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Contracts induced by means of bribery: Should they be void or valid?

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- Should they be Void or Valid? -**

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Volkswirtschaftliche Reihe ISSN 1435-3520

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Für den Inhalt der Passauer Diskussionspapiere ist der jeweilige Autor verantwortlich.
Es wird gebeten, sich mit Anregungen und Kritik direkt an den Autor zu wenden.

Contracts Induced by Means of Bribery

Should they be Void or Valid?

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Abstract

This paper argues that contracts induced by means of bribery should be valid. Nullity and voidability decrease the incentive for voluntary disclosure, assist corrupt actors with enforcing their bribe agreements and provide leeway for abuse. Thus, they run counter to effective anti-corruption. It is argued that other instruments are more suitable for preventing corruption.

JEL Classification: G34, G38, K12, K14, K42

Keywords: Bribery, Contracts, Corruption, Due Diligence, Enforcement, Impugment, Liability, Leniency, Nullity, Private Law Validity, Voidability, Voluntary Disclosure (Program)

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1 Introduction

Asia Media: Taipei City Government annuls EMG arena deal

“The Taipei City Government announced yesterday it would annul a contract with scandal-ridden Eastern Multimedia Group (EMG) to run the Taipei Arena after EMG chairman Gary Wang was indicted on Monday for allegedly bribing city government officials to win the nine-year contract. The city government announced it would form a special team to run the arena before finding a new operator through a new public tender. ‘The group won the bidding illegally, and the city government has to annul the contract. We will protect the rights of consumers and companies,’ Taipei Mayor Hau Lung-bin said yesterday after a municipal meeting at Taipei City Hall.”¹

BBC News: Nigeria suspends Siemens dealings

“Siemens was found guilty of paying bribes to Nigerian officials and fined 201m euros (\$248m; £122.3m) by a Munich court on 4 October. A Nigerian anti-corruption agency has since begun investigating former ministers alleged to have taken bribes. [...] Mr Yar'Adua [Nigeria’s President] ordered the investigation into allegations that Siemens paid 10m euros in bribes to officials, including ministers, in Nigeria between 2001 and 2004. [...] The Nigerian government cancelled a 128.4m naira (\$1.1m; £532,683) contract with Siemens for the supply of circuit breakers and other power generation accessories on Wednesday. ‘[The] Council cancelled the contract bid won by Siemens Nigeria because of the current investigation against the company relating to corrupt practices,’ information and communications minister John Odey said. ‘[The] Government will not have any dealings with Siemens Nigeria in terms of contracts until the investigation is concluded and the company is exonerated or otherwise,’ Mr Odey said.”²

Times Online: Blow for EADS as India cancels deal for 197 Eurocopter aircraft

“The Indian Army yesterday scrapped a \$600 million (£295 million) deal for 197 helicopters with Eurocopter, the world’s largest maker of civil and military helicopters, after complaints about the bidding process and allegations of illegal use of middlemen. Government officials said that they would issue a new tender next year after ending exclusive talks with the subsidiary of EADS, the European defence and aerospace group. [...] The move also denies Eurocopter, a supplier to the Indian Army, a chance to fulfill an order pipeline estimated at \$2 billion. [...] Eurocopter’s contract was suspended in June after allegations that agents that it used had links to an army general. India prohibits middlemen in military deals. [...] Eurocopter said it would reapply for the contract depending on any fresh criteria from the Indian Army.”³

¹ See AsiaMedia (15 August 2007: “Taipei City Government annuls EMG arena deal”), <http://www.asiamedia.ucla.edu/article-eastasia.asp?parentid=75998>, downloaded on 21 August 2007.

² See BBC News (6 December 2007: “Nigeria suspends Siemens dealings”), <http://news.bbc.co.uk/1/hi/business/7130315.stm>, downloaded on 14 December 2007.

³ See TimesOnline: (7 December 2007: “Blow for EADS as India cancels deal for 197 Eurocopter aircraft”), http://business.timesonline.co.uk/tol/business/industry_sectors/engineering/article3013247.ece, downloaded on 14 December 2007. See also Süddeutsche Zeitung (8/9 December 2007: “Indien storniert großen Auftrag für EADS”), Süddeutsche Zeitung Nr. 283, p. 28.

Bribes are paid with the aim of obtaining an economic advantage. The economic advantage regularly involves the conclusion of a contract whose legal fulfilment is the intended result. However, as the above cases illustrate, contracts obtained by means of bribery can be annulled. Or, in many cases, they are void or voidable by law (Ax and Schneider 2006: 73-88).

Nullity and voidability of contracts induced by corruption are oftentimes adjudicated significant powers for preventing corruption as they entail substantial costs and risks, especially for the bribe-giving party (Schlüter 2005; Acker, Froesch and Kappel 2007; Meyer 2007). While this is certainly true, they are also afflicted with many deficiencies that run counter to effective anti-corruption. Nullity and voidability decrease the incentive for voluntary disclosure and thus potentially cancel penal deterrence. They assist corrupt actors with enforcing their bribe agreements. Besides, there is ample leeway for abuse. The nullity of a contract tainted with bribery may be used as a pretext to opt out of disadvantages contracts or to gain power in renegotiations. The usefulness of nullity and voidability for anti-corruption is thus contestable.

