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Comparative Contract Law and Economics

MITJA KOVAČ

New Horizons in Law and Economics

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Mitja Kovač, at the Oudegracht in Utrecht (The Netherlands)
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1. Introduction

1.1. INTRODUCTION

Sol iustitiae illustra nos

'May the Sun of Justice Enlighten Us,' has been the motto of Utrecht University since its beginning in 1636, and indeed a comparatist could not find a more suitable motto for his own research. The quest for a new, deeper understanding of the apparent similarities and differences between different legal systems, between their doctrines, rules and decisions presents the ultimate challenge for every comparatist. A true comparatist should strive for this understanding, for the unraveling of seemingly widely accepted beliefs, follies and half-truths; he should, once he has isolated this quest from its national legal backgrounds, then bridge the apparent divisions; and he should fill in the gaps created by previous researches, where, indeed, the sun of justice should be the enlightening, inspiring motive.

A traditional handbook on comparative contract law usually contains short summaries of different legal systems and tries to demonstrate significant differences between the compared legal systems, and especially between civil and common law. What surprised me, however, was the lack of any deeper, methodological framework for the evaluation of the differences or similarities. Being trained in law and economics, the benefits of an interdisciplinary approach where an economically-inspired optimal model rule would serve as a uniform term of comparison for the assessment of pre-contractual duties of disclosure, unforeseen contingencies and unilateral termination of contracts, seemed clear. The more I analysed these differences from an economic perspective, the more I became convinced that many of them were matter-of-fact similarities.

The question arose in my mind as to whether compared legal systems are, in the field of contract law, indeed as different as many comparatists tend to believe and if there is, apart from the simple borrowing of historical and cultural reasons, something more at stake explaining established legal changes, inconsistencies and similarities.

This question soon became my inspiration and joy.

1.2. SUBJECT MATTER

> Though great progress has been made, most work in comparative law even today still starts from a particular question or legal institution in national law, proceeds to treat it comparatively, and ends, after evaluating the discoveries made, by drawing conclusions for national law alone. This attitude could be called national comparative law. What we must aim for is a truly international comparative law which could form the basis for a universal legal science.[1]

The aim of finding a truly international comparative law which could form the basis of a universal legal science is also the aim of this book. Inserting new, economically-inspired contents into traditional, comparative contract law in order to understand the similarities, differences and evolutionary patterns of different legal systems presents the scope and the subject matter of this work. This book is primarily aimed at lawyers, both practitioners and scholars, and provides a deep analysis of the pre-contractual duties of disclosure, unforeseen contingencies and unilateral termination of the French, English, American and German law of contracts.

Contract law has long been one of the core subjects of comparative law, and among the most popular because it is, as Farnsworth notes, among the practically most salient areas of law, both in terms of economic importance and in terms of the realities of international negotiation and litigation.[2] Almost all trade and economic relations nowadays depend on private contracts. Moreover, it may be argued that contracts are an essential part of the modern economy, where practical daily considerations call for further understanding of similarities and differences among the various national legal systems or legal families. Hence, legal practitioners, international business, the bench and the bar, and the legislators have an increasing interest in understanding contract law in a transnational context.

However, despite the importance of contract law in comparative law, an economic approach, that is to say comparative contract law and economics, is still relatively recent. Moreover, comparatists tend to believe that legal systems are profoundly different. Yet the Levmore thesis, which is the central thesis in comparative law and economics, states that in principle we can expect the same legal rules in all legal systems (of societies in the same stage of development).[3] The reason for this is that all legal rules are confronted with essentially the same problems of self-interested behavior. According to Levmore, variety between

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[1] Zweigert, Konrad and Hein Kötz, 'Introduction to Comparative Law,' 3rd ed., Clarendon Press, 1998, p. 46.

[2] Farnsworth, Allan E., 'Comparative Contract Law,' in Reimann, Mathias and Reinhardt Zimmermann (eds.), 'The Oxford Handbook of Comparative Law,' 2nd ed., Oxford University Press, 2008, p. 899.

