

# Modern Law for Global Commerce

Congress to celebrate the fortieth annual session of UNCITRAL

Vienna, 9-12 July 2007

---

## Transaction Costs, Choice of Law and Uniform Contract Law

Prof. Dr. Gerhard Wagner, LL.M., Bonn (Germany)

### I. The Benefit of Harmonization: Reduction of Transaction Costs

Harmonization of commercial law would replace the many legal systems of the different nations with a single legal instrument. Obviously, such a sweeping measure would simplify a lot of things. Courts sitting within one of the signatory states would have to apply the same provisions, commentators would have to refer to the same language, theorists would have to theorize on one and the same set of rules, and parties would have to accept or contract around the same balance of costs and benefits that is enshrined in a particular legal rule.

It cannot be disputed that full harmonization of commercial law would yield considerable benefits in the form of transaction costs saved. The proliferation of legal rules under the current system of legal diversity imposes serious costs on enterprises doing business in more than one jurisdiction because they have to comply with the differing standards of a whole array of legal systems. Although the many different legal systems of the world may be lumped together to a rather small set of "families" each of which contains similar provisions, the variance in detail remains vast, even within one and the same family. Each legal system supplies rules on, e.g. form requirements, duress, and unconscionability, on prescription periods and the like which may rest on common principles in the abstract but are nonetheless different in detail and thus yield divergent outcomes when applied to a case at hand.

The resulting legal diversity forces an international enterprise to change its way of doing business upon crossing the border from one jurisdiction to another. The enterprise has to develop and draft specific contracts for each and every jurisdiction in order to obtain a perfect fit with the respective legal environment and institutional framework. Company law is a good example. The usual strategy for a multinational enterprise to deal with the fact that each jurisdiction has its own set of corporate entities, runs its own register and has its own minimum standards and requirements for incorporation is to form a different legal vehicle for each jurisdiction which is in charge of the business done in the particular market. Of course, the need to establish a separate corporate vehicle in each jurisdiction comes at a cost which increases the price of the goods in the market. With respect to the European internal market, judges and lawmakers have taken measures aimed at economizing on these costs, e.g. the institution of the *European Company/Société Européenne* and the *Centros*-Jurisprudence of the ECJ which allows companies incorporated in one member state to move to another member state without changing their legal status.

Also in the area of contractual dealings, the financial burden associated with the necessity to make special provision for each and every jurisdiction in which the enterprise does business is likely to be considerable. It looms particularly large in the service industry which oftentimes "sells" products which are created with the means of the law, in the sense that the core of the obligation of the supplier cannot be identified and described without reference to the applicable legal regime. Insurance contracts are a pertinent example. The current fragmentation of insurance law places considerable costs on multinational insurance firms, raises barriers to entry into foreign markets and thus supports the current fragmentation of insurance markets.

However, the mere existence of transaction costs does not automatically entail that they must be saved. The crucial question is not whether transaction costs exist but whether they outweigh the benefits associated with legal diversity which is the current state of affairs in international law. What would be lost in the course of harmonization is the treasure of different solutions to a given legal problem which is preserved within the many legal systems still existing on this planet. In this respect, law behaves like any other feature of life. Just as the extinction of species reduces the variance within the biological system, so the annihilation of the municipal systems of commercial law would reduce the variance within the legal system. The experience to draw on would be diminished and the potential for fatal errors increased.

But still, there clearly are examples in legal history where a single nation or a commonwealth of nations came to the conclusion that the benefits of harmonization are greater than the benefits of diversity. In Germany, argument over this question went on throughout the 19<sup>th</sup> century until a uniform German civil code – the Bürgerliches Gesetzbuch – came into force on the 1<sup>st</sup> of January, 1900. In our days, the European Union is faced with the same choice of whether to replace the contract laws of the Member States with a single European Civil Code. On the international level, UNCITRAL works for the harmonization of divergent laws by promulgating model laws like the Model Law on International Commercial Arbitration and convention which supply a uniform set of rules for cross-border transactions. The most prominent example here is of course the CISG. The success of both the CISG and the Model Law on International Commercial Arbitration are evidence of the fact that both, lawmakers and the business community think that there are gains from adopting the Model Law and signing the CISG. These gains are in the form of transaction costs saved. In both cases, adoption of the UNCITRAL texts makes it easier for foreign practitioners to find their way into a foreign legal system that otherwise would be very difficult to access. The example of international arbitration is particularly striking: In this area it is thought that adoption of the Model Law makes a given country much more attractive as a place of arbitration as it would otherwise be. In a similar vein, it is thought that adhering to the CISG as the international standard in the area of sales law makes enterprises residing in a given country more attractive as a trading partner.

