurisdictions for brokers to arrange marriages for money. The idea appears to be that such marriages may be more likely to prove unsuitable to one or both spouses, since the broker may be motivated--by money--to arrange a marriage as quickly as possible, whether it is good for the marrying parties or not.

5.4d Agreements That Harm the Administration of Justice Are Unenforceable

Agreements that harm the administration of justice are void and unenforceable. The administration of justice basically means the operation of the legal system. That generally includes the courts and those who enforce the laws, such as the police.

An example of an agreement that would be unenforceable because it would harm the administration of justice would be one in which a person agreed to pay money to a witness--or the judge--if that person won a lawsuit. Such an agreement would harm justice, because it would make it difficult for the court to base its decision solely on the relevant law and facts. This could cause an incorrect or unfair decision, instead of justice.

CASE STUDY 126

FACTS In a criminal case, the prosecution alleges that Thrasher beat up Scrummy after finding part of a dead rat in his Scrummy brand soup. Scrummy has no memory of the beating because of his injuries. The prosecution says Huot was the only person who saw Thrasher beat up Scrummy, and that Huot will be called to appear in court as a witness.

However, Huot works for a rival soup manufacturer named Yummy. Yummy is happy that Scrummy was hurt. He does not want Thrasher to be found guilty at the trial. Yummy knows that if the prosecution has no witness to the beating, then it is likely that there will not be enough evidence to convict Thrasher. So Yummy tells Huot to take a holiday in Preah Vihear and not return until the trial is over, when Yummy will give Huot \$100. Huot agrees and takes the holiday.

As the trial date approaches, the prosecution cannot find Huot. Thrasher is acquitted. But when Huot returns from Preah Vihear and asks Yummy for the \$100, Yummy just laughs and tells him to get back to work.

QUESTION OF LAW Can Huot enforce his agreement with Yummy?

DECISION No. Huot's agreement with Yummy harms the administration of justice, so it is void and unenforceable, even if it does not violate a specific statute.

Agreements that harm the administration of justice are unenforceable. In this case, Huot and Yummy agreed that Huot would make himself unavailable to testify in the prosecution of Thrasher--even though they knew Huot would be an important witness! This kind of agreement harms the administration of justice, because it prevents the court from hearing all the evidence required to make a fair decision, based on all the relevant facts. So the agreement is contrary to public policy, and Huot cannot enforce it.

It also harms the administration of justice for a party to make an agreement to prevent those who enforce the law (such as the police) from enforcing it against that person. For example, if a business owner has evaded tax on his profits, and a tax inspector agrees not to prosecute him in return for a lifetime's supply of noodle soup, that agreement would be unenforceable. The reason is that it would prevent the law from being properly enforced, and so harm the administration of justice.

5.4e Agreements That Harm Public Service or Interfere in Public Affairs Are Not Enforceable

Agreements that harm public service or interfere in public affairs are void because they violate public policy. This is true under judicial rules in common law jurisdictions, and there may also be statutes that say so in both civil law jurisdictions and common law jurisdictions. These kinds of agreements harm the legitimate functions of government. So they harm the interests of the entire nation.

(1) Agreements That Harm Public Service (Official Corruption)

Agreements that harm public service are unenforceable. They are agreements under which a public official performs official acts on the basis of unauthorized compensation--bribes--instead of the best interests of his society. Such agreements are examples of official corruption. Two types of such corruption will be examined in this Section: general corruption and bidding corruption.

***** WHY IS THIS IMPORTANT?** Why are agreements that harm public service unenforceable? Why is official corruption contrary to public policy?

The law will not enforce such agreements because official corruption can hurt a nation badly. When important public decisions are made on the basis of the personal profit of a few officials--instead of what is best for the entire society--those decisions are often bad ones which harm the nation. For example, awarding an important government contract to the bidder who has paid the largest bribe, instead of the best qualified bidder, can result in poor quality work. It may also be dangerous.

Official corruption can discourage investment. Most responsible investors want to rely on their business abilities and the rule of law. Most do not want to lose their investments because an official decides their bribe is not big enough, or that someone else can pay a bigger one. And most want to be able to enforce contracts based on the law.

Official corruption can also slow development in other ways. It robs the government of precious resources, but often provides no benefit to most people. This lack of resources can prevent advances in every area of public work,

including health care, education, law, public works, the environment, and national defense.

In addition, widespread official corruption can shatter the public's faith in the government. Ordinarily honest individuals may be unable to get what they deserve through merit or legal ways. So they too may be forced to use corrupt practices. In fact, there may be less motivation for most people to work hard at school or at a job if advancement is not related to merit. In the end, this may result in a lack of qualified and hard working persons to develop the nation. In addition, there may be little trust in the legal system. Court cases may be decided based on which party pays the larger bribe--not on law. So less wealthy people may be discouraged from trying to assert their rights.

Finally, official corruption can reward unqualified members of society with power and influence. The result is that persons with limited abilities may end up controlling important parts of society. When unqualified persons rule and qualified persons are excluded from power, the results can include poverty, poor health, ignorance and violence.

No nation is free from official corruption. But many nations recognize its bad effects and try to fight it. Of course, this can be difficult, because corruption may result from things that are hard to change, such as low government wages.

(1) General Corruption -- Agreements that involve paying bribes to public officials are unenforceable. Such agreements can take many forms. Examples include agreements to sell public jobs (such as paying money to become a ministry official), and agreements to obtain pardons or paroles (such as giving a new Mercedes to a prison official in return for a pardon of an imprisoned person). Some of these illegal agreements may also harm the administration of justice, as explained in Section 5.4d, above.

CASE STUDY 127

FACTS Gummy is a food scientist who supervises the testing of soup products at the Ministry of Soup. Gummy is also the son of a soup magnate named Scrummy.

The Ministry has been testing the latest Scrummy product: Monkey Eye noodle soup. A junior technician named Sen finds that the soup contains an artificial substance which is prohibited by soup regulations because it may harm people. Sen submits a report recommending that the soup be banned from sale. Gummy tells his father Scrummy about the report. Scrummy asks Gummy to pay Sen to destroy the report and write a new one that approves the product.

Gummy and Sen agree that Gummy will pay Sen \$5,000 to destroy the old report and submit the new one. Gummy pays Sen the \$5,000. But the next

day, Sen refuses to write a new report--and sends the old one to the Minister and to the press! Gummy asks the court to enforce his agreement with Sen.

QUESTION OF LAW Can Gummy enforce his agreement with Sen?

DECISION No. The agreement between Gummy and Sen harms the public service, so it cannot be enforced.

Agreements of public officials to perform official acts in exchange for some consideration beyond their salaries are unenforceable. In this case, Gummy and Sen agreed that Sen would destroy his report about the illegal substance in Scummy soup and write a new false one, in exchange for \$5,000. This is an agreement of a public official to change official actions in exchange for money from a private source. So it is illegal and unenforceable. In fact, the agreement could harm public health. If the false report is published, and the Scummy soup remains on the market, the soup might harm many people.

(2) **Bidding Corruption** -- Agreements that reflect bidding corruption are also unenforceable because they harm public service. In most jurisdictions, important government contracts to provide services and goods are bid upon by private companies. Examples include construction and telecommunications projects. Bidding corruption occurs when bidders give public officials money or other benefits in return for the contracts. Most free market jurisdictions believe that this kind of corruption harms society, leading to poor work, wasting government money, and even endangering people's lives.