[3] Levmore, Saul, 'Rethinking Comparative Law: Variety and Uniformity in Ancient and Modern Tort Law,' 61 Tul. L. Rev. 235, 1986.

legal systems can be expected either when the content of the rule does not really matter (for example driving on the left versus the right side of the road), or when reasonable people (even in the same culture) disagree about the optimal rules (for example the optimal divorce rules). Levmore's thesis provides a functional explanation for Schlesinger's common core observations.[4]

The analysis provided confirms Levmore's thesis by suggesting that the legal systems of France, England, the US and Germany differ less than comparatists tend to believe. Moreover, my analysis suggests that the compared legal institutions invariably tend towards efficiency, where the wealth maximization principle evolves as the actual operational mechanism of judicial decision-making. This, however, also confirms Judge Posner's thesis on wealth maximization as the core judicial decision-making principle.[5] The explanatory potential of this optimal model rule for established statutory and judicial inconsistencies and apparent differences becomes evident.

Employing an economically-inspired optimal model rule as the uniform term of comparison, the presented essays assess some of the most controversial contractual issues, that is pre-contractual duties of disclosure, unforeseen contingencies and unilateral termination of contracts. In each of these essays, law and economics literature is surveyed and systematized into a coherent optimal model rule, which then serves as a uniform term of comparison. After each legal system is compared, it is followed by an examination of the current legal doctrine, and of the related law in action. The law and economics, and comparative contract law literature on all of these issues provide several striking insights. However, although pre-contractual duties of disclosure and the problem of unforeseen contingencies present one of the old moral and legal cruxes of legal scholarship, many questions still need to be resolved and further elaboration is required.

Hence, the main purpose of this book is to provide an objective, economically-inspired assessment of the compared legal systems. My aim is to overcome inconsistencies resulting from subjectivity or nationalism, to challenge widely accepted comparative premises, and to shed light upon sometimes even parochial legal postulates and to contribute to comparative contract law research.

1.3. METHODOLOGY

Throughout this book, the approach is interdisciplinary, focusing on legal and economic issues. Whereas an economic approach is becoming increasingly

[4] De Geest, Gerrit and Roger Van den Bergh, 'Introduction,' in De Geest, Gerrit and Roger Van den Bergh (eds.), 'Comparative Law and Economics,' Edward Elgar, 2003.

[5] Posner, Richard A., 'Overcoming Law,' Harvard University Press, 1995. See also Posner, Richard A., 'How Judges Think,' Harvard University Press, 2008.

common and influential in the study of substantive contract law of the US and some European countries, its application in comparative contract law has, as a new discipline, evolved relatively recently and is positioned at the frontiers of progressive legal thought.[6] This innovative scholarly paradigm, combining the analytical tools of adjoining and complementary social sciences in order to develop a critical approach to legal rules and institutions, conveys a distinctive comparative perspective on the theory, practice and understanding of the law of contracts of different legal systems. The approach utilized combines analytical methods and concepts used in the economic analysis of law with pure comparative contract law discussions. However, in order to provide an overview of applied methodology, the concepts and methods of both concepts will be briefly summarized and then combined in a unified methodological principle.

1.3.A. Methodology and concepts used in the economic analysis of law

The economic approach to law is one of the most ambitious and probably the most influential concepts that seek to explain judicial decision-making and to place it on an objective basis. It is regarded as the single most influential jurisprudential school in the US.[7] Although a comprehensive examination of the field is beyond the scope of this book and can be found elsewhere,[8] the basic approach will be outlined.[9] The central assumption of economics is that all people (except children and mentally disabled) are rational maximizers of their satisfactions in all of their activities. In other words, the rational choice approach is the basic methodological principle in this book, which besides maximizing behavior and market equilibrium, also comprises the assumption of stable preferences. The notion of maximizing behavior comprises the principle of wealth maximization, where the measure for parties' maximizing behavior is their willingness to pay. That is to say, if goods are in hands of the persons who were willing and able to pay the highest amount, wealth is maximized. Wealth maximization is also applied as the leading principle of comparison.

