

2013

Harmonization, Heterogeneity and Regulation: CESL, the Lost Opportunity for Constructive Harmonization

Richard A. Epstein

Follow this and additional works at: http://chicagounbound.uchicago.edu/journal_articles



Part of the [Law Commons](#)

Recommended Citation

Richard A. Epstein, "Harmonization, Heterogeneity and Regulation: CESL, the Lost Opportunity for Constructive Harmonization," 50 Common Market Law Review 207 (2013).

This Article is brought to you for free and open access by the Faculty Scholarship at Chicago Unbound. It has been accepted for inclusion in Journal Articles by an authorized administrator of Chicago Unbound. For more information, please contact unbound@law.uchicago.edu.

HARMONIZATION, HETEROGENEITY AND REGULATION: CESL, THE LOST OPPORTUNITY FOR CONSTRUCTIVE HARMONIZATION

RICHARD A. EPSTEIN*

1. Introduction: Freedom of contract, mandatory terms, and the CESL

Any system of contract law must deal with two broad classes of transactions: those that take place within a single jurisdiction, and those which involve cross-border transactions between two (or more) jurisdictions. In the former case, the local law necessarily governs all parties. In the latter case, there is often a question as to which system of law should govern the transactions. Should the parties be allowed to choose the law of either jurisdiction, or are there external constraints that require them to adopt the law of one or the other jurisdiction?

This article examines that last question in connection with the various sales transactions that are governed by the Common European Sales Law (CESL)¹ proposal of the European Commission, which once enacted may be used by firms on an optional basis to govern, at least in part, underlying contractual rules. Any accurate overall assessment recognizes that the CESL, like all contract codes, combines two types of provisions. The first are intended to facilitate voluntary transactions. The second are intended to set out certain mandatory terms. These mandatory terms do not force the parties to enter into a particular transaction in services or goods. But once those parties choose a particular transaction type, they are forced into discrete channels, and they must accept the government's mandatory terms to enter the market.

* Richard A. Epstein is the Laurence A. Tisch Professor of Law, New York University Law School, The Peter and Kirsten Bedford Senior Fellow, The Hoover Institution, and the James Parker Hall Distinguished Service Professor of Law Emeritus and Senior Lecturer, the University of Chicago. He would like to thank Oren Bar-Gill, Lisa Bernstein, Chantel Mak, and Gerhard Wagner for their useful comments on earlier drafts of this paper, and Christopher Dodge, Christopher Lang, and Sean Childers, NYU Law School, class of 2013, and Jordana Haviv, Benjamin Margo, Joshua Stanton, NYU Law School, class of 2014, for their valuable research assistance.

1. Proposal for a Regulation of the European Parliament and of the Council on a Common European Sales Law, COM(2011)635 final (11 Oct. 2011) (hereinafter: CESL Proposal). The CESL does not cover consumer-to-consumer (C2C) contracts.

The CESL is, of course, an optional statute for dealing with cross-border transactions. All parties can stay out of it if they wish. But if they choose to opt out of CESL, they pay a high price, for under Article 6 of the Rome I treaty they will be required to follow the consumer rules that apply in the consumer's "habitual residence" so long as the professional seller "by any means, directs [his commercial or professional] activities to that country".² The central function of the CESL is to avoid the inefficiencies of Article 6 by making the CESL the domestic law within the Rome I framework for the parties who opt into it. Thus it is said that:

"The Common European Sales Law will be a second contract law regime within the national law of each Member State. Where the parties have agreed to use the Common European Sales Law, its rules will be the only national rules applicable for matters falling within its scope. Where a matter falls within the scope of the Common European Sales Law, there is thus no scope for the application of any other national rules."³

Abstractly, it is difficult to object to the CESL to the extent that it is "[a]n optional uniform contract law regime" that applies only to "those traders wishing to use it for their cross-border trade",⁴ especially since it appears that traders can decide to opt into the system on a transaction-by-transaction basis.⁵ But it is possible to criticize CESL for having set up the wrong set of optional terms, which force the following unwise trade-off: the price for uniformity in cross-border transactions is compliance with the unduly burdensome substantive provisions in the CESL, which is required under the proposed integration of the CESL with Rome I.⁶ At this point, the hard policy question is why this, or any other, optional code should contain a long set of mandatory provisions, mostly in business-to-consumer (B2C) contracts, thereby forcing parties to adopt the CESL in particular transactions on an all-or-nothing basis.

