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2005

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MPRA Paper No. 8192, posted 17 Apr 2008 00:57 UTC

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© Jan M. Smits  
Published in Maastricht, October 2005

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This paper is to be cited as Maastricht Faculty of Law Working Paper 2005/9

# Diversity of Contract Law and the European Internal Market

Jan M. Smits\*

## Abstract:

This contribution discusses the question whether diversity of contract law among the European member states is a barrier to cross-border trade. This question is important in view of the ongoing debate about the need for a unified European private law. It is tried to answer the question by building upon insights from psychology, economics and law. It turns out that no definitive answer can be given to the question whether the savings in transaction costs through the removal of legal diversity are greater than the losses caused by the termination of competition of legal systems.

## Keywords:

**European Private Law; Unification; Interdisciplinary approach**

## 1. Introduction: Aim of this Contribution

Does diversity of (contract) law stand in the way of the proper functioning of the European economy? Do diverging legal rules form a barrier for international trade? Is a consumer inclined to buy less abroad because he does not know about the other country's legal system? All these questions deal with the relationship between diversity of (contract) law and decisions made by businesses and consumers. This contribution intends to discuss these questions against the background of the debate on harmonisation of contract law in Europe. This implies that insights from various disciplines are drawn together. It is after all not only (comparative) law, but also economics and psychology that may have something to say about the relationship between legal diversity and the enhancement of interstate trade. The main aim of this contribution is to try to link insights from these various disciplines. In doing so, it is hoped that more insight can be gained into the question to what extent diversity of law is actually a barrier to the proper functioning of the European economy.

There are at least two reasons why this question is of paramount importance. First, there is a rather practical reason. In recent years, an extensive debate has evolved on the need for harmonisation of contract law in Europe. In this debate, it is often asserted that diversity of contract law is burdensome for the European internal market. This is typically 'evidenced' by saying that an Italian businessman may be deterred from contracting in for example Belgium because he does not know about Belgian law.<sup>1</sup> This argument was one of the main reasons for the European Union to start a debate on the most proper way of harmonising contract law in Europe.<sup>2</sup> It is however still an open question to what extent legal diversity in the field of contracts is really a barrier to international trade. This question cannot be answered on basis

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\* The author wishes to thank Renske van Dijken for valuable research assistance.

<sup>1</sup> See for example Lando (1993) 157 and Lando (2000) 61.

<sup>2</sup> See below, section 3.

of knowledge about the law alone. It needs an interdisciplinary approach. As long as there is no evidence for an affirmative answer to the question, it will be difficult for the European Commission to come to a true harmonisation of contract law (see section 2.3).

Second, there is an important scholarly aspect to the relationship between legal diversity and the enhancement of the European economy. In recent years, behavioural models are being incorporated more and more into traditional legal scholarship: it has become increasingly important to integrate realistic insights of what people or businesses actually do into legal and economic questions.<sup>3</sup> The question whether legal diversity influences decisions of companies and consumers fits in very well.

This paper is divided into several sections. The next section describes the present situation in European contract law. This situation can be characterised as *diverse*: several contract law regimes exist next to each other. It is often assumed that this diversity is problematic. This is elaborated in the sections 3 and 4. Section 3 is devoted to the diversity created by the community *acquis* and section 4 to diversity among national legal systems. In this section, several arguments pro and against uniform contract law are discussed. Some conclusions are drawn in the fifth section of this contribution.

## **2. The Present Situation in European Contract Law: Diversity of Legal Systems**

### **2.1 Four contract law regimes**

If one is to characterise contract law in Europe, one can do so by saying that it is *diverse*. Within the European Union, there are at least four types of contract law regimes. First, every member state has its own national contract law, which implies that there are now 25 of such national systems within the EU. Next to these national regimes, there is a set of rules on contract law of European origin. This set consists of a rapidly increasing amount of directives issued by the European Union. Third, there is the international regime created by the Convention on the International Sale of Goods (CISG). This regime is not specifically European, but it certainly does play an important role within the European Union. Finally, there are – within several countries – regional variations of the national model or even (like in the United Kingdom) several fully-fledged legal systems standing next to each other. These four types of regimes are explored in the underneath.

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<sup>3</sup> For the United States, I point at the work of Cass Sunstein (e.g. Sunstein (2000)), Christine Jolls (e.g. Jolls (2004)) and Steven Levitt (e.g. Levitt (2001)).

## 2.2 National legal systems

The 25 member states of the European Union all have their own contract law regime. This implies that each national legislator has its own competence in drafting contract law rules and that each country has its own national courts to deal with contract cases. There is at present no highest European authority that could provide binding contract law rules outside the (rather limited) competence of the European Union. This implies that, from all political, economic and monetary unions in the world,<sup>4</sup> the European Union is the most diverse as to the law. Whereas in the United States, contract law is not a matter for the federal government either, one cannot say that American contract law is diverse. In fact, the regimes on sale of goods and commercial transactions are very comparable, not in the last place because of the example set by the Uniform Commercial Code, now taken over in almost all American states.<sup>5</sup>

It may be useful to make a distinction between four types of national contract law regimes within the European Union. These four types can be distinguished on basis of common history, the sources of law recognised and the predominant mode of legal thought.<sup>6</sup> The first type then consists of the common law systems of England and Ireland with their emphasis on judge-made law and the central authority of the English House of Lords and the Irish Supreme Court respectively. The common law system of Cyprus (that was a British colony until 1960) also belongs to this group. The second type consists of the traditional civil law countries, characterised by a central role for a national civil code,<sup>7</sup> but also by a highest court whose decisions are in practice often just as important as the code provisions. Among these countries, one can distinguish between those that have a code that is to a greater or lesser extent still based on the Code Napoleon (France, Belgium, Luxemburg, Spain, Portugal, Italy and Malta) and those that have a code more based on the German model (Germany, Austria,<sup>8</sup> Greece and the Netherlands). A third group consists of the Scandinavian member states (Denmark, Sweden and Finland). They are not only characterised by a common history, but also by the existence of several common statutes. Among these are a common statute on sale of movables and a common contract law act.<sup>9</sup> Finally, there is the large group of countries that have entered the European Union in 2004 and that almost all have a new or at

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<sup>4</sup> The most important economic union outside Europe is the North American Free Trade Agreement (NAFTA) between the US, Canada and Mexico. See on regional integration Mattli (1999).

<sup>5</sup> On the UCC, see for example White and Summers (2000).

<sup>6</sup> Cf. Zweigert and Kötz (1998) 68 ff.; see on these types of distinctions Husa (2004) 11 ff.

<sup>7</sup> Cf. Zimmermann (1997) 259 ff.

