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Stefan Vogenauer

Invalidity

1. Degrees of invalidity

All European legal systems know different degrees of invalidity. These are distinguished on the basis of who may invoke the invalidity, how it is invoked and what its consequences are. Normally, the pertinent provisions do not define these degrees. It is left to legal scholarship to conceptualize them and to bring them into a coherent system. Legal scholarship has tackled this task since the 19th century. In contrast, a coherent system of degrees of invalidity was unknown to → Roman law and the earlier → *ius commune*. Today, European legal scholarship has to engage in this task for the following three reasons. First, there are terminological and conceptual differences between the different European legal systems which must be understood. Secondly, there is a multitude of different terms at the European level that are in need of systematization: the draft of a → *Code Européen des Contrats (Avant-Projet)*, for example, speaks of *nullité, inefficacité, inexistence, annulation, rescision, extinction, [cesser] d'avoir effet*. Finally, legal scholarship should work towards a coherent use of the different degrees of invalidity in future projects of legal harmonization.

2. What are the objects of invalidity?

Invalidity is often discussed within the general principles of contract law (Italy, England, France) or as a problem relating to *Rechtsgeschäfte* (private → juridical act: Germany). As the → Principles of European Contract Law (PECL) and the → UNIDROIT Principles of International Commercial Contracts (PICC) are confined to contract law they only deal with the invalidity of contracts. Yet, judgments, statutes or administrative acts may also be invalid. When bringing the degrees of invalidity into a coherent system should these legal acts therefore also be included? There are, indeed, common historical roots: the action for retrial of a case, for instance, developed from the Roman *restitutio in integrum*, and the *restitutio in integrum* was also applicable if a contract was to be set aside on the basis of one of the contract parties being a minor. However, it would lead to a level of abstraction too high for practical purposes if one tried to bring the degrees of invalidity for all legal acts into one coherent system; and such attempts have in the past, indeed, proven to be unsuccessful.

Even within contract law and the rules relating to *Rechtsgeschäfte* (→ juridical act) one will often find special rules for the invalidity of special legal acts, such as for example in family law (marriages), → succession law (→ wills), labour law (contracts of employment) or company law (shareholders' resolutions and articles of incorporation). In such cases, however, the question as to who may invoke the invalidity, how it is invoked, and what its consequences are may receive different answers. European legal scholarship needs to identify the reasons which justify such departures from the general principles. Only then will it be possible to pave the ground for a coherent intellectual integration of these exceptions in future attempts at legal harmonization.

If the parties to an invalid contract have already exchanged their performances, the contract may be unwound (→ unwinding of contracts). Invalidity and the process of unwinding are distinct. Only legal acts can be invalid. The performance of a contract does not need to be a legal act. It may also be a real act which can be undone but which cannot be invalid. Moreover, the questions of the invalidity of a contract and of its unwinding are often conceptualized differently. Nullity is a degree of invalidity; it does not describe the process of unwinding the contract. Whether a contract is null and void is a question of contract law; a contract which is null and void has to be unwound, and that is a question of the law of restitution, or unjustified enrichment. In other instances, invalidity and the process of unwinding the contract are not as clearly separated and conceptual overlaps exist: the Spanish *acción de nulidad* aims at nullifying a contract, eg for mistake, and is at the same time directed at undoing the contract; in England if a party wishes to rescind and, thus, to invalidate a contract, it has to make *restitutio in integrum*, and the term rescission is thus often used also to include the process of unwinding the contract. Finally, the PECL and UNIDROIT PICC, as part of their respective rules on validity, also deal with the unwinding of the contract as an effect of invalidity.