In order to implement its vision of an optional uniform regime the CESL imposes an exacting legal regime in its chosen mixture of optional or mandatory terms. First, under the CESL, the Explanatory Memorandum states, "in business-to-business ("B2B") transactions, traders enjoy full freedom of contract and are encouraged to draw inspiration from the Common European Sales Law in the drafting of their contractual terms".⁷ So far, so

2. Regulation (EC) No. 593/2008 of the European Parliament and of the Council of 17 June 2008 (hereinafter: Rome I).

3. CESL Proposal, 6.

4. *Ibid.*, 8.

5. *Ibid.*,

6. *Ibid.*, 2–4.

7. *Ibid.*, 18.

good. But not quite good enough. Thus Article 1 of the CESL endorses this principle of freedom of contract, but only “subject to any applicable mandatory rules,” which include in Article 2 a non-waivable duty on all parties to meet an obligation of good faith and fair dealing, coupled with in Article 3 an obligation to “co-operate with each other to the extent that this can be expected for the performance of their contractual obligations,” which term could easily be read as non-waivable as well.

The duty of good faith is found in other codes, including the Uniform Commercial Code provisions on unconscionability, which have been sparingly applied in recent years. In business transactions in the US, good faith now tends to function only as a default provision.⁸ In contrast under the CESL good faith obligations are far more robust, applying to all B2B transactions. The provision covers not only businesses and consumers, but also extends to all traders, including any natural or legal person who is acting for purposes relating to that person’s trade, business, craft, or profession.⁹ The opening Explanatory Memorandum in paragraph (31) only adds uncertainty to the scope of the good faith doctrine, which now depends, in part “on the relative level of expertise of the parties and should therefore be different in business-to-consumer transactions and in business-to-business transactions. In transactions between traders, good commercial practice in the specific situation concerned should be a relevant factor in this context”.¹⁰ Under the first quoted sentence, it is uncertain whether all B2B and B2C are judged by uniform categorical rules tailored for each respective class, or whether the content of the duty may also vary within each of these two classes, depending on “relative expertise”. In practice, the categorical approach will win by default as individual determinations of good faith are not possible in a mass economy.

In addition, paragraph (31) also makes it clear:

“As some rules constitute specific manifestations of the general principle of good faith and fair dealing, they should take precedent [sic] over the general principle. The general principle should therefore not be used as a tool to amend the specific rights and obligations of parties as set out in the specific rules.”¹¹

8. *Corenswet, Inc. v. Amana Refrigeration, Inc.*, 594 F.2d 129 (5th Cir. 1979) (refusing to allow a generalized obligation of good faith “to override or strike express contract terms”). For my defence of a narrow reading of unconscionability, see Epstein, “Unconscionability: A critical reappraisal”, 18 *Journal of Law & Economics* (1975), 293–311.

9. CESL Proposal, cited *supra* note 1, Art. 2(e).

10. *Ibid.*, 20.

11. *Ibid.*

It appears that many specific rules fall into this class. Articles 168 to 171 dealing with “Late Payments by Traders,” make its rules explicitly mandatory on all traders, without any limitation to either B2C or SME contracts. Articles 172 to 177, which deal with Restitution on contract termination, are mandatory such that “[i]n relations between a trader and a consumer the parties may not to the detriment of the consumer, exclude the application of this Chapter or derogate from or vary its effects”. The prescriptive periods set out in Article 186 state that “a contract between a trader and a consumer may not be applied to the detriment of the consumer”. It is not clear, however, whether some portion of these restrictions on prescription carry over to contracts among traders, as part of their non-waivable obligation to deal in good faith. “Full freedom of contract” cannot survive this thicket of provisions that applies to all traders.

All of these provisions raise general considerations that are not applicable only to the CESL, but to any effort to rationalize sale arrangements. In my view, the general presumption that regulation of business behaviour is a harm until shown to be a good applies to the CESL as it does to other aspects commercial law. In this paper, I shall examine this theme in the following sequence. First, section 2 offers a general examination of the relationship between transaction costs and gains from trade. Section 3 continues this general theme by asking what concerns with heterogeneity, administrative burdens, and public choice theory tell us about the mandatory terms that CESL includes in its optional legislation. Section 4 examines the gains from vertical harmonization, and rejects the view that these require the adoption of a single set of terms or are compatible with a wide range of EU regimes from which the parties are allowed to choose. Section 5 contrasts the CESL’s approach with the successful use of open choice in the United States with both forum selection and choice of law clauses. Section 6 then argues that these principles indicate that CESL is unwise to include separate options to deal with the cross-border issues faced by SMEs. The conclusion of this article is that the stiff terms found in the optional approach of CESL constitute a lost opportunity by ratcheting up, and not tamping down, on the overall level of regulation in cross-border sales transactions.

