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Introduction to special issue: Harmonisation of contract law: an economic and behavioural perspective

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1 Introduction

The recent publication of the Draft Common Frame of Reference of European Private Law (DCFR)[1] and the Feasibility Study of the Expert Group on European Contract Law[2] have given even more impetus to the debate about a harmonised European contract law than existed before. While the idea of a harmonised contract law for the European Union is widely discussed among academics since at least a decade, it is now also part of a political discussion in which both the European institutions and the member states are playing an increasingly important role.

The debate about harmonisation of contract law is still primarily informed by legal arguments.[3] What is often missing is a more broad-ranging perspective that opens up the discussion to arguments from the fields of economics and behavioral science. This state of affairs is to be criticised: in particular when it comes to the questions of the *need for* and the optimal *design of* a European contract law,

[1] Von Bar and Clive (2009).

[2] A European contract law for consumers and businesses: Publication of the results of the feasibility study carried out by the Expert Group on European contract law for stakeholders' and legal practitioners' feedback (2011), following Commission Decision of 26 April 2010 setting up the Expert Group on a Common Frame of Reference in the area of European contract Law, 2010/233/EU and Green Paper from the Commission on policy options for progress towards a European Contract Law for consumers and businesses, COM (2010) 348 final. This culminated in the Proposal for a Common European Sales Law, COM (2011) 635 final.

[3] See about the state-of-the-art in European private law Basedow et al. (2009), Zimmermann (2009) and Twigg-Flesner (2010).

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economics and psychology can provide us with important insights. And although some specific aspects of the harmonisation debate have been looked at from the economic perspective,[4] other aspects have been neglected. The input from psychological[5] and empirical[6] studies is almost completely missing. This is why we organised[7] a small conference in which we specifically looked at the question how legal harmonisation and regulatory competition in contract law influence the way in which firms and consumers act, and what consequences this has for the ideal design of a future European contract law (in particular an optional instrument). The contributions to this conference are brought together in this special issue of the *European Journal of Law and Economics*.

The following offers a brief introduction to this special issue. It starts with the identification of the main question (Sect. 2) and then goes on to introduce how the various authors contribute to answering this question (Sect. 3).

2 Harmonisation of contract law: phrasing the question

It does not need much explanation that present day contract law in the European Union is highly diverse. Despite obvious similarities, the 28 jurisdictions that are part of the European Union show remarkable differences.[8] These differences have prompted the traditional argument in favour of harmonisation of contract law: a contracting party that wants to deal with a foreign party may be deterred from doing so because of the different legal system in the other party's country. Likewise, a consumer may refrain from buying a product on the other side of the border or over the internet because it might fear that a foreign law applies to the transaction. And if a party would still decide to contract, this will be more costly than if it would do so in its own country. This view is well formulated by Ole Lando[9]:

> The Union of today is an economic community. Its purpose is the free flow of goods, persons, services and capital. The idea is that the more freely and more abundantly these can move across the frontiers, the wealthier and happier we will become. All of these move by way of contracts. It should, therefore, be made easier to conclude and perform contracts and to calculate contract risks. (…) Foreign laws are often difficult for the businessmen and their local lawyers to understand. They may keep him away from foreign markets in Europe. (…) The existing variety of contract laws in Europe may be regarded as a non-tariff barrier to trade.

[4] See the contribution by Gomez and Ganuza to this issue.

[5] See however Low (2010).

[6] See however Vogenauer and Weatherill (2005); cf. Smits (2005b).

[7] Harmonisation and Diversity in European Contract Law: Perspectives from Law, Economics and Psychology, a Roundtable Conference held at Tilburg University on 5 March 2010. The conference was part of a broader research project funded by The Hague Institute on the Internationalisation of Law (HiiL).

[8] The following is based upon Smits (Smits 2005a).

[9] Lando (2000, p. 61).

The European Commission has since long been of the same view. Already in 2001 it stated[10]:

> For consumers and SME's in particular, not knowing other contract law regimes may be a disincentive against undertaking cross-border transactions. (…) Suppliers of goods and services may even therefore regard offering their goods and services to consumers in other countries as economically unviable and refrain from doing so. (…) Moreover, disparate national law rules may lead to higher transaction costs (…). These higher transaction costs may (…) be a competitive disadvantage, for example in a situation where a foreign supplier is competing with a supplier established in the same country as the potential client.