CASE STUDY 128

FACTS The Minister of Defense wants to make sure his soldiers get good rations. So he solicits bids for a contract to supply fifty million packets of instant noodle soup for the Army. By statute, the lowest viable bid will get the contract.

Two instant soup manufacturers named Yummy and Scummy are the only viable bidders. Yummy's bid is for \$4,000,000, and Scummy's bid is for \$6,000,000. After Scummy's bid is submitted, he rings Pochin. Pochin works at the Defense Procurement Office and will be responsible for the final decision about who gets the soup contract. Scummy asks Pochin to do his best to make sure Scummy wins the contract. Pochin agrees, in return for Scummy's promise of a \$100,000 payment. Pochin complies with Scummy's request, and Scummy's \$6,000,000 bid is accepted.

The next day, the Minister's security aide tells the Minister that she has discovered corruption at the Procurement office. The Minister rings Scummy, and tells him the Ministry is canceling the contract. Scummy threatens the Minister with a lawsuit, and refuses to give Pochin the \$100,000 he had promised.

QUESTIONS OF LAW Can Pochin enforce his \$100,000 agreement with Scrummy? Can Scrummy enforce his agreement with the Ministry?

DECISION No. The agreements are unenforceable by Pochin or Scrummy, because they harm public service. The agreement with Pochin violates public policy and possibly the bidding statute. The soup contract violates the bidding statute.

Agreements to obtain public contracts through bribes are unenforceable because they violate public policy. Here, Scrummy and Pochin agreed that Pochin would do his best to make sure Scrummy would get the soup contract, even though Scrummy's bid was higher than Yummy's, and the bidding statute required the contract to go to the lowest viable bidder. In return, Scrummy promised to give Pochin \$100,000. This corrupt agreement cannot be enforced. It might violate the statute itself, depending on how the statute was written. But even if it did not violate the statute, it would not be enforceable because it violates public policy.

As noted above, statutes often require that public contracts be awarded to the lowest viable bidder. Here, the Ministry (because of the actions of Pochin) awarded the soup contract to Scrummy, who did not have the lowest viable bid. So the soup agreement violated the bidding statute, and Scrummy cannot enforce it.

(2) Agreements That Interfere in Public Affairs and Harm the National Interest

Agreements that interfere in public affairs and harm the national interest are unenforceable because they violate public policy. Public affairs are affairs of the government and other public institutions. The national interest is the well-being of the nation. An example of the national interest is the protection of national borders.

This Section will discuss two types of agreements that interfere in public affairs and harm the national interest: agreements which damage a nation's security, and agreements which harm relations with other nations. There are very few situations where courts refuse to enforce agreements on this basis, because few agreements really have such harmful effects. The law does not wish courts to act in this area unless the harm to the national interest is real and very serious.

(1) Agreements that damage a nation's security are unenforceable. For example, an unauthorized agreement to sell national secrets to a foreign government would generally damage a nation's security. In addition, it would generally harm a nation for its nationals to trade with another nation officially at war with the first nation. This rule might also apply to trade with a guerrilla group that is fighting to overthrow the government of a nation. Such agreements may actually help the enemy nation or group! In addition, it

may be immoral to profit by trading with an enemy while fellow citizens die in a war with that enemy. Such agreements, if made during a war, are illegal and unenforceable in many jurisdictions.

***** CASE STUDY 129**

FACTS Because of a border dispute, the neighboring countries Vadia and Gordia declared war on each other. Three days after the declarations of war, Chhay, a Gordian shoe manufacturer, signed a foreign export agreement with a Vadian distributor. Under the agreement, Chhay was to supply 20 container loads of boots to the Vadian distributor. However, the border between the two countries was sealed off, and the boots could not get through. The Vadian distributor threatened to sue Chhay for not performing the contract.

QUESTION OF LAW Can the Vadian distributor enforce this agreement?

DECISION No. The agreement would be unenforceable in many jurisdictions because it damages the security of Vadia and Gordia, harming the national interest.

Agreements that damage a nation's security are illegal and unenforceable. Although very few agreements actually do this, one example of agreements that generally do are those between the citizens of nations that are at war. In this case, Chhay and the Vadian distributor made an agreement after declarations of war between Vadia and Gordia. In many jurisdictions, this agreement would be considered interference in public affairs (a war). Courts believe that to enforce such an agreement would harm the national interest. So neither party could enforce the agreement.

***** ADDITIONAL REFERENCE:** Chapter 4 ("Capacity"), Section 4.8 contains further discussion of the status of agreements made with "enemy" foreigners, which may also be void because the "enemy" foreigners lack capacity.

(2) Agreements that harm relations with other nations are also unenforceable. However, the harm must be very clear for a court to act here. The following Case Study shows the kind of situation where a court might do so.

***** CASE STUDY 130**

FACTS The nations of Bodia and Kaos have been friendly for decades. In fact, it is vital for Bodia's national security and development that it have good relations with Kaos.

Unfortunately, Kaos is having problems with the neighboring nation of Narnia, whose human rights problems are causing widespread unrest and a major refugee crisis. Kaos has imposed an economic embargo on Narnian

goods. The embargo says no Kaotians can do business with Narnians. And recently, Narnia's numerous violations of the Kaotian border have led Kaos to declare war on Narnia! The Bodian government assures the government of Kaos that it will do all it can to support Kaos, and that it will discourage trade and other contact between its citizens and those of Narnia. The Bodian National Assembly overwhelmingly endorses that policy.

However, a Bodian soup manufacturer named Scrummy continues to do business with a Narnian spice merchant called Narstee. Scrummy agrees to buy from Narstee a shipment of the rare spice kondimenta. Scrummy pays Narstee for the spice. However, Narstee fails to deliver the spice. Scrummy asks Narstee to refund the money he paid for the spices, but Narstee refuses. Scrummy asks a Bodian court for help.

QUESTION OF LAW Can Scrummy enforce the contract with Narstee in Bodia?

DECISION Perhaps not. Scrummy may not be able to enforce the agreement, because that might harm Bodia's relations with Kaos.

Agreements that harm relations with other nations are not enforceable because they harm the national interest. In this case, the agreement between Scrummy (a Bodian) and Narstee (a Narnian) to trade in Narnian goods (the spices) did not violate Kaos' embargo, which applied only to trade between Kaos and Narnia.

However, the agreement may harm Bodia's relations with Kaos. This is because it helps Narnia by providing it with trade--and money--at a time when Narnia is actually under embargo and at war with Bodia's important ally Kaos. That is contrary to clear Bodian government policy. So even though the agreement violates no Bodian statute, it may violate Bodian public policy. So it may not be enforceable.

However, this does not mean that a court may refuse to enforce contracts simply because it does not like a particular trader or nation! The court must consider the national interest only, as clearly expressed through sources of public policy, such as legislation or executive action. In Case Study 130, the Kaotian embargo and declaration of war, the importance of Kaos to Bodian national security, and the clear statements of the Bodian government and National Assembly may show that such a public policy existed in Bodia. But there are few situations where agreements would actually have this kind of serious effect on the national interest.