2. Transactions costs and gains from trade

The complex structure of the CESL’s basic strategy offers an occasion to re-examine the basic relationships between transactions costs and gains from trade, on which the success of any regulatory scheme necessarily turns. As a general matter, we should be suspicious of these State-imposed tie-in

arrangements, whereby two parties must agree to one set of State-imposed terms in order to adopt a contract that otherwise reflects their own joint wishes. The risk here is that the gains from the voluntary portion of the deal will be eroded by the implicit losses that both parties sustain when the State engrafts its own requirements onto their agreement.

To see why, note that the key challenge in any voluntary transaction is set out by one deceptively simple equation that derives squarely from the Coasean (or transaction-cost economics) tradition. The parties themselves have a set of business objectives which should produce joint gains so long as each party receives in the transaction something that it values more than the things that it surrenders, which, as rational agents, they will do. These advantages in any individual case are not determined by any general contract theory, for they derive from the needs and desires of the parties to the particular transaction. But whatever the doubts about the scope of the principle of mutual gain, it surely covers all transactions governed under the CESL.

Notwithstanding these putative gains, all voluntary transactions must negotiate a set of business obstacles, both in finding the right trading partners, and setting the right contractual terms to increase the odds of mutual gains, as the CESL itself stresses.¹² The basic point can be made just by looking at a two party case as it relates to transaction gains, G , and transaction costs, T . If $G = G_b + G_s$, and $T = T_b + T_s$, the task in all these cases is to make sure that $G > T$, for otherwise the transaction implodes. Note that it is possible for $G > T$ even if G_b (or G_s) $<$ T_b (or T_s) for any given party. What is required in that situation is for the party with the lion's share of the gain to pick up (by modification in the contract price) some of the transaction costs borne in the first instance by its opposite number, so that each party generates gain, at which point the two together are able to go ahead with these transactions.¹³ Stated otherwise, the deal will only go through if for any person T_x is always less than G_x from which it always follows that $G > T$ for all people. Put otherwise, if the distributional constraint is satisfied, the aggregate constraint is necessarily satisfied as well. In addition, if the aggregate constraint is satisfied and initially the distributional constraint is not, a side payment between buyer and seller can solve the problem, unless the cost of making that side payment exceeds the gains that would otherwise be obtainable.

12. CESL Proposal, cited *supra* note 1, 4.

13. Just this happens in all two-sided markets, on which see, Epstein, "Dunwody distinguished lecture in law, the constitutional paradox of the Durbin amendment: How monopolies are offered constitutional protection denied to competitive firms", 63 *University of Florida Law Review* (2011), 1324. The classic article on the subject is Baxter, "Bank interchange of transactional paper: Legal and economic perspectives", 26 *Journal of Law & Economics* (1983), 541–588.

3. Heterogeneity, administrative burdens and public choice

The operation of a market will only remain fully open so long as any State-imposed restrictions provide benefits sufficient to offset their admitted costs, for if $G_x > T_x$ then the gains from trade still exceed the transaction costs in question. It is at this point heterogeneity enters into the analysis, by asking whether this constraint is satisfied on a transaction-by-transaction basis. The CESL and its report use “trader,” “consumer” and “SME” in the singular, which (perhaps unintentionally) creates the unfortunate impression that no variation within each of these two classes matters for the overall analysis. All consumers are said to have similar deficits and all SMEs face similar difficulties. In virtually all market settings the implicit assumption of a zero variance necessarily leads the overall analysis astray. In voluntary markets, these differences are positive because the greater variation increases gains from trade.¹⁴ Yet heterogeneity poses real challenges to regulations with uniform application. The more heterogeneous the class, the more difficult it is to determine the impact of regulation, first in the individual case and then in the aggregate. High variation makes it hard to adopt a simple rules approach that sets a uniform standard for, say, all consumers. But it also makes it highly unlikely that any flexible or case-by-case approach can make reliable determinations at reasonable cost. Under the CESL, the high variance makes it highly likely that a regulation intended to protect the needy and unsophisticated will necessarily increase the transactional burdens on knowledgeable merchants and consumers. The relationship between G_x and T_x will differ strongly across persons, for even if $G > T$ for some people, $T > G$ for others.

The full range of mandatory devices under the CESL responds to this risk by adopting certain standardized measures to combat perceived forms of market failure. The Explanatory Memorandum rests its case for its single set of optional rules on the proposition that its “optional uniform contract regime . . . would also at the same time increase the level of consumer protection offered to consumers who shopped across a border thereby creating confidence as they would experience the same set of rights across the Union”.¹⁵

Unfortunately, this rationale is ill-conceived on both counts. There is no general principle that establishes that any “increase” in the level of consumer protection will enhance consumer welfare. Setting consumer protections too high could easily block sensible consumer transactions. Nor will the CESL be

14. For discussion, Epstein, “Inside the Coasean firm: Why variations in competence and taste matter”, 54 *Journal of Law and Economics* (2012), s.41-s.62.