Often, parties deal with the problem of legal diversity by setting their contract terms themselves and by choosing an applicable law. But there are several reasons why this may not sufficiently remedy the problem of diverging laws.[11] First, it does not prevent the national mandatory law—applicable in accordance with the conflict of law rules—to apply. Part of these mandatory rules deals with consumer protection and is thus directly related to European directives.[12] A party will then still need to take advice on the unknown applicable law, which will be costly and will also present a commercial risk for that party. Second, it may be that a party with insufficient bargaining power is overruled by the other, economically stronger, party. It is likely that this party is then still deterred from contracting, *also* because of the fact that it is obliged to accept the other party's choice of law.

In this context, it is useful to make a distinction between different types of parties. It is often asserted that in particular small and medium sized enterprises (SME's) suffer from problems through legal diversity. Large companies are usually more experienced in international trade and can benefit from their strong bargaining position. In addition, large companies that deal abroad typically engage in big transactions. Such transactions justify transaction costs. But as large companies usually make their own contract terms, regardless whether their business partners are located in another country or not, these transaction costs do not fundamentally differ between purely national and international contracts.[13] This is different for SME's. SME's usually do not set contract terms themselves and therefore have to rely on default law. If the applicable default law is foreign law, uncertainty about its contents could deter this party from contracting. Also the content of the other country's mandatory law could be uncertain.[14] Put differently: for SME's, it is often

[10] European Commission, *Communication from the Commission to the Council and the European Parliament on European Contract Law*, COM (2001) 398 final, no. 30–32; cf. European Commission, *Communication from the Commission to the European Parliament and the Council. A More Coherent Contract Law—An Action Plan*, COM (2003) 68 final, no. 34; also see Staudenmayer (2002, p. 254).

[11] Cf. European Commission (2003) no. 28 ff.

[12] Cf. Reactions to the Communication on European Contract Law, European Commission (2003) 31: 'Businesses are discouraged from cross-border transactions more by differences in the details of different consumer protection regimes than by diversity in the overall level of protection afforded.'

[13] Cf. Ott and Schäfer (2002, p. 209).

[14] Ott and Schäfer (2002, p. 213).

disproportionate to pay for legal advice compared to the value of the transaction.[15] Also consumers may be deterred from buying abroad as they typically have no knowledge at all of foreign law and are not able to choose for their own national legal system when confronted with a foreign commercial party: usually, it is the law of the supplier that is the applicable law, be it based on the supplier's general conditions or on the basis of Art. 4 of the Rome I Regulation.

Another relevant distinction is between types of transaction costs involved in international contracting. Ott and Schäfer[16] define the transaction costs of transfrontier transactions as costs to obtain information about the legal system applicable to the transaction, the contents of this system and the differences between the other system and the system of the contracting party. Ribstein and Kobayashi distinguish in greater detail between, what they describe as, types of costs that are reduced by uniformity.[17] These costs are:

a. *Inconsistency costs.* These are costs that arise through inconsistent (divergent) state laws. If a company sells its products in different states, it will be confronted with these costs. It is obvious, however, that adopting a uniform law will still leave room for different applications of this law and will thus not completely reduce these inconsistency costs.
b. *Information costs.* These are the costs of determining what law applies in each state. These costs decrease in case of uniform law, provided that *all* relevant rules are unified, thus not only those in the field of contract law but also in property law, tax law, administrative law, etc. Here too, the problem of divergent application remains after 'unification'.
c. *Litigation costs.* It may happen that information about how to bring a claim against the other party has to be obtained. Uniform law will therefore make litigation less expensive.
d. *Instability costs.* If a contract is concluded, a change in the law applicable to this contract decreases the efficiency of the deal. Uniform law reduces these costs because information on future changes of the uniform law will be more readily available than information of changes in a foreign legal system.
e. *Externalities.* National law typically takes into account the national interests: the national legislator is inclined to help its constituents and not groups outside the state, such as foreign manufacturers. This means that costs are externalised, thus decreasing the efficiency of the uniform market as a whole. In case of uniform law, this may be avoided.[18]
f. *Drafting costs.* Ribstein and Kobayashi suggest that uniform lawmakers can concentrate their resources on drafting particular laws and can hire experts in particular fields. National legislators however would have little incentive to concentrate on carefully drafting legislation. This argument may be true for the

[15] Cf. Wagner (2002).