In order to make the economic analysis accessible to lawyers not acquainted with law and economics, some of the basic concepts used will be briefly summarized.

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[6] For the first anthology on comparative law and economics see De Geest, Gerrit and Roger Van den Bergh (eds.), 'Comparative Law and Economics,' Edward Elgar, 2003.

[7] Posner, Richard A., 'Frontiers of Legal Theory,' Harvard University Press, 2001.

[8] See for example Shavell, Steven, 'Foundations of Economic Analysis of Law,' Harvard University Press, 2004; Polinsky, Mitchell A. and Steven Shavell (eds.), 'The Handbook of Law and Economics,' Vol. I, Vol. II, North-Holland, 2008.

[9] For a synthesis see Kerkmeester, Heico, 'Methodology: General,' in Bouckaert, Boudewijn and Gerrit De Geest (eds.), 'Encyclopedia of Law and Economics,' 2000; Georgakopoulus, Nicholas L., 'Principles and Methods of Law and Economics: Basic Tools for Normative Reasoning,' Cambridge University Press, 2005.

Wealth maximization

The term 'wealth maximization' is often misunderstood, and confused with conscious calculations or selfishness. Moreover, many lawyers still think of economics as the study of inflation, extraction of profits, businesses and other mysterious phenomena, remote from the daily concerns of any legal system. Yet in economics the concept of a man as a rational wealth maximizer of his self-interest implies that people respond to incentives if a person's surroundings change in such a way that he could increase his satisfactions by altering his behavior.[10] It should also be noted that those decisions, in order to be rational, need not be well thought-out at the conscious level, in fact they need not be conscious at all, since as Posner states, 'rational' denotes suiting means to ends and that much of our knowledge is tacit.[11] Moreover, it is evident that non-monetary as well as monetary satisfactions enter into such an individual's calculus of maximizing. It should also be stressed out that, despite the valuable insights of new behavioral approaches, the main reason why I remain within the rational-choice framework is that it is the framework which makes my points sharper and it should not be understood as downplaying the importance of behavioral considerations. However, after defining 'rational' one should also assess the notion of 'wealth maximization.' One of the main fallacies is to equate business income to social wealth. Wealth maximization refers to a sum of all tangible goods and services, weighted by offer prices and asking prices.[12] The notion of wealth maximization is that the value of wealth in society should be maximized.[13] In this context wealth should be understood as the summation of all valued objects, both tangible and intangible, weighted by the prices they would command if they were to be traded in markets.[14] The transaction is wealth maximizing, where, providing that it has no third-party effects and is a product of free, unanimous choice, has made two people better off and no one worse off. This is so-called 'Pareto efficiency,' where it is impossible to change it so as to make at least one person better off without making anyone worse off. Parties enter into transactions on the basis of rational self-interest where voluntary transactions tend to be mutually beneficial. Hence, the term 'efficiency' used throughout this book denotes that allocation of resources whose value is maximized. As is common in modern economics, I will use the Kaldor–Hicks variant of the Pareto optimality criterion, according to which it is sufficient that the winners could, in theory, compensate the losers, even if this compensation is not effectively paid.

The assumption that those entering into exchanges are rationally self-interested is the basic assumption of law and economics.

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[10] Posner, Richard A., 'Economic Analysis of Law,' 7th ed., Aspen Publishers, 2007, p. 4.

[11] Posner, Richard A., 'The Problems of Jurisprudence,' Harvard University Press, 1993, p. 354.

[12] *Ibid.* p. 356.