What is interesting about these examples is the fact that the Model Law and the CISG gain their followers not so much or not only for the sake of their inherent virtues. Of course both instruments aim at representing the best legal practice in their respective fields but – as always – there is no consensus as to whether this aim has been reached. States which adopt the Model Law or which sign the CISG are not motivated by the intrinsic virtues of these instruments but by the simple fact that they want to run with the crowd. Whether the CISG really is superior to any other given law of sales will always be a matter of dispute; the decisive point is that many lawyers around the world feel comfortable with the CISG – for better or worse. The reason they feel so comfortable is that they know something about the CISG, are thus better able to predict outcomes and to anticipate outcomes when drafting the terms of their contracts and making choices about the way they do business.

It needs no further explanation that a quantitative analysis of the relative costs and benefits of legal diversity and legal unity does not exist and is impossible to come by. There is simply no way of measuring with some exactness the benefits and costs both of legal harmonization and of legal diversity in order to compare the two. However, the mere fact that it is impossible to come up with numbers must not foreclose the door to a more thorough analysis of the crucial issues. In particular, it should not spare us the task to investigate the costs and benefits to the fullest possible extent, and to engage in some sort of weighing up of advantages and disadvantages, costs and benefits of diversity on the one side and of unity on the other.

## **II. Choice of Law as a Substitute?**

Businesses do not need harmonization in order to be able to operate on the basis of a single set of legal rules. The same result may be obtained by using the mechanism of choice of law. By exercising this choice in favour of a single legal system, uniformity may be achieved across all transactions in which a particular business engages.

It is easy to see that the argument just made is highly stylized. What is true in theory may be dead wrong in practice. To be sure, there is no doubt that choice of law is a question which is ordinarily discussed and resolved in the course of contract negotiations. There are not many cross-border transactions where there is no choice-of-law-clause included in the agreement. In doing so, the parties are able to reap considerable benefits. In particular, the parties are being transformed in a position where it is at all possi-

ble to write a contract with confidence that it will not be annulled by a court should a dispute arise. To put the matter straight, it is only possible to contract around default rules and to avoid mandatory rules with the potential to nullify the entire contract or significant parts thereof if the parties know what those rules are. Unless the prerequisites for a finding of unconscionability are known, the parties are unable to avoid the consequences of this doctrine. A contract will be written differently if the parties anticipate that the judge or arbitrator interpreting the contract down the road will follow a passive approach and honour the principle of party autonomy to the greatest possible extent or if they imagine an active judge or arbitrator who is under a duty to question the fairness of a contract and to set aside specific provisions which he or she deems unfair. This list of examples could be expanded considerably. The power of the parties to designate the law applicable to their contract enables them to anticipate the rules which will be applied in case a dispute should arise in the future, and to draft their agreement accordingly.

What choice of law still cannot do is to provide a uniform legal framework for all the business activities an international enterprise engages in. Even for powerful international firms who have enough bargaining power to impose their terms on their contract partners, the idea to put each and every business relationship on the same legal footing remains an illusion. In some markets and with some clients the firm will be able to have its way but no firm will be powerful enough to always have its way and to include the same choice of law provision into every single contract it concludes.

The upshot of the preceding analysis is that choice of law is a valuable instrument for parties in the process of negotiating the contract “in the shadow of the law”. What it does not do, however, is to provide the enterprise with a single legal environment. Powerful firms will be able to fix the law of their home state as the applicable law in many instances but they will not be able to push this position through each and every time. Apart from this, it must not be forgotten that there is always another party to the transaction. Assuming that the other contracting partner imposed the terms by insisting on the legal system he always chooses because he knows it best, this means for the other party that it has to live with the choice of a foreign law which this party might not be able and willing to understand, let alone to anticipate the outcomes of legal disputes arising in the future.