3. What are the reasons for invalidity?

In their chapter on validity, the PECL name the classical grounds for invalidity: lack of → capacity, immorality, → illegality of contracts, → mistake, → fraud and threats. All of these defects exist at the time of formation of the contract and avoid it *ex tunc*. Thus, invalidity seems to consist of three elements: it nullifies the contract, it has retrospective effect and the reason for invoking it exists at the time of the formation of the contract. The literature in many European legal systems follows a similar concept, and in Germany one finds a parallel approach to the invalidity of *Rechtsgeschäfte*. European legal scholarship, however, needs to be aware of its limits. For a number of reasons these three elements are only an approximation to, but not a definition of, invalidity: if one wanted to systematize the possible defects that may arise in the formation of contracts, invalidity is the wrong concept to start with as it denotes a consequence and not a defect. Fulfilment of a resolutive → condition, for example, also invalidates it even though it occurs only after the contract has been concluded. On the other hand, not all initial defects are included (eg → impossibility, initial) but only those which nullify the contract *ex tunc*. There is also no correlation between the time of a defect and its effect, as many legal systems hold that defects in the formation of contracts of employment, for example, only operate prospectively. If one were to focus only on the nullifying effect in order to define invalidity, then unenforceability would be excluded (which is, at least in England and Scotland, considered to be a degree of invalidity); in addition, all cases in which the parties are only excused from performing of the contract (initial impossibility, → non-performance) would equally be excluded. Similarly, the PECL in their chapter on validity refer to illegality as a reason for invalidity, but in their chapter on illegality they designate illegal contracts only as ineffective and provide a flexible list of degrees of invalidity, including unenforceability.

Invalidity should be defined as a response whereby an invalid contract is understood as either failing (fully or partially) to create its intended legal effects or as losing them subsequently. A ground for invalidity is a cause that generates such response. According to this definition unenforceability is a degree of invalidity. This definition simplifies comparison: today it is more and more frequently acknowledged that termination for non-performance and initial impossibility do not nullify a contract; they merely excuse the parties from making performance, and a terminated contract does not allow the parties to keep what they received under the contract (Germany). Yet, in some European legal systems initial impossibility still renders the contract void (France, Italy, Portugal, Hungary), and in others termination annuls the contract *ex tunc* (France, Spain, Austria). With the proposed definition, these differences only appear as different degrees of invalidity. They do not demarcate a fundamental divide in the approaches to initial impossibility and termination. The proposed definition also simplifies future efforts of legal harmonization as it provides draftsmen with a graded system of degrees of invalidity to choose from. Finally, the definition does not stand in opposition to any legal system in Europe. Even though they all make use of the concept of invalidity, they do not define it as a generic term; nor do they presuppose a certain definition. European legal scholarship is free to develop a concept of invalidity that best serves the purposes of comparative research and legal harmonization.

4. Who may invoke the invalidity?

If only one of the parties can invoke the invalidity this is referred to as relative invalidity. The invalidity is absolute if either party, or even third parties, may rely on it. Sometimes only certain third parties may invoke the invalidity, as is the case with challenges to a will. This may also be referred to as relative invalidity. The borderlines between absolute and relative invalidity, on the one hand, and between voidness and voidability, on the other hand correlate in most, but not all, cases. Absolute invalidity does not necessarily equal voidness just as relative invalidity does not necessarily equal voidability. Under the PECL illegality can have the effect that only one party is barred from enforcing the contract. Invalidity is thus relative in such cases. However, the judge will consider *ex officio* that the contract is only enforceable by one party. The contract is neither void nor voidable. In Germany, if a marriage has been entered into although impediments to marriage existed, the marriage may be annulled by judicial decision. It is voidable. Yet an action can be filed by a public authority, and this corresponds to an absolute invalidity, as the public authority will represent the general public.

Whether a contract is absolutely or relatively invalid depends on the policy considerations underlying each individual ground for invalidity: does it protect the interests of the general public or only those of a specific person? European legal systems find different answers to these questions for the different grounds of invalidity, as for example in the case of lack of → capacity (absolute: Germany, Poland, Greece; relative: France, Italy, the Netherlands) and unconscionability (unfair advantage-taking) (absolute: Germany; relative: France, Italy, Poland, Hungary, the Netherlands, PECL).

5. How is invalidity invoked?

In some cases one party, or a third party, needs to take special steps before the legal act in question can be disregarded; in other cases invalidity may be taken into account without such special steps having to be taken. The former is true for voidability, the latter for voidness. The distinction between void and voidable acts is known to most legal systems (Portugal, Italy, England, Scotland, Ireland, the Netherlands, Germany, PECL, UNIDROIT PICC, Draft → Common Frame of Reference (DCFR). However, the term 'void' does not only point to the fact that the act is considered automatically as invalid, but it also denotes that it is null and void in every respect *ab initio*. Thus, the term 'void' also points to the consequences of this degree of invalidity. Moreover, voidness is not the only degree of invalidity which will take effect without the need first to invalidate the legal act: the same is true for unenforceability.