<sup>8</sup> Austria has a special position as its AGB of 1811 is, as the French Code Civil, also a 'natural law code'.

<sup>9</sup> Cf. Zweigert and Kötz (1998) 280 ff.

least recently revised civil code (Poland, the Czech Republic, Slovakia, Hungary, Estonia, Lithuania, Latvia and Slovenia).<sup>10</sup> The way in which these new or revised codes are applied and interpreted by the courts of these countries cannot be compared to the way in which this is done in the traditional civil law countries. Generally speaking, the mode of interpretation is much more literal.

Diversity among these 25 contract law regimes does not mean that it is impossible to draft principles all these legal systems have in common. There are now two sets of such principles available: the Principles of European Contract Law<sup>13</sup> and the Gandolfi Code.<sup>14</sup> Neither of these sets, however, represents the individual national contract law regimes. One can only say that they try to provide a common structure (a common denominator) to Europe's legal systems, leaving out essential details as to substance and the divergent ways of dealing with this substance by the courts.<sup>15</sup> Despite an often common history of most legal systems mentioned (most of them are to a greater or lesser extent based on the Roman law of the *ius commune*<sup>16</sup>), most systems have, over the last 200 years, had a separate history. To look at this as mere historical accident or as something one could get rid off easily does not do justice to the vigour of the differences or to the difficulties to overcome in changing this diversity.<sup>17</sup>

### **2.3 Contract law of European origin: directives**

A second type of contract law regime is the one created by the European Union. Unlike the national legal systems, the European Union can only act in so far as there is a legal basis for it in the EC Treaty.<sup>18</sup> The most important basis<sup>19</sup> is art. 2, which provides that the European community has for a task to promote, throughout the community, 'a harmonious and balanced development of economic activities'. This takes place through the creation of a common market and an economic and monetary union. Art. 3 then makes clear that to reach this goal, an internal market characterised by the abolition of obstacles to the free movement of goods,

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<sup>10</sup> Cf. Reich (2004).

<sup>13</sup> Lando and Beale (2000) and Lando et al (2003).

<sup>14</sup> Gandolfi (2001). The Unidroit Principles of International Commercial Contracts (new edition 2004) are a third set, though not restricted to the European Union.

<sup>15</sup> For a critique of the European principles approach, see Smits (2002b) 239 ff.

<sup>16</sup> A theme stressed by Reinhard Zimmermann. See e.g. Zimmermann (2004).

<sup>17</sup> Cf. Smits (2002a).

<sup>18</sup> Consolidated version of the Treaty establishing the European Community, *OJ EC* 2002, C 325/33.

<sup>19</sup> There are other bases, such as art. 61 sub c jo. 65 EC Treaty on the 'area of freedom, security and justice.' This basis was introduced with the Maastricht Treaty of 1992.

persons, services and capital is to be established. In this context, the EC undertakes, inter alia, the ‘approximation of the laws of member states to the extent required for the functioning of the common market’. All this implies that the competence of the EU in the field of contract law is only *indirect*: in so far as national contract law (or any other part of the law) stands in the way of the further development of the internal market, the EU is allowed to act. This means that the EU’s interest in contract law is *functional*: only if the economic development of the EU is threatened to be disturbed, it can intervene.

One of the problematic aspects of this functional demarcation of the EU competence is that the formulation of art. 3 ‘to the extent required for the functioning of the common market’ is rather vague. In its Tobacco judgment of 2000,<sup>20</sup> the European Court of Justice held that art. 95 (in which arts. 2 and 3 are elaborated) does not give a general power to regulate the internal market:

‘A measure adopted on the basis of art. 95 of the Treaty must genuinely have as its object the improvement of the conditions for the establishment and functioning of the internal market. If a mere finding of disparities between national rules and of the abstract risk of obstacles to the exercise of fundamental freedoms or of distortions of competition liable to result there from were sufficient to justify the choice of art. 95 as a legal basis, judicial review of compliance with the proper legal basis might be rendered nugatory.’

Instead, there must be actual or at least probable obstacles to the functioning of the internal market, if art. 95 is to be used as a basis and the elimination of these obstacles must be the purpose of the measure. With this judgment, the competence of the EU to act on basis of the provisions on the internal market (arts. 2, 3 and 95) is seriously restricted. It also explains the European Commission’s eagerness to establish to what extent European companies really suffer from diversity of law.<sup>21</sup>

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<sup>20</sup> ECJ Case C-376/98 *Germany v. Parliament and Council* [1998] ECR I-8419. See on this decision in the context of harmonization Weatherill (2001) and now also ECJ Case C-210/03 *The Queen v. Secretary of State for Health* (not yet reported).

<sup>21</sup> There is an interesting parallel with the United States, where the mere fact that goods and services cross state lines does as such not justify federal intervention under the ‘commerce clause’: see for example Krauss and Levy (2004).

The above led to at least twelve different European directives in the field of contract law.<sup>22</sup> All these directives are based on the internal market provisions of the EC Treaty. This therefore implies that the justification for European intervention is that the subjects covered by the directives are of such importance that divergences in national legislation of the member states distort the internal market. Although most of the directives intend to protect the consumer, consumer protection was therefore not the primary goal. The goal was much more to avoid unfair competition between sellers of goods and suppliers of services within the EU: if national legislation shows differences (for example in the field of consumer sale), this implies according to the European Commission that ‘the national markets for the sale of goods and services differ from each other and that distortions of competition may arise amongst the sellers and suppliers, notably when they sell and supply in other member states.’<sup>23</sup> Another aim, to be found in several directives, is to encourage consumers to buy more abroad.

It is characteristic of the *acquis* in the area of contract law that directives do not cover contract law in general, but are only applicable to specific types of contracts and to specific parts of traditional contract law. If one takes the classic distinction between formation, content and performance of the contract, the following overview can be given. The formation of contracts is governed by rules on formal requirements,<sup>24</sup> agency,<sup>25</sup> the time of conclusion of the contract<sup>26</sup> and information to be provided before and after formation of the contract.<sup>28</sup> The content of the contract is usually governed by rules on interpretation,<sup>29</sup> unfair terms<sup>30</sup> and

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<sup>22</sup> EC Directives 85/577 on (...) contracts negotiated away from business premises, *OJ EC* 1985, L 372/31; 86/653 on (...) self-employed commercial agents, *OJ EC* 1986, L 382/17; 87/102 on (...) consumer credit, *OJ EC* 1987, L 42/48; 90/314 on (...) package travel, *OJ EC* L 158/59; 93/13 on (...) unfair terms in consumer contracts, *OJ EC* 1993, L 095/29; 94/47 on (...) timeshare, *OJ EC* L 280/83; 97/7 on (...) distance contracts, *OJ EC* L 144/19; 1999/44 on (...) sale of consumer goods, *OJ EC* L 171/12; 2000/31 on (...) electronic commerce, *OJ EC* L 178/1; 2000/35 on (...) combating late payment in commercial transactions, *OJ EC* L 200/35; 2002/47 on (...) financial collateral arrangements, *OJ EC* L 168/43 and 2002/65 on (...) distance marketing of financial services, *OJ EC* L 271/16. An overview is also given in European Commission (2001).