Therefore, at least one party to the transaction will be burdened with the high information costs which are due once a dispute arises. Now the party or parties not familiar with the chosen law will have to search for an attorney in another jurisdiction in addition to the one regularly employed, it will have to explain its business practices to a foreign court and mingle them into the law that was chosen, hoping that the latter will accept the gift, and so on. For the rank and file contracting party, the costs associated with such investigations may be prohibitive.

The upshot of the preceding analysis is that choice of law is an indispensable tool to provide legal certainty and the protection of legitimate expectations. What it does not do, however, is to fully cure the transaction cost problem. Rather than decreasing the costs of contracting, choice of law may rather add a considerable sum to the bill. Therefore, the transaction costs rationale for harmonization remains intact.

### **III. Uniform Contract Law in Action: Procedural Prerequisites**

The final question to be asked in this short presentation comes back to the cost reduction argument developed above. Now is the time to examine more carefully the underpinnings and prerequisites for harmonization to bear the fruit that it is expected to yield. The objective of harmonization is to economize on transaction costs by allowing a multinational business to operate within a uniform legal framework and to use a single set of contracts and other legal products. How realistic is it to assume that matters will ever be as simple as that? This leads to the question whether harmonization “on paper” is enough to generate the benefits of a uniform legal framework.

As lawyers know only too well, different courts might understand identical texts in utterly different ways. What some regard as a major principle, others regard as a rare exception. What some regard as so obvious as to merit no further discussion, others take to be extremely controversial. And, most often, where some lawyers are convinced that *A* is the proper solution to a given problem, others think that *non-A* is preferable or they prefer an intermediate or an utterly different solution. As a consequence, a uniform legal framework not only presupposes that statutory sources are identical but also that there is a single decision-maker charged with the authority to decide controversies of opinion one way or another.

Current experience with one of UNCITRAL’s most prominent achievements, the CISG, may illustrate this point. International conventions necessarily represent a compromise between the conflicting views of the states involved and their respective legal systems. One strategy to reach a compromise in the face of strong differences in substance is to resort to vague terms. If states cannot agree whether a time limit for a

particular remedy should be two weeks or two months, one solution could be to agree on one month but another one might be to stipulate that notice shall be given or a statement of claim served within a “reasonable” time or without “unreasonable” delay. The strategy to overcome differences in substance by resorting to vague standards instead of hard-and-fast rules works fine for negotiators and lawmakers but it is anathema for courts and practitioners. Legal certainty and the foreseeability of outcomes are sacrificed in order to achieve the harmonization goal.

Whenever a bad compromise in the sense just described is reached, the responsibility to fashion a legal rule is shifted to the courts. Within the context of the national legal systems it is then for the supreme court of the particular jurisdiction to decide what the lawmakers were unable to settle. The same consequences ensue within the European Union where the European Court of Justice is charged with the authority to resolve disputes involving the interpretation and application of European law. There is no doubt, for example, that the Brussels-I-Instrument – now a Regulation, formerly a Convention – has made such a stunning career for the simple reason that the European Court of Justice was accorded the competence to authoritatively interpret the legal text on which the member states had agreed. Without the jurisprudence of the ECJ, there would be as many versions of Brussels-I as there are member states.

On the international level, however, an institution charged with the authority to finally settle disputes turning on a question of international law is missing. There is no court competent to interpret the CISG with a binding effect for all the signatory states. Quite the contrary, it is for the judicial systems of the several signatory states to resolve disputes around the CISG. Not surprisingly, they have come up with different interpretations and solutions. A pertinent example is Art. 39 para 1 CISG which requires the buyer to give notice to the seller of any defect of the goods delivered, and to do so “within a reasonable time” after he has discovered the defect or “ought to have discovered it”. Courts in different countries have differed widely about how long a “reasonable” time might be. For the parties writing a contract and thinking about choice of law, such ambiguities are much worse than clear-cut rules although the risk with the latter is that they got it wrong, e.g. provide a time limit which is too strict or too lenient. Clear-cut rules have the important advantage to be foreseeable in their application. Thus, it is easy to contract around them if need be.

