CLIFFORD
CHANCE

Client briefing
May 2011

European contract law: draft code published

The European Commission wants a European contract law. As part of its long march towards this nirvana, it has published and asked for comments on a "feasibility study" (ie a draft contract code). This is the first time that the Commission has officially opened up the content, as opposed to the concept, of its code to scrutiny. The draft code covers primarily the sale of goods and services, involving both business to consumer and business to business contracts, but if the current draft is eventually pushed into law, it will form the foundation for the Commission's inexorable expansion into other areas. The draft code should, therefore, concern everyone. Judged against precepts of freedom of contract and certainty, the draft code is wanting.

Key Issues

- **Draft European contract code published for consultation**
- **Code aimed at helping the EU recover from the financial crisis**
- **Code includes a far-reaching obligation of good faith**
- **Code limits freedom of contract**
- **Code is unlikely to provide contractual certainty**

The European Commission's consultation period for its green paper on "policy options for progress towards a European Contract Law for consumers and businesses" closed on 31 January 2011 (see our note entitled *European contract law: the politics of law*), though, as is normal within the EU, responses continue to dribble in long after the deadline, particularly from the member states. The Commission is, in theory at least, considering the responses it has received and, having done so, will announce towards the end of 2011 whether and, if so, how it intends to proceed. Not content with this deep and sincere process of ratiocination, the Commission has published an important document called *A European contract law for consumers and businesses: Publication of the results of the feasibility study carried out the Expert Group on European contract law for stakeholders and legal practitioners' feedback* (the Paper). The Paper is important because it represents the first time that the Commission has issued a draft contract code and explicitly asked for comments. The Commission is not giving respondents long to have their say on a complex document: the consultation period closes on 1 July 2011.

Feasibility?

The Commission asked its Expert Group ("legal practitioners, former judges and academics" - though 13 out the 17 members bear the title "Professor") to prepare a "feasibility study on a draft instrument of European contract law" based on an earlier Commission-sponsored work, the draft Common Frame of Reference (DCFR). The Expert Group has, unsurprisingly, a heavy overlap with those responsible for the DCFR. The DCFR is a draft European contract code, though it covers more than just contract law; the feasibility study is also a draft contract code, albeit on a more limited scale.

The draft code covers both business to consumer and business to business contracts, but is specifically directed at "sales contracts and service contracts associated with sales, such as installation and maintenance". The draft should not, however, be viewed as of interest only to those who sell goods and services. If the Commission is able to secure the passage through the EU's legislative process of a code covering sales of goods, it is inconceivable that it will stop there. Sale of goods is the beachhead - a break out into financial services, leasing, custody and everything else will follow if the beachhead can be established. Any later departures from the original text will be difficult, if not impossible, no matter how unsuitable the original text may be.

The idea that a "feasibility study" is required for a contract code is itself curious. France has a contact code, as does Germany and most of the other members of the EU. Even the United States has a near equivalent in the Uniform

If you would like to know more about the subjects covered in this publication or our services, please contact:

Simon James +44 (0)20 7006 8405

To email one of the above, please use firstname.lastname@cliffordchance.com

Clifford Chance LLP, 10 Upper Bank Street, London, E14 5JJ, UK
www.cliffordchance.com

Commercial Code. No feasibility study is required for a contract code any more than a feasibility study is required for a wheel. It is obviously feasible to create a European contract code - indeed, the Commission already has one in its hands in the DCFR. Desirability, not feasibility, is the issue, and, if desirable, the content of the code and its legality. However, the Commission remains desperate, for political reasons, to avoid saying that it is preparing a code: a common frame of reference, a feasibility study, a toolbox - anything but a code. Yet a code it is.

As far as desirability is concerned, the Commission's focus is now on the economic and financial problems faced by Europe in the light of the credit crunch and the strains within the eurozone. Anything that might assist Europe to surmount these problems must surely be welcomed, and a contract law might be one of Europe's little helpers in this regard. Who, the Commission implicitly asks, could possibly object? More specifically, the Commission identifies three particular problems that, it claims, a European contract law would address: additional transaction costs; increased legal uncertainty; and lack of consumer confidence. The Commission illustrates these problems by three somewhat patronising examples.

