

A cattle rancher operates a large ranch with many employees. State law requires all employees within the state to pay a state income tax, and all employers are required to accurately report their employees' incomes. Enforcement of the state law is a civil matter. There are no criminal penalties for failure to pay or failure to accurately report.

The rancher entered a written employment contract with a veterinarian, who agreed to manage the health of the rancher's cattle for six months. Both parties knew about the state income tax, and the veterinarian wanted to avoid paying it. The rancher therefore agreed to compensate the veterinarian by paying the veterinarian's monthly mortgage directly to the bank without reporting the payments to the state. The rancher paid the veterinarian's mortgage for the first three months of the contract and then stopped making payments even though the veterinarian continued to work.

If the veterinarian sues the rancher, what will he likely recover?

- A. Expectation damages, because the rancher breached the contract and it did not involve any criminal conduct.
- B. Restitution damages, because the rancher withdrew from the agreement by failing to make additional mortgage payments.
- C. Restitution damages, because the veterinarian was less culpable than the rancher.
- D. Nothing, because the contract had an illegal purpose.

Explanation:

An **illegal contract** arises when one or both parties' purpose, formation, or performance is against the law—such as the rancher's agreement not to report the veterinarian's income as required by state law. Such contracts generally are **void** and there is **no remedy for breach**. However, an illegal contract is **enforceable** for the full amount of the nonbreaching party's **expectation damages** if:

- the nonbreaching party was justifiably ignorant of the facts that made the contract illegal*
- the nonbreaching party substantially performed and lacked an illegal purpose
- the contract can be easily separated into legal and illegal parts *or*
- the contract is illegal due to a violation of a licensing requirement designed only to raise revenue.

None of these exceptions apply here. The veterinarian knew about the state income tax and purposely contracted to evade it. The agreed method of compensation is entirely illegal and cannot be separated from any legal part. Additionally, the illegality does not stem from a licensing violation. As a result, the veterinarian cannot recover expectation damages **(Choice A)**.

However, **restitution damages** may be an alternative form of recovery. A party to an illegal contract can recover such damages if that party conferred a benefit on the other party and:

- was justifiably ignorant of the facts that made the contract illegal*
- was less culpable than the other party *or*
- withdrew before the contract's illegal purpose was achieved and did not engage in serious misconduct.

Here, both parties knew about the law, so they were equally culpable in agreeing to violate it **(Choice C)**. And only *after* the contract's illegal purpose was achieved through the first few payments did the rancher (not the veterinarian) withdraw by failing to make additional payments **(Choice B)**. Therefore, the veterinarian also cannot recover restitution damages.

*However, recovery on this basis will be barred if the other party also was justifiably ignorant.

Educational objective:

An illegal contract generally is void and there is no remedy for a breach. However, in limited situations, a party to an illegal contract can recover either expectation damages (eg, if the party was justifiably ignorant of the illegality) OR restitution damages (eg, if the party was less culpable than the other party).

References

- Restatement (Second) of Contracts § 178 (Am. Law Inst. 1981) (explaining when promises are unenforceable on public-policy grounds).

- Restatement (Second) of Contracts §§ 197–199 (Am. Law Inst. 1981) (availability of restitution).

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Recovery for breach of illegal contract

