

SOME THOUGHTS ON THE REGULATION OF BUSINESS TRANSACTIONS IN EUROPE

By:

*Dr. Nicole Kornet LL.M.*¹

When businesses transact an important question will be what rules are applicable to their contract. In the absence of a solution provided by the contract itself, the relevant default rules of the applicable contract law will be applied to settle a conflict that arises. This becomes more complex when businesses enter into cross-border transactions, since more than one set of rules could potentially apply. In the European Union, contract law is characterized by its diversity; each of the 27 Member States has its own contract law system. The diversity of contract law systems is often regarded as problematic because a business wanting to transact with another business in a different EU member state may be deterred from doing so because of the differences in legal systems. It is consequently claimed that private law, and in particular contract law, which is seen to form the backbone of economic activity, must be harmonized in order to facilitate economic integration within the EU.² Proponents of comprehensive harmonization of contract law in Europe argue that the creation of a uniform European contract law that is at least applicable to all cross-border transactions, would eliminate the variety of transaction costs associated with legal diversity, and facilitate cross-border transactions, in particular among small and medium-size businesses, thus promoting competition and the proper functioning of the internal market. The focus in Europe is currently on new developments in the direction of regulation of contract law at a European level, e.g. the Common Frame of Reference, Principles of European Law, the *Acquis* principles, and on the possible creation of an (optional) European contract law code. Although many of these developments are currently directed at consumer transactions, there are also calls from various stakeholders to develop an (optional) instrument that applies to cross-border business transactions.

The harmonization of private law relating to business transactions raises many questions, including whether it is feasible to create a single contract law instrument in light of the divergent legal traditions within the EU. Would such uniform rules be tailored to the preferences of businesses? And even if uniform contract rules are created, will that resolve the alleged problems faced by contracting parties due to legal diversity? It is questionable whether a uniform contract law could have the desired harmonizing effect. Despite the existence of uniform rules, the differences in implementation and application of the norm from one member state to another could lead to legal uncertainty, promote forum shopping, raise transaction costs and thus negatively impact on cross-border trade.

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² In general, Communication from the Commission to the Council and the European Parliament on European Contract Law, Brussels, 11.07.2001, COM(2001) 398 final. Also see Smits, Jan, *The Making of European Private Law. Toward a Ius Commune Europaeum as a Mixed Legal System* (Antwerp-Oxford-New York: Intersentia, 2002), p. 2; McKendrick, Ewan, 'Harmonisation of European Contract Law: The State We Are In', in Stefan Vogenauer and Stephen Weatherill (eds.), *The Harmonisation of European Contract Law. Implications for European Private Laws, Business and Legal Practice* (Oxford and Oregon, Portland: Hart Publishing, 2006), 5-29, p. 14. Vogenauer, S. and Weatherill, S., 'The European Community's Competence to Pursue the Harmonisation of Contract Law - an Empirical Contribution to the Debate', in Vogenauer, S. and Weatherill, S. (eds.), *The Harmonisation of European Contract Law: Implications for European Private Laws, Business and Legal Practice* (Oxford and Portland, Oregon: Hart Publishing, 2006), 105-148.

Another relevant question is whether the intended users of such European measures will actually use them. There is some evidence in the United States that seems to suggest that despite the creation of uniform law, businesses may prefer to substitute (uniform) public regulation with private regulation. In the US, private law is a matter regulated by the individual states. To deal with uncertainty caused by the diversity in the existing commercial laws of the various states and to create uniform commercial law among the various jurisdictions, the Uniform Commercial Code (UCC) was developed.³ However, in a number of empirical studies, Bernstein has shown that various trades and industries opted out of the UCC, substituting it with their own private regulatory framework.⁴ Business transactions are then governed by the private regulatory framework as opposed to the UCC. In light of this experience from the US, it becomes relevant to examine private regulation as a response to the obstacles encountered by businesses caused by divergent contract law systems in the EU. Private regulation may be more suited to simplifying dealings, reducing transaction costs, and overcoming existing legal diversity thus encouraging cross-border transactions within certain sectors. That being said, there are concerns *inter alia* in the area of competition law and policy.