Mrs Korhonen and her shoes

The Commission's first example involves Mrs Korhonen, who lives in Turku, south west Finland, and has the most common surname in her homeland. Mrs Korhonen visits her daughter, Taru, in Paris, where she finds shoes significantly cheaper than at home. After Mrs Korhonen has returned to Finland, Taru encourages her mother to buy footwear online from her mother's favourite Parisian magasin de chaussures in order to save money. However, Mrs Korhonen is so concerned as to whether her legal rights would be the same as she enjoys in Finland that she refuses to buy online, instead continuing to pay the higher prices on the Turku high street. "What", she frets, "if the delivered shoes are of a different size than I ordered? Can I send them back? What if a sole wears out only after a week - can I ask for a replacement?"

It is plausible that Mrs Korhonen might be reluctant to shop online from a French store, but entirely implausible that it would be through uncertainty as to her legal rights against the French vendor. If Mrs Korhonen possesses the in-depth knowledge of Finnish consumer protection law that the Commission imagines, she would surely know that, under article 6(2) of the Rome I Regulation, a decision by the French shop to subject any contract to French law will not deprive Mrs Korhonen of the protection afforded to her by provisions of Finnish law that cannot be derogated from by agreement.

Even if Mrs Korhonen's legal expertise does not extend to private international law, she would know that most consumer protection law rises from a baseline set by the EU's eight consumer law directives. Finland might have gold-plated the protection it gives to its consumers, but could Mrs Korhonen really believe that EU law would allow a retailer to deliver shoes of the wrong size, leaving her with no redress? And if Mrs Korhonen is so profoundly concerned about the vagaries of French law, would she be any more comfortable with European contract law?

The issues that would concern a true Finn like Mrs Korhonen are not legal issues but practical ones. If she buys shoes at her local shop, she can be sure that she is getting the right size. If the soles fall off after a week, she can take them back in person. Practical redress is available in a manner that it is not online. If the French shoes are the wrong size, who could Mrs Korhonen contact? Does Mrs Korhonen speak enough French to telephone the shoe shop (though, one might have thought, Taru would be able to help her mother in this), and what about the cost? Can she write enough French to complain? What if the French shoe shop ignores Mrs Korhonen's request for shoes of the correct size?

Mrs Korhonen might be reluctant to shop online, but it is fanciful that this would be because of uncertainty as to her legal rights. It comes down to trust, and a European contract law will not help Mrs Korhonen to achieve the necessary level of trust.

Mr Kowalski and his organic beds

The Commission's second example involves Mr Kowalski from Radom, a town some 100 kilometres south of Warsaw. Mr Kowalski, who has the second most common surname in Poland, develops a unique organic bed for children, which attracts the attention of well-known German and Italian retailers at a trade fair. Neither retailer will accept Mr Kowalski's standard terms, which are governed by Polish law, because it is not familiar with Polish law and would prefer the contract to be on its standard terms governed by its local law. Mr Kowalski could have obtained legal advice from his local lawyer for €750, but he finds that he has to pay €10,000 to an international firm to advise him as to his obligations under German and Italian law and to negotiate the contracts for him. Alternatively, he can just sign the retailers' contracts and hope that no problems arise.

Legal spend is an overhead that most businesses would rather avoid, but like rent, auditing fees and insurance premiums, it is often simply a cost of doing business. In the Commission's example, Mr Kowalski and the retailers all want lawyers to advise them as to their contracts. Legal expenditure will therefore be incurred whether or not there is a European contract law. The Commission's unspoken assumption is that the legal expenditure will be lower if the contracts between Mr Kowalski and each of the retailers could be governed by European contract law than if they were governed by a national law, whether the home law of one of the participants or a neutral alternative.

But is that assumption right? If there were a European contract law, Mr Kowalski might be able to use his good value local lawyers to advise him on European contract law, and the retailers might also be able to use their local lawyers. This could, perhaps, lead to some savings (assuming that all concerned speak a common language), but is it realistic to suggest that by going to lawyers outside Poland, Mr Kowalski's legal costs would be over thirteen times the amount he would have spent on his domestic lawyers? Perhaps Mr Kowalski needs to drive a harder bargain.