15. CESL Proposal, cited *supra* note 1, 8.

able to supply the “same set of rights” to all consumers, given that its rules will not displace the higher levels found in any Member State.¹⁶ The best way to expand consumer confidence is for firms to invest in their brand name and reputation. In some cases that could include a statement that it adheres to the optional CESL terms, but by the same token, it could also achieve the same result by signing on to an optional code prepared by any other private or public body.

These irreducible variations among regulated parties places make it highly unlikely that any single optional code, especially one as intrusive as the CESL, will work in most or all cases. Two large forces are constantly at work in this context. First, legal rules are never costless to promulgate or enforce on the public side, or to comply with on the private side. For purposes of exposition, setting $G = T$ is a sensible first working assumption for additional regulation. There is every reason to think that $G > T$ for the first round regulations for a wholly unregulated market. There is, for example, a strong case for some formality, like the English Statute of Frauds, or system of recordation for certain classes of transactions, or even some minimum disclosure norm directed at systematic forms of misinformation. But by the same token, *at the margin*, the assumption that $T > G$ gains strength once those fundamental issues have already been addressed. The drafters of the CESL tend to underrate the large administrative, compliance and error costs of implementing new rules, by understating the risk that regulation is badly designed, subject to ambiguity, or pressure from political interest groups. The slippage between what was enacted at the legislative level and the set of rules that administrators implement on the ground is large. It is a common, but not invariant practice, for administrators sympathetic to the basic mission of a statute to expand its scope, which commonly happens in the United States with the aggressive enforcement of environmental, anti-discrimination, or consumer protection statutes. To give but one example, the decision of the Environmental Protection Agency (EPA) to treat carbon dioxide as a pollutant has resulted in the massive expansion of EPA authority.

Second, the dynamic effects of interventionist rules are in general negative, which makes it less likely that parties will opt in to CESL on a voluntary basis, even though it displaces the separate consumer protection laws of the individual Member States. Thus in dealing with any consumer or SME rules, assume that the less-sophisticated half of SMEs or consumers stand to benefit from the regulation and the more-sophisticated half of SMEs or consumers are hurt by them, in equal degrees. Over time, the harm to the more-sophisticated group will reduce its level of growth relative to the less-sophisticated group, as the even-handed application of uniform rules operates as an implicit

16. *Ibid.*, 2.

cross-subsidy of weak consumers by their stronger counterparts. In addition, the individual in the stronger group will tend to become less careful in their own practices, because they know that they can now take advantage of the set of public law protections now in place. If incentive effects of protective rules are negative and their enforcement costs are positive, the only debate is about the magnitude of the social loss, not its existence. Even within an optional system, firms will be more reluctant to opt in to rules with these effects.

The removal of the protective devices has, moreover, exactly the opposite effect. The weak consumers now know that they will operate at a systematic disadvantage to their stronger counterparts, unless they improve their performance. In this context, these consumers use firm branding as a low cost way to assess quality. To be sure, this passive, if low cost, strategy may not allow these weak players to match the performance of the stronger group with its multiple sources of information. In an unregulated market, moreover, nothing precludes weaker consumers from taking advice from strong ones, or otherwise acquiring the education or experience needed to improve their own performance, whether or not a firm opts into the CESL. The dynamic effects therefore strongly favour holding back on these various forms of protection. Once again opting out of CESL becomes, relatively speaking, a more appealing alternative.

In reaching this conclusion about the particulars of the CESL, it is not my intention to reject the use of any and all remedies for fraud, either before or after the fact. Some of these measures would be adopted even in an optional system. But that is most likely to happen with antifraud protections that meet one of two conditions. First, it is critical to identify a standard set of transactions in which fraud has been practised, which calls for legal remedies. For example, the rise of fraud-rings to obtain benefits from no-fault insurance, workers compensation or health care fraud is often a major problem that involves just these issues.¹⁷ In dealing with these cases, the best protection often involves cutting out or limiting certain entitlements that breed the fraud, rather than using higher standards of proof for policing applications. Long (i.e. 14 day) return periods for consumers under the CESL¹⁸ could easily result in the return of goods that the consumer wanted for a single occasion or which were damaged by improper use. The CESL does impose some narrow limits on the right of return,¹⁹ but these may well be far less robust than those

17. Schwartz, "Waste, fraud, and abuse in workers' compensation: The recent California experience", 52 *Maryland Law Rev.* (1993), 983–1015 (detailing fraud mechanisms in California for so called mental-mental cases in California). A mental-mental case is one where an external stimulus triggered a psychological reaction, without physical invasion or physical injury.