5.4f Agreements That Unreasonably Restrain Trade Are Not Enforceable

In many jurisdictions, agreements that unreasonably restrain trade are unenforceable even if they do not violate specific statutes, because

such agreements are contrary to public policy. As discussed above in Section 5.3e, many jurisdictions also have statutes that forbid unreasonable restraints of trade. In fact, even in many common law jurisdictions, most trade restraints are governed by statutes. But some restraints are not, and these may violate public policy. Trade restraints that violate public policy seem to be mostly ones that restrain individual parties from conducting their business or trade, rather than the more far-reaching types discussed earlier, such as agreements to fix prices or divide territory.

*** **WHY IS THIS IMPORTANT?** Why are agreements to unreasonably restrain trade unenforceable in many jurisdictions, even when the restraints do not violate specific statutes?

First, as discussed in Section 5.3e above, such agreements harm the public's interest in free competition. In addition, it is not in the public interest for a person or organization to be unreasonably restricted in conducting a lawful trade or business. For example, if a talented young engineer cannot work in a nation, that nation will lose the benefits of his skill and efforts, including passing on his skills to associates. Many nations believe that they work best when every person is free to do the work he does best. In addition, the engineer will not pay tax on his income as an engineer, so the state may lose revenue.

Moreover, the law seeks to protect the freedom of individual parties to work and trade as they wish. This freedom might be harmed if such parties were allowed to negotiate away the freedom to someone else who might be in a stronger bargaining position. For example, if a senior engineer makes his departing associate agree never to work as an engineer in Cambodia again, that restraint would probably be too broad to be enforced. It might prevent the person from working again in that field, and rob him of his livelihood.

A number of different kinds of agreements may unreasonably restrain trade and violate public policy. We will briefly discuss only two important types of such agreements: agreements not to compete, and exclusive dealing agreements.

(1) Agreements Not to Compete

Agreements not to compete are agreements in which someone promises that he will not engage in a certain business, in a certain geographical area, for a certain amount of time. This generally prevents the party making the promise from competing with the party receiving the promise.

In many jurisdictions, a promise not to compete is enforceable only if:

- (1) restricting competition is not the main purpose of the agreement in which the promise is made;
- AND (2) the restriction is reasonable as to time and place, based on the nature of the business and other circumstances.

In fact, some jurisdictions enforce such promises only if they are part of contracts for the sale of a business or employment contracts. And even in those situations, the promise cannot restrict a competitor for too long or in too large an area. If the restriction goes further than is necessary to protect the legitimate interests of the other party--further than is "reasonable"--then it is unenforceable.

Such promises may occur when a party buys an existing business. In that situation, the buyer is not only buying physical assets (such as a building), but also goodwill. Goodwill is the positive opinion of customers that can arise from an established and well-run business. In fact, goodwill can be the most valuable asset of a business! A buyer of a business can at least try to keep this asset by requiring the seller to promise not to compete. For instance, a restaurant owner who sells his business may agree that he will not open another new restaurant in the same area for a certain period. Otherwise, some of his old customers might simply go to his new restaurant! This could make business difficult for the buyer of the old restaurant.

Promises not to compete are also found in employment agreements.

CASE STUDY 131

FACTS Sethik worked for Scummy, a soup manufacturer, as a business development manager. When Sethik first started this work, he promised Scummy as part of his employment contract that if he ever left Scummy's employ, he would never work for the soup industry again anywhere. In his job, Sethik dealt with Scummy's biggest customers, who got to know and like Sethik. After working for Scummy for 15 years, Sethik quit.

Ten years later, Scummy learned that Sethik had set up a soup factory in the neighboring country of Kaos. In fact, Sethik was selling to most of Scummy's best customers, who liked Sethik's soups better! Scummy asked the court for help.

QUESTION OF LAW Can Scummy enforce this promise not to compete?

DECISION No. Sethik's promise not to compete with Scummy is not reasonable as to time and area, so it is not enforceable.

In many jurisdictions, promises not to compete are enforceable only if restricting competition is not the main purpose of the agreement in which

the promise is made, and the restriction is reasonable as to time and place. In this case, Sethik's promise not to compete was part of his original employment contract, so restricting competition was not the main purpose of the agreement. However, the agreement also required that Sethik never work in the soup industry again anywhere! This kind of restraint as to time and area is not reasonable. It does more than protect Scrummy's legitimate interests--it eliminates a potential competitor forever. So it is unreasonable, and unenforceable.

The effects of unenforceable promises not to compete vary. It appears that some courts will not enforce them at all. Other courts will enforce such promises, but only to the extent of a reasonable restraint. For example, in Case Study 131 above, some courts might permit Scrummy to state a reasonable restriction, and if he could, they would enforce that. This situation is similar to the way some courts treat usurious loan agreements: they will enforce the usurious agreement, but only at the legal interest rate. In addition, if such a competition restraint was unenforceable but was only part of a larger agreement that could stand on its own--without the illegal clause--many courts would "sever" the clause and still enforce the rest of the agreement. This is explained in Section 5.5.

(2) Exclusive Dealing Agreements

Exclusive dealing agreements occur where independent parties agree that one or both of them will not trade goods or services with anyone else. Such agreements are unenforceable if they unreasonably restrain trade. Two situations where this can occur are service contracts and trading agreements.

(1) Exclusive Service Contracts -- A service contract is a contract between two independent parties in which one party agrees to perform some service for the other. It is not an employer-employee relationship, but a principal-independent contractor relationship. An independent contractor is one who agrees to do certain work but who is not subject to the control of his employer (the principal) except as to the result of the work. That is, unlike an employee, the contractor decides how the work is done.

Sometimes a principal may seek the exclusive services of an independent contractor. In many jurisdictions, this is a reasonable restraint (and enforceable) if the main purpose of the clause is to ensure that the contractor's services will be available to the principal. If the clause is not aimed at this goal, but at ensuring that no one else can get the services, then the clause is unreasonable.

CASE STUDY 132

FACTS Sovenn, a contractor, provides special cleaning services and hygiene maintenance to the food industry. Scrummy makes instant soup. Scrummy and Sovenn make a service agreement under which Sovenn will

provide his services to Scrummy's two main soup plants but to no one else. This work takes Sovenn's firm 12 working days each month. The rest of the time, Sovenn's workforce is idle.

Yummy, a rival soup maker, asks Sovenn to provide his services at Yummy's factories. This would give Sovenn's workforce 8-10 more days of work each month, without interfering with Sovenn's work for Scrummy. Sovenn gladly accepts the offer. But when Scrummy learns about this agreement, he complains to the court.

QUESTION OF LAW Will a court enforce the exclusive services clause in Sovenn's contract with Scrummy?

DECISION No. The purpose of the exclusive services clause here appears to be to prevent anyone else from getting Sovenn's services, so it is not enforceable.

Exclusive services agreements are enforceable if the main purpose is to ensure the services are available to the party who receives the promise. In this case, it appears that the exclusive services clause between Scrummy and Sovenn was not intended mainly to ensure Sovenn's special cleaning services for Scrummy. Instead, it seems that it was intended to prevent anyone else from getting these services. In fact, Scrummy only needs Sovenn's services for 12 work days per month. So this is an unreasonable restraint, and it is not enforceable. It harms the free market and Sovenn, because it ensures no other food maker can get Sovenn's special services.

