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The Practical Importance of Harmonization of Commercial Contract Law

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1. Introduction

This contribution discusses the practical importance of harmonization of commercial contract law.¹ Do we need such harmonization and, if so, how should we achieve it? All three speakers of today were asked to go into this question. My job is to discuss the several economic arguments in the debate. However, Gerhard Wagner already discussed the most important economic argument of the reduction of transaction costs through harmonization of law. I will therefore build upon his talk by discussing some of the other arguments in the debate. It will show that I am quite sceptical about the need for harmonization of commercial law and that if one wants to harmonize this area, one should do so from the bottom up.

The question I will discuss is to what extent diversity of contract law forms a barrier for international trade. Put otherwise: would a unified contract law promote international transactions? Lawyers and legal scholars tend to answer these questions in the affirmative. I think that the following statement by Ole Lando is representative for the lawyer's view:²

'It should (...) 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.'

This argument can be summarised by saying that disparate national laws may lead to higher transaction costs, in particular for SME's.³ But the thing is that the two questions just formulated are not really *legal* questions: they ask about the effect of law on the conduct of businesses and therefore these are questions that can only be answered by (behavioural) economists or even psychologists. These are the disciplines that deal with human behaviour and therefore also with the behaviour of commercial parties.⁴

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¹ This paper is based on previous papers that I wrote about the need for the harmonization of contract law. See in particular Jan Smits, Diversity of Contract Law and the European internal market, in: id., (ed.), *The Need for a European Contract Law: Empirical and Legal perspectives*, Groningen 2005, 153 ff., on which a large part of the following is based.

² O. Lando, *Optional or Mandatory Europeanisation of Contract Law*, 8 *European Review of Private Law* (2000), 61.

³ 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 D. Staudenmayer, *The Commission Communication on European Contract Law: What Future for European Contract Law?*, 10 *European Review of Private Law* (2002), 254.

⁴ The important theoretical arguments that diversity of law enhances competition and experiment, thus leading to a more efficient and a better law are not discussed here. A passionate plea in favour of these arguments can be found in Jan M. Smits, *European private law: a plea for a spontaneous legal order*, in: Deirdre M. Curtin et al, *European Integration and Law*, Antwerpen-Oxford 2006, 55 ff.

In the remainder of this paper, three types of arguments about the need for uniform contract law are looked at: empirical, economic and psychological arguments.

2. Empirical arguments on the importance of (uniform) contract law

There are two types of empirical evidence on contracting that may be useful to answer the question about the need for a uniform contract law. The first is concerned with the importance of contract law *as such* for business relationships, the second with the importance of a *uniform* contract law for international contracting.

Stewart Macaulay's survey of contracting in the state of Wisconsin⁵ is still the most important evidence of the importance of contract law for commercial parties. Macaulay discovered that in most cases businesspeople are not interested in the meticulous drafting of contracts at all, while in case of a dispute about the performance of the contract, a majority of businesspeople is not prepared to undertake legal action but instead tries to informally settle the dispute and takes its losses if it does not succeed in doing so. Beale and Dugdale confirmed Macaulay's findings for England.⁶ One of the reasons for this reluctance to rely on contract law is that, according to these surveys, most of the time parties deal with counterparts they regularly do business with. Too much of contract enforcement would put these relationships under pressure. Another reason was that elaborate planning of the contract is expensive and is not justified by the few cases in which a conflict arises. These findings show that contract law as such is not as important for the enhancement of trade as governments or academics sometimes think. This also puts the need for a uniform law into perspective. The effect that unification of contract law will have is probably not as important as the effect of Europeanization (or globalisation) on the market as such.

A good starting point for the second point (the influence of *uniform* contract law on international contracting) is the European Commission's Communication of 2001.⁷ In this consultation paper, the European Commission asked businesses to indicate whether they experienced problems through diversity of (contract) law. Most reactions of business organisations and practitioners showed this was not the case.⁸ In most reactions, it was remarked that the internal market may not function perfectly, but that this was not caused primarily by differences in private law, but much more by language barriers, cultural differences, distance, habits and divergence in other areas of the law such as tax law and procedural law.⁹ *Orgalime*, representing the interests of 130.000 companies in the European mechanical, electrical and metalworking industries, remarked:¹⁰

'it will of course always to some extent be easier to trade with companies and persons from your own country. This has, however, more to do with ease of communication, traditions and other factors, which are not dependent on contract law.'