2 Important Preliminaries

A contract can be void, voidable or valid. In economic crimes, a contract is void when it violates specific statutory prescriptions. Collusive agreements between firms geared to limit competition are in breach of competition law and are null and void. The same is commonly true for bribe agreements as these secret agreements between one party and another about the giving or promising of an illicit benefit in return for unjustified preferential treatment infringe upon criminal law or violate good customs (Ax and Schneider 2006: 73-87, 81-88). Similarly, a contract induced by such bribe agreements is oftentimes void conclusively, either from the beginning (rescission *ab initio*) or for the future (termination *ex nunc*) (Schlüter 2005: 129).

In turn, voidability means that a contract is void as long as its validity is not induced. The decisive criterion for the contract's legal status, then, is affirmation. The contract is void conclusively if not affirmed and valid conclusively if affirmed. In corruption cases, conclusive nullity is induced if the party harmed by a bribe agreement does not affirm the contract because it deems it unbalanced and disadvantageous (Ax and Schneider 2006: 87). Such disutility stems from the fact that bribe agreements regularly lead to an inflated purchase price. Accordingly, conclusive validity is induced if the harmed party affirms the contract because it nevertheless deems it balanced and advantageous (Schlüter 2006: 103; Meyer 2007: 95-97). In principle, nullity and voidability are not imperative, however. A contract induced by bribery can also be valid conclusively without the requirement of advance affirmation. The contract, albeit tainted with corruption and possibly disadvantageous due to an inflated purchase price, is then nevertheless inalterably binding and enforceable.

The three systems aim at different objectives. Above all, conclusive nullity is targeted on protecting collective interests such as those in the community of values and in fair competition by refusing legal effectiveness of a contract that is deemed immoral and anti-competitive due to it being induced by bribery (Meyer 2007: 95). By doing so, conclusive nullity seeks also to protect the legal estate of competitors that lost out due to bribery. Moreover, the system aims at preventing corruption by making bribery a risky business because the briber loses his legal entitlements to the contract's benefits and profits.

The protection of the contractual partners' legal estate is clearly secondary in a system of conclusive nullity. This particularly holds in public tenders. Bribery usually violates statutory prescriptions laid out in official contracting terms. If a contract is thereupon declared void conclusively, commonly new tenders have to result (Ax and Schneider 2006: 198-199). This certainly is in the interest of the losing bidders. But it involves substantial costs for the contractual parties, especially if the contract is already at a late stage of performance. However, in a system of conclusive nullity, these costs are accepted for protecting the community of values and fair competition. In fact, these costs also explain conclusive nullity's preventive powers (Schlüter 2005: 233).

In a system of voidability, in contrast, the protection of the contracting body's legal estate is prioritized. The protection of collective interests, of losing bidders or of the contractor's legal estate is subordinate (Meyer 2007: 96). The contracting body, as the party usually harmed, for instance, by an inflated purchase price, is given the right to decide whether to annul the contract or to continue it based on a simple cost-benefit calculation. It can refuse affirmation if the benefits associated with nullity outweigh its costs and can affirm the contract if does not. The general public, the losing bidders, as well as the contractor have to submit to this decision.

Accordingly, in a system of conclusive validity, the contractor's legal estate is primarily protected. The contract, albeit tainted with corruption, is valid. If the contracting body wishes to cancel it, it can only do so via a contractual notice of dismissal. One may thus infer that conclusive validity is not adequate for protecting collective interests, for preventing corruption or for protecting the harmed parties' legal estate. This conclusion is, however, premature. As will be shown in the subsequent section, conclusive validity may well be better suited for anti-corruption. It may correspond more with the general public's ultimate interest of seeing corruption curbed. Moreover, the harmed parties' legal estate can be protected in other ways.

3 Void or Valid? – Nullity and its Effects

3.1 Voluntary Disclosure and Due Diligence

For illustrating the effects of nullity, let us consider the following exemplary case (Figure 1). The contracting body *A* invites tenders for a contract involving the construction of several apartment buildings. Employee *E* is commissioned by *A* to solicit and evaluate the bids and to award the contract. Both price and quality are relevant for the contract award. The contractor *B* is one of the bidders. *B*'s director *D* is in charge of preparing the bid. *D* offers *E* a bribe which the latter readily accepts. To 'price in' the bribe, *E* and *D* agree to add the bribe to the purchase price. The contract is made between *A* and *B*.⁴

A and *B* are not implicated in the bribe agreement. The bribe agreement is struck secretly between *E* and *D*. Both agents act without the consent and authorization of their respective principals. *E* breaks his fiduciary duties by taking a bribe from *D* for awarding the contract in return. He thereby acts *mala fide* towards *A*. Moreover, owing to the inflated purchase price, *E* harms *A*'s interest and legal estate (Ax and Schneider 2006: 85). Due to the secret bribe

⁴ For a similar constellation see Acker, Froesch and Kappel (2007).

agreement, *D* exceeds his empowerment to act as *B*'s representative. Thus, even though he may act in the financial interest of *B*, *D* acts *mala fide*.