[16] Ott and Schäfer (2002, p. 207).

[17] Ribstein and Kobayashi (1996, p. 137 ff).

[18] Critical, however, Ribstein and Kobayashi (1996, p. 140).

United States, but does not seem too convincing in the European situation as in Europe national legislators also tend to engage in meticulous lawmaking.

It is clear that these differences in types of parties and types of costs need to be taken into account when assessing the need for and the method of harmonisation. However, the key question of what is the influence of uniform law on contracting cannot be answered on basis of this analysis. It is difficult to measure this influence because this could only be done by isolating the factor '(uniform) contract law' from a whole range of possible factors that influence decisions of businesses and consumers. In other words: the effect of the so-called 'natural' barriers like language or distance is difficult to assess separately from 'policy-induced' barriers like regulation and taxation.[19] This is confirmed in the economic literature, which has not only difficulties in explaining the exact relationship between globalisation and economic growth,[20] but also finds it difficult to establish a causal lien between (harmonisation of) law and economic growth.[21]

This leads us to the main question discussed in the following four contributions: what can we learn from economic and behavioral insights for the further development of European contract law and in particular for the creation of an optional instrument? Such an optional instrument is proposed in the Green Paper (2010) and in the Proposal for a Common European Sales Law (2011) as a means to improve the functioning of the internal market by removing obstacles to cross-border trade allegedly caused by legal diversity. This seems an acceptable solution in view of the difficulty of establishing the need for a uniform contract law: if parties are able to choose for a European '28th' regime that exists next to the existing national jurisdictions, it is left to the parties to decide to what extent they are in need of a uniform law. However, it is not at all clear to what extent an optional instrument will in fact be chosen.

3 Four perspectives on harmonisation and the optional instrument

The following provides four perspectives on the further development of European contract law and in particular on the use of an optional instrument. While Gomez and Ganuza apply insights from law and economics-scholarship, O'Hara offers a political science perspective. Low and Wagner predict the possible success of harmonisation efforts by considering insights from behavioral science and economics.

One of the salient features of an optional instrument in contract law is that it will stand next to existing national jurisdictions. This is the starting point of the

[19] Cf. for this distinction Commission Staff Working Paper Extended Impact Assessment on the Directive concerning unfair business-to-consumer commercial practices in the internal market, COM (2003) 356 final, 6.

[20] Van den Berg (2001, pp. 324–325).

[21] See recently Faure and Smits (2011).

contribution of Gomez and Ganuza.[22] They offer an economic analysis of the lawmaking and harmonisation dimensions in such a multi-level European private law. Their starting point rightly is that the question of *how* to design a European private law is just as important as the question of *whether* we need a uniform law at all. By sketching different modes of harmonisation (distinguishing between spontaneous convergence, conscious coordination and political harmonisation), they make clear that each option has different effects on the harmonisation process. The challenge is how to build optimal harmonised standards if—as is the case—diverse national standards already exist, a question of design that cannot be separated from the contents of the rules and standards.

Using a mathematical model, Gomez and Ganuza reach important conclusions about the desired relationship between (existing) national laws and (new) European rules. Optimal decisionmaking in a process of harmonisation requires an account of the costs for firms and the preferences of people in different societies regarding the substance and design of contract law. The choice of the harmonisation regime (full harmonisation, minimum harmonisation or co-existence) is decisive for the substantive decision over the standards. In the end, they see the optional instrument as an attractive alternative to minimum and full harmonisation if it is feasible for the firms subject to the legal rules to use both a national and a European standard.

Erin O'Hara[23] presumes that increased harmonisation is desirable, but asks why—if this is indeed the case—not more harmonisation of contract law has occurred. In a convincing political science perspective, she claims that legal harmonisation, as any other form of law reform, requires more than that change is objectively good. The extent to which resistance exists against harmonisation depends on the market actor involved: State actors, consumers, commercial parties and trust intermediaries all have their own role to play.