There are different ways to rescind a voidable contract. Many legal systems regard avoidance as a judicial remedy: the party who is entitled to ask for the contract to be avoided has to bring an action, and only the judge may nullify the contract (France, Belgium, Greece, Spain). If an action is brought against this party, it may rely on the invalidity also by way of defence. These legal systems stand in the tradition of the → *ius commune*. During the time of the *ius commune* avoidance was also, as a rule, enforced by way of *actio* and *exceptio*. Yet, in recent times the idea has prevailed that avoidance is a self-help remedy: the contract is avoided by notice to the other party (Germany, Poland, PECL, UNIDROIT PICC, DCFR). Thus, the English discussion to abolish rescission as a self-help remedy (O'Sullivan) seems to be regressive. Dutch law recognizes both judicial rescission and rescission by notice, but the latter is the paradigmatic case. All legal systems which, as a rule, allow avoidance by notice provide for exceptions, especially for those → juridical acts that affect the status of a person or for acts affecting a multitude of parties. In Germany, for example, shareholders' resolutions in → stock corporations and marriages can only be invalidated judicially. Where rescission by notice is sufficient, usually no special form needs to be observed (PECL, UNIDROIT PICC, DCFR). In some legal systems the notice has to be in writing (Poland). In others a special form only needs to be observed when certain types of contracts are to be avoided, for example in Germany in case of the avoidance of a contract of inheritance. In addition to judicial avoidance and avoidance by notice, a third way to avoid juridical acts was known in legal history. Savigny discussed the possibility of avoidance in the form of an 'obligation to execute a legal act that is directed at the result that is contrary to an earlier legal act'. Today, this kind of avoidance is of little importance.

Many modern legal systems strictly distinguish between avoidance, termination for → nonperformance and a → right of withdrawal (England, Scotland, Germany). In these legal systems one only refers to avoidance if the contract is avoided *ex tunc*. Yet, avoidance has this narrow meaning only within the general principles of the law of contract. Outside of this field the term avoidance is often used in a much wider sense (Germany). In England the term rescission was until recently also used to encompass termination. If one simply defines rescission as that degree of invalidity of which a judge only takes account after one party has invalidated the contract, by notice for example, then there is no problem with including termination in such a wide concept of rescission.

The modern model rules do not draw further distinctions within avoidance, narrowly conceived (PECL, UNIDROIT PICC). Some European legal systems, however, still distinguish between different forms of avoidance, such as for example English law between rescission at law and at equity, and as Italy, France and the draft of a → *Code Européen des Contrats (Avant-Projet)* which all recognize a special type of avoidance for lesion.

Most European legal systems distinguish between voidness and voidability. However, there are exceptions (France, Spain). In France, for example, the distinction is rather drawn between *nullité absolue* and *nullité relative*. *Nullité absolue* is said to correspond to voidness, but it is a judicial remedy. To speak of nullity if the invalidity has to be enforced by way of action seems at first sight surprising. But outside the field of general contract law other legal systems also refer to

voidness, even though the invalidity needs to be enforced by means of a legal action: in Germany a court judgment may be void (*nichtig*), but the voidness has to be enforced by bringing an action (*Nichtigkeitsklage*). In Austria the same is true for void marriages.

It is generally accepted throughout Europe that non-compliance with a → formal requirement will make a contract void whereas defects in consent will make the contract only voidable. In contrast, there is again no agreement as to whether lack of → capacity and unconscionability (unfair advantage-taking) will lead to voidness or voidability. Under the PECL, unfair contract clauses which were not individually negotiated are voidable rather than void. In general, it will again depend on the policy considerations underlying the ground of invalidity whether a contract, or a contractual term, is void or only voidable: does it protect the interests of the general public or only those of a specific person? However, other considerations will also influence this decision. Important or complex legal acts and legal acts that affect a multitude of persons will often not simply be void but will need to be avoided by (perhaps formal) notice or by bringing an action.

6. What are the consequences of invalidity?

With regard to the consequences of invalidity there is first the question of whether it should work retrospectively or only prospectively. In general, the term 'void' entails *ex tunc* effect, as does avoidance for defects in the formation of a contract. However, all European legal systems know exceptions to this rule as, for example, in the case of contracts of employment or articles of incorporation.