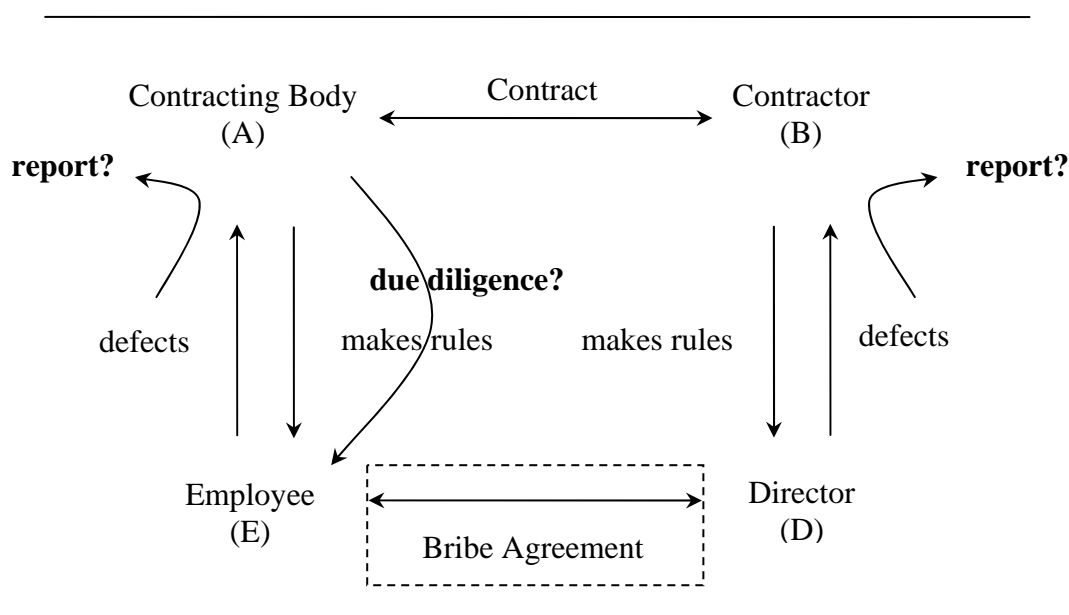


Figure 1

As stated in the preceding section, the three systems differ from each other in one important aspect. Conclusive nullity takes effect at the time the bribe agreement between *E* and *D* is verified by a court via a “balance of probabilities” (Pope 2000: 275).⁵ Voidability passes into conclusive nullity only if *A*, as the damaged party, does not affirm the contract. Otherwise, the contract is valid. Conclusive validity by definition does not result in nullity.

From the perspective of preventing corruption on the bribe-giving side, the system of conclusive nullity is often seen as superior to voidability or conclusive validity “because the bribing party does not only lose its bribe, but also its economic advantage, the induced contract, that has been the motive for corruption” (Schlüter 2005: 233). Or, as Pope (2002: 277) puts it: “A bidder’s knowledge that such contracts rest on shaky ground may be a further inducement against corrupt conduct.”

This is certainly a crucial point. Nullity entails substantial costs and risks for *B*, especially in public procurement. First, *B* loses the contract and thus the profits accruing from it. Second, transaction specific investments are largely sunk. Third, *A* can lodge considerable claims for refund as well as for damages, while oftentimes *B* cannot do the same (Acker, Froesch and Kappel 2007). *B* may thus specifically prohibit bribery by *D* and closely attend to its duties of supervision to ensure *D*'s compliance. This is not the whole business, however. Despite *B*'s efforts to prevent bribery, *D* may nevertheless find a loophole. Would *B* expose *D*? Most

⁵ A conviction of *E* and/or *D* is mostly not a precondition. It suffices if a civil court ascertains the bribe agreement (Ax and Schneider 2006: 84).

likely not if the contract is void conclusively. Rather, *B* would supposedly decide to seek private and covert compensatory and disciplinary measures against *D*.⁶

This also holds for voidability. If it is likely that *A* deems nullity beneficial, *B* has to reckon with losing the contract and remains silent about *D*'s misconduct. Because it is difficult for *B* to anticipate *A*'s decision, the safest bet is to maintain silence. While nullity and voidability create an incentive for *B* to prevent corruption by instigating due diligence measures, they, at the same time, do not offer *B* a real incentive for voluntary disclosure.

This is counterproductive as corrupt deals, by nature, involve a high degree of secrecy. Rates of random detection are usually low and prosecution and conviction of those involved are difficult and tedious. Therefore, effective anti-corruption significantly depends on relevant information given by insiders and whistle-blowers or by people of the (work) environment of the bribe-giver.

If voluntary disclosure leads or is likely to lead to conclusive nullity, however, *B* hardly has an incentive to report *D*'s deviance. As a result, *D* may also feel pretty safe that he will not be prosecuted and convicted. Neither would he have to fear civil action taken against him because this would necessitate *B*'s disclosing. Conclusive nullity and voidability ultimately also lower the deterrent and preventive effect of both criminal and civil law. It is only the system of conclusive validity that really induces *B* to report *D*'s misdemeanor, assists with uncovering corruption by means of voluntary disclosure, and that does not undermine criminal and civil law's deterrent and preventive powers.

A similar train of thought applies to *A*. In contrast to conclusive nullity, voidability and conclusive validity tend to result in *A*'s failing to instigate comprehensive systems of due diligence since *A* can, at any rate, avoid the costs and risks associated with nullity. This is especially true for voidability since *A* can cancel or maintain the contract at will and assert claims for damages against *B*. The risk and costs associated with nullity, then, do not play a role. The only reason for *A* to apply due diligence would be for fear that contracts harming its legal estate would not be detected otherwise.

However, while conclusive nullity motivates preventive measures it, at the same time, reduces *A*'s incentive for voluntary disclosure. The costs of nullity, even though they can, to some extent, be absorbed by claims for damages, may still be too high, especially if the contract is already at a late stage of performance. Since irregularities are oftentimes detected only long after the initial bidding, *A* may prefer to cover up the affair and manage it behind closed doors rather than to expose *E*. Conclusive nullity thus reinforces *A*'s incentive for secrecy. Penal deterrence and prevention by civil law are again undercut. Voidability and conclusive validity countervail these adverse effects. *A* can expose *E*, assert claims for damages against both *B* and *E* and affirm/continue the contract. Voluntary disclosure is supported by both systems.