(2) **Exclusive Trading Agreements** -- Exclusive trading agreements may also unreasonably restrain trade. They occur where a party agrees to buy certain products from one seller only, or to sell to one buyer only. In fact, these are similar to output and requirements contracts, which were discussed in Chapter 3 ("Consideration"), Section 3.5d. For example, petrol companies often ask those who lease their service stations to agree not to buy petroleum products from anyone else.

Many jurisdictions say that such exclusive trading agreements are enforceable if they go no further than is necessary to protect the legitimate interests of the party receiving the promise. Examples of unenforceable restrictions vary in different jurisdictions. But they might include restrictions for too much time, or ones that force the party making the promise not to trade with anyone else with regard to too great a range of different products.

*** **ADDITIONAL REFERENCE:** Chapter 3 ("Consideration"), Section 3.5d contains a more complete discussion of output and requirements contracts.

5.4g **Exculpatory Clauses Are Not Enforceable as to Intentional or Reckless Torts, but They May Be Enforceable as to Negligent Torts**

Parties often place exculpatory clauses in their contracts. Exculpatory clauses are not enforceable as to intentional or reckless torts, but they may be enforceable as to negligent torts.

***** DEFINITION:** An **exculpatory clause** is a clause that attempts to relieve a person of liability for future harm, generally for torts.

In some jurisdictions, exculpatory clauses are very common, especially in standard form agreements used by large businesses. However, that does not mean that courts always enforce them!

To understand these rules, it is necessary to know about a few basic aspects of torts. Torts are non-contractual civil wrongs. They were briefly explained in Sections 5.3a and 5.4b, above. Very basically, many jurisdictions say there are two main kinds of torts: intentional and unintentional.

Generally, an intentional tort occurs where a party intentionally commits an act that violates a non-contractual legal duty he owes to another person. An example might be where a party intentionally hits a pedestrian with his car.

An unintentional tort basically occurs where a party unintentionally violates a non-contractual legal duty he owes to another person. Some jurisdictions say that there are two types of unintentional torts: reckless and negligent.

Negligent torts occur where a person fails to meet a duty of care owed to others and by doing so causes harm. The person need not intend to commit the act that causes harm in order to commit a negligent tort. An example might occur where a party driving his car fails to drive carefully enough and unintentionally hits a pedestrian.

Reckless torts fall in between intentional and negligent torts. Such torts basically occur where parties do not intentionally cause harm, but perform acts in a way that shows genuine disregard for the danger their acts cause to the well-being of others. An example might be where a drunken person driving his car at night with no headlights unintentionally hits a pedestrian.

Suppose a health club has an exculpatory clause in the agreements it makes with members who exercise there. In such a clause, the club might try to deny responsibility for any injury to a member. The club probably could enforce the clause to avoid liability if a member tripped on a loose exercise mat and was injured, then claimed the club was negligent about keeping the area safe. But the club would not be able to enforce the clause to avoid liability

where a club employee punched a member intentionally and injured him--because that would be an intentional tort. The reason for these rules may be that courts do not wish to allow parties to negotiate rights to hurt others intentionally or recklessly, which may be more serious violations of public policy than negligence. Of course, negligence can also have very bad effects.

Even where exculpatory clauses only try to relieve parties from liability for negligence, many jurisdictions will not enforce them where even that enforcement would violate public policy. The situations where courts do this vary in different jurisdictions. In general, courts seem to feel that parties in some important positions in society should not even be able to negotiate the right to be negligent. We will briefly discuss two examples of such situations.

First, many jurisdictions will not enforce exculpatory clauses as to negligence if the party trying to enforce the clause is a provider of a public service trying to avoid liability for harm caused by its performance of that service, and the other party has no real ability to choose another provider of the service. An example might be a railroad trying to avoid liability for harm caused to passengers by its negligent maintenance of its trains.

Second, many jurisdictions will not enforce an exculpatory clause where the party trying to enforce it has much more bargaining power than the party against whom the clause is being enforced, and the weaker party has little real ability to bargain about the clause. An example might be where a large employer asks a new employee to sign a standard form contract relieving the employer from liability for all harm to the employee. This type of situation might occur where there is an unconscionable agreement. An unconscionable agreement basically occurs where the process of formation or actual terms of an agreement are so extremely unfair that it shocks the conscience of the court. Such agreements are especially likely where there are adhesion contracts. Those occur where a party with much greater bargaining power drafts and presents a contract to the other party in circumstances where that party has no real chance to negotiate about the terms. It is rare that courts refuse to enforce agreements because of unconscionability, but it is possible. These issues were briefly discussed in Chapter 1 ("Basic Aspects of Contract Law"), Section 1.4f, and they will be discussed in more detail in Chapter 7 ("Other Contract Formation Problems"), Section 7.7.

*** **ADDITIONAL REFERENCE:** Chapter 7 ("Other Contract Formation Problems"), Section 7.7 contains a more complete discussion of unconscionable agreements and adhesion contracts.

CASE STUDY 133

FACTS Nikea is desperate to find a job. Camtex, a powerful textile company, hires Nikea for its new factory. Many other workers are unable to get jobs at the factory, and Nikea feels very lucky. On his first day of work, Camtex has Nikea sign a standard form employment agreement which

contains a clause saying Camtex will not be liable for any harm caused to Nikea (intentional or negligent).

One day during Nikea's third month on the job, his supervisor hits him for not working fast enough, injuring Nikea. As Nikea is walking across the factory floor to get health care, a different employee negligently drops a heavy machine on him, injuring him further. Nikea asks the court to order Camtex to pay him compensation for his injuries. Camtex says it is not liable for anything because of the exculpatory clause.

QUESTION OF LAW Can Camtex enforce the exculpatory clause?

DECISION Probably not. This exculpatory clause violates public policy as to intentional torts, and probably as to negligent torts also, in many jurisdictions.

Exculpatory clauses are not enforceable as to intentional or reckless torts. They are not enforceable as to negligent torts, in many jurisdictions, if the party trying to enforce the clause has much more bargaining power than the other party, and the other party has little ability to bargain about the clause.

In this case, Nikea signed an employment contract with an exculpatory clause that tried to relieve his employer Camtex of all liability for harm to Nikea. The Camtex supervisor's hitting of Nikea was an intentional tort, and no exculpatory clause can relieve Camtex of liability for that. The other employee's dropping of the machinery on Nikea was a negligent tort. Normally exculpatory clauses can relieve liability for negligent torts. But in this case, Camtex had much more bargaining power than Nikea, and Nikea had little real choice about the clause if he wanted the job. Many jurisdictions would not enforce this clause even as to negligent torts, because it would violate public policy to allow a party like Camtex to avoid liability in this situation.

The general effect of an unenforceable exculpatory clause is that the clause cannot be enforced, at least to the extent it tries to limit liability in violation of the above rules. However, as with clauses containing agreements not to compete, this will not cause the rest of the agreement to be unenforceable if the agreement can stand on its own without the clause. For example, an employment contract with an exculpatory clause would probably not become unenforceable simply because that one clause could not be enforced. This is called "severing" the illegal part of an agreement, and it will be discussed in Section 5.5b, below.

5.4h Agreements That Promote Immorality Generally Cannot Be Enforced

In many jurisdictions, an agreement that promotes immorality is illegal and unenforceable, even if the performance of the agreement itself

would normally be legal. “Immorality” is basically something contrary to the moral standards of a particular society.