<sup>23</sup> Preamble to Directive 93/13/EC on unfair terms in consumer contracts, *OJ EC* 1993, L 095/29.

<sup>24</sup> Art. 4 of Directive 87/102 on consumer credit; art. 4 s. 2 of Directive 90/314 on package travel; art. 4 of Directive 94/47 on timeshare; art. 9 s. 1 of Directive 2000/31 on electronic commerce; art. 3 of Directive 2002/47 on financial collateral arrangements.

<sup>25</sup> Art. 9 s. 1 of Directive 2000/31 on electronic commerce.

<sup>26</sup> Art. 11 of Directive 2000/31 on electronic commerce.

<sup>28</sup> Art. 3-4 of Directive 90/314 on package travel; art. 3 of Directive 94/47 on timeshare; art. 4-5 of Directive 97/7 on distance contracts; art. 5-6 and 10 of Directive 2000/31 on electronic commerce; art. 3-5 of Directive 2002/65 on distance marketing of financial services.

<sup>29</sup> Art. 5 of Directive 93/13 on unfair contract terms.

<sup>30</sup> See Directive 93/13 on unfair contract terms.

general conditions.<sup>31</sup> Most rules that exist are however about performance of the contract. Thus, there are rules on conformity on consumer sale,<sup>32</sup> the consumer's remedies in case of non-performance,<sup>33</sup> commercial guarantees,<sup>34</sup> the time of performance and the amount of interest to be paid in case of non-performance.<sup>35</sup>

The question should be raised to what extent this EC contract law is really a separate system. This question can arise since directives should be implemented in the national legal systems of the member states, leaving the choice of form and methods to the national authorities (art. 249 EC Treaty). Still, the EC *acquis* remains a European system: national courts are obliged to interpret the national implementation in accordance with the aim of the directive. It is also the European Court of Justice that has the final word on the interpretation of the *acquis*.

## 2.4 The Vienna Convention on the International Sale of Goods (CISG)

In addition to the national and European systems of contract law, there is the international regime created by the Convention on the International Sale of Goods (CISG) of 1980.<sup>36</sup> Of the 25 European member states, 20 are a party to the CISG.<sup>37</sup> Its field of application is restricted to the international sale of moveable goods between professional parties. In such a case, the CISG applies *unless* the parties have opted out of it. This seems to suggest that the CISG is an important regime in practice, but there are several reasons why this suggestion is false.

First of all, the CISG is in fact often excluded by the parties. This is the case in many general conditions set by branch organisations such as FOSFA (Federation of Oils, Seeds and Fats) and GAFTA (Grain and Feed Trade Association).<sup>38</sup> A survey<sup>39</sup> among some large Dutch companies showed that most of them exclude the applicability of the CISG in their general conditions as well. Smaller Dutch companies often did not exclude the CISG, unless legal advice was sought by one of the companies involved. It is likely that other European countries

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<sup>31</sup> Inter alia art. 10 s. 3 of Directive 2000/31 on electronic commerce.

<sup>32</sup> Art. 2-3 and 5 of Directive 1999/44 on sale of consumer goods. Also see art. 5 s. 2 of Directive 90/314 on package travel.

<sup>33</sup> Art. 5 of Directive 85/577 on contracts negotiated away from business premises, *OJ EC* 1985, L 372/31; art. 4-5 of Directive 90/314 on package travel; art. 5 of Directive 94/47 on timeshare; art. 6 of Directive 97/7 on distance contracts; art. 3 of Directive 1999/44 on consumer sale; art. 6 of Directive 2002/65 on distance marketing of financial services.

<sup>34</sup> Art. 6 on Directive 1999/44 on sale of consumer goods.

<sup>35</sup> Art. 3 of Directive 2000/35 on combating late payment in commercial transactions.

<sup>36</sup> Vienna 1980. See on the CISG for example Schlechtriem (2004) and Honnold (1999). Databases on the CISG include <http://www.unilex.info> and <http://www.cisg.law.pace.edu>.

<sup>37</sup> Not a party are the United Kingdom, Ireland, Portugal, Malta and Cyprus.

<sup>38</sup> Bertrams (1995) 72.

<sup>39</sup> See Bertrams (1995) 72 ff. and Kanning (1996).

show similar results. One of the reasons for opting out of CISG is that it contains many open-ended concepts (like reasonableness or impediment<sup>40</sup>) that still leave room for varying interpretations. Another reason seems to be that the content of the CISG is often unknown to the parties and that they do not find it worthwhile to put time and money into getting to know this content.<sup>41</sup> There is apparently no need to make use of it as national legal systems already fulfil these parties' needs.

Secondly, even if the CISG is applicable, this does not mean that the whole relationship between the parties is governed by it. On the contrary: in many respects national law (applicable in accordance with the rules of private international law) remains of importance. This is not only true for certain rules of national mandatory contract law (see for example art. 4 CISG on validity), but also for rules on securities and other topics not related to contract law as such. This does not enhance the willingness of parties to make use of the CISG as they need to rely on some national system anyway.

## 2.5 Divergence within one country

Finally, there is still a different type of diversity. It is the phenomenon of *institutionalised* diversity within one country.<sup>42</sup> This regional diversity can take very different forms. Here, I pay attention to the two most important examples of regional diversity as they exist in Spain and the United Kingdom.

The first example is Spain. In Spain, several autonomous regions have the competence to enact their own legislation in some areas of private law.<sup>43</sup> It is the region of Catalonia where the regional government has taken the most far going steps to enact a separate system of law. Since 1975, Catalonia enacted 30 different statutes in the field of civil law, building on the Catalan law as it existed before General Franco abolished the autonomy of Catalonia in 1938. Thus, Catalonia has, alongside the Spanish Civil Code of 1888, its own Code of Succession (1991) and its own Family Code (1998) and it is envisaged to draft a complete Catalan civil code in the near future.<sup>44</sup> As far as contract law is concerned, it is however debated to what extent the regions have in fact competence to draft their own rules. Art. 149 of the Spanish Constitution grants the state competence to draft rules relating to 'the bases of contractual obligations'. The rather broad interpretation of this provision by the Spanish

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<sup>40</sup> Cf. Lubbe (2004).