One important caveat has to be kept in mind, however. In a private law system applying conclusive nullity or voidability, *A* can have a decided interest in *E*'s venality because this gives it the opportunity to induce the contract's nullity at any time. This can be a very valuable option, particularly if *A* would like to back out of a contract that runs the risk of

⁶ With the ever-present threat of making a penal report *B* will in most instances easily be able to ditch *D* – in order to avoid risky malevolence potentially also with a 'golden handshake'.

becoming too expensive or that is fiercely criticized by opposition (Stremitzer 2007). The possibility of inducing nullity of a contract because it is tainted with corruption, coupled with ensuing claims for damages, is a valuable 'opting-out clause' for *A*.

Furthermore, the threat of inducing nullity by refraining from affirming the contract can be used by *A* to renegotiate with *B* parts of the contract. Not only with regards to the purchase price, but beyond that, e.g. materials used or dates of completion. *B* will hardly be able to counter this, especially if *B* cannot make claims for damages, (Acker, Froesch and Kappel 2007: 1511), or if *B* has already made significant unverifiable transactions concerning specific investments (Aghion, Dewatripont and Rey 1994).

Put cynically, in some tenders, *A* may even have an explicit interest in the corruptive behavior of *E* in order to come into the possession of a valuable opting-out clause or to have significant bargaining power in renegotiations at a later stage. Less cynically, *E*'s venality may come in surprisingly handy for *A*.

This is supported by a recent case involving the purchase of 18 Eurofighter (Typhoon) fighter jets by the Austrian government from aerospace corporation EADS. The sales order in the amount of EUR 2 billion was reached in 2002 between EADS and the former conservative government. The contract, however, is (since 2006) subject to a parliamentary inquiry due to alleged irregularities in the fighter jets' procurement.

The wife of indicted, and now-suspended for misuse of authority, Austrian major general Erich Wolf obtained an 87.600 EUR loan from EADS-lobbyist Erhard Steiniger. Mrs. Wolf was, at that time, director of the firm Creativ Promotion Werbe- und Sportvermarktungsgesellschaft, a firm providing marketing services. Mr. Wolf was limited partner and authorized signatory of that firm. However, he was also a member of the committee that evaluated the purchase of the fighter jets.

The inquiry commission's findings prompted the new coalition-government, led by the social democratic party that always fiercely opposed the fighter jets' purchase, to inquire into possibilities of canceling the contract. EADS threatened to sue for damages in the amount of EUR 1.2 billion in that case. Finally an 'amicable settlement' was reached involving the reduction of the 18 fighter jets to a number of 15 for lower unit costs. Finance minister Norbert Darabos was able to successfully renegotiate the contract also because of the suspected irregularities.⁷

It certainly cannot be claimed that the former Austrian government either abetted or took a permissive stance towards the irregularities involving the purchase of the Eurofighters. Still, the story underscores the point that corruptive misconduct can, at some time, come in quite handy for a contracting body in order to opt out of an objectionable contract or to increase its renegotiation power. As one commentator puts it: "The pattern is well known: The old government orders expensive toys, the new government regards this as waste of money and wants to cancel the order."⁸

⁷ See Die Presse (6 April 2007: "Eurofighter: U-Ausschuss deckt dubiose Geldflüsse auf"); Der Spiegel (18 April 2007: "Streit um Eurofighter: EADS droht Österreich mit Klage").

⁸ See Süddeutsche Zeitung (13 December 2007: "Made in Austria"), Süddeutsche Zeitung Nr. 287, p. 4, own translation.

Against this background, it is not evident that “civil law should [...] clearly state that contracts which are obtained through corrupt means are enforceable only at the discretion of the state” and that it should be enabled “to decide [...] whether or not to be bound by a contract tainted by corruption” (Pope 2000: 276). Rather, the future possibility to cancel a contract (or to credibly threaten with cancellation) may sometimes even tend to result in a contracting body’s failing to seriously exercise due diligence and to rather pursue window-dressing. This runs counter to an honest commitment to tackling corruption among bureaucrats. Conclusive validity would strip a contracting body of such abuse and more adequately promote due diligence than conclusive nullity or voidability.

3.2 Enforcement of Bribe Agreements

Nullity may also help in the enforcement of the bribe agreement. In Figure 2, *E* again acts mala fide towards *A* by agreeing to take a bribe and harms *A*’s interest and legal estate. *D*, however, now promises or pays the bribe with *B*’s explicit knowledge and consent.

With respect to the bribe agreement, both *D* and *E* can behave opportunistically. In the extreme case, the bribe is not paid after the contract was awarded, or *E* does not award the contract after having received the bribe. *E* may also claim that changes in the contract’s form or the maintenance of silence of others who also want a piece of the cake necessitate a higher payment. Similarly, *D* may claim that continuing payment as agreed upon was impossible because financial controls were tightened and thus stops payment or procrastinates *E*. Many other ways to behave opportunistically are conceivable (Lambsdorff 2002: 234-236; Lambsdorff and Nell 2007).