It may be that the Commission really hopes to achieve the well-known aspiration of one of Shakespeare's lesser known characters, Jack Cade, in Henry VI, Part 2. The Commission instructed its Expert Group to prepare a draft contract code that could be "understood and used by businesses and consumers who would not necessarily be specialists in the area of contract law." Jack Cade, a pretender to the throne, offered his supporters a similar vision of the utopia that would follow his coronation ("seven half-penny loaves sold for a penny… I will make it a felony to drink small beer… and in Cheapside shall my palfrey go to grass"), agreeing enthusiastically with an essential feature of this utopia proposed by Dick the butcher: "The first thing we do, let's kill all the lawyers".

Perhaps the Commission thinks that Mr Kowalski and the retailers would also be happy to see the demise of lawyers, and to draft and negotiate the contracts themselves if only they had available the multi-lingual simplicity of a European contract law. But it would be a brave bed-maker who dared, or wanted, to enter on the Commission's near 80 pages of draft code in order to work out his rights. He might agree with Jack's comment that "Is not this a lamentable thing, that the skin of an innocent lamb should be made parchment? that parchment, being scribbled o'er, should undo a man?" The Commission's draft code might not require the slaughter of innocent lambs, but paper it certainly does consume, and it has the capacity to undo Mr Kowalski unless he is careful. Care will often involve instructing lawyers.

The Commission's example therefore misses the point. Nevertheless, we cannot ignore the fact that 83% of respondents to Clifford Chance's survey of European businesses in 2005 indicated that they favoured a European contract law. This might not help Mr Kowalski greatly, but it could assist others who sell services across Europe. Costs might be lower if a supplier could draft its contractual terms on the basis of a single law to which it could reasonably hope to adhere rather than potentially having to negotiate different provisions with buyers in different countries. An example is the insurance industry. Its business comprises the sale of contractual rights and, as a result, many insurers favour a European contract law. As one trade body, AMICE, put it, "… there are as many insurance laws as Member States in the EU. This undoubtedly constitutes a major obstacle to the free circulation of insurance contracts throughout the EU."

British jewellery and the celebrity effect

The Commission's final example concerns a British company (though one without the benefit of a homely, reassuring name) that makes designer jewellery. It achieves popularity when a celebrity is seen wearing its products at a gala dinner. To take advantage of this, the company decides to distribute its products across Europe through an online shop. It is, however, warned that it needs to take advice on the laws of each EU member state and to draft suitably amended terms for each state. This will take a lawyer a week for each country, costing over €230,000 in total (in the Commission's exemplary world, a lawyer's working week is 30 hours). On top of that, the software has to be able to determine the consumer's location in order to bring up pages in the right language and with the right terms. This adds more than €80,000 to the company's potential bill. Faced with these costs, the company decides to offer its products only in two large markets, France and Germany, rather than cover the whole of the EU.

"… problems caused for small businesses by article 6 of Rome I (business to consumer) must be resolved"

European Small Business Alliance

Here the Commission has a point. It would undoubtedly be cheaper for the jewellery company if it did not have to concern itself with the national laws of each EU member state but could, instead, trade with all European consumers on one set of terms under a single governing law. But it is the EU's fault that the company cannot do this. Article 6(2) of the Rome I Regulation provides that whatever law is chosen to govern a consumer contract to which article 6 applies (which will include the jewellery company's contracts), that "choice may not... have the result of depriving the consumer of the protection afforded to him by provisions that cannot be derogated from by agreement by virtue of the law which, in the absence of choice, would have been applicable on the basis of paragraph 1", which is the consumer's home law. It is this overriding effect of national consumer protection laws that requires the company to look into the laws of each member state. The EU has created the problem which it now sees as a bottleneck in the internal market and which it proposes to solve by adding a European contract law to its institutional infrastructure rather than by addressing the underlying issue.

The problem will only be solved if article 6(2) of Rome I does not apply if European contract law is selected. Achieving this will not be straightforward. Organisations representing consumers do not like this idea because the choice of law will inevitably be made by the business rather than by the consumer (if consumers were given the choice of their local law or of European law, the cost to the business would be higher, not lower). Although the Commission's instructions to its Expert Group are that the code must include "a high level of consumer protection", that level may be lower than a consumer enjoys at home, and it will certainly be different. How will politicians explain to their voters a potential diminution in consumer rights? It is for these reasons that the proposed Consumer Rights Directive, which would harmonise consumer protection laws, has proved difficult for the Commission to progress. Member states, as well as consumer organisations, are attached to the level of consumer protection that each provides, and do not want to surrender it to a common European standard (unless, of course, that standard happens to be identical to their own).