18. CESL Proposal, cited *supra* note 1, Arts. 41–42.

19. *Ibid.*, Art. 45.

supplied in voluntary markets, at which point the well-behaved consumers will have to subsidize the misconduct of others. These mandatory terms offer yet another reason for traders to opt out of the CESL.

More generally, the term “consumer fraud” always carries two distinct meanings: the first is fraud *on* consumers, the second is fraud *by* consumers. In my view, the second risk is greater than the former risk for two reasons: first, the reputational constraint on major firms is so powerful that if they make serious errors in individual cases, they face the risk that an entire consumer population could be lured to a competitor. Second, given the level of direct regulation already in place, traders already face serious sanctions for modest offences. Let the individual consumer commit a fraud, and there is no effective reputational check or form of legal redress. It is for good reasons that large firms keep close tabs on the complaint records of their customers. They typically have no remedy against dubious consumer behaviour, so they must be alert not to preserve or expand relationships with high risk customers. The legal system therefore should always be alert to offset these unprincipled consumer advantages.²⁰

Second, the anti-fraud regulations must be narrowly tailored to the fraud risk which allows their reliable use at low cost. The best illustration of such a practice may involve the use of the Annual Percentage Rate (or even the expanded Schumer Box)²¹ in consumer lending transactions. Use a few key measures and avoid information overload or mistakes in communication. The CESL, however, has no such modest anti-fraud ambition. Instead it rests on the undefended claim that vertical harmonization within the EU should be paired with highly intrusive consumer protection regulation.

4. The elusive gains from harmonization

One common theme in dealing with CESL involves the tricky issue of how much to harmonize different legal systems. On this matter, the CESL by design does nothing to address the differences in the sales law of Member States as it applies only to internal transactions. Those differences, of course, would be eliminated if these Member States all adopted CESL for their internal business, which they are free to do. The stated objective of CESL however, is to create an *optional* instrument that paves the way for vertical competition between CESL and the contract laws of various Member States in

20. For illustration, see Wagner, in this issue, speaking about the return policies under CESL.

21. The Schumer box is named after then-Congressman Charles Schumer who proposed it as a device to list all the key terms in covered credit transactions. For a general description, see credit.com at <www.credit.com/products/credit_cards/schumer-box.jsp>.

dealing with these cross-border transactions. But the Explanatory Memorandum does not do a good job in explaining why this extra measure of competition is likely to be adopted by firms, given the large dose of mandatory provisions that it contains. Traders can unilaterally increase the benefits they provide to consumers in any case they choose, without having to bear the cost of mandatory provisions that they do not wish to include. Indeed if the need for harmonization were that pronounced, individual firms and industry groups would already have developed their own standardized set of background terms to respond to any perceived difficulties. It is precisely because that has not happened that the anticipated gains from the CESL are not likely to be large.

Notwithstanding these difficulties, the CESL's defence of vertical harmonization begins with this observation: "The existing harmonization of consumer law at Union level has led to a certain approximation in some areas but the differences between Member States' laws remain substantial".²² But it then quickly veers to assume that more protection is better when it insists: "the Common European Sales Law would contain fully harmonized consumer protection rules providing for a *high* standard of protection throughout the whole of the European Union".²³ Or again, "The minimum harmonization approach meant that Member States had the possibility to maintain or introduce *stricter* mandatory requirements than those provided for in the *acquis*".²⁴ And in a somewhat different key: "It should also include fully harmonized provisions to protect consumers".²⁵ Using only these modest justifications, the CESL's new provisions, as detailed by Bar-Gill and Ben-Shahar, are truly breathtaking in their scope. They deal with mandated provisions, mandated disclosures, mandated rules for entering and exiting contracts, and sticky pro-consumer default terms.²⁶ The CESL opts not just for uniformity, but largely, but not entirely, for a uniformly higher level of consumer protection than is found in many of the laws of the Member States.

It is, however, an open question whether the gains from uniformity outweigh the losses associated with the further diminution of freedom of contract under the CESL for both business and consumer contracts. Any gains from uniformity are limited for any firm doing business in its home market, the EU market, and each State in which it enters into consumer transactions. That proliferation of laws necessarily makes it more difficult for any firm to give the same standard set of terms to all customers regardless of their location. There is no reason to eliminate the CESL, but the odds of it being

22. CESL Proposal, 2.

23. *Ibid.*, 4 (emphasis added).