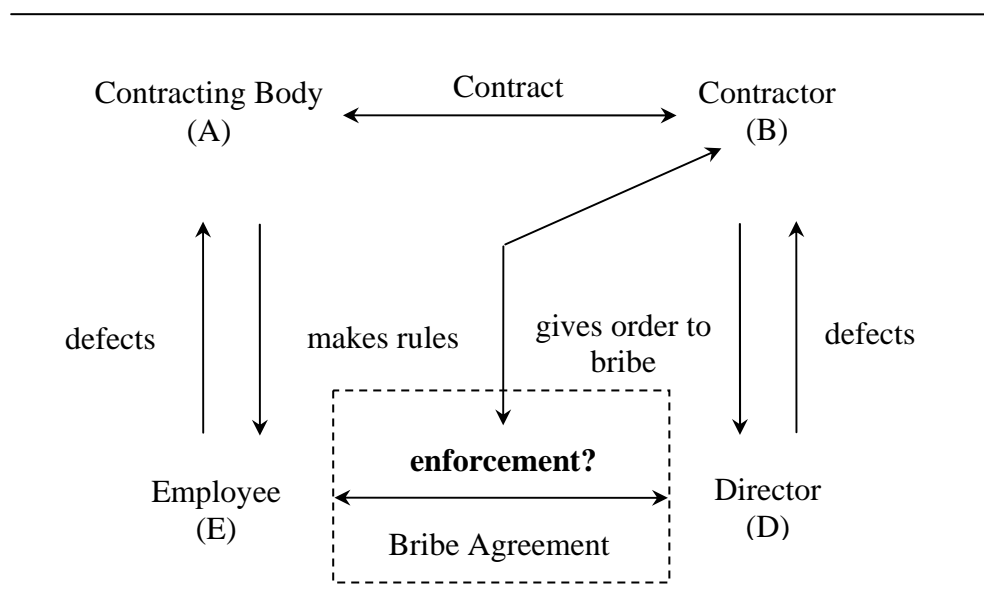


Figure 2

Generally, obfuscation of corruption usually requires the quid to be separated in time from the quo. Besides, bribes are oftentimes not paid directly but through elaborate schemes involving offshore accounts and third persons. There is ample room for opportunism that corrupt actors seek to avoid. For instance, corrupt partners in many cases integrate vertically to form a new company with common ownership and control to ‘align’ the actors’ interests.

Or, they hand out free shares or put/call options as bribes instead of direct monetary payments in order to ensure long-term compliance (Lambsdorff 2002: 232). Oftentimes, social ties and cohesion play an important role, as well (Lambsdorff 2002: 233-234; Kingston 2007). And in rougher environments, opportunism may be cut off by threats to life or physical condition, backed, for instance, by organized crime groups (della Porta and Vanucci 1999: 232-236; Gambetta 1993).

Also, the omnipresent risk of nullity or voidability may ensure that a bribe agreement goes off without a hitch. *B* and *D* cannot afford to scare off *E*, as he can strike back. Outright exposure on *E*'s part is unlikely if criminal and disciplinary penalties are severe. However, *E* may be conceded leniency if he self-reports (Gneuß 2002; Buccirosi and Spagnolo 2005, 2006; Lambsdorff and Nell 2007; Nell 2007). Or, *E* may be able to throw up enough dust or may have sufficient political clout to evade criminal charges. In the worst case, he may even enjoy outright immunity from prosecution. In any case, his threat to expose the deal if *B* or *D* should not adhere to the bribe agreement; therefore, raising the risk of nullity or voidability then carries weight.

Even if *B* and *D* do not have to reckon with *E*'s reporting, cheating him can, nevertheless, backfire. As an insider, *E* may have information that he can use against both *B* and *D*. For instance, *E* may know that *B* uses inferior building materials and can make anonymous tips to the building inspection agency. In other cases, *E* may have information on violations of environmental or safety regulations that can constitute the basis for nullity or voidability. Moreover, *E* may know that *B* and *D* are implicated in other corruption cases.

That the risk of anonymous tips is significant is corroborated by the following case involving German behemoth Siemens. In 2004, Siemens prematurely terminated a contract with a Saudi distributor. The Saudi retaliated and demanded a multimillion 'payment of compensation'. Former chief financial officer Heinz-Joachim Neubürger is said to have testified to German prosecutors that the Saudi, in fact, extorted Siemens. If Siemens would not pay, the Saudi is said to have threatened to accord the American Securities and Exchange Commission (SEC) documents revealing illegal payments made by Siemens in the late 1990s concerning Saudi Telecom contracts. Neubürger is said to have testified that, thereupon, Siemens paid EUR 50 million to the Saudi.⁹ If Siemens had not acceded to the payments, the ensuing SEC investigations would have likely resulted not only in severe penalties, but also in the probing of the legitimacy of many contracts that Siemens obtained both in the U.S. and abroad.

The omnipresent risk of nullity and voidability hovers above *D* like the sword of Damocles and ensures compliance with the bribe agreement. Against this background, the system of conclusive validity is clearly to be preferred to either conclusive nullity or voidability. If a contract induced by means of bribery is valid, *E* cannot use the threat of nullity or voidability to enforce the bribe agreement. This is also supported by another corruption case from Germany.¹⁰

⁹ See Berliner Zeitung (15 December 2006: "Diesem Spuk ein Ende machen"), <http://www.berlinonline.de/berliner-zeitung/archiv/.bin/dump.fcgi/2006/1215/wirtschaft/0005/index.html>, and Netzzeitung.de (31 January 2006: "Siemens hatte Geheimcode für Schmiergeld"), <http://www.netzzeitung.de/wirtschaft/unternehmen/516089.html>, downloaded on 20 November 2007.

¹⁰ See (BGH, 6.5.1999 – VII ZR 132/97), <http://lexetius.com/1999,871>, downloaded on 14 November 2007.