<sup>41</sup> Bertrams (1995) 76-77.

<sup>42</sup> See on this MacQueen, Vaquer and Espiau Espiau (2003).

<sup>43</sup> This competence was re-established after the death of General Franco in 1975. See for an overview Badosa Coll (2003) 136 ff.

<sup>44</sup> See Gispert I Catalá (2003) 164 ff.

Constitutional Court (indeed leaving only limited competence for the regions in the field of contract law) is criticised in legal doctrine.<sup>45</sup>

The second example concerns the United Kingdom. Here, regional diversity takes a very different form. While in Spain there are, alongside a general Spanish law, separate regional systems, in the United Kingdom there is no uniform national law but separate systems standing next to each other. These three systems are English law (not only applicable in England, but also in Wales), Scots law and Northern-Irish law.<sup>46</sup> In the debate on the harmonisation of private law in Europe, it is in particular Scots law that attracted a lot of attention. Scots law, as a mixed legal system, is said to offer an example for the future development of private law in Europe:<sup>47</sup> if there is to be some uniform system, it will necessarily be a mix of civil law and common law.

## **2.6 Problematic aspects of diversity within the European Union**

Is the co-existence of the four types of contract law regimes as described in the above problematic? This is certainly not the case in so far as these systems do not interfere with each other. In the case of diversity within one country, there is no problem in so far as only one system applies to the contract. Problems only arise in case several regimes may be applicable to the same contract, thus in particular if the contracting parties are from different member states (or different regions). In such a case, parties have to rely on the rules of private international (or interregional) law. In the context of the European Union, the main source of conflict of law rules is the EC Convention on the Law Applicable to Contractual Obligations of 1980.<sup>48</sup> According to this convention, the primary reason for the applicability of a certain national legal system is that the parties made a choice of law (art. 3).<sup>49</sup> If they did not, the contract is governed by the law of the country with which it is most closely connected (art. 4).<sup>50</sup> However, this type of private international law is often criticised. In the absence of an explicit choice of law, the questions what legal system is applicable and what is the content of

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<sup>45</sup> See Espiau Espiau (2003) 180 ff.

<sup>46</sup> There are still other legal systems within the United Kingdom. Thus, the Channel Islands and the Isle of Man have their own law.

<sup>47</sup> MacQueen (2000); Smits (2001). For a critical view, see Evans-Jones (1998).

<sup>48</sup> Convention on the law applicable to contractual obligations. Rome 1980, consolidated version *OJ EC* 1998, C 27/34. It is envisaged to turn this treaty into an EC-regulation: see the Green Paper on the Conversion of the Rome Convention of 1980 (...) into a Community instrument and its modernization, COM (2002) 654 (01).

<sup>49</sup> Gerhard Wagner (in: Smits (2005)) proposes to allow a choice of law also with respect to purely domestic transactions, thus allowing competition of legal systems to work even better.

<sup>50</sup> See on the problems caused by this e.g. Atrill (2004).

this system, are not always easy to answer.<sup>51</sup> In addition, national mandatory rules applicable on the basis of arts. 5 and 7 of the Rome Convention remain applicable, even if a choice of law was made.

In the context of this paper, attention needs to be paid to two aspects of diversity of legal systems that are often considered problematic. The first deals with the Community *acquis* (section 3), the second with national legal systems (section 4).

### **3. Diversity Through the Community *Acquis***

Despite the fact that directives in the area of contract law are supposed to create a harmonised set of rules in order to create a ‘level playing field’ for European business, this type of harmonisation still allows for diversity. This is the case for at least three different reasons. The first of these has to do with the minimum-character of directives. All directives issued in the field of contract law allow member states to create more stringent rules in the area covered by the directive.<sup>52</sup> In particular in the area of consumer protection, some member states tend to enact rules that are more protective than the directives prescribe. Although this does enhance consumer protection as such, the effect of it also is that business is still confronted with differences in national legislation among the member states and may consequently still be deterred from doing business abroad. Put differently: the question is whether minimum-harmonisation is the right means to reach the goal of promoting the internal market.

A second reason why the present *acquis* still allows for diversity, is that directives often contain abstract terms such as ‘damage’, ‘compensation’ or ‘fraudulent use’. How these terms are to be interpreted in a ‘European’ way is unclear. The European Court of Justice usually interprets such terms in light of the particular directive, consequently several concepts of for example damage exist next to each other. This is because the Court denied that the definition of a term in one directive is indicative for the interpretation of the same term in another directive.<sup>53</sup> There is thus no interpretation of directives in view of the *acquis* as a whole. The creation of a ‘common frame of reference’, as envisaged by the European Commission, has the goal of improving this,<sup>54</sup> although it remains to be seen whether this non-binding instrument will really enhance uniformity.

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<sup>51</sup> Cf. e.g. Leible (1998) 286 ff.

<sup>52</sup> The recent proposal for a directive on unfair business practices (18 June 2003, COM (2003) 356 final) is an exception to this.

<sup>53</sup> ECJ Case C-168/00 *Simone Leitner/TUI Deutschland* [2002] ECR I-2631 on which Smits and Hardy (2003).

<sup>54</sup> European Commission (2003) no. 59; European Commission (2004).

<sup>56</sup> Also see Teubner (1998) 11 ff.

The European *acquis* can still be criticised for a third reason. The *acquis* is fragmentary as it only deals with specific topics, whereas in most legal systems contract law is part of a comprehensive civil code. This fragmentation is reinforced because of the need for a national implementation of directives: the European rules are encapsulated in national legal systems. As national courts are obliged to interpret these implementing rules in accordance with the scope of the directive, it leads to new unintended divergences *within* the national legal system.<sup>56</sup> This phenomenon is sometimes referred to as ‘multi-level governance’: decision making at various levels leads to problems of coordination and democratic legitimacy and therefore, by necessity, to a new role for the national state.<sup>57</sup>

Apart from the fact that directives still allow for divergence, there are more reasons why the EC *acquis* can be criticised. One of these is that the *acquis* is impressionistic<sup>58</sup> (it is often unclear why some topics are covered and others are not) and suffers from inconsistencies (sometimes it contains conflicting rules<sup>59</sup>). These problems have not gone unnoticed by the European Commission. Although the idea of creating a European Civil Code to deal with these problems was already put forward by the European Parliament in 1989,<sup>60</sup> it was not before 2001 that the European Commission issued a discussion paper on the future of contract law in Europe. This Communication on European Contract Law of 2001<sup>61</sup> was followed in 2003 by the European Commission’s Action Plan<sup>62</sup> and in 2004 by a Communication on the revision of the *acquis*.<sup>63</sup> The European Commission intends to deal with diversity through directives by reconsidering the idea of minimum harmonisation in consumer directives and by creating a non-binding ‘common frame of reference’ that the European institutions could look at in drafting new legislation.<sup>64</sup>

On basis of the above, one can conclude that an important part of divergence in contract law rules is created by the European Union itself: it is European legislation *as such* that leads to undesired divergence. This conclusion fits in with what the interested parties

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<sup>57</sup> Bache and Flinders (2004).