It is also worthwhile to make mention of the recent Clifford Chance survey.¹¹ 175 businesses across Europe were asked whether differences in national contract laws presented obstacles to cross-border trade. Two-thirds experience 'some' (51%) or 'large' (14%) obstacles to cross-border trade between member-states.¹² But these were not only due to legal issues, but also to 'natural' barriers (like language). And among the legal issues, it was not contract law only, but also tax law, procedural law, etc. In addition, the ability to make a choice of law from different contract law systems was seen as an advantage

⁵ S. Macaulay, Non-contractual relations in business: a preliminary study, 28 *American Sociological Review* (1963), 55 ff.

⁶ H. Beale and T. Dugdale, Contracts between businessmen, 2 *British Journal of Law & Society* (1975), 45-60.

⁷ European Commission (2001).

⁸ Cf. Reactions to the Communication on European Contract Law, European Commission (2003) 30 ff.

⁹ Cf. e.g. the Reaction of the UK Government, available through <http://europa.eu.int/comm/consumers>.

¹⁰ Reaction of Orgalime, available through <http://europa.eu.int/comm/consumers>. This is confirmed by other reactions of business organisations.

¹¹ S. Vogenauer & S. Weatherill, The European Community's Competence to Pursue the Harmonisation of Contract Law – an Empirical Contribution to the Debate, in: S. Vogenauer & S. Weatherill (eds.), *The Harmonisation of European Contract Law*, Oxford 2006, 105 ff.

¹² Vogenauer & Weatherill (2006), 125.

by two-thirds of the businesses. Two thirds preferred to choose their home law (but only 43% in the Netherlands against 97% in the United Kingdom). In line with what one could expect, English law was regarded as the most popular.

This leads me to conclude that the anecdotal and empirical evidence there is about the effect of uniform law does not clearly point in one direction or another. What is clear, however, is that commercial parties usually deal with the problem of legal diversity by setting their own contract terms and by choosing an applicable law. But there are several reasons why this does not sufficiently deal with the problem.¹³ First, it does not prevent the national mandatory law – applicable in accordance with the conflict of law rules – to apply. A party then still needs to take advice on the unknown applicable law, which will be costly and will also present a commercial risk to 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.

3. Economic arguments on the need for a uniform contract law

Gerhard Wagner already discussed the transaction costs argument in detail. It is clear that diversity of law does have its costs.¹⁴ Three points should be stressed.

The first is that not all types of parties experience transaction costs to the same extent. Often it is asserted that in particular small and medium sized enterprises (SME's) suffer from problems through legal diversity.¹⁵ 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.¹⁶ 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.¹⁷ Put differently: for SME's, it is often disproportionate to pay for legal advice compared to the value of the transaction.¹⁸

Second, in an economic analysis the transaction costs argument that legal diversity is costly should always be balanced against the costs of creating a uniform law. Seen from the purely financial perspective,¹⁹ it could well be that the costs of diversity are larger than the costs of unification. Uniform law should therefore only be adopted if the benefits outweigh the costs.²⁰ This is not easy to calculate. A type of costs that is not mentioned by Ribstein and Kobayashi concerns the costs of transition of one legal system to another or, put differently, the transaction costs of eliminating national legal systems. Such costs are considerable. They include costs of political decision-making and the costs of effective realisation of the reform as well as the costs of adaptation to the new regime (such as the cost of amending contracts and of educating lawyers and judges). When a new civil code was introduced in the

¹³ Cf. European Commission (2003), no. 28 ff.

¹⁴ For different types of transaction costs, see L.E. Ribstein and B.H. Kobayashi, *An Economic Analysis of Uniform State Laws*, 25 *Journal of Legal Studies* (1996), 137 ff.

¹⁵ Cf. European Commission (2003), no. 30.

¹⁶ Cf. C. Ott and H.-B. Schäfer, *Die Vereinheitlichung des europäischen Vertragsrechts: Ökonomische Notwendigkeit oder akademisches Interesse?*, in: C. Ott & H.-B. Schäfer (eds.), *Vereinheitlichung und Diversität des europäischen Zivilrechts in transnationalen Wirtschaftsräumen*, Tübingen 2002, 209.