A German firm owning several apartment buildings in 1992 invited bids for a redevelopment contract. An architect promised the firm's director a monthly bribe amounting to DM 5.000 (EUR 2.500) if he was awarded the contract. The director readily accepted the offer and the architect got the contract. In the contract, advance payments to the architect amounting to DM 100.000 (EUR 50.000) once a month were agreed upon. But, in May 1993, the firm suddenly stopped paying the installments. Thereupon, the architect informed the firm about the bribe payments to its director. The firm fired the director and cancelled the redevelopment contract, referring to incomplete and poor services on part of the architect.

The case ended up in court. The architect claimed residual fees amounting to DM 3.68 (EUR 1.84) million while the firm claimed back the installments amounting to DM 1.34 (EUR 0.67) million. The district court dismissed the architect's and acceded to the firm's claim. It substantiated its verdict by saying that the contract was induced by means of bribery and was thus void. The appellate court confirmed the district court's sentence. In 1999, however, the Federal Court of Justice annulled the appellate court's judgment. It ruled that while the redevelopment contract was induced by means of bribery, the contract per se was not illicit since the architect's services were accounted for pursuant to the official Fee Structure for Architects and Engineers. Since the bribe agreement did not result in a higher purchase price, the contract was valid, so the Federal Court of Justice ruled (Meyer 2007: 96).

The exact reasons for the architect's reporting were not revealed in court. Disputes concerning the bribe agreement are likely. This is supported by the fact that the architect stopped paying the bribes in February 1993 and the firm stopped paying the installments only two months later, possibly at the director's ordering. It stands to reason, though, that the architect would have neither stopped the payments nor reported the bribe agreement if he had known that the contract was void. Rather, the differences concerning the bribe agreement could have easily been settled. Running the risk of losing a contract worth several millions just because of disputes about a few thousand of euros simply does not pay. Against this background, the Federal Court of Justice's ruling is to be welcomed because it preserves the incentive for mutual betrayal and hence supports anti-corruption.

3.3 Competitors and Impugment

Taipei Mayor Hau Lung-bin justified the Taipei City Government's step to annul the contract with EMG by saying that "the group won the bidding illegally, and the city government has to annul the contract. We will protect the rights of consumers and companies."¹¹ In many cases, a contract induced by bribery is annulled to protect competitors (and consumers). But oftentimes, the contracting body will be interested in protecting its own legal estate rather than that of competitors and remains silent about the bribe agreement or affirms the contract if it can. The question then is whether firms that presumably or knowingly lost out due to bribery should be able to impugn a contract induced by bribery. To answer this question, the principal-agent constellation is extended by a direct competitor *C* of *B* (Figure 3).

In Germany, for instance, *C* could sue for damages or file for injunctive relief (Meyer 2007: 101). Oftentimes, these are idle means of restitution (Meyer 2007: 101-103). Rather, *C*'s legal estate would be more effectively protected if the contract was rescinded ab initio or terminated ex nunc, giving *C* the chance to (re-)bid for the contract. The possibility to

¹¹ See AsiaMedia (15 August 2007: "Taipei City Government annuls EMG arena deal"), <http://www.asiamedia.ucla.edu/article-eastasia.asp?parentid=75998>, downloaded on 21 August 2007; see Section 1.

impugn a contract tainted with corruption, for example, via a negative declaratory judgment, would comply with this.

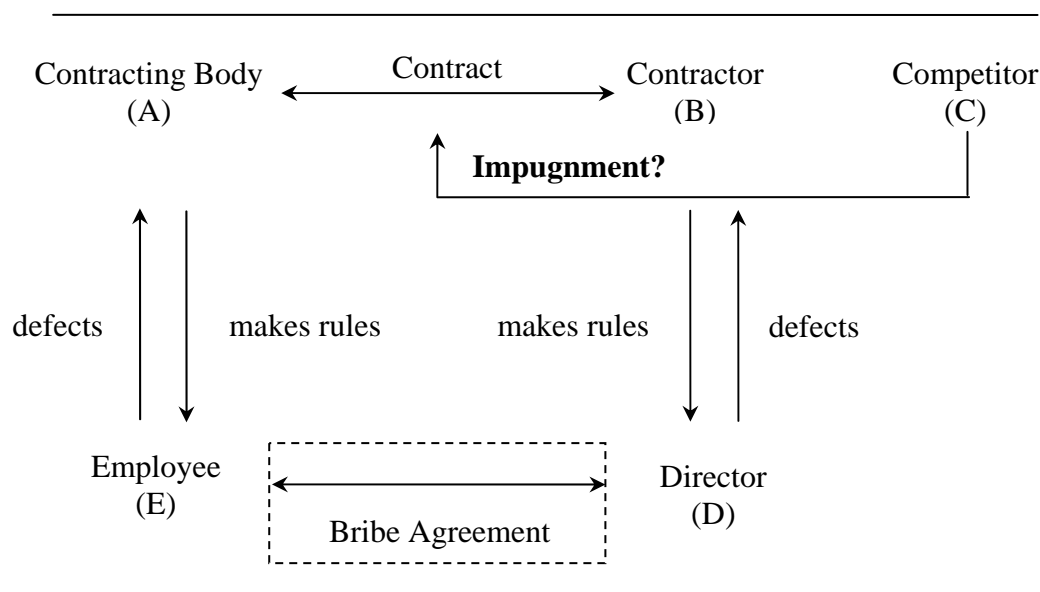


Figure 3

Besides protecting *C*'s legal estate, there is also an economic argument in support of rescission proceedings by means of impugment. *B* and *C* may be in a prisoner's dilemma. Collectively, *B* and *C* are better off by not engaging in or abetting bribery because they increase their joint profit. But, both *B* and *C* have an incentive to bribe. *B* obtains an edge over *C*, or loses by refraining from bribery when *C* bribes, and vice versa (Søreide 2007: 338). In the end, both *B* and *C* may end up paying bribes.