Then there is the question of partial invalidity: if only part of a contract is invalid, will the rest of it remain in force? During the time of the *ius commune* it was deduced from the Roman sources that the invalidity was, as a rule, indeed only partial (*utile per inutile non vitiatur*). In Germany § 139 → *Bürgerliches Gesetzbuch* (BGB) departed from this rule: a partial invalidity will normally render the entire contract invalid. Yet, both case law and legal scholarship have, in accordance with the predominant position in Europe, again adopted the reverse position: if only part of a contract is invalid the rest of it will, as a rule, remain in force. The question of what factors will justify exceptions to this rule is answered differently within Europe: in some legal systems the will of the parties is decisive (Greece); in other jurisdictions the answer to this question depends on whether the invalidity concerns an integral part of the contract or not (France), or whether the part affected by invalidity and the remainder are inseparable (the Netherlands). Under the PECL, the UNIDROIT PICC and the DCFR, the answer to this question turns on reasonableness: the invalidity will not only be partial if it would be unreasonable to uphold the remaining contract. Finally, in all legal systems the policy considerations behind the ground for invalidity will be of importance.

Furthermore, there is the question of whether the invalidity of a contract will also affect the validity of a conveyance which was executed in fulfilment of the contract. Legal systems which adopt the principle of abstraction will, as a rule, answer this question in the negative (Germany, Scotland); legal systems where this principle is unknown will answer it, as a rule, in the affirmative (Italy, France, the Netherlands, Portugal). One may also make a distinction on the basis of whether the invalidity is final or whether there is a state of pendency. Finally, if one considers termination and withdrawal as being merely different degrees of invalidity, further distinctions have to be drawn concerning the effect of these remedies for the contract. Voidness and voidability regularly nullify the contract *ex tunc* in every respect. Termination, as a rule, nullifies the contract *ex tunc* in so far as it provides a cause allowing the parties to keep what they have received under the contract: the contract will have to be unwound. In other respects, eg with regard to limitation, exclusion, and arbitration clauses, termination usually only operates prospectively.

7. How can an invalid contract be rescued?

All European legal systems provide for various instruments to remedy invalidity, eg convalescence, conversion, ratification and confirmation. Furthermore, in many European legal systems and according to the PECL, an interpretation which leaves the contract intact is to be preferred over an interpretation which would render it invalid.

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Phillip Hellwege

Investment Funds

1. Meaning and development of investment companies

Investment funds serve as legal entities for joint investment, especially in securities. They enable investors to spread the investment risk by investing small amounts. At the end of 2007, almost €8 trillion (€7,909 billion) were held by European investment funds. Due to the financial crisis, this value was reduced by almost two trillion Euros to €6.088 trillion in 2008, while by the end of 2010 the amount had risen again to €8.025 trillion. Equity was the class of assets that experienced the sharpest decline, although it still remains the most important investment type. Quite remarkably, a truly European market for investment funds has emerged. The largest European market for investment funds is in Luxembourg, followed by France, Germany, Ireland and the United Kingdom. In 2006, Luxembourg ranked as the world's second largest location for investment funds, trailing only behind the United States. The bulk of the investment funds in Europe are subject to the European → directive relevant in this regard.

The origins of the investment business go back to the 19th century. As early as the first half of the 19th century, business trusts in the United States were in practice closely linked to the insurance business and many banks were founded as 'Trust & Banking Companies'. In Europe, the first investment companies emerged in the second half of the 19th century in Scotland and England. They shared many characteristics with the Anglo-Saxon → trust. Later, in the 19th century, the idea of collective investment in investment companies spread to continental Europe, namely to Switzerland and the Netherlands. It seems that in Germany, two entities existed in the 1920s which could be classified as investment funds. At the beginning of the 1930s, an attempt was made to establish so-called capital management companies. Ultimately this led to the tax obstacles for investment funds merely being relaxed rather than abolished, and investment funds only asserted themselves in Germany after World War II. Investment funds were codified for the first time in the United States with the Investment Company Act of 1940, which heavily influenced the German Investment Companies Act of 1957.

2. European regulations

At the European level, investment funds have since 1985 been subject to the directive on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS Directive, Dir 85/611), which was revised several times before being substituted recently by Dir 2009/65. The UCITS Directive was one of the first directives to achieve the desired internal market and, in particular, provides for a → European passport for investment funds. In November 2006, the European Commission issued a White Paper as part of a fundamental review of the UCITS Directive. One question currently under review is whether to harmonize investment funds not currently covered by the UCITS Directive, such as open-ended real estate investment funds. This would make all investment funds subject to common rules, thus entitling them to a European passport. A further proposition is to facilitate the investment by professional investors in non-mutual funds and to liberalize such cross-border transactions. Finally, new rules are being put forward to facilitate cross-border merger of funds.