[13] See Shavell, *supra* note 8, p. 669 *et seq.*

[14] See generally Posner, Richard A., 'Frontiers of Legal Theory,' Harvard University Press, 2001, p. 98 *et seq.*

Transaction costs

Economic theory refers to the costs attached to any transaction as 'transaction costs.' The voluntary transaction is beneficial to both parties, but transaction costs reduce the value of an exchange and both contracting parties will want to minimize them. In other words, transaction costs slow the movement of scarce resources to their most valuable uses and should be minimized in order to spur allocative efficiency. This phenomenon was first discussed by Ronald Coase in his seminal articles[15] and developed by other eminent authors.[16] As shown, in a world of zero transaction costs parties would always produce economically efficient results without the need for legal intervention. However, since in reality transaction costs are imposed daily, intervention becomes necessary and the legal rules by reducing transaction costs imposed upon an exchange can improve allocative efficiency, and thus maximize social welfare. Hence, efficiency requires economizing on transaction costs.

Uncertainty and risks

Economists established that one of the basic characteristics of economic actors is their attitude towards risks. Economists believe that most people are risk-averse most of the time, although a number of institutional responses (such as insurance contracts and corporations) may make people act as if they are risk-neutral in many situations.[17] Risk-averse people are willing to pay more than the expected value of a possible loss to eliminate the risk therein.[18] A person will be risk-averse if the marginal utility of money to him declines as his wealth increases. The widespread use of insurances witnesses the value of this argument, where risk-averse persons are prepared to pay insurance premiums for not having to suffer the losses when risks occur. In contrast, a risk-loving person places a value on risk lower than the expected value of the losses, whereas a risk-neutral person places a value on risk equal to the expected value of the losses.

Economic theory suggests that whenever one person can bear the risk at lower costs than another, efficiency requires assigning the risk upon such a superior risk bearer. In such an instance there is an opportunity for mutually beneficial exchange, where risk-averse persons are willing to pay risk-neutral persons to bear such risks. In cases where transaction costs preclude parties from making such an arrangement, efficiency offers a hypothetical bargain approach of the most efficient risk bearer. Such a bearer is the party to an

[15] Coase, Ronald, 'The Nature of the Firm,' 4 Econometrica 394, 1937; Coase, Ronald, 'The Problem of Social Cost,' 3 J. L. & Econ. 15, 1960.

[16] For a synthesis see Williamson, Oliver E. and Sidney G. Winter (eds.), 'The Nature of The Firm: Origins, Evolution, and Development,' Oxford University Press, 1993.

[17] See generally Posner, *supra* note 7, p. 10 *et seq.*

[18] For example you are risk-averse if you prefer to be given €5 million than a 10 percent chance of €25 million. See also Shavell, *supra* note 8, p. 258 *et seq.*

exchange who is best able to minimize the losses. It should be noted that almost any contract shifts risks, since contracts by their nature commit the parties to a future course of action, where the future is far from certain.

1.3.B. Methodology and concepts used in comparative contract law

An overview of comparative law theory reveals that there are, besides functionalism, several different approaches towards micro-comparison, for example comparative legal history, the study of legal transplants, and the comparative study of legal cultures.[19] However, many experienced comparatists have noted that a detailed method cannot be laid down in advance, and that all one can do is to take a method as a hypothesis and test its usefulness and practicability against the achieved results.[20] Hence, due to the efficient institution serving as a uniform term of comparison, the functionality principle appeared as a natural choice, and after testing it with achieved results its usefulness and practicability appear to be a sound decision.

Thus, the test of functionality, as emphasized by Markesinis, Zweigert and Kötz,[21] and as has become both the mainstream and the *bête noire* of comparative law,[22] is employed as a basic methodological comparative principle. Although debating functionalism is beyond the scope of this chapter, and although it should also be stressed that, as a theory, at least in its elaborated version it hardly exists, one should note that its major shortcoming is the surprising lack of proper evaluation tools for determining which of the compared laws is 'better.'[23] This lack of a proper evaluation benchmark comes as no surprise, since the notion of which law is 'better' actually depends upon one's preferences, opinions, cultural, religious background and so forth. Moreover, this lack of precise criterion actually hinders proper analytical discussion and evaluation. Instead, I propose that the 'better law' should be evaluated in terms of which one maximizes social welfare, that is the one which is more efficient. Hence, the efficiency as a uniform term of comparison may overcome this lack of proper evaluation tools, add to the functional micro-