For example, suppose it was normally legal to sell land mines, but in a particular case the seller knew the buyer was buying a mine in order to mine a busy road 15 minutes later. In that situation, a court might refuse to enforce the agreement, because it would be immoral.

Courts refuse to enforce agreements on this basis only in very limited circumstances. This is because what is “immoral” is very hard to define. It can change over time, and people often disagree about what it means. So courts refuse to enforce agreements on this basis only when they clearly promote immorality. Of course, people may also disagree about what is “clear.”

In addition, different jurisdictions have different approaches to this area. Some may be more likely than others to refuse to enforce agreements on this basis. So it is very important to check the local law.

Usually courts require some clear expression of public policy, such as a statute, to show that an agreement is immoral. Without such an expression of public policy, it is rare that courts would refuse to enforce agreements because they are “immoral.” For instance, in the example above, the mine seller may not be guilty of a crime if he sells the mine. But the criminal statutes defining murder and other wrongs that may result from mining might show that the mine sale was immoral.

Often, one party to this kind of agreement is much more involved in the immoral conduct than the other party--perhaps because that first party secretly plans to use the agreement to help him do something illegal! When this occurs, some jurisdictions say that the more “guilty” party cannot enforce the agreement. The more “innocent” party can enforce the agreement only if:

- (1) he has substantially performed the agreement;
 - (2) he did not know about any misconduct of the more guilty party that involves grave social harm;
- AND (3) he did not become actively involved in such misconduct.

CASE STUDY 134

FACTS Thim sells chemicals. One day, Im tells Thim he will pay \$1,000 for 20 barrels of a certain chemical, which it is legal to sell in Thim’s nation and can be used to make a variety of lawful products. Thim loads the 20 barrels into Im’s truck, and Im gives him the \$1,000 and drives away.

About one week later, two police officers visit Thim. They tell him that Im used the chemicals to manufacture dangerous illegal drugs, and they say the money Im paid Thim was counterfeit money. They also mention that they

have not found any of the chemicals. Thim is very upset. He asks the court to enforce the agreement against Im so he can get a real \$1,000 payment.

QUESTION OF LAW Can Thim enforce this agreement with Im?

DECISION Perhaps, in some jurisdictions. Although the agreement between Thim and Im may indirectly promote immorality, Thim was innocent of the immorality, so he may be able to enforce the agreement.

Courts will not generally enforce agreements that promote immorality. Where the performance of the agreement itself is legal, but one party plans to use the agreement to do something illegal, the more “guilty” party cannot enforce the agreement. However, some jurisdictions say that the more “innocent” party can enforce it if he has substantially performed, and he did not know about or become part of any grave social harm.

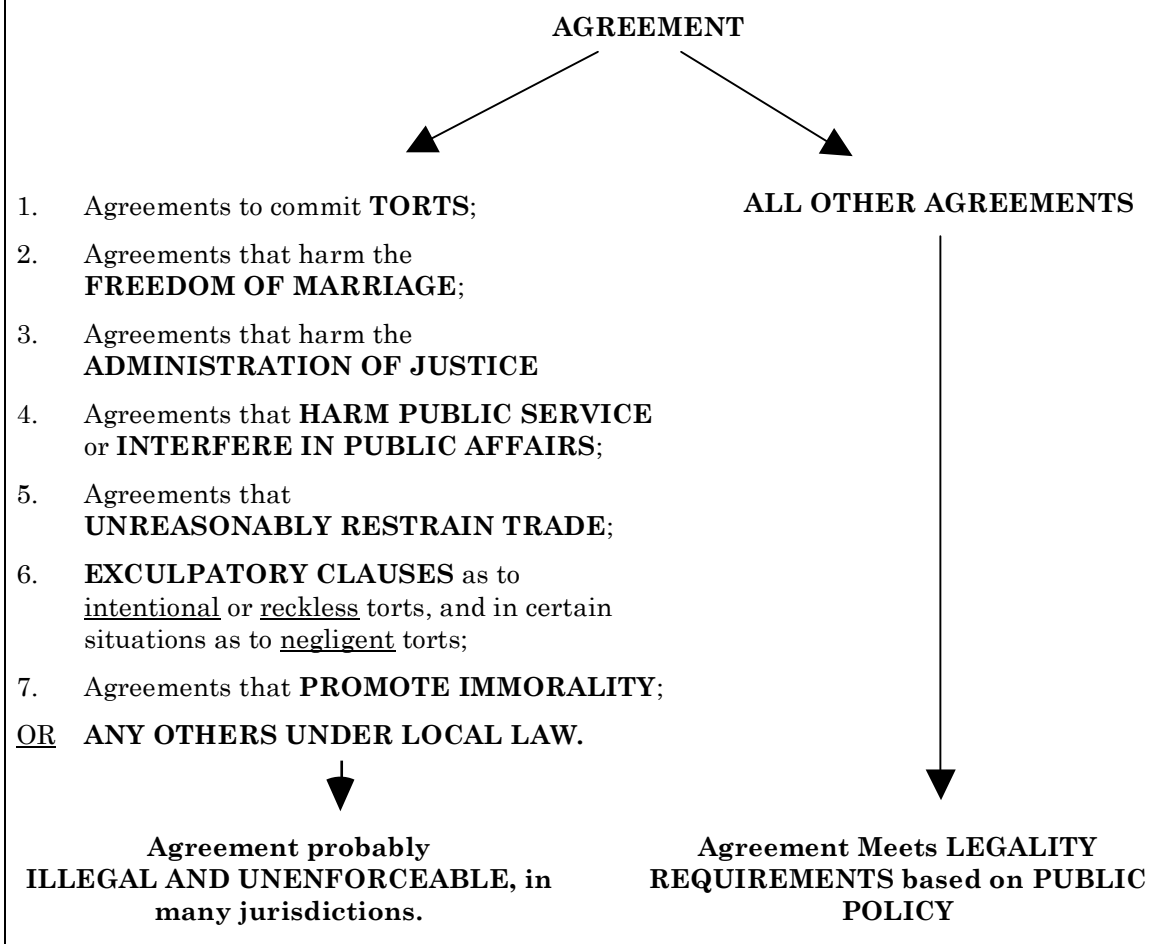
In this case, some jurisdictions would say that the agreement between Thim and Im for the sale of the chemicals promoted immorality, even though it was normally legal. This is because Im planned to (and did) use the chemicals to make dangerous illegal drugs. As the more guilty party, Im could not enforce the agreement. But Thim might be able to enforce it in some jurisdictions. This is because Thim substantially performed the agreement, and although Im’s misconduct involved grave social harm, Thim did not know about or become actively involved in the misconduct.

5.4i Summary of Some Basic Rules about Agreements Prohibited by Public Policy

As discussed above in Sections 5.4a-h, certain types of agreements are prohibited by public policy, in many free market jurisdictions. The chart below summarizes some basic rules about such agreements.