Directive 2009/65 consolidates the text of the UCITS Directive and carefully develops the UCITS Directive itself. The numerous amendments to the UCITS Directive in 1985 are integrated in the new UCITS Directive. Furthermore, the new directive includes provisions for national and cross-border mergers of investment funds. Also included are new provisions for master/feeder structures, in which a UCITS (feeder-UCITS) invests all or almost all assets in another UCITS (master-UCITS). Another focus is on the provisions of investor information. The reporting requirements, which make possible the European-wide distribution of UCITS, have been simplified and improved.

Undertakings for the collective investment in transferable securities (UCITS) have the sole purpose of investing and managing joint accounts with funds that have been raised from the public. Under national law, the collective investment in transferable securities may assume a contractual form (managed by the management fund), a trust form (unit trusts) or the form of an investment company. The principle of risk diversification is essential. The investment policies and barriers are included in the UCITS Directive as well as in an implementing directive. Securities within the meaning of the UCITS Directive are shares and other securities equivalent to shares, bonds and other forms of securitized debt, and all other marketable securities that authorize the acquisition of securities within the meaning of the directive by subscription or exchange. UCITS are subject to approval and the approval is valid for all Member States. The safekeeping of the assets of a UCITS is transmitted to a depositary.

3. Historical development of selected national rules

The German law of investment, which was initially contained in the Investment Company Act of 1957 and is now found in the Investment Act, is characterized by the management of several investment funds through one company and, especially, the so-called investment triangle. In addition to the investment fund and the investor, the deposit bank is a compulsory part of the investment triangle. The investment company instructs the custodian with the safekeeping of the fund and the issuance and redemption of units on the subject. The involvement of a custodian is modelled on the US Investment Company Act of 1940, in terms of which the unit investment trusts must install a bank as trustee or custodian. According to the German legislation on investment companies, the UCITS Directive requires a depositary, which also has supervisory tasks. The redemption obligation and the prohibition on borrowing were also based on the US model and are now subject to the UCITS Directive.

In England, the UCITS Directive constituted an impetus for the creation of investment companies. The traditional unit trust schemes, in which the assets are held for the investors in trust, were also further developed. For unit trust schemes to participate in the European market using the single passport, special provisions for authorized unit trust schemes have been created. In order to comply with the rules of the UCITS Directive, the Financial Services Markets Act of 2000 prescribes that the functions of the trustees and the managers of unit trusts be separated.

Luxembourg's first investment fund was founded in the 1950s. Investment funds are now regulated by the *Loi du 20 décembre 2002 concernant les organismes de placement collectif.* The companies covered by the UCITS Directive are described as OPCVM (*organisme de placement collectif en valeurs mobilier soumises à la Directive 85/611*). Investment companies, described as SICAF (*société d'investissement à capital variable*), have been regulated since 1980 and are thus the oldest of their kind in the European Union.

In France, investment funds are regulated in the *Code monétaire et financier*, Art L 214-1-146. Much emphasis in French legal literature is placed on the regulation by the Financial Supervision Authority, the *Autorité des Marchés Financiers* (AMF). As is the case in Luxembourg, the investment companies are called SICAF. Other investment funds exist by the name of FCP (*Fonds Commun de Placement*).

4. Public and special funds

The European UCITS Directive regulates only those investment funds that raise money from the public. In principle, two types of investment companies exist, namely investment funds and special funds. Management in mutual funds is a sub-form of standard asset management. In Germany, special funds which are subject to the Investment Act are used particularly by private pension institutions as a special investment vehicle for pooled assets. These investment vehicles are thus aligned with a particular investment strategy. Since no investment in securities occurs in real estate investment funds, the latter are not subject to the UCITS Directive.

5. Use of investment funds for occupational and individual pensions

The use of investment funds as a vehicle for occupational and individual pensions has thus far not been regulated at the European level. The Pension Funds Directive regulates only → pension funds as vehicles for → occupational pensions. In its White Paper, the Commission nevertheless recognizes the importance of greater investment for retirement as a means of expanding the single market for investment funds. Internationally, the investment in investment funds is widespread in the context of individual and occupational pensions since no (biometric) guarantees must be given for preferred tax treatment. Based on this phenomenon, the European