To assist firms in overcoming this dilemma, so-called integrity pacts were developed and are now frequently used in (public) procurement (Boehm and Olaya 2006). In these integrity pacts *A*, *B* and *C* pledge themselves on pain of penalties not to pay, offer, demand or accept bribes.¹² The possibility to contest a contract tainted with bribery increases such integrity pacts' effectiveness by stepping up the consequences of violations. Still, there are strong arguments that militate against the usefulness of impugment.

On the one hand, voluntary disclosure on the acts of corruption in their ranks on the part of both *A* and *B* becomes less likely. This is because the unveiling of the bribe agreement gives *C* the evidence necessary for activating rescission proceedings and for filing requests for a new tender. This is supported by a survey carried out by Søreide (2007) in 2004.

¹² Developed by Transparency International, an integrity pact "is a tool aimed at preventing corruption in public contracting. It consists of a process that includes an agreement between a government or a government department (at the federal, national or local level) and all bidders for a public contract. It contains rights and obligations to the effect that neither side will: pay, offer, demand or accept bribes; collude with competitors to obtain the contract; or engage in such abuses while carrying out the contract." See Transparency International, http://www.transparency.org/global_priorities/public_contracting/integrity_pacts, downloaded on 11 November 2007.

In the survey, executives of Norwegian exporting firms were asked why firms do not formally complain about corruption. Twelve percent of the 82 respondents cited ‘lack of proof’ as a probable explanation. That is, “even if convinced that a competitor had been favoured on an illegitimate basis, many firms would not react against it because of the difficulties of proving the case in court” (Søreide 2007: 340). This suggests that if firms had the proof, they would contest the illegitimate awarding of a contract.¹³ Unveiling of the bribe agreement gives *C* the evidence necessary for activating rescission proceedings and for filing requests for a new tender. Voluntary disclosure on the part of *A* and *B* becomes less likely. This is substantiated by a case involving irregularities in U.S. Pentagon procurement.¹⁴

In 1988, Comptek Research Inc., a Buffalo-based producer of military electronic equipment, was eliminated during the first round of competition for a Navy contract involving a Marine Corps system for controlling and directing tactical aircraft in combat. Amid federal investigations into alleged bribery by one of its competitors, Norden Defense Systems, Comptek filed a protest with the General Accounting Office. The protest contended that the investigations have shown that illegal acts were committed during the selection process and that those acts “render invalid any award resulting from the process.” As a consequence, the contract, which should have been awarded in July 1988, was held up by the Comptek protest. Members of the House Armed Services Committee thereupon warned in a statement that “the problem of potential ‘tainted’ contracts is compounded by the potential for a legal gridlock that could paralyze the defense acquisition system for an indefinite period.” In the end, Comptek’s plea was dismissed by the General Accounting Office.

Clearly, if irregularities are suspected in the bidding stage, these should be probed and the contract award postponed. Yet, the case also corroborates the point that potential impugment impairs the incentive for voluntary disclosure. Would the more honest at Norden Defense Systems have reported this in light of potential impugment? Probably not. Risking the loss of a multimillion contract may, in the end, crowd out honesty. As stated, this is counterproductive as effective anti-corruption significantly depends on relevant information given by insiders and whistle-blowers or by people of the (work) environment of those entangled in corruption.

On the other hand, impugment also assists corrupt actors with enforcing their bribe agreements. In our case, *E* can now threaten *B* and *D* with public disclosure, with making anonymous tips to the building inspection agency and, in addition, with tip-offs to *C*. Having to fear recourse not only by *A* but also by *C*, *B* and *D* would likely comply with the bribe agreement instead of scaring off *E*. The risk of nullity or voidability induced by a competitor can stabilize corrupt deals.

4 Policy Implications and Conclusion

Nullity and voidability of contracts induced by bribery are adjudicated significant powers for preventing corruption as they entail substantial costs and risks for the bribe-giving party. Moreover, the view is held that they guarantee the protection of the legal estates of the

¹³ Another reason for not formally complaining was “Concern about future business cooperation” (31%). For the whole survey see Søreide (2006).

¹⁴ See The New York Times (25 August 1988: “Losing Bidder Contests Contract Involved in Pentagon Case), <http://query.nytimes.com/gst/fullpage.html?res=940DE4DA133EF936A1575BC0A96E948260>, downloaded on 20 November 2007.

harmed parties, particularly of the contracting body and of competitors. These are important aspects. Nullity and voidability have several considerable disadvantages, though, that render their usefulness for anti-corruption contestable.

First, those who make a report on corrupt conduct of their employees are punished. Voluntary disclosure becomes less likely. This ultimately reduces the deterrent and preventive powers of criminal and civil law. Second, nullity and voidability undermine due diligence since the option to terminate or renegotiate a contract on the grounds of corruption can be very valuable. Third, nullity and voidability assist corrupt actors with enforcing their bribe agreements, thereby stabilizing rather than breaking up corrupt deals. Fourth, nullity and voidability only punish those who successfully obtained a contract. The unsuccessful but nevertheless corrupt are not punished. An effective anti-corruption strategy has to entail consequences for all who try to seek influence by giving bribes, and not only of those who were successful in doing so.