So, while there would be advantages to businesses from a European contract law that overrode article 6(2) of the Rome I Regulation - always assuming that the EU has power under its treaties to pass such a law - politics may yet make this difficult.

"… the introduction of an optional instrument for business to consumer contracts would lead to a series of disadvantages for EU consumers"

BEUC, the European Consumers' Organisation

Commissioner Reding, the Commissioner in charge of this project, is fervently committed to a European contract law. A former journalist, Luxembourg MP, MEP and now in her third term as a European Commissioner, Mrs Reding is said to be a formidable operator in the smokeless corridors of Brussels, but will even she be able to bring the other Commissioners along with her? The EU prides itself on its levels of consumer protection, and, as a result, the consumer lobby is powerful. If Mrs Reding cannot push it through, might she default to a law that only applies to business to business transactions in order at least to get some form of European contract law on the books, even though the immediate justification is less obvious?

What about the draft code's content?

The Commission's instruction to its Expert Group was to select those parts of the DCFR that were of direct relevance to contract law and to "simplify, restructure, update, and supplement the selected content." The Commission wanted a draft of 150 articles - never mind the quality, feel the length (or lack thereof). The Expert Group was never happy with this artificial limit, and has delivered 189 articles.

The draft code covers both business to business and business to consumer contracts, focusing on sale of goods and the related supply of services. Its general provisions (how to make a binding contact, interpretation of the contract, implied terms, limitation periods etc) are potentially applicable to all contracts. To these general provisions, the Expert Group has added chapters dealing specifically with the sale of goods and related services - the equivalents in English law of the Sale of Goods Act 1979 and the Supply of Goods and Services Act 1982. Further chapters dealing with other kinds of contract - loan agreements, financial services, leasing, custody and bailment, assignment and so on - could easily be bolted on to the superstructure created by the Expert Group. When these or other chapters are suggested, it will be difficult to argue that the existing general provisions should be amended. As a result, anyone whose business involves contracting - that is, every business - should be interested in the draft code.

The draft code is not the same as English law or, indeed, any other national law (though some suggest that it shows a German influence). Mere difference from English or any other law is not on its own a ground for criticism. Not even the most blinkered of lawyers would claim that his or her national contract law is perfect in all respects. For example, English law requires consideration to form a contract; the draft code does not. Dropping the requirement of consideration in favour of a more general test of intention to create legal relations might well be an improvement to English law. As a judge put it some years ago, "a defence of no consideration rarely has merit" (*Thoreson v Weymouth Portland Borough Council* [1977] 2 Lloyd's Rep 614, 619).

So what criteria should be used to judge the content of the draft code? The first point is to distinguish business to consumer contract law and business to business contract law. The former was parented, like employment law, by contract, but has grown into an adolescent with a closer resemblance to regulation than to its forebears. Freedom of contract counts for little; most consumer contracts are not, and cannot be, negotiated in any meaningful way. What counts is fairness to the consumer, and what is fair is dictated by the law rather than agreed by the parties. Indeed, much consumer protection law is already derived from EU requirements.

As far as business to business contracts are concerned, the two prime requirements are freedom of contract and certainty of outcome. Contracting parties should be able to do what they want unless there are strong policy reasons to prohibit them from doing so. So, for example, a contract to commit a criminal offence should obviously be unenforceable. Having entered into a contract, the parties should be able to know with as much certainty as possible what their rights and obligations deriving from the contract are. This is of particular importance in financial contracts. Parties need to know (for regulatory reasons amongst others) when they can set off, or net, two sums against each other, when a sum is due and what they can do when faced with an event of default. Uncertainty is anathema to business. However, the core concept in the draft code creates not only uncertainty but also undermines freedom of contract.

Good faith and fair dealing

At the heart of the draft code is the requirement that each party act "in accordance with good faith and fair dealing", an obligation that cannot be excluded (article 8). "Good faith and fair dealing" means "a standard of conduct characterised by honesty, loyalty and consideration for the interests of the other party to the transaction or relationship in question" (article 4(10)).