<sup>58</sup> Also see Hesselink (2002) 36.

<sup>59</sup> Compare European Commission (2001) no. 35 and European Commission (2003) no. 16 ff.

<sup>60</sup> Resolution A2-157/89 *OJ EC* 1989, C 158/400. The call was repeated in 1994 (Resolution A3-00329/94, *OJ EC* 1994, C 205/518) and 2000 (Resolution B5-0228/2000, *OJ EC* 2000, C 377/323).

<sup>61</sup> European Commission (2001), on which e.g. Grundmann and Stuyck (2002). The Communication prompted a new Resolution of the European Parliament: Resolution C5-0471/2001, *OJ EC* 2002, C 140 E/538.

<sup>62</sup> European Commission (2003). Also see the Resolution of the European Parliament of 2 September 2003 (P5\_TA (2003) 0355) and the Council Report of 22 September 2003, press note 12339/03.

<sup>63</sup> European Commission (2004). Further developments can be traced on the website <http://europa.eu.int/comm/consumers>.

<sup>64</sup> European Commission (2004).

remarked in their reactions to the 2001 Communication on European Contract Law.<sup>65</sup> Much more than divergence among national legal systems, they regarded the European intervention in contract law itself as problematic.

## **4. Diversity of National Legal Systems**

### **4.1 Introduction**

The second aspect often thought of as problematic is the diversity of *national* contract law regimes within the European Union. Does this diversity really deter businesses and consumers from contracting abroad? And would a unified contract law promote transfrontier transactions? These are questions one can only answer on basis of empirical evidence or economic and psychological theory. In this section, these various perspectives are addressed. First, the traditional argument in favour of harmonisation is analysed (4.2). Then, this argument is contrasted with some empirical and economic evidence (4.3 and 4.4). In section 4.5, it is seen whether the behavioural perspective offers anything of interest, while section 4.6 pays attention to the traditional economic argument against unification of law.

### **4.2 The traditional argument in favour of harmonisation**

The traditional argument in favour of harmonisation of contract law is that a contracting party that wants to deal with a foreign party is deterred from doing so because of the different legal system in the other party's country. And if the other 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:<sup>77</sup>

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<sup>65</sup> The more than 200 reactions to the Communication are available through [http://europa.eu.int/comm/internal\\_market/contractlaw/overview\\_en.htm](http://europa.eu.int/comm/internal_market/contractlaw/overview_en.htm). Also see Smits and Hardy (2002) 827 and Staudenmayer (2003) 120 ff.

<sup>77</sup> Lando (2000) 61.

‘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.’

Also the European Commission seems to be of this view. It states:<sup>78</sup>

‘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.’

It is useful to look at this argument in more detail, paying attention to both different types of parties and different types of transaction costs. Usually, 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 does not sufficiently deal with the problem.<sup>79</sup> First, it does not prevent the national mandatory law – applicable in accordance with the conflict of law rules – to apply. In the above, it became clear that part of these mandatory rules deals with consumer protection and is thus directly related to European directives.<sup>80</sup> 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

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<sup>78</sup> European Commission (2001) no. 30-32; cf. European Commission (2003) no. 34; also see Staudenmayer (2002) 254.

<sup>79</sup> Cf. European Commission (2003) no. 28 ff.

<sup>80</sup> 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.’

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<sup>81</sup> 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.<sup>82</sup> 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.<sup>83</sup> Put differently: for SME's, it is often disproportionate to pay for legal advice compared to the value of the transaction.<sup>84</sup> 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 national legal system in a relationship 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 Convention.<sup>85</sup>

Another question is what type of transaction costs are involved in international contracting. Ott and Schäfer<sup>86</sup> 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.<sup>87</sup> 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

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<sup>81</sup> Cf. European Commission (2003) no. 30; Basedow (1996); Ott and Schäfer (2002) 209 ff.

<sup>82</sup> Cf. Ott and Schäfer (2002) 209.

<sup>83</sup> Ott and Schäfer (2002) 213.

<sup>84</sup> Cf. also Staudenmayer (2002) 255 and, generally, Gerhard Wagner, in: Smits (2005) par. VI.2 and Helmut Wagner, in: Smits (2005) par. 4.

<sup>85</sup> Kerkmeester, in: Smits (2005) par. 3.2, makes the interesting suggestion that behavioural analysis of contract law supports the case for unification.

<sup>86</sup> Ott and Schäfer (2002) 207.

<sup>87</sup> Ribstein and Kobayashi (1996) 137 ff. In a similar vein, Helmut Wagner in: Smits (2005) par. 2.2.1 distinguishes costs caused by legal uncertainty.

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.<sup>88</sup>

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

Apart from this economic argument, there are other arguments available to support harmonisation of contract law (or private law in general). Thus, there is the *identity* argument: the European identity may be reinforced by a European code. It may also be that a European code would enhance the European values.<sup>89</sup> However, Thomas Wilhelmsson makes clear that these values consist primarily of fundamental human rights and these rights cannot offer any

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<sup>88</sup> Critical, however, Ribstein and Kobayashi (1996) 140.

<sup>89</sup> Cf. the contributions to ERA-Forum (2002).

real guidance in contract law.<sup>90</sup> More importantly, Wilhelmsson analyses present day Europe as a late modern fragmented and *risk* society. Such a society is not in need of a systematic codification of contract law, but requires a flexible and *learning* law. This is an important argument against codification that will not be further explored here. Instead, the economic argument will be tested against the background of empirical evidence and economic theory.

### 4.3 Empirical and anecdotal evidence

There are two types of empirical evidence on contracting that may be of use to the question raised in this contribution. 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 transfrontier contracting.

The best known survey of the importance of contract law for business relationships was done by Stewart Macaulay who interviewed businesspeople in the state of Wisconsin.<sup>91</sup> Macaulay discovered that in many cases businesspeople are not interested at all in the meticulous drafting of contracts, 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 would not succeed in doing so. If a party has for example a right to price reduction or adaptation of the contract, this right is often not enforced, while if there is no right to it the other party often *does* agree to reduce the price. Macaulay's findings were confirmed for England by Beale and Dugdale.<sup>92</sup> One of the reasons for this reluctance to rely on contract law was that, according to these surveys, most of the time parties dealt with counterparts they regularly did 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 into perspective the need for a uniform law. The effect that unification of contract law can be expected to have, is probably not as important as the effect of Europeanisation (or even globalisation) of the market as such.