24. *Ibid.*, 5 (emphasis added).

25. *Ibid.*, 16.

26. Bar-Gill and Ben-Shahar, in this issue, 2–3.

adopted would be reduced if all Member States were allowed to offer on the same optional basis a set of contract terms for traders to adopt. These options need not eliminate all mandatory terms, but they do have the advantage of forcing the CESL to compete with other systems for adoption. Using this competitive mechanism among Member States does not require any *a priori* judgments about the trade-offs between the costs and benefits of government programmes.

The CESL, however, flatly prohibits any inter-jurisdictional competition over contract terms to deal with the question of vertical competition. To be sure, the defence of the CESL is correct to note that the proposal is able “to contribute to the proper functioning of the internal market by making available a voluntary uniform set of contract law rules”.²⁷ It is clear that subsidiarity does require that that action be taken at the Union level, since no State has the power to regulate cross-border transactions for all States. It is equally clear that a single set of EU terms would be necessary if the CESL were mandated for cross-border transactions. But once the CESL is made explicitly optional for each trading party, subsidiarity no longer requires that only the CESL be made available to facilitate cross-border trade.²⁸ Nothing in the principle of subsidiarity prevents the European Commission from letting *any* Member State provide its preferred set of optional terms for all traders to use in their cross border transactions, regardless of location. On this view the CESL will then face a variety of competitors in the effort to achieve vertical harmonization. Indeed, why limit the set of optional rules only to Member States? The EU could also allow every trade association in the EU to roll out its own terms for use. The University of Chicago could also post on its web-page its rival to the CESL, just as the Creative Commons posts a wide range of possible licenses for the use of copyrighted material.²⁹ Opening the CESL up to competitors has no downside in the market for vertical harmonization, so long as Member States continue to have the right to impose their own mandatory conditions for the protection of their local consumers. Competition can show whether CESL’s implicit linkage between more regulation and vertical harmonization can gain market traction.

27. Ibid.

28. CESL Proposal, 21.

29. See Creative Commons, at <creativecommons.org/licenses>.

5. Jurisdictional issues: Forum selection, choice of law, and mandatory terms

The fundamental decision in CESL is to insist that the only parties that can take advantage of its vertical harmonization are those that accept its strict dose of mandatory terms. One implicit assumption in that view is that jurisdictional competition over the choice of these transnational rules should be regarded as a race to the bottom, which should be avoided at all costs. A different take on this subject comes, however, from the American case law which resolves these tensions in the law of consumer contracts in favour of jurisdictional competition. In its formative stages, the American law tied personal jurisdiction in contractual disputes to the defendant's presence in the territory when the suit was brought.³⁰ It did not ask whether the defendants' presence at that location reflected the joint preferences of the parties at the time of the agreement, for it allowed a defendant who left the place where the contract was made and performed to defeat jurisdiction by leaving before suit was filed. Over time, that misguided territorial fixation unravelled,³¹ in favour of an approach that looked to the "minimum contacts" that the parties to the transaction had at the time of its occurrence.³² The minimum contacts rule shifts the legal focus back from the time the dispute arises to the time of the transaction, and thus, I believe, edges closer to the correct approach, which lets the parties select their own forum and own substantive rules *by agreement*, which often happens whenever a large number of repetitive transactions raise the same issues.

The single most instructive decision in the United States is *Carnival Cruise Lines v. Shute*.³³ *Carnival Cruise* addresses this jurisdictional question under the same contractual framework that applies to the substantive terms under CESL. In *Carnival Cruise*, the forum selection clause required the passengers, the Shutes, to litigate their personal injury claims against Carnival Cruise only in Florida. The Court held that this clause bound the Shutes, residents of Washington State, for injuries that took place on board a ship in international waters. Under *Carnival Cruise* the Supreme Court would have also upheld any choice of law provision requiring the use of Florida law, given that no territorial law clearly governs disputes that arise in international waters.

30. *Pennoyer v. Neff*, 95 U.S. 714 (1878).

31. For my account, see Epstein, "Consent, not power, as the basis of jurisdiction", (2001) *University of Chicago Legal Forum* 1–34.

32. See *International Shoe v. Washington*, 325 U.S. 310 (1945), allowing the State of Washington to sue International Shoe in State court for sales taxes owed on sales within the State.

33. 499 U.S. 585 (1991).