This definition differs from the equivalent provision in the DCFR, which required "openness" rather than "loyalty". To an English lawyer (though article 1(1) requires issues on the draft code to be settled "without recourse to national laws"), "loyalty" immediately conjures up the spectre of fiduciary duties: "The distinguishing obligation of a fiduciary is the obligation of loyalty. The principal is entitled to the single-minded loyalty of his fiduciary" (*Bristol & West Building Society v Mothew* [1998] Ch 1, 18). All contracting parties cannot owe fiduciary duties to their counterparties. Each party loyally putting the other's interests above its own would be like two very polite gentlemen who never get through a door because each is too busy inviting the other to go first. So what

does loyalty mean in this context? How can a party loyally make time of the essence, terminate a contract for breach, or sue for damages?

"… it is ironic that just as Europe looks likely to favour a private law based on the majority civil law traditions, commercial practice seems to be adopting Anglo-Saxon transaction practices"

Professor Geraint Howells, University of Manchester

Even if loyalty were replaced by openness, that still begs the question of whether any obligation of good faith is appropriate. Most civil law systems require good faith, though the extent of the obligation is far from the identical, but English law has no such generalised obligation. In the financial sector, it could, for example, be seriously problematical if there were uncertainty over whether the exercise of a contractual right accorded with the requirement of good faith. Would rejecting the exercise of an option because it was, by mistake, a day late or in the wrong form be in good faith? Would reliance on section 2(a)(iii) of the ISDA Master Agreement to avoid paying a defaulting party while at the same time refusing to terminate the transaction be in accordance with good faith? How much is one party supposed to consider the interests of another party when taking a decision that will be detrimental to that other party?

The effect of a failure to act in accordance with the requirement of good faith is itself obscure. Article 8(2) provides that breach of the duty of good faith "may" preclude a party from exercising or relying on a right, remedy or defence it may otherwise have. Is it discretionary, or does the obligation only have effect where the draft code subsequently refers to good faith? For example, article 27(2) imposes a duty to negotiate in accordance with good faith, and not to break off negotiations contrary to good faith and dealing. More specifically, article 23 requires a business to disclose to another business with which it proposes to contract "information concerning the main characteristics of the goods... which the supplier has or can be expected to have and which it would be contrary to the good faith and fair dealing not to disclose to the other party."

This ambiguity flows into the question of whether the obligation in article 23 can be excluded. Parties can exclude any rules in the draft code unless the draft code provides otherwise (article 7(2)). The obligation to act in accordance with good faith cannot be excluded, but does that also apply to article 23 even though the code does not expressly say that article 23 cannot be excluded? Uncertainty is created, and freedom of contract potentially undermined.

Freedom of contract

The Commission demanded that its Expert Group include a "high level of consumer protection". So far, so normal within the EU. The Commission asserts that "for business to business contracts, freedom of contract would prevail", but goes on that "mindful of the weaker position of most SMEs, the Expert Group also drafted a number of rules which would afford businesses a degree of protection under certain circumstances." Perhaps also mindful of the impracticability of splitting business contract law between bigB2bigB, bigB2SME, and SME2SME, these protections apply to everyone, big or small, detracting significantly from freedom of contract.

Examples of the protections include the pre-contractual disclosure requirements in article 23, referred to above. In addition, once a contract has, apparently, been made, article 48 allows a party to avoid the contract if that party was "improvident, ignorant, inexperienced or lacking in bargaining skills", and the other party exploited that by "taking an excessive benefit or unfair advantage." If the improvident party does not wish to avoid the contract, it can ask the court to "adapt" the contract so that it accords with what the parties would probably have agreed had the requirements of good faith and fair dealing been observed. Article 48 cannot be excluded (article 54). Would any financial restructuring under the shadow of insolvency be safe?

"We have serious concerns on the likely impact of an EU instrument based on the [DCFR]"

British Bankers Association

Articles 77 and 85, which cannot be excluded (article 79), provide that a term is not binding if it forms part of non-individually negotiated terms supplied by one party, if it significantly disadvantages the other party, and if its use grossly deviates from good commercial practice, contrary to good faith and fair dealing. A term supplied by one party is not individually negotiated if the other party has not been able to influence its content, in particular because it has been drafted in advance, whether or not as part of standard terms (article 5(1)). A draft contract will be drafted in advance by one party, which may mean that any term of that draft which survives to the final version is vulnerable to attack.