For this reason, it was perhaps no accident of history but a well-made choice, either deliberate or intuitive, that procedural law goes first when the hour of harmonization strikes. At the end of the 19<sup>th</sup> century, when Germany finally became a nation state, one of the first areas which were harmonized was the code of civil procedure. The substantive law followed almost a quarter-century later. The same development evolved on the European level during the last 40 years. The former European Community of six nations enacted the Brussels-I-Convention on the harmonization of the rules on jurisdiction and recognition and enforcement of judgments in civil and commercial matters already in 1968, long before the legislation of the Community reached the substantive law.

Without a judicial system authorized to interpret and apply the products of harmonization, the whole enterprise is questionable. Harmonization “on paper” remains worthless unless it is transformed into or supplemented by “law in action”. While it is certainly true that the mere fact that there is a common legal text which is binding for everybody leads to convergence, this is a far cry from the legal certainty and predictability of outcomes a business enterprise needs in order to write its contracts accordingly.

In other words: A uniform law of contract is in urgent need of a unified system of judicial administration in civil matters that is capable of resolving the many issues of doubt with which any civil code will invariably be afflicted. Harmonization of civil law makes full sense only in conjunction with a thorough and ground-breaking reform of the international system of civil justice.

To be sure, issues of procedural reform have recently been discussed at the European level but the scope of the analysis was narrow, i.e. focussed on reforms within the current system of one or rather two central European courts. The superior court of the two, the European Court of Justice, serves at once the function of a constitutional court, of a forum for disputes involving a vast range of issues of administrative law, and of the highest European court in civil matters as far as the application of community law is concerned. To everybody who takes harmonization seriously it should be obvious that such a system of judicial administration simply does not live up to the objective of administering a European contract law that is relevant to the thousands of disputes that are heard in the many European courts every day.

The procedural cornerstone of harmonization is still missing even in the area where European Community law governs, but even more so on the international level. For this reason, international harmonization of commercial law necessarily remains incomplete. It is of course true that man-made solutions are

rarely “complete” or perfect. Every human institution necessarily is defective if judged against a model of pristine perfection. To say that something is incomplete does not mean that it is to be discarded.

However, the problem with harmonization goes deeper than the acknowledgment of the unavoidable deficiencies of human institutions. It is no secret that many parties and their advisers prefer national legal systems of good reputation like the English and the Swiss one to instruments of international law like the CISG. The main reason for said preference is certainly not that parties or counsel think that the national system in question is superior to the CISG. Such a conclusion would presuppose comprehensive analysis comparing the two systems which is costly, time-consuming and whose results will always remain controversial. The forces behind the drive towards national systems rather is the high degree of certainty and predictability of outcome these systems have to offer in conjunction with the good reputation of the respective judicial system charged with applying and developing the national law in question. These interests must not be sacrificed for the sake of harmonization. Rather, the parties must retain the power to come back to local law, i.e. by exercising their choice in favour of a well-renowned system of national law.

#### **IV. Conclusion**

This presentation dealt with a few aspects of harmonization only. The common thread linking the topics raised is the question of what the costs and benefits of harmonization might be. The approach is deliberately down-to-earth and party-centred. Harmonization is thought to be an object of choice rather than an end in itself. If decision-makers ask whether they should harmonize commercial law or continue to live with diversity – or rather: a mix of harmonized and national law – the answer must be that this depends on whether the balance of costs and benefits is positive. Although it is impossible to arrive at a definitive answer, even a sketchy analysis raises serious doubts whether the benefits will really outweigh the costs. Therefore, it is crucial to leave the parties the choice to opt out of instruments of international law and to come back to the national system they prefer. As long as this is possible, the downside of harmonization may easily be avoided and the costs of harmonization shrink to the point where they are equal to the costs of drafting and negotiating the international instrument in question. These costs will always be worthwhile.