These clauses are in obvious tension with the consumer-first approach of CESL, which ties the choice of law in consumer transactions to the consumer's habitual residence.³⁴ But why find some public policy objection to the terms upheld under the American approach? Consumer protection is not an end itself, especially in competitive markets; it can be justified, if at all, solely as a means to maximize the net value for both parties. The choice of the correct forum and the substantive law depends not solely on the one transaction but on the full portfolio of transactions that face the firm. *Carnival Cruise* shows the importance of taking this broader perspective. The passengers on any given cruise come from all over, and the place of injury could be in any one of a number of domestic or foreign territories, or, as in *Carnival* itself, on the high seas. To allow the consumer to impose, as of right, either forum selection or choice of law clauses in his or her own State could create awkward situations by forcing a seller to litigate its disputes in multiple jurisdictions (including those in foreign countries) whenever many passengers are injured in a given accident. Picking the home State reduces those costs *ex post* for some parties enough to increase the value of the contract *ex ante* for all parties, by reducing the costs of potential legal defence; it also allows for easier consolidation of multiple claims. A uniform rule for all consumers of a single firm could easily be preferable to the current set of arrangements under European law where each consumer is given the protection of the law of his or her Member State.

In principle, one could fear that these forum selection and choice of law clauses could be rigged to favour the defendant. It is easy to imagine, and even possible to find clauses that meet that description, such as those found in the notorious Gateway 2000 contract, whose reference to arbitration before the International Chamber of Commerce did not reveal its steep non-refundable filing fees, which were typically in excess of the amount in controversy.³⁵ But the ability to invalidate any egregious clause does not require the wholesale invalidation of any all choice of law provisions. On this issue, the U.S. Supreme Court adopted two simple safeguards against this type of advantage taking, which in tandem seem to have worked well. By the first, the dominant party has to have some independent and prior connection with the chosen forum. By the second, that party has to choose this forum for all future disputes, not just some. Virtually every firm can live comfortably within the

34. See CESL Proposal, 15: "whenever a trader directs its activities to consumers in another Member State the consumer protection provisions of the Member State of the consumer's habitual residence that provide a higher level of protection and cannot be derogated from by agreement by virtue of that law will apply, even where another applicable law has been chosen by the parties".

35. *Brower v. Gateway 2000, Inc.*, 676 N.Y.S.2d 569 (N.Y. App. Div. 1998) (arbitration before International Tribunal with high fees undisclosed in basic contract).

safe harbour created by these dual limitations. The history after *Carnival Cruise* is not replete with businesses seeking to push the envelope in either forum-selection or choice-of-law provisions, precisely because these well-designed constraints protect customers against roguish surprises without crippling honest cost-minimizing transactions. As best one can tell, most use their own State of business. Indeed the most recent uneasiness with *Carnival Cruise* is well aware of the competing efficiency claims, but it relies, without elaboration, on general statements on the dangers of contracts of adhesion in ordinary consumer transactions,³⁶ which are of course always at play in the various issues that are regulated by CESL. But the subsequent case law follows the initial decision pretty faithfully.³⁷ The solution looks efficient. Why then rule it out of bounds?

6. Special rules are not needed to spur cross border transactions for SMEs.

The previous discussion of forum selection and choice of law provisions points out why it is dangerous to think that special rules are needed to deal with any subclass of cross-border transactions. The gist of the case for these special rules is contained in these two paragraphs:

“Differences in contract law between Member States hinder traders and consumers who want to engage in cross-border trade within the internal market. The obstacles which stem from these differences dissuade traders, small and medium-sized enterprises (SME) in particular, from entering cross border trade or expanding to new Member States’ markets. Consumers are hindered from accessing products offered by traders in other Member States.”³⁸

36. See Davis and Hershkoff, “Contracting for Procedure”, 53 *Wm. & Mary L. Rev.* (2011) 507–564, 525, n. 63: “In *Carnival Cruise*, the Court ratified use of a forum selection clause in a standard contract between a large company and an elderly consumer who did not see the term before agreeing to the deal, holding that such provisions presumptively are acceptable. 499 U.S. at 593–594.” As noted earlier in the discussion of consumer variation, the “elderly consumer” should carry no weight. First, these consumers get the same deal as the most informed consumers. Second, there is no rule that divides consumers into subclasses that makes any sense. And third, if anything, the likelihood that the plaintiff’s wife caused her own injury is greater in these cases, where assumption of risk, based on known public conditions is likely to play a very large role in connection with background conditions at sea. Davis and Hershkoff rely on Ehrenzweig, “Adhesion Contracts in the Conflict of Laws”, 53 *Colum. L. Rev.* (1953), 1072–1090, 1076.