For private regulation to work as a “bottom-up” alternative to a European contract law, groups of businesses (contracting communities) that enter into the same type of transactions with each other on a regular basis need to work together. The members of a particular trade, industry or business sector share specialist, technical knowledge about the characteristics of the product or service, and through repeated interaction, they accumulate collective knowledge and experience about what can typically go wrong, and how typical problems are usually dealt with, leading to the development of shared understandings and practices.⁵ Within the contracting community a trade, industry or sectoral organization is responsible for facilitating transactions, disseminating information and representing the interests of its members. Through these organizations the members of the contracting community can combine efforts to develop a private regulatory framework that provides a comprehensive set of detailed contracting solutions for the members of the contracting community reflecting the shared understandings and practices of the contracting community. An important entrepreneurial role can therefore be set aside for European trade, industry and sectoral organizations in order to provide a forum for the creation of comprehensive private regulatory frameworks.

The private regulatory frameworks created by these European organizations could combine the following elements: model contracts, sets of general conditions, sectoral regulations and alternative dispute resolution mechanisms. The model contracts

³ The UCC has been enacted in 49 states (with some local variations), as well as partially in Louisiana. §1-103 provides that the underlying purposes and policies of the UCC are: ‘(1) to simplify, clarify, and modernize the law governing commercial transactions; (2) to permit the continued expansion of commercial practices through custom, usage and agreement of the parties; and (3) to make uniform the law among the various jurisdictions’.

⁴ Bernstein, Lisa, 'Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms', *University of Pennsylvania Law Review*, 144 (1996), 1765-1821; Bernstein, Lisa, 'The Questionable Empirical Basis of Article 2's Incorporation Strategy: A Preliminary Study', *University of Chicago Law Review*, 66 (1999), 710-780; Bernstein, Lisa, 'Private Commercial Law in the Cotton Industry: Creating Cooperation through Rules, Norms, and Institutions', *Michigan Law Review*, 99 (2001), 1724-1790.

⁵ Wightman, John, 'Beyond Custom: Contracts, Contexts, and the Recognition of Implicit Understandings', in David Campbell, Hugh Collins, and John Wightman (eds.), *Implicit Dimensions of Contract. Discrete, Relational and Network Contracts* (Oxford and Portsmouth, Oregon: Hart Publishing, 2003), 143-86, p. 150; Epstein, Richard A, 'Confusion about Custom: Disentangling Informal Customs from Standard Contractual Provisions', *University of Chicago Law Review*, 66 (1999), 821-35, p. 828. Also see Cooter, Robert D, 'Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant', *University of Pennsylvania Law Review*, 144 (1996), 1643-1696, p. 1646, 'Wherever there are communities, norms arise to coordinate the interaction of people.'

provide the members of the contracting community with assistance for drafting their own individual contracts, and provide the parties with alternative solutions from which they are able to choose the solution that is best suited to their individual transaction. These model contracts can also leave room for the parties to complete the contract in order to customize it to their particular transaction. In this sense, the parties are not restricted to one set way of conducting business. Sets of general conditions can be applied in a standardized way to all transactions of a particular type. These general conditions should balance the typical needs of the parties involved and can be used as standard documents, without the parties having to complete or adjust the terms. The sectoral regulations would contain general rules, practices, and common definitions that are applicable within the particular trade, industry or business sector. These sectoral regulations are to be viewed as specialist 'statutes' that incorporate the shared understandings and practices of a particular contracting community.⁶ These sectoral rules would address general issues such as formation, interpretation, performance and non-performance, remedies and excuse. A final element of the private regulatory framework could be to adopt an alternative form of dispute resolution. For instance, the contracting community may choose to settle disputes through arbitration by a sectoral panel. By creating such a comprehensive private regulatory framework, businesses transacting within the particular sector are likely to prefer private regulation to the less tailored and comprehensive European contract law.