Illustration: Some Basic Rules about Agreements Prohibited by Public Policy



5.5 The Effects of Illegality on Agreements

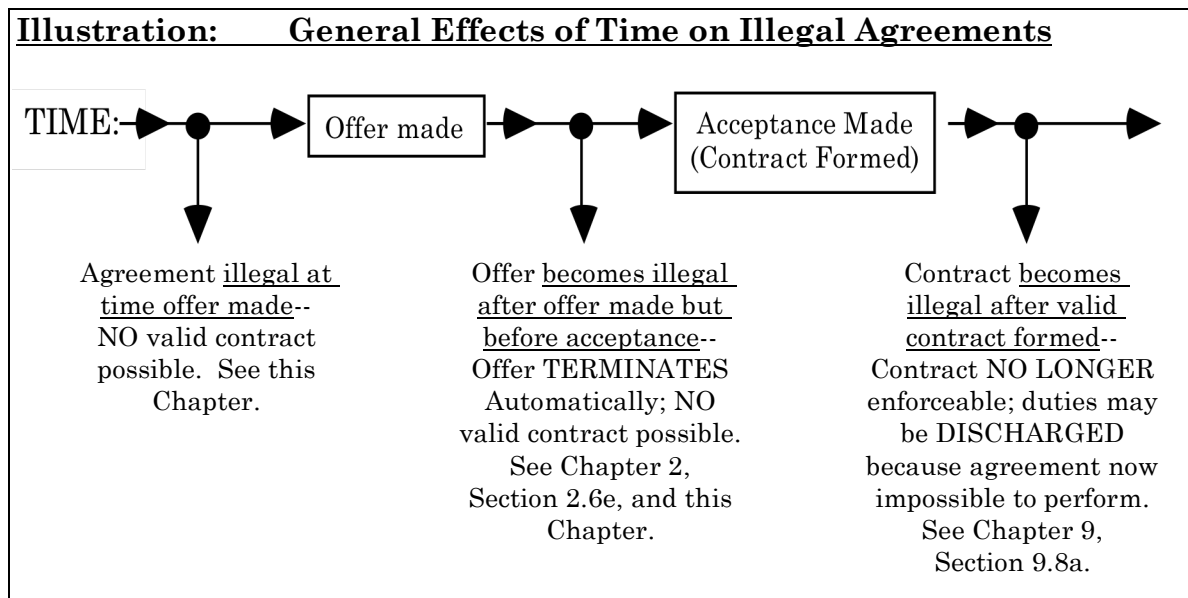
Although illegal agreements are generally unenforceable, there are limits on that rule. This Section will explain the general rule and some limits.

5.5a Illegal Agreements Are Generally Void, but in Certain Situations Parties May Be Able to Enforce Them or Get Restitution or Other Remedies

As noted above, illegal agreements are generally void. That means they generally cannot be enforced.

However, illegality has somewhat different effects on agreements depending on when the illegality occurs. If a proposed contract is illegal at the time an offer is made, no valid contract can result, as discussed in this Chapter. If an offer becomes illegal after it is made but before acceptance, it appears that many jurisdictions say the offer terminates, as explained in Chapter 2 ("Real Agreement (Offer and Acceptance)"), Section 2.4e.

No valid contract can result. Finally, if a contract becomes illegal after it is formed, the duties under the contract will probably be discharged under the doctrines of impossibility or impracticability, as discussed in Chapter 9 ("Performance and Discharge of Duties"), Section 9.8a. Of course, in all of these situations, the contract or proposed contract cannot be enforced once it becomes illegal. The chart below illustrates these possibilities.



Although illegal agreements cannot generally be enforced, and nothing transferred under them can generally be recovered, there are several limits on that general rule in some jurisdictions. These limits are discussed in the following Sections.

(1) One Party May Be Able to Enforce an Illegal Agreement in Certain Situations

In a few limited situations, one party to an illegal agreement may actually be able to enforce it. We will discuss two of these special situations.

First, some jurisdictions say that a person not aware of the illegality may be able to enforce the agreement under certain limited circumstances. In particular, the unaware party may be able to enforce the agreement where there is a contract that would normally be legal, but one of the parties secretly intends to use it for some illegal purpose. This was already discussed in Section 5.4h, which explained about agreements that violate public policy because they promote immorality.

For example, in Case Study 134, the chemical seller Thim might be able to enforce the agreement he made with Im. That is because the sale itself would normally be a lawful agreement, and Thim did not know that Im planned to use the chemicals to manufacture illegal drugs. However, it seems unlikely that a court would enforce such an agreement if it would assist

the guilty party in furthering the illegality. For example, in Case Study 134, it seems unlikely that a court would ever order Tim to actually give Im the chemicals if it knew of the illegal plan--even if it was Tim who asked the court to enforce the agreement.

Second, sometimes one party is in a special class protected by statute or public policy. In that situation, an agreement that violates the statute or policy may not prevent a party in that special class from enforcing the illegal agreement.

For example, in many jurisdictions, minimum wage statutes require that all full time workers (with a few exceptions) be paid no less than a certain amount of money per hour. If an employment agreement violates these laws, the employer cannot enforce the agreement. But the employee can enforce the agreement--and at the legal minimum wage, not the lower wage the employer agreed to pay!

(2) Restitution or Other Remedies May Be Available in Certain Situations

There are also a few situations where parties to an illegal agreement may be able to get restitution or other remedies. In particular, parties may in certain cases be able to get restitution even though the illegal agreement is not enforceable. And it seems possible that a party to an illegal agreement might in very limited situations be able to get a remedy based on promissory estoppel, if he justifiably relied on a promise and harm would result if the promise was not enforced to some extent. These possibilities are briefly discussed below.

Restitution may be possible in certain situations involving illegal agreements, under the doctrine of quasi-contract. Two of these situations might be called the "withdrawal" situation, and the "less guilty" situation.

First, restitution may be available where a party withdraws from an illegal agreement. In particular, some jurisdictions allow restitution where:

- (1) a party withdraws from the agreement before its improper goal has been reached; AND
- (2) the withdrawing party has done nothing seriously wrong.

To get restitution in this situation, a party must refuse any further participation in the illegal agreement.

CASE STUDY 135

FACTS Bora and Chheng agree that they will find harmful information about Bora's uncle Sim, then blackmail him. Blackmail is a crime. Bora and Chheng agree that Chheng will give Bora \$1,000 so he can get the information

they need, which will require time, travel and many bribes. Chheng gives Bora the money.

However, a few hours later, Chheng decides that she no longer wishes to blackmail Sim. She tells Bora that she is withdrawing from the agreement, and asks him to give her \$1,000 back. But Bora says no. Chheng asks the court for help.

QUESTION OF LAW Can Chheng get her \$1,000 back from Bora?

DECISION Perhaps. Although this illegal blackmail agreement is not enforceable, Chheng might be able get restitution of her \$1,000, because she withdrew from the agreement before the improper goal was reached and before she did anything seriously wrong.

In some jurisdictions, parties can get restitution of what they have given under an illegal agreement if they withdraw from it before the illegal goal has been reached, and they have done nothing seriously wrong. In this case, the blackmail agreement between Chheng and Bora was illegal and could not be enforced. However, Chheng withdrew from the agreement before its goal was reached, and without doing anything seriously wrong. So she might be able to get restitution of the \$1,000 she gave Bora.

Of course, some courts might say that she did do something seriously wrong--and so there is no "unjust enrichment"--because she agreed to commit blackmail, a serious crime. What do you think?