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<sup>90</sup> Wilhelmsson, in: Smits (2005).

<sup>91</sup> Macaulay (1963).

<sup>92</sup> Beale and Dugdale (1975).

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.<sup>93</sup> In this consultation paper, the European Commission asked businesses and consumers (and other interested parties) to indicate whether they experienced problems through diversity of (contract) law. Most reactions of business organisations and practitioners showed this was not the case.<sup>94</sup> 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.<sup>95</sup> *Orgalime*, representing the interests of 130.000 companies in the European mechanical, electrical and metalworking industries, remarked: '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.'<sup>96</sup>

This anecdotal evidence is supported by several studies on consumer behaviour. A survey of consumer confidence shows that the confidence of consumers in being protected against a seller in case of transfrontier transactions is considerably less (31%) than in case of a purely national transaction (56%).<sup>97</sup> This is, however, not primarily related to differences in contract law. Research on transfrontier shopping<sup>98</sup> confirms that consumers also consider other barriers such as taxes, language, time and distance more important than contract law.

#### **4.4 Economic theory on growth of the economy and national borders**

The problem with the anecdotal and empirical evidence presented above is that it does not indicate what the influence of uniform law on contracting actually is. It is of course 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. The effect of the so-called 'natural' barriers like language or distance is

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<sup>93</sup> European Commission (2001).

<sup>94</sup> Cf. Reactions to the Communication on European Contract Law, European Commission (2003) 30 ff.

<sup>95</sup> Cf. e.g. the Reaction of the UK Government, available through <http://europa.eu.int/comm/consumers>.

<sup>96</sup> Reaction of *Orgalime*, available through <http://europa.eu.int/comm/consumers>. This is confirmed by other reactions of business organisations.

<sup>97</sup> See the EOS Gallup Europe 'Consumers survey' of January 2002, published on [http://europa.eu.int/comm/dgs/health\\_consumer/events/event42\\_en.html](http://europa.eu.int/comm/dgs/health_consumer/events/event42_en.html). In the Netherlands, 66% of the consumers consider its rights well protected if they deal with a Dutch seller, but only 23% consider this to be the case if it deals with a foreign seller.

<sup>98</sup> See for example the explanatory memorandum to the proposed Directive concerning unfair business-to-consumer commercial practices in the internal market, COM (2003) 356 final.

difficult to assess separately from the ‘policy-induced’ barriers like regulation and taxation.<sup>99</sup> True, it is argued<sup>100</sup> that if people share a conviction about what is just and appropriate in the society they are part of, transaction costs are less. This point is taken up in the so-called New Institutional Economics.<sup>101</sup> According to the adherents of this approach, 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. Economic literature does not however elaborate on what type of contract law would be required to minimise transaction costs, other than that the law should be certain.<sup>102</sup> Uncertainty implies higher transaction costs, which is reflected in higher prices, leading to lower investment, lower consumption and lower national income.<sup>103</sup>

What *is* possible, however, is to measure the importance of borders on trade. It is clear that the existence of national borders has a negative effect on international contracting. American research shows that national borders between Canada and the United States reduce trade between these two countries by 44%, while this percentage would be around 30% for other industrialised countries. And, although this is debated, even within the United States (with one language and culture), a ‘home market effect’ (home bias) is visible within the different states.<sup>104</sup> These findings on the deterring effect of borders on contracting were confirmed for Germany in a statistic study by Volker Nitsch.<sup>105</sup> Nitsch shows that after German reunification, West-German shipments to the formerly East-German part were 120% larger than deliveries to an otherwise similar foreign country like Austria or the Netherlands. Unfortunately, economic literature that tries to explain this effect is scarce.<sup>106</sup> In the case of Canada and the United States, it may be that differences among their contract law regimes may account for the lesser amount of trade, but it is likely that other factors are more important. This argument gains weight in the case of the United States, where there may be in principle different contract laws in every state, but where the Uniform Commercial Code provides in practice the uniform model for almost every state.<sup>107</sup> And in the case of Germany,

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<sup>99</sup> 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.

<sup>100</sup> Cf. Van den Berg (2001) 416 and North (1987) 419 ff.

<sup>101</sup> Van den Berg (2001) 417; Mattli (1999) 45.

<sup>102</sup> Also see the contribution of Helmut Wagner, in: Smits (2005) par. 2.1.

<sup>103</sup> For this ‘causal chain’, see Helmut Wagner, in: Smits (2005) par. 2.2.2.

<sup>104</sup> See, be it critical of the data suggesting this, Millimet and Osang (2004) and Brown (2003). They both build on the pioneering work of McCallum (1995) 615 ff.

<sup>105</sup> Nitsch (2002), available through <http://www.hwva.de>.

<sup>106</sup> Nitsch (2002) 2.

<sup>107</sup> Cf. Reimann (1996); Gray (1986).

it is even impossible that a difference in (contract) law accounts for the difference as, at the time of the survey, East- and West-Germany were already united.

These insights on the effect of borders on trade are also confirmed in the economic literature. It shows that there is a positive relationship between economic growth and globalisation. There is little doubt that economic growth is linked to globalisation although it is not certain what causes what: is it globalisation that causes economic growth or is it the other way around? In any event, evidence shows that there is ‘a strong positive relationship’<sup>108</sup> between international trade and economic growth. This relationship is most probably bi-directional: trade causes growth and growth causes trade to increase.<sup>109</sup> It is part of economic science to study *why* there is such a relationship. Van den Berg<sup>110</sup> makes clear that economic growth rates are lower if a country is less open to trade: openness of the economy is strongly related to the growth performance of the country involved. The logical explanation for this is that international trade allows economies to specialise in producing goods in which they have a comparative advantage. Companies can also exploit economies of scale because they have a much bigger market than just their own country. Thus, international trade favours the economy more than restricted trade. This theoretical insight is evidenced by empirical material. 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.<sup>111</sup>

But how do economists look at the relationship between growth and the law? In economics,<sup>112</sup> law is usually looked at as one of the ‘institutions’ responsible for economic growth. According to Van den Berg,<sup>113</sup> institutions are ‘the laws, social norms, traditions, religious beliefs, and other established rules of behaviour that provide the incentives that rational people react to’. This implies that there is a causal link between institutions and rational behaviour of people: given the assumption that all people respond rationally to incentives, differences in economic growth can only be the result of different institutions in different societies. This makes highly relevant which institutions increase human welfare and which do not. If one assumes that human welfare is best served by economic growth, the most effective institutions are those that lead people to be innovative or productive from a long-

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<sup>108</sup> Van den Berg (2001) 324 and Mattli (1999) 31 ff. and 58.