¹⁷ Ott and Schäfer (2002), 213.

¹⁸ Cf. also Staudenmayer (2002), 255 and, generally, the contributions of Gerhard Wagner and Helmut Wagner to Smits (2005).

¹⁹ Leaving out the benefits that competition of jurisdictions brings with it. See for the 'virtues of competition' e.g. Gerhard Wagner, in: Smits (2005).

²⁰ Ribstein and Kobayashi (1996), 137 ff.

Netherlands in 1992, it was estimated – be it disputed – that the costs of this re-codification amounted to almost 7 billion euro over a period of 20 years.²¹

Third, we should realise that the effect of the so-called ‘natural’ barriers like language or distance on cross-border contracting is difficult to assess separately from ‘policy-induced’ barriers like regulation and taxation.²² Following the New Institutional Economics, a distinction can be made between formal and informal incentives (or constraints) for transacting. Formal incentives for rational behaviour are organised by the government such as law and regulations, informal incentives are habits, traditions, ‘networks’ and other informal norms. It seems hard to identify the exact influence of the formal incentives. For example, with the strengthening of the European internal market the amount of cross border transactions undoubtedly increased. Between approximately 1985 and 1995, the volume of commerce within the European Union doubled as compared to export to third states, but apparently this was not caused by unification of commercial law.²³

4. Behavioural analysis of uniform contract law

Finally, it is useful to look at behavioural analysis. Behavioural economic analysis takes as a starting point that the rationality assumption of economic models (‘rational choice theory’²⁴) is wrong: in real life, people do not always behave rationally. The unrealistic assumptions of economic analysis are thus replaced by the more empirical evidence provided by cognitive psychology.²⁵

Can behavioural analysis inform us about how contracting parties make their decisions? On the basis of Sunstein’s book,²⁶ one can distinguish several psychological phenomena that can help to explain behaviour of contracting parties. One of these is the ‘status quo bias’: people tend to like the status quo and are often not willing to depart from it. If a certain situation is to be evaluated, this is usually done by referring to a reference point that is known to them and gains and losses will be evaluated from this point. This implies that contracting parties are more likely to choose for a legal system they know than for a new (uniform) system. This is confirmed by the experience with the Convention on the International Sale of Goods (CISG), that is in practice often excluded.

Another insight from psychology is that it is often difficult to calculate the expected costs and benefits of alternatives and that therefore people simplify their decision making by reasoning from past cases, taking only small steps ahead.²⁷ This ‘case based decision making’ is important in the courts that decide most cases by analogy, but it may also explain why, again, contracting parties are often not prepared to choose for a system they do not know.

A third rule of thumb is that people are loss averse and therefore twice as displeased with losses than that they are pleased with gains.²⁸ This may imply that parties would be less willing to take legal advice on how to draft their contract or to inform themselves about the applicable legal system and instead just wait until a conflict arises. This is confirmed by Macaulay’s survey. It is also consistent with the ideas of Gerhard Wagner²⁹ that, if it is uncertain whether uniformity is desired or not, it is best to take only small steps ahead, for example by way of an optional code.

²¹ See J.M. van Dunné, E.A.A. Luijten and P.A. Stein, *Kosten en tekortkomingen van het Nieuw Burgerlijk Wetboek* (boeken 3, 5 en 6): rapport uitgebracht aan de vaste Commissie voor justitie van de Tweede Kamer, Arnhem 1990.

²² 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.

²³ See S. Grundmann, *The Structure of European Contract Law*, 9 *European Review of Private Law* (2001), 509 ff.

²⁴ Cf. R. Korobkin, *A Multi-Disciplinary Approach to Legal Scholarship: Economics, Behavioral Economics, and Evolutionary Psychology*, Research Paper 01-5 UCLA School of Law (Los Angeles 2001), 4.

²⁵ See the pioneering work by R.B. Korobkin and T.S. Ulen, *Law and behavioural science: Removing the rationality assumption from law and economics*, 88 *California Law Review* (2000), 1051 ff. and C. Sunstein (ed.), *Behavioral Law and Economics*, Cambridge 2000.