Another special situation where some jurisdictions may allow a party restitution is where that party is significantly "less guilty" than the other party. In particular, some jurisdictions allow restitution where:

- (1) one party is significantly less "guilty" than the other party; and
- (2) that less guilty party has done nothing seriously wrong.

Obviously, if this exception was used too much, courts might end up enforcing many illegal agreements--since there may be many situations where one party is somewhat more "guilty" than the other. So courts are very careful to allow recovery here only in very limited circumstances. One possible example is where a minor purchases prohibited articles, as discussed in Section 5.3a.

CASE STUDY 136

FACTS Diva is a nurse whose nation has been torn apart by a bloody civil war fought mostly between two ethnic groups. The ethnic group to which Diva belongs is about to lose the war. Persons in her ethnic group are trying desperately to escape the country before their territory is finally captured, because they know that if they do not escape, they will probably be killed by the other ethnic group. However, it is very difficult to escape.

Diva tries many ways to get a visa to settle in a foreign nation, but she has no success. Finally, she agrees to give all her gold and jewels to a government official named Siphann if he will agree to (illegally) get her a visa to Redland. From Redland, Diva hopes to reach Blueland, a safe nation which some of her family has managed to reach. However, after taking the gold and jewels, Siphann disappears.

Diva is very tough, and she escapes anyway. Two years later, after Diva has found her family and is living with them in the capital city of Blueland, she happens to see Siphann on the street. She grabs him and drags him to court, where she asks the judge for help in recovering her gold and jewelry.

QUESTION OF LAW Can Diva get restitution of her gold and jewelry?

DECISION Yes, in some jurisdictions. Although the agreement to get the Redland visa was illegal, Diva is far less guilty of wrongdoing than Siphann, and she has done nothing seriously wrong in attempting to save her own life.

Some jurisdictions allow a party to an illegal agreement to get restitution if that party is significantly less guilty than the other party, and she has done nothing seriously wrong. In this case, the agreement between Diva and Siphann to get the Redland visa was illegal and unenforceable.

However, some jurisdictions might allow restitution for Diva. This is because Diva appears to be significantly less guilty than Siphann. And she did nothing seriously wrong in attempting to escape her war torn nation and save her own life. Siphann appears to be more “guilty” because--although both parties made the illegal agreement together--Siphann made the agreement in order to make a large profit (rather than to save a life). In addition, Siphann left Diva in an even weaker position than she had been in before--by taking her gold and jewelry but doing nothing in return! So courts in some jurisdictions might order Siphann to return her jewelry and gold, or its reasonable value.

Finally, it seems possible that a party might make a promise as part of an illegal agreement that would meet the requirements of promissory estoppel, even though that agreement could not be enforced under the usual contract law rules. As noted previously, promissory estoppel is a doctrine some common law jurisdictions apply where one party justifiably relies on a promise by another party, and injustice will result if the promise is not enforced, at least to some extent. Of course, it would seem rare that it would be “justifiable” to rely on a promise given as part of an illegal agreement.

However, one situation where it seems possible would be where two parties agree to marry, one party spends money on wedding preparations, the other party refuses to marry, and the law will not enforce the agreement because that would violate public policy. This potential problem was noted in Section 5.4c above. In this situation, restitution would not help the party

who spent money, unless that money had gone to the other party. However, reliance damages--which seek to put a party in the position he occupied before the agreement was made--would compensate the party who spent money. The injured party might argue that he justifiably relied on the other party's promise to marry, and injustice would result if the other party did not compensate him for the money he spent, or at least share the expense.

*** **ADDITIONAL REFERENCE:** Chapter 1 ("Basic Aspects of Contract Law"), Section 1.5 contains further discussion of quasi-contract; Chapter 2 ("Real Agreement (Offer and Acceptance)"), Section 2.4e discusses promissory estoppel; Chapter 7 ("Other Contract Formation Problems"), Section 7.8 contains more detailed discussion of promissory estoppel; and Chapter 10 ("Remedies"), Section 10.4 contains further discussion of restitution.

5.5b Sometimes Courts “Sever” the Illegal Part of an Agreement and Enforce the Rest

Illegal agreements are unenforceable only to the extent that the illegality violates a statute or public policy. So if the illegality in an agreement does not extend to the whole contract, many courts will enforce the rest of the agreement if it can stand on its own without the illegal part. This practice of removing the illegal part of an agreement and enforcing the rest is called “severance.”

*** **DEFINITION: Severance** is a court's removal of unenforceable parts of an agreement, leaving behind an agreement the court will enforce.

Illegal parts of an agreement can be severed only if the severing does not destroy the whole meaning and purpose of the contract. In other words, an illegal part of an agreement can be severed where it leaves the remaining part of the contract capable of standing alone. For example, agreements to commit murder or bribe public officials cannot be partly enforced, because the illegality is the main part of the agreement. But illegal exculpatory clauses or “non-competition” clauses in employment agreements might be severable, since the rest of such agreements might be capable of standing alone, without the illegal clauses. Likewise, agreements for the sale of different kinds of goods (some legal and some illegal) might be severable, because a court might be able to sever the illegal parts and enforce the rest.

In general, courts do not wish to rewrite agreements for the parties. That might produce something entirely different from what the parties intended. Courts wish to respect the principle of freedom of contract as much as possible--even as to persons who make illegal agreements. So if a court cannot sever and leave a contract that can be enforced basically as the parties intended, the agreement will not be enforced.

Specifically, many jurisdictions require three elements for severance of illegal parts of agreements:

- (1) the court must be able to divide the remaining agreement into corresponding performances between the parties;
- (2) the illegality must not affect the whole agreement;
- AND (3) there must have been no serious wrongdoing by the party trying to enforce the agreement.

Consider the following Case Study.

***** CASE STUDY 137**

FACTS Vorn, a self-employed lorry driver, made an agreement to haul three loads of hardwood and three loads of rattan wood from a logging company site to the nearest sea port for export. Vorn's fee was 100,000 riels per load.

Unfortunately, because of overlogging, it was illegal to haul or export hardwood when the agreement was made. When Vorn learned this, he told the logging company that he would haul the rattan wood, but not the hardwood. The company said he had to haul all of the wood or none.

QUESTION OF LAW Can Vorn enforce this agreement as to the rattan wood only?

DECISION Possibly. The part of the agreement to haul hardwood was void because it was illegal, but if that part could be severed, the agreement to haul the rattan might be enforceable, in some jurisdictions.

In some jurisdictions, where part of an agreement is unenforceable because it is illegal, a court may still enforce the rest of the agreement if the illegal part can be severed without destroying the main part of the agreement. In this case, Vorn agreed to haul six loads of wood: three loads were illegal (the hardwood), but three loads were not illegal (the rattan wood). Vorn's fee was 100,000 riels per load. In this situation, it seems fairly easy to sever the hardwood hauls and simply enforce the rest of the agreement: three rattan wood loads at 100,000 riels per load. So in this case, a court might sever the illegal part of Vorn's agreement and enforce the legal part.

Where a part of an agreement is normally allowed within certain limits, but the agreement goes too far, the court may simply enforce the agreement within the limits. For example, some courts might enforce a usurious loan agreement, but only at the legal rate. Similarly, unreasonable promises not to compete in employment agreements might be enforceable, but only within legal limits.