<sup>109</sup> Van den Berg (2001) 324-325.

<sup>110</sup> Van den Berg (2001) 326 ff.

<sup>111</sup> See Grundmann (2001) 509 ff.

<sup>112</sup> The underneath is largely based on the textbook of Van den Berg (2001) 415 ff.

<sup>113</sup> Van den Berg (2001) 409.

term perspective.<sup>114</sup> There is common ground among economists that institutions that lower transaction costs are the most effective.<sup>115</sup> But, again, whether a uniform contract law is part of these institutions is not truly explored.

This is not to say that economic analysis does not say anything about what type of contract law serves the economic interests best. Mahoney<sup>116</sup> found evidence that common law countries experienced faster economic growth than civil law countries. His evidence is based on a statistic study of differences among 102 countries in average annual growth in capita gross domestic product. It followed from this study that common law countries grew, on average, significantly faster than civil law countries in the period 1960-1992. For an explanation, Mahoney refers to Hayek,<sup>117</sup> who argued that the common law tradition is superior to the civil law, not so much because of differences in legal rules but because of different assumptions about the role of the state.<sup>118</sup> Common law systems would be less inclined to impose government restrictions on economic (and other) liberties. Historically, this can be explained by pointing at the development of the common law as a system that would *protect* landowners and merchants against the Crown, while for example French civil law developed as an instrument of state power to *change* existing property rights.<sup>119</sup> This different ideology, it is argued, is still apparent in present day civil and common law. To quote Mahoney:<sup>120</sup>

‘The common law and civil law continue to reflect their intellectual heritage and, as a consequence, legal origin is both relevant to the ideological background and the structural design of government. At an ideological or cultural level, the civil law-tradition assumes a larger role for the state, defers more to bureaucratic decisions, and elevates collective over individual rights. It casts the judiciary into an explicitly subordinate role. In the common-law tradition, by contrast, judicial independence is viewed as essential to the protection of individual liberty.’

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<sup>114</sup> Van den Berg (2001) 414; cf. Helmut Wagner, in: Smits (2005) par. 2.2.3.

<sup>115</sup> North, cited by Van den Berg (2001) 415: ‘In fact the costs of transacting are the key to the performance of economies.’

<sup>116</sup> Mahoney (2001) 503 ff.; also see Helmut Wagner, in: Smits (2005) par. 2.3.

<sup>117</sup> Hayek (1973).

<sup>118</sup> Mahoney (2001) 504.

<sup>119</sup> Mahoney (2001) 505.

<sup>120</sup> Mahoney (2001) 511. This point is also apparent in the work of Pierre Legrand. He argues that this is the main reason why any harmonisation of private law in Europe is doomed to failure. See e.g. Legrand (1996).

Also in another way it is argued that the common law is more efficient than civil law systems. Rubin<sup>121</sup> argues that in the common law inefficient rules will be more readily adjudicated instead of settled. The decisions of litigants whether they want to sue or settle will therefore drive the law to efficiency. In addition to this, Helmut Wagner<sup>122</sup> cites research showing the strong relationship between high standards of governance or rule of law and economic growth. But it should be emphasised, again, that this does not say anything about the effect of *uniform* law on trade.

If one is to summarise the above, it is that it is difficult to separate uniform contract law from the many other factors that account for the behaviour of contracting parties. Apparently, traditional economic analysis does not provide a sufficient answer to the question under review. But as the effect of uniform law on contracting parties is also a question of *behaviour* of the parties, it may be useful to see whether behavioural insights can be integrated in the analysis. Behavioural analysis belongs traditionally to the discipline of psychology, but recently we have seen the incorporation of behavioural insights in economic science as well. It seems useful to pay some attention to this behavioural analysis.

#### **4.5 Behavioural analysis: from *homo economicus* to *homo psycho-economicus***<sup>123</sup>

Behavioural economics takes as a starting point that the rationality assumption of economic models is wrong: in real life, people do not always behave rationally. The idea of the *homo economicus*, on which most economic models are based, is simply not true in practice. While traditional economic analysis aims to evaluate and predict human behaviour on the basis of rationality ('rational choice theory'<sup>124</sup>), behavioural analysis is aimed at giving a more accurate account of human decision making. The unrealistic assumptions of economic analysis are thus replaced by the more empirical evidence of cognitive psychology. Pioneering work on the behavioural analysis of law was done by Jolls, Sunstein and Thaler<sup>125</sup> and by Korobkin and Ulen.<sup>126</sup> In 2000, Sunstein edited a volume on this 'behavioural law and economics'.<sup>127</sup> It deals with questions that are also addressed in the field of 'economic psychology'.<sup>128</sup>

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<sup>121</sup> Rubin (1977) 51 ff. and Rubin (2004).

<sup>122</sup> Par. 2.3.

<sup>123</sup> Cf. Rostain (2000) 976.

<sup>124</sup> Cf. Korobkin (2001) 4.

<sup>125</sup> Jolls, Sunstein and Thaler (1998) 1471 ff. (also in Sunstein (2000) 13-58; Sunstein (2000).

<sup>126</sup> Korobkin and Ulen (2000) 1051 ff.

<sup>127</sup> Sunstein (2000); cf. the review by Engel (2003).

<sup>128</sup> Antonides (1996) 1; Webley et al (2001) 2; also see the contribution of Kerkmeeester in: Smits (2005).

Does behavioural analysis tell us something about how contracting parties make their decisions? One general insight is that human beings generally do not consult a ‘preference’ menu from which rational selections are made at the moment of choice. Choices are made on basis of ‘procedure, description, and context.’<sup>129</sup> On basis of Sunstein’s book,<sup>130</sup> 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.<sup>131</sup> 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 are 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 CISG. 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, making only small steps ahead.<sup>132</sup> This ‘case based decision making’ is important in the courts that make most of their decisions 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.<sup>133</sup> 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.<sup>134</sup> It is also consistent with the ideas of Gerhard Wagner<sup>135</sup> and Jaap Hage<sup>136</sup> that, if it is uncertain whether uniformity is desired or not, it is best to make only small steps ahead, for example by way of an optional code.

There is one interesting insight that needs further attention here. Korobkin applies the status quo bias to default contract terms.<sup>137</sup> 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

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<sup>129</sup> Sunstein (2000) 1.

<sup>130</sup> See the overview in Sunstein (2000) 3 ff.; cf. Kerkmeester, in: Smits (2005) par. 3.1.