²⁶ See the overview in Sunstein (2000), 3 ff.

²⁷ Sunstein (2000), 5.

²⁸ Sunstein (2000), 5.

²⁹ Wagner, in: Smits (2005).

There is still another interesting insight that needs further attention here. Korobkin applies the status quo bias to default contract terms.³⁰ This means that the preference of the parties for certain contract terms is dependent on the status quo. Unlike the assertions in economic analysis of contract law, parties often do not choose for wealth-maximizing contract terms but for the status quo (consisting of default rules). In other words: parties often prefer inaction to action and sacrifice wealth in order to be inert.³¹ This is not optimal from the efficiency viewpoint. Korobkin argues that it would therefore be more efficient for lawmakers to have initially created an alternative status quo. Next to term 'A', a term 'B' could be created as the default rule, thus allowing the parties to have both the wealth-maximizing term and the status quo term.³² Put otherwise: if the legislator chooses a different default rule (and status quo), this influences the parties to choose the more efficient rule. If parties simply will not contract around inefficient default terms because of the status quo bias, the legislator should make default rules that the fewest number of parties have to contract around to achieve efficient agreements.³³ These are certainly not 'untailored' default rules that apply to all parties regardless their status or their circumstances.³⁴ Korobkin claims:³⁵

'The lawmaker charged with determining a tailored default term must ask not what term *most* contracting parties would have agreed to had they made provisions for a contingency – a question that does not require an inquiry into the specifics of any one transaction – but what term *two particular* parties would have agreed to had they provided for the contingency.'

This is an important argument in favour of an optional default contract regime for transfrontier contracts. In its Communication of 2004,³⁶ the European Commission indicates it wants to pursue a discussion on an optional contract code that could contain provisions for commercial parties that engage in international transactions. Parties opting in to such a code could thus indeed profit from both the status quo *and* an efficient international contract regime.

5. Conclusions; an optional code

The above analysis shows that there is no conclusive evidence that unification of law enhances international trade. Empirical, economic and behavioural analysis confirm that it is difficult to establish the exact relationship between legal diversity and the enhancement of the economy through trans-frontier contracting. Three conclusions can be drawn.

First, it seems impossible to calculate either the cost of legal diversity or the cost of uniform law: a quantitative analysis cannot provide the answer to the question raised. This does not mean that the economic arguments set out in the above cannot play a role, but they should be put into perspective. The best way to address the question is probably to put it in terms of a comparison: would the savings in transaction costs through the removal of legal diversity be greater than the losses caused by the termination of competition of legal systems? This question cannot be provided with a definitive answer either, but phrasing it like this does allow to make an analysis on basis of the *quality* of the arguments. How these are appreciated depends on one's own preferences.

The second outcome is that it seems wrong to link an increase of international contracting to uniform law. One of the most important arguments of proponents of unification is that legal diversity refrains businesses and consumers from contracting because of the legal uncertainty diversity brings with it. It is indeed likely that legal uncertainty is a barrier to trade, but there is no evidence that uniform law would create *more* legal certainty than diverse contract law regimes. Provided that enough information is available about the various regimes, the demands of legal certainty can also be satisfied.

³⁰ R. Korobkin, Behavioral Economics, Contract Formation, and Contract Law, in: C. Sunstein (ed.), Behavioral Law and Economics, Cambridge 2000, 137 ff.

³¹ Korobkin (2000), 138.

³² Korobkin (2000), 138

³³ Korobkin (2000), 139.

³⁴ Korobkin (2000), 140.

³⁵ Korobkin (2000), 140.

³⁶ European Commission (2004).

The third conclusion that can be drawn from the above concerns the way to proceed with the development of uniform contract law. If one is uncertain about the effects of uniformity on international contracting, it is best to adopt a step-by-step approach. It means the time is not ripe for grand projects. Instead, one should adopt a model that allows corrections at an early stage and allows business and consumers to get acquainted with a new contract law regime. This points in the direction of drafting an optional contract code that parties can choose for if they find this code suits their interests best.³⁷ Such an optional code would allow harmonization to take place from the bottom-up. Unlike the CISG, it could contain rules about different types of commercial contracts and even allow a choice between different sets of rules for these contracts.

³⁷ For an elaboration of this idea, see Smits (2006).