*** **ADDITIONAL REFERENCE:** Chapter 7 ("Other Contract Formation Problems"), Section 7.7c discusses severance of unconscionable parts of agreements; and Chapter 10 ("Remedies"), Section 10.7c discusses severance of parts of contracts in general.

5.6 Illegality in the Cambodian Legal Tradition and the Civil Law Tradition

*** **CAMBODIAN LAW PERSPECTIVE:** Many Cambodian laws address the legality of contracts, and the approach they show seems generally compatible with the approach discussed in this Chapter. These laws include the Constitution (1993), the Contract Law (Decree #38D (1988)), the Marriage and the Family Law (1989), the Land Law (Decree #100D (1992)), the Labor Law (1997), and the Zoning Law (1994).

I Basic Rules

Article 3 of Decree #38D, the current Contract Law of Cambodia, states that every contract is valid provided that, among other things, it “has a subject matter that is lawful.” Article 5 of the Decree provides that agreements are void if they are, among other things, “illegal,” “not consistent with public order or good custom,” or “not consistent with social interests or principles of social ethics.” These latter phrases may describe agreements that are not enforceable because they violate Cambodian public policy. No definition of these standards appears in the Contract Law. So it would seem that, as with public policy in many other jurisdictions, the courts must determine what it is.

In general, these provisions seem consistent with the approach discussed in this Chapter with respect to legality. One possible difference is that the phrases “social interests” and “social ethics” may suggest that courts may refuse to enforce agreements in a broader range of situations than courts in some other free market jurisdictions.

II Specific Kinds of Illegal Agreements

Crimes and Torts

Cambodia has a number of criminal laws, including the Law on Criminal Procedure (1993) and the UNTAC Penal Code (1992). In addition, the Constitution (1993) and the Drug Law (1996) regulate acts related to certain prohibited articles, such as illegal drugs and unsafe consumer goods. It seems likely that no court would enforce an agreement that violated one of these laws.

In addition, Articles 121-135bis of Decree #38D discuss “Other Liabilities,” and provide that anyone damaged by the fault of others may get compensation for that damage. These provisions appear to describe

non-contractual civil wrongs (torts). Agreements violating the above articles would almost certainly be unenforceable.

Gambling

The Law on the Suppression of Gambling (1996) regulates gambling in Cambodia. Presumably agreements that violate this law would be unenforceable.

Usury

Article 59 of Decree #38D says that the maximum legal interest rate on a loan is 5% per year, except where the law sets a different rate. Article 60 provides that any usurious interest already paid by a borrower shall be deducted from the loan principal and considered part of the repayment of that principal, or returned to the borrower (with interest for the borrower) if the borrower has paid more than the total amount allowed by the law. This is similar to severance, which was explained in this Chapter. Article 60 also says that the lender will be subject to criminal law.

Licensing

Cambodian law has some licensing requirements. One example is the Bar Statute (1995), which provides that only licensed Cambodian lawyers may practice law in Cambodia.

Another example appears in Article 15 of the Zoning Law (1994), under which only certified Khmer architects, or anyone recognized by the competent authorities, may prepare certain parts of a request for permission to build “large construction.” It is not clear if agreements made by those who violate these licensing requirements are enforceable.

Restraint of Trade

The current Cambodian Labor Law (1997) deals with restraint of trade in Article 70. Article 70 provides that all contract provisions that “prohibit the worker from engaging in any activity after the expiration of the contract” are void. This appears to invalidate all non-competition clauses in labor contracts. It appears to differ from the approach discussed in this Chapter, which allows such restrictions in labor contracts if they are reasonable as to time and place.

Marriage

Article 45 of the Constitution provides that “marriage shall be conducted according to conditions determined by law based on the principle of mutual consent between one husband and his wife.” This would appear to mean that marriage without the consent of one of the parties would be illegal and unenforceable. It is not clear if other agreements related to marriage (such as agreements to marry or not marry) are enforceable.

The Law on Marriage and the Family (1989) also deals with marriage and its legality. Articles 6 to 8 of the Marriage Law prohibit certain marriages, including marriages to those who are already married.

Public Affairs

Article 55 of the Constitution provides that “any treaty and agreement incompatible with the independence, sovereignty, territorial integrity, neutrality and national unity of the Kingdom of Cambodia shall be annulled.” This may prohibit agreements that interfere in public affairs and harm the national interest, as discussed in this Chapter. Such agreements would appear to be void.

Sale of Land and Other Property

Article 44 of the Constitution declares that only “Khmer” legal entities and “Khmer” citizens may own land, and there are similar provisions in the Land Law (1992) and the Investment Law (1994). This was explained in the Cambodian Law Perspective in Chapter 4 (“Capacity”). Agreements violating these provisions would be illegal. Article 48 of Decree #38 also provides that if a vendor obtained property by way of a felony or misdemeanor, the purchaser could ask to rescind the contract, even if there was no threat from a third party to deprive the purchaser of the property. Article 48 says that agreements contrary to it are void.

***** CIVIL LAW PERSPECTIVE:** The civil law approach to legality appears to be generally compatible with the approach discussed in this Chapter. Of course, there are some differences, and the law varies to some extent in different jurisdictions.

In France, the general policy of freedom of contract is limited by the requirement of legality. This requirement is specified in statutes--including at least one about public policy. The *Code Civil* states that, for an agreement to meet the requirement of legality, it must have a licit *cause*. *Cause* is basically the reason or purpose a party made the agreement. The *Code* provides that a *cause* is illicit when it is prohibited by statute, or when it is contrary to morality or to public order (*ordre public*). *Ordre public* appears to be very roughly comparable to the idea of “public policy” discussed in this Chapter. It is formulated by the courts and changes with new social conditions.

The French *Code Civil* also states that if a *cause* is illicit then “the obligation can have no effect.” This means that an illegal agreement is void, and courts will not enforce it. It appears that an illegal agreement is not void if one party does not know of the illegal intention of the other party. If that occurs, it appears that the innocent party may enforce the contract.

5.7 Questions for Review

CHAPTER 5 – QUESTIONS FOR REVIEW

1. What is the general effect of an illegal agreement?
2. Will courts enforce agreements to violate criminal or tort statutes?
3. In general, will courts enforce gambling agreements? Why?
4. What are the effects of usurious loan agreements?
5. Will courts enforce agreements made by persons who have violated regulatory licensing statutes?
6. Will courts enforce agreements that unreasonably restrain trade? Why?
7. Give examples of unreasonable trade restraints.
8. What is public policy?
9. Will courts enforce agreements to commit torts, even where no statute specifically defines such torts?
10. Will courts enforce agreements that harm the freedom of marriage?
11. Will courts enforce agreements that harm the administration of justice?
12. Will courts enforce agreements that harm public service? Why?
13. Give examples of agreements that harm public service.
14. Will courts enforce agreements that unreasonably restrain trade, even if no specific statute prohibits the restraint? Give examples.
15. Will courts enforce exculpatory clauses?
16. Will courts enforce agreements that promote immorality?
17. Will courts enforce illegal agreements? Will they give any remedies?
18. What does severance mean? When will some courts do that?
19. Is the approach to legality discussed in this Chapter generally compatible with the current Cambodian law approach?
20. Is the approach to legality discussed in this Chapter generally compatible with the civil law approach?