<sup>131</sup> Also see the contributions of Kerkmeester, in: Smits (2005) and Rachlinski, in: Smits (2005).

<sup>132</sup> Sunstein (2000) 5.

<sup>133</sup> Sunstein (2000) 5.

<sup>134</sup> See above, section 4.3. Also Macaulay’s finding that parties are often willing to cooperate instead of pursuing their own interests is mirrored in behavioural analysis. Cf. Sunstein (2000) 8.

<sup>135</sup> Wagner, in: Smits (2005).

<sup>136</sup> Hage, in: Smits (2005).

<sup>137</sup> Korobkin (2000) 137 ff.

action and sacrifice wealth in order to be inert.<sup>138</sup> 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.<sup>139</sup> 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.<sup>140</sup> These are certainly not ‘untailored’ default rules that apply to all parties regardless their status or their circumstances.<sup>141</sup> Korobkin says:<sup>142</sup>

‘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,<sup>143</sup> 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.

Rachlinski describes another interesting bias.<sup>144</sup> This ‘availability heuristic’ refers to the tendency to assess the frequency of events by the ease with which one can recall exemplars. Vivid salient issues that make memorable impressions seem more significant than others. Rachlinsky applies this bias to the lawmaking process: the legislator is likely to address issues that attract greater attention, leaving aside more important issues. It could well be that the interest of the European Commission and Parliament in harmonising contract law

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<sup>138</sup> Korobkin (2000) 138.

<sup>139</sup> Korobkin (2000) 138; cf. Kerkmeester, in: Smits (2005).

<sup>140</sup> Korobkin (2000) 139.

<sup>141</sup> Korobkin (2000) 140.

<sup>142</sup> Korobkin (2000) 140.

<sup>143</sup> European Commission (2004).

<sup>144</sup> Rachlinski, in: Smits (2005); also see Kerkmeester, in: Smits (2005).

is caused by the emphasis legal academics have put on the importance of unification of contract law,<sup>145</sup> thus denying the marginal influence such uniformity may have on the decisions of contracting parties. The importance of other influences on parties' behaviour, like language, distance and culture, are thus not given their proper place.

#### 4.6 The economic argument against unification

Until now, the traditional argument in favour of harmonisation was considered. In this section, the argument *against* harmonisation still needs to be addressed. The survey of this argument can be much shorter than that of the argument in favour as discussed in section 4.2: it was already touched upon in the above and is also elaborately discussed by others.<sup>146</sup> In view of the scope of this contribution, the argument against unification is best put in terms of *costs* of uniformity. Ribstein and Kobayashi<sup>147</sup> distinguish three types of such costs:

*a. Exit costs.* The classic argument in favour of diversity of law was brought forward by Tiebout.<sup>148</sup> The fact that people and firms can exit a jurisdiction they do not like, motivates national governments to reflect the preferences of the voters. Unified law decreases this exit opportunity and will thus lead to less efficient law. Put otherwise: competition of legal systems means that more preferences are satisfied.

*b. Reducing innovation and experimentation.* In case of diversity of law, more solutions to a problem are provided than in case of one uniform law. Experimentation with these several solutions may lead to some better laws than a uniform law can offer.

*c. Reducing local variation.* Uniform law does not only decrease experimentation and thus the possibility of finding the 'best' rules, it also may be the case that local variation produces rules that are best suited for particular localities.<sup>149</sup>

In short, this argument praises the virtues of competition.<sup>150</sup> The general economic idea is that if every individual pursues its own interests, this individual *and* society as a whole will be better-off. But individuals can only pursue their own preferences if there *is* something to choose. The chance that a national government can provide this possibility is not optimal. It is therefore best to also have competition among lawmakers, allowing several legal systems to exist next to each other. Tiebout therefore argued that if citizens have different preferences,

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<sup>145</sup> Cf. Ogus (1999) 411.

<sup>146</sup> Gerhard Wagner, in: Smits (2005).

<sup>147</sup> Ribstein and Kobayashi (1996) 140 ff.

<sup>148</sup> Tiebout (1956) 416. Also see Helmut Wagner, in: Smits (2005) par. 3 (a) and Gerhard Wagner, in: Smits (2005) par. III.2.

<sup>149</sup> Ribstein and Kobayashi (1996) 141.

<sup>150</sup> Cf. Wagner (2002) 999 and Ogus (1999).

only competition among several systems will lead to efficient outcomes.<sup>151</sup> This argument is further explored by Gerhard Wagner,<sup>152</sup> who also gives examples of successful competition in family law and corporate law. The argument is subsequently looked at from the behavioural perspective by Heico Kerkmeester.<sup>153</sup>

All this does not mean that diversity is always to be preferred above unification. It could well be that the costs of diversity as described in section 4.2 are larger than the costs of unification. Uniform law should thus still be adopted if the benefits of uniformity outweigh the costs.<sup>154</sup> When this is the case is, again, difficult to calculate. There is, however, a type of cost involved that is not mentioned by Ribstein and Kobayashi. These are 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).<sup>155</sup> When a new civil code was introduced in the Netherlands in 1992, it was estimated that the costs of this recodification amounted to almost 7 billion euro over a period of 20 years.<sup>156</sup> Helmut Wagner<sup>157</sup> explains that because of these transition costs *and* because of the costs identified by Ribstein and Kobayashi, full harmonisation is not recommendable.

## 5. Concluding Remarks

The aim of this contribution was to see whether the European Union is in need of uniform contract law. The criterion to assess this need is primarily the development of the internal market. But the above shows that it is difficult to establish the exact relationship between diversity of law and the enhancement of the economy through transfrontier 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 (sections 4.2 and 4.6) cannot play a role, but they should be put into perspective. The best way to address the question is

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<sup>151</sup> Tiebout (1956).

<sup>152</sup> Wagner, in: Smits (2005).

<sup>153</sup> Kerkmeester, in: in: Smits (2005).

<sup>154</sup> Ribstein and Kobayashi (1996) 137 ff.

<sup>155</sup> Part of these costs originate from path dependence: see Smits (2002a).

<sup>156</sup> See Van Dunné, Luijten and Stein (1990).

<sup>157</sup> Wagner, in: Smits (2005).

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.

A second outcome is that it seems wrong to link legal certainty 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. Economic analysis abundantly shows that legal uncertainty is indeed a barrier to trade,<sup>158</sup> but there is no evidence that uniform law would create *more* legal certainty than diverse contract law regimes. Provided that enough information is available on the various regimes, the demands of legal certainty can also be satisfied.

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.

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<sup>158</sup> Helmut Wagner, in: Smits (2005).

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