Unless the draft code states that a provision cannot be excluded, the parties can exclude or vary the code's terms (article 7). The Commission has pointed to this as demonstrating its commitment to freedom of contract. Most business to business rules in the draft code are said to be default rules, ie rules that apply unless the parties have agreed something else. The reality is more complicated. The parties cannot create their own rules about the formation of a contract, but there are other provisions that, in practice, will never be excluded. For example, the provisions, mentioned below, dealing with how a contract must be interpreted can in theory be excluded. Even if it is possible to sidestep the

conundrum of what rules govern the interpretation of provisions in a contract setting out how the contract is to be interpreted, will contracting parties in practice ever lay down their own rules of interpretation? There is little the parties can do to avoid the rules on interpretation, even if they consider them inappropriate.

Then, article 69 provides that a term in a contract requiring modification or termination by agreement to be in a particular form establishes only a "presumption" that the form must be followed for the agreement to be legally binding unless in that form. Even if it were clear what a "presumption" is for these purposes, what do the parties need to do to exclude this other than saying that the any amendment must be in writing? Is in necessary expressly to disavow article 69?

The draft code is not, deep down, committed to freedom of contract. It wants to regulate rather than to empower.

Contractual certainty

Where freedom of contract is diminished, there is uncertainty. Even beyond the examples given above, the philosophy of the draft code follows not the old-fashioned approach of certainty derived from strict rules but rather the modern approach of open-textured rules that give judges the flexibility to reach the "right" answer in the cases before them. Thus, for example, the rules on the interpretation of contracts. Article 56(1) requires a judge to search for the common intention of the parties, even if it differs from the normal meaning of the words used in the parties' contract. In undertaking this search, the judge can take into account the negotiations and the parties' conduct, both before and after the contract was made, usages, and good faith and fair dealing (article 57). A usage includes anything "which would be considered applicable by persons in the same situation as the parties, except where the application of such usage would be unreasonable" (article 69(2)).

A judge is therefore required to undertake a wide-ranging (and expensive) exploration of the contractual premises and their surroundings. This is not limited to the signed contract, but starts with the parties' first discussions about the contract, meanders through market practice, and on to the parties' (perhaps self-serving) performance. The parties will never be sure that what they wrote down means what it says, still less will an assignee. Yet certainty is one of the key functions of a contract, particularly in the financial markets. Drafting can never achieve perfect certainty, but the draft code is determined to reduce it still further.

Does it matter?

The Commission will not propose a contract code to replace the national contract laws of all the EU's member states. Realpolitik will restrain the Commission's instinctive impulse to uniformity. Barring a major volte face or political defeat, the Commission will propose an optional instrument of European contract law. But if it's optional, why can't it simply be ignored? If it's no good, don't use it.

If and when a European contract law is enacted, everyone will have to consider whether using it will be advantageous. No one imagines that parties will overnight, indeed ever, change the governing law of international financial documents to European contract law. But anyone who contracts with EU institutions may have little choice but to use it, and it may have value in other circumstances. For example, it might save money for the Commission's imaginary British jewellery company, and it could offer an economical alternative in other situations. But to achieve anything, it must be a law that business can feel comfortable using, and business must engage with its preparation if it is ever to reach that stage.

Conclusion

The Commission's publication for comments of the draft code produced by its Expert Group is a welcome change in direction. In the past, the Commission has regarded the content of any code it may eventually enact as a matter of mere technical detail that could be left to the experts without troubling the users of contract law, or even politicians. This is the wrong approach. Contract law involves choices, and the first steps in the preparation of any code should be identifying the areas where choice is required, debating the options, and making the choices. A good code cannot be produced by sending experts into a closed room, and waiting for the white smoke to rise from the chimney. As Macbeth might have put it: "If it were done when 'tis done, then 'twere well it were done slowly and with wide consultation."

A European contract law could in time offer a useful alternative in some circumstances to national laws. But in order to do so, a European contract law must meet the legitimate aspirations of business, including a commitment to freedom of contract and to certainty. Having been prepared behind closed doors, the draft code is not that law.