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[19] For a synthesis see Reimann, Mathias and Reinhardt Zimmermann (eds.), 'The Oxford Handbook of Comparative Law,' 2nd ed., Oxford University Press, 2008. See also Cruz de, Peter, 'A Modern Approach to Comparative Law,' Kluwer, 1993; Palmer, Vernon Valentine, 'From Lerotholi to Lando: Some Example of Comparative Law Methodology,' 2 Global Jurist. Frontiers 4, 2004; Legrand, Pierre and Roderick Munday (eds.), 'Comparative Legal Studies: Traditions and Transitions,' Cambridge University Press, 2003.

[20] See for example Radbruch, Gustav, 'Einführung in die Rechtswissenschaft,' 12th ed., Quelle & Meyer, 1969; Zweigert and Kötz, *supra* note 1, p. 33.

[21] Markesinis, Basil S., 'Foreign Law and Comparative Methodology: a Subject and a Thesis,' Hart Publishing, 1997; Zweigert and Kötz, *supra* note 1, p. 34.

[22] See Markesinis, Basil S., 'Always on the same Path – Essays on Foreign Law and Comparative Methodology,' Vol. II, Hart Publishing, 2001. For a synthesis see Michaels, Ralf, 'The Functional Method of Comparative Law,' in Reimann, Mathias and Reinhardt Zimmermann (eds.), 'The Oxford Handbook of Comparative Law,' 2nd ed., Oxford University Press, 2008, p. 340.

[23] Michaels, *supra* note 22, p. 374.

comparison an additional perspective, and may actually overcome the analytical disadvantages of the functional method. Social welfare maximization as the central concept used in comparative contract law and economics will be introduced and elaborated in the next subsection. However, for reasons of structural consistency the principles of the fundamental functional method will be elaborated first.

According to functional micro-comparison, that which is incomparable cannot usefully be compared, and in law the only things which are comparable are those which fulfill the same function. Zweigert and Kötz's proposition rests on what every comparatist actually learns, namely, that the legal system of every society faces essentially the same problems and solves these problems by quite different means, though with similar or identical results. They also pronounce the basic rule of comparative law, the so-called *praesumptio similitudinis,* which states that:

> different legal systems give the same or very similar solutions, even as to detail, to the same problems of life, despite the great differences in their historical development, conceptual structure, and style of operation. It is true that there are many areas of social life which are impressed by especially strong moral and ethical feelings, rooted in the particularities of the prevailing region, in historical tradition, in cultural development, or in the character of the people.[24]

So, one should generally expect different legal systems to produce identical results. However, it should be stressed that the starting point of my analysis was one of objectivity where neither similarity nor difference was favored in advance, yet the results invariably tend towards similarity, and thus once again confirm this basic rule of functionalism. However, before elaborating three applied analytical stages in these comparisons, several methodological preliminaries will be illuminated.

Macro- and micro-comparison

Micro-comparison, with a focus on specific legal problems, is employed as the principal comparative technique. The related distinction between macro- and micro-comparisons was firstly drawn by Zweigert and Kötz in their seminal work on the introduction to comparative law in 1977.[25] Micro-comparison aims at the specific legal institutions or problems, that is, with the rules used to solve actual problems or particular conflicts of interest, whereas macro-comparisons relate to the methods of handling legal materials, procedures for resolving and deciding disputes, or the roles of those engaged in law.[26]

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[24] Zweigert and Kötz, *supra* note 1, p. 34.

[25] Zweigert and Kötz, *supra* note 1, p. 4 *et seq*. See also Dannemann, Gerhardt, 'Comparative Law: Study of Similarities or Differences,' in Reimann and Zimmermann, *supra note 19, p. 387.*

[26] Zweigert and Kötz, *supra* note 1, p. 4.