Attitudes of State officials towards harmonisation are often biased in favor of the status quo, leading them to be resistant to change unless they have strong incentives to overcome the status quo bias. This well explains the difference in attitude between Germany and the United Kingdom towards harmonisation. While Germany mostly produces consumer goods for export, it will benefit from harmonisation. England on the other hand is a net importer of commercial legal business, which may explain why it is overall less enthusiastic: it simply has less to gain from harmonisation.

Apart from States, also market participants have their role to play in explaining resistance against harmonisation. While the European Commission is always eager to argue that consumers will benefit from harmonised laws, O'Hara makes clear that this belief may be false: consumers rarely pay attention to legal differences. In so far as consumer organisations claim that harmonisation is needed, they do so because they are interested in the extra *protection* it may offer to consumers, not because of the harmonisation itself; this explains the large amount of minimum-harmonisation in European private law. In the end, law is only an instrument to create trust among

[22] Fernando Gomex and Juan Jose Ganuza, How to Build a European Private Law: an Economic Analysis of the Lawmaking and Harmonization Dimensions in European Private Law.

[23] Erin O'Hara O'Connor, The Limits of Contract Law Harmonization.

market participants and this means that in some contracting environments, this trust is created in another way than through one uniform law. O'Hara rightly argues that this may mean that increased protection (through harmonisation) is needed in cross-border transactions, but not in domestic contracts (that are already governed by a domestic contracting environment).

While the case for minimum-harmonisation can therefore be made for cross-border consumer transactions, 'sticky nation state laws' are not likely to change in sophisticated commercial contract settings. Commercial parties are unlikely to support harmonisation as they can create their own private contract terms and can use choice-of-law clauses to suit their own interests. This means that they have little incentives to lobby for harmonisation of substantive contract law. O'Hara's conclusion is therefore as fascinating as it is realistic: political forces are not likely to fight for harmonisation outside of the field of consumer contract law. This implies that an optional instrument is not going to be used much by commercial parties.

This finding is confirmed by Gary Low, who adopts an approach to legal harmonisation that is informed by insights from behavioral and organisational science.[24] His main question is whether firms will actually opt into an optional instrument in contract law. Low rightly claims that this is dependent on how firms perceive legal diversity as a problem and an optional instrument as a solution in cross-border trade. His conclusion is that some firms may consider an optional instrument, while others may ignore it. Much depends on the firm's aspirations (i.e. SMEs cannot be assumed as-yet to have pan-European aspirations), how the firm perceives the problems of legal diversity, and how it searches for and decides upon solutions. It would appear that a European optional instrument may not be as useful or widely considered as its proponents would like to believe.

Finally, Helmut Wagner[25] deals critically with the call for harmonisation of legal rules as a way to reduce the costs of doing business in cross-border transactions. In an insightful essay, he identifies four economic functions of rules: they reduce uncertainty, abolish negative externalities, ensure sufficient production of public goods and restrict market power. It is not self-evident that these functions of legal rules can be guaranteed at not only the national, but also at the international level: in the absence of a State, rules cannot be enforced. His cost-benefit analysis of the arguments pro and contra harmonisation shows that the reduction of transaction costs always has to be balanced against the costs of harmonisation. The recent financial crisis is a good example of how a lack of well-enforceable harmonised rules is problematic. Wagner makes clear that harmonisation through competition or international policy coordination is not enough: real harmonisation cannot be ordered from the above, but has to come about by conviction and socialisation. In addition, harmonised rules tend to lead to weak compromise rules. This means that harmonisation is not likely to succeed easily, unless one deals with similar-minded countries, such as in the European Union. One conclusion is therefore that the smaller and more structurally-similar countries are, the more succesful

[24] Gary Low, Will Firms Consider a European Optional Instrument in Contract Law?

[25] Helmut Wagner, Is Harmonization of Legal Rules an Appropriate Target? Lessons from the Global Financial Crisis.

harmonisation of legal rules is likely to be. This implies a lesson for the use of an optional instrument: it may be used more in some countries than in others, but which countries these will be is dependent on its contents.

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