37. See e.g. *Walker v. Carnival Cruise Lines, Inc.*, 889 N.E.2d 687 (Ill App. 2008) (upholding clause). For an exhaustive collection, see 4 A.L.R. 4th 404 (WEST 2012).

38. CESL Proposal, 2.

“The costs resulting from dealing with various national laws are burdensome particularly for SME. In their relations with larger companies, SME generally have to agree to apply the law of their business partner and bear the costs of finding out about the content of the foreign law applicable to the contract and of complying with it. In contracts between SME, the need to negotiate the applicable law is a significant obstacle to cross-border trade. For both types of contracts (business-to-business and business-to-consumer) for SME, these additional transaction costs may even be disproportionate to the value of the transaction.³⁹

According to the drafters, the cure for these alleged defects is the creation of “a self-standing uniform set of contract law rules” for these SMEs,⁴⁰ which “is also consistent with the Union policy of helping SME benefit more from the opportunities offered by the internal market”.⁴¹ The entire approach is, however, subject to criticism on both empirical and theoretical grounds. Hubbard has offered a powerful critique of the so-called Eurobarometer studies, showing that those firms that want to engage in cross border transactions are already there, and that most mom-and-pop businesses are not included in their ranks.⁴²

His critique does contradict the possibility that better studies could show a higher volume of cross-border transactions. But even if that were true, there is still no reason to fashion special protective rules in this context. Initially, it seems clear that any consumer protection found in the CESL should not apply to transactions with SMEs. So, as a matter of general theory, why worry which body of contract law is used? As noted earlier, the key question in all cases is whether the *sum* of the transaction costs for *both* parties exceeds the potential gains from trade. That principle is ignored by any one-sided effort to reduce the costs of the small SME, which will, of course, increase the cost for the larger firms with whom they do business. So long as there is any element of variation across firms, there is no reason to believe that an externally driven shift in legal regimes will improve the overall rate of contracting, or indeed that the overall rate should be increased.

As the CESL proposal notes, there are many other regulatory reasons which make it more difficult to do cross-border transactions. In addition, the costs of these transactions are likely to be higher even if there are no differences whatsoever in dealing with contract terms, precisely because it is harder for

39. *Ibid.*, 3.

40. *Ibid.*, 11.

41. *Ibid.*, 7.

42. Hubbard, “Another look at the Eurobarometer surveys”, in this issue.

parties to work at a distance to iron out their differences or to make assessments of the credibility of their trading partners. The strong preference for doing business within the Member States may well be attributable to some combination of clashing regulatory regimes on the one hand and well-developed internal markets on the other. Expanding the scope of markets by knocking down trade barriers is always a desirable good, and in this regard the optional nature of the CESL reduces the risk in question. But this optional provision does not look to be optimal, and, as is the case with other optional provisions, the correct approach of the European Commission should be to make as many options available as possible, and not to restrict the parties to its own preferred choice, which may well not match up with the preferences of either party. Uniformity in this instance is a way to minimize total transaction costs, which is not likely to be reached by singling out SMEs for special treatment.

7. Conclusion

As a matter of first principle, the objectives of the CESL are laudable insofar as the law is intended to increase the options available to parties in cross-border transactions. But it is important to ask the question of whether the option that the CESL provides is the ideal choice for the occasion when it ties the advantages of a uniform set of laws for all cross-border transactions to the acceptance of a strict regime of consumer protection. On this score, the chief objection to the CESL is that it will not unlock its full potential because the options that it provides will impose a heavy set of mandatory terms that are likely to make it less attractive than the current regimes now in place by the Member States. As a result, three final points are worth noting.

First, harmonization need not be tied to an effort to raise the level of regulation in all cross-border transactions, whether they involve consumers or SMEs. Harmonization downward must in principle be regarded as at least as desirable as harmonization upward, given that overregulation is a serious risk in both the long and the short term.

Second, coherence in individual transactions does not require comprehensive EU articulation of either mandatory or background norms. For mandatory terms, one possible system is to allow each Member State to articulate the rules that it wishes to impose, so that firms could then pick from that roster the terms that they want, knowing that if these are too one-sided, they will lose customers to rival firms who select packages that are more favourable to customers. For transactions between SMEs and larger firms, there is no need for intervention at all, as the two parties should, in line with the

American practice after *Carnival Cruise*, let whoever wants specify the background terms of their choice, not only on forum selection or choice of law terms, but on any of the substantive terms covered by CESL.

Third, CESL made the right decision to keep its regime optional. But its heavy dose of mandatory terms makes it unlikely that many firms will rush to use it. As such, CESL represents a lost opportunity for market liberalization, which could have generated far greater social benefits.