For these reasons, I argue that contracts obtained by means of bribery should not be void or voidable, but valid. Nullity and voidability are neither imperative for preventing corruption nor for protecting the legal estates of the harmed parties. Rather, there are instruments that have similar preventive and protective effects but that, at the same time, avoid the disadvantages of nullity and voidability.

Corporate liability, for instance, determines when and to what extent a corporation is liable for acts of corrupt conduct of its employees (Lederman 2000). Corporate liability is a collective punishment, as are nullity and voidability. It induces *B* to exercise due diligence in a similar fashion. One advantage of corporate liability, however, is that it can be reduced in the case of voluntary disclosure. The incentive for reporting *D* can be sustained, especially if *B* exercised due diligence and hence did nothing wrong. Similar incentive-compatible concessions are not possible in the case of nullity or voidability. Here, the materialization of the bribe agreement between *D* and *E* usually suffices to induce nullity or voidability of the contract. Whether or not *B* exercised due diligence does not play a role in this outcome.

The same train of thought in principle applies to contract penalties. These oblige a contractual party to pay a fine if it does not fulfill its obligations. As a bribe agreement commonly violates statutory prescriptions laid out in (official) contracting terms, it would inflict a contract penalty. The pending penalty also urges *B* to exercise due diligence (Noll 2001, 2004). One advantage over nullity and voidability is that contract penalties can be designed such to reflect the economic advantage obtained by corruption (Lambsdorff 2007). Contract penalties are proportionate while nullity and voidability in many cases are not.

Moreover, specific clauses can also be applied that formulate that the contract penalty is reduced by, say, 50 percent if *B* voluntarily discloses acts of corrupt conduct of *D*. Similar concessions are again not possible with nullity or voidability. Either the contract is void or not. There is no in-between that maintains the incentive for reporting. Moreover, as Lambsdorff (2007) points out, the contract penalty can be paid to the losing bidder *C*, thereby protecting its legal estate.¹⁵ Besides, in the course of an integrity pact, contract penalties can be imposed on all firms (*B* and potentially *C*) and not only on the successful one (*B*).

¹⁵ If the contract penalty accrued to *A*, there is an adverse incentive. *A* would benefit from its own organizational failure and may thus allow *E* to take bribes so as to demand the payment, (Lambsdorff 2007).

Debarment (exclusion) as an administrative remedy available to a government that prevents or disqualifies contractors from obtaining new contracts is yet another tool available in the anti-corruption arsenal. However, debarment may not be proportionate to the severity of the crime. Moreover, if designed improperly, it shares some of the disadvantages of nullity and voidability disadvantages. Debarment, for instance, can also reduce the incentive for voluntary disclosure if no clear guidelines exist on how to deal with a firm that proactively reports acts of wrongdoing. But such potential disadvantages of debarment can be cleared out whereas this would be elusive in the case of nullity or voidability. The World Bank's voluntary disclosure program, for instance, is a case in point.¹⁶ Corrupt contractors in World Bank-financed contracts are not debarred if they voluntarily report acts of wrongdoing and work with the World Bank on measures to prevent future misconduct (Williams 2007: 277-306).

Finally, severability deserves close attention. Severability refers to a provision in a contract which states that if parts of a contract are held to be illegal or otherwise unenforceable, all other contractual elements nevertheless remain valid. As discussed, corruption usually leads to an inflated purchase price because the bribe is oftentimes 'priced in'. Severability implies that a bribe agreement only renders the price agreement void or voidable while the rest of the contract remains valid.

In fact, this was subject to a ruling made by the higher regional court in Munich, Germany (Meyer 2007: 97). In 2004, Karl-Heinz Wildmoser, Jr. was indicted for corruption in connection with the awarding of the construction of the Allianz Arena, a football stadium in the North of Munich. Wildmoser, Jr. was director of the Allianz Arena München Stadion GmbH, the contracting authority for the Allianz Arena. He awarded the construction contract at an inflated price, provided the Austrian construction company, Alpine, with inside information that enabled the company to win the contract, and in return received EUR 2.8 million from Alpine. In 2005, Wildmoser, Jr. was convicted and sentenced by a Munich court to four and a half years in prison. He was released on bail pending his appeal. In 2006, the German Federal Court of Justice rejected the appeal and Mr. Wildmoser, Jr. is since serving his sentence (ZRFG 2006: 137-138).

Following several civil proceedings, Wildmoser, Jr. had to pay back EUR 2.8 million to the Allianz Arena München Stadion GmbH, the equivalent of the bribe he accepted. According to present German adjudication, the construction contract would have had to be void because the bribe agreement led to a higher purchase price. However, in 2007, the higher regional court in Munich independently ruled that only the price agreement is void while the other parts of the contract remain valid (Meyer 2007: 97).

Because severability only affects the price agreement, it largely avoids the considerable disadvantages that nullity or voidability entail. Still, it may not be the adequate instrument in some cases. Illicit construction projects in nature reserves, for instance, should be annulled and the buildings erected demolished. Moreover, if contracts were obtained by means of threats to life and physical condition, nullity or voidability may also be necessary. Aside from such special cases, though, I argue that nullity and voidability are not imperative for anti-corruption. Other instruments such as corporate liability, contract penalties, debarment and severability serve the purpose of curbing corruption in a better way.

¹⁶ See www.worldbank.org/vdp for more information.

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