A number of advantages of private regulation by the contracting community can be identified:

1. Tailored solutions: the private regulatory framework is tailored to the needs, interests and preferences of the members of the contracting community.⁷ After all, the objective of the private regulatory framework is to channel the collective knowledge and experience, shared understandings, customs and usages, into the model contracts, general conditions and sectoral regulations. In contrast, a uniform contract law will by its nature contain open-ended and general rules that are not tailored to the specific needs of the particular business community.
2. Flexibility: the model contracts, general conditions and sectoral regulations are capable of change in light of changing needs and practices and developments within the particular contracting community. If a particular term no longer serves the best interests of the contracting community, it can be replaced with another, more suitable solution. A uniform contract law would be much harder to adapt to new developments.
3. Simplified dealings and transaction cost reductions: Individual contracting parties are not required to 're-invent the wheel' every time they transact. Instead, through membership of the contracting community, they can benefit from the collective knowledge and experience accumulated within the contracting community. Businesses are able to trade at short notice, because they no longer have to conduct extensive negotiations on the terms of their transaction. With a uniform contract law, the rules would not be tailored and may require businesses to enter into further negotiations to obtain the solutions they desire.

⁶ See Kraus, Jody S, and Walt, Steven D, 'In Defense of the Incorporation Strategy', in Jody S Kraus and Steven D Walt (eds.), *The Jurisprudential Foundations of Corporate and Commercial Law* (Cambridge: Cambridge University Press, 2000), 193-237, p. 225; Kornet, Nicole, *Contract Interpretation and Gap Filling: Comparative and Theoretical Perspectives* (Ius Commune Europeum, nr. 60; Antwerp - Oxford: Intersentia, 2006), chapter 11, section 4.2.2.

⁷ Livanos Cattai, Maria (2001), 'Harmonising Commercial Law: Keeping Pace with Business', in Ian Fletcher, Loukas Mistelis and Marise Cremona (eds.), *Foundations and Perspectives of International Trade Law* (London: Sweet & Maxwell, 2001), 37-42, p. 39, refers to 'rules by users for users.'

4. Balanced solutions: the private regulatory framework balances the interests of various parties within a particular trade, industry or sectoral organization. For instance, the interests of both buyers and sellers within a particular market should be represented within the organization. Through the representation of all participants in the particular market within the organization, the private regulatory framework should aim to address and balance the interests and expectations of the different members of the trade, and incorporate their understandings, needs, and practices. Furthermore, if the private regulatory framework is set up by representatives of all the participants of a particular contracting community, i.e. buyers and sellers, the bargaining power of both ends of the transaction will remain balanced, thus reducing the likelihood of collusion and price-fixing (see below).
5. Increased certainty and predictability: by incorporating relevant practices and usages in the private regulatory framework, reliable evidence of the relevant commercial norms and practices is provided by the contracting community itself.

Despite these advantages, it is necessary to recognize that there are concerns relating to private regulation.⁸ Economists in particular warn of:⁹

1. Dangers of barriers to entry: trade organizations that operate as closed networks create barriers to entry to newcomers, who must for instance establish a good reputation to gain entry to the contracting community. This problem does not exist in the case of an open network, allowing open entry and exit. The private regulatory framework should therefore be available to new members of the relevant contracting community. They can opt into the private rules by using the model contracts, and including a specific provision in their contract rendering the sectoral regulation and dispute resolution mechanism applicable. The contracting community should not, however, unduly restrict the possibility of members to adopt alternative contracting solutions. It can be assumed, however, that if the private regulation responds to the needs of the members of the contracting community, they will adopt them.
2. Potential for collusion and monopolistic price-fixing: where the relative bargaining power between buyers and sellers is altered or pushed 'out of balance' the possibility of collusion and monopolistic pricing can arise. The power to fix prices will depend, however, on the nature of the organization. Collusion and monopolistic pricing will in particular take place if the organization is one-sided, favouring (usually) sellers over buyers. But collusion becomes more difficult when the number of participants increases and the organization includes (representatives of) all sides of the transaction, i.e. both buyers and sellers as members.¹⁰ If there are competing organizations performing similar functions, collusion will also be

⁸ See for instance, Ogus, Anthony, 'Rethinking Self-Regulation', *Oxford Journal of Legal Studies*, 15 (1995), 97-108, p. 98; Ogus, Anthony, 'Self-Regulation', in Boudewijn Bouckaert and Gerrit De Geest (eds.), *Encyclopedia of Law and Economics* (Edward Elgar; University of Ghent, 1999), 587-602, p. 587; Pirrong, Stephen Craig, 'Self-regulation of private organized markets', in Peter Newman (ed.), *The New Palgrave Dictionary of Economics and the Law* (London: New York: MacMillan; Stockton Press, 1998), 433-438.

⁹ McMillan, John, and Woodruff, Christopher, 'Private Order Under Dysfunctional Public Order', *Michigan Law Review*, 98 (2000), 2421-2458, p. 2454-2458; Richman, B.D., 'Firms, Courts and Reputation Mechanisms: Towards a Positive Theory of Private Ordering', *Columbia Law Review*, 104 (2004), 2328-2367, p. 2346-2347. Also see Posner, Eric A, 'The Regulation of Groups: The Influence of Legal and Nonlegal Sanctions on Collective Action', *University of Chicago Law Review*, 63 (1996), 133-197, who doubts whether private group norms are efficient due to externalities, strategic behaviour, information asymmetries, human nature and appeal to other moral values. Also see Katz, Avery, 'Taking Private Ordering Seriously', *University of Pennsylvania Law Review*, 144 (1996), 1745-1763, p. 1749.

¹⁰ Richman (2004), above fn. 9, p. 2347; McMillan & Woodruff (2000), above fn. 9, p. 2456; Epstein (1999), above fn. 5, p. 829.

reduced.¹¹

In the context of the discussion on the harmonization of contract law in Europe, private regulation could constitute an effective mechanism to deal with the additional costs associated with legal diversity and to encourage cross-border transactions if European-wide contracting communities or private regulatory organizations developed.¹² This could occur through cooperation between national sectoral organizations, or through the creation of sectoral organizations that address the needs of the members of a particular trade or industry who transact on a European level. They can use their collective knowledge and resources to adapt model contracts, general conditions and sectoral regulations to cross-border transactions. In the European context, the effective use of a private regulatory framework may be threatened, however, if national legal systems continue to have divergent mandatory laws concerning general conditions.¹³ In the context of business transactions, however, freedom of contract should play a decisive role and mandatory rules should be kept to a minimum, in particular if there is a private regulatory framework created by a contracting community that has balanced the relevant interests of all the parties involved. At the same time, the warnings of the dangers of monopolies and price-fixing should not be neglected. This will require measures to be undertaken to address concerted practices and anti-competitive behaviour and to promote competition between contracting communities. In this way, there is an important role for public regulation, in the form of competition law (articles 81 and 82 EC Treaty), to establish the boundaries of private regulation by businesses.

¹¹ McMillan & Woodruff (2000), above fn. 9, p. 2456.

¹² Also see Katz (1996), Above Fn. 9, p. 1748, 1753 ff., who explains that choice between state and private regulation, following the Coase Theorem depends on a comparison of the relevant transaction costs, which will usually be less for private institutions than public ones. From this perspective, the jurisdiction to make rules should be allocated to 'the institution that is best able to recognize and respond to transactional problems.'

¹³ Also see Bernitz, U., 'The Commission's Communications and Standard Contract Terms', in Vogenauer, S. and Weatherill, S. (eds.), *The Harmonisation of European Contract Law. Implications for European Private Laws, Business and Legal Practice* (Oxford and Portland, Oregon: Hart Publishing, 2006), 185-195.

