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AN (UN)COMMON FRAME OF REFERENCE: AN AMERICAN PERSPECTIVE ON THE JURISPRUDENCE OF THE CESL

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1. Introduction

The European Commission's *Proposal for a Common European Sales Law* ("CESL") adopts an approach toward the interpretation of contracts between businesses ("B2B") that is strikingly similar to the approach taken by Article 2 of the American Uniform Commercial Code ("Code"). Like the Code, the CESL is deeply legal-realist and subjectivist in its approach to contract negotiation, formation, performance, interpretation, and breach. It relies heavily on usage of trade, good commercial practices, the practices of the parties and other elements of the contracting context to give meaning to contracts and content to its many standard-like default rules.

Numerous studies and surveys informed the drafting of the CESL. Input was sought from members of the European business, academic, and legal communities. Yet, the drafters of the CESL simply assumed that trade usages and good commercial practices that are known by traders both exist and are likely to be relatively uniform across significant areas of the Internal Market or within particular industry sectors that are ripe for an increase in volume of cross-border trade. The Commission did not even consider the possibility that differences in trade usages might create significant barriers to the very type of cross-border trade the CESL seeks to promote. It seems to have entirely overlooked the significant costs and serious practical difficulties that small and medium enterprises ("SMEs") in particular might face if they sought to learn the usages of another country.

Given the Commission's failure to explore whether the types of cross-border usages and good commercial practices the CESL relies on actually exist in either particular countries or across the Internal Market, this essay begins by reviewing evidence from American merchant communities that casts doubt on the idea that trade usages that are geographically

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coincident with the scope of exchange are as common as the drafters of the Code and the CESL assumed. It then explores the extent to which, if usages across the Internal Market turn out to resemble usages across the American market, the CESL will be able to achieve its goals of reducing transaction costs, promoting cross-border trade, and encouraging the emergence and maintenance of cooperative contracting relationships.

The essay also explores the likely effects of the Commission's proposal to support the implementation of the CESL by adopting a flanking measure to encourage industry groups to draft standard-form contracts or provisions that transactors could use at a relatively low cost, thereby increasing the desirability of entering into cross-border transactions. Drawing on the experience of American trade associations that have undertaken similar efforts, it suggests that while this flanking measure may be successful in supporting trade in some industries – assuming it is implemented with appropriate process-based safeguards – it would be far more likely to succeed if the Commission were to replace the CESL with an instrument that contained menus of clear rule-like provisions and embodied a less contextualized adjudicative approach. Such an instrument would decrease the cost of disputing and give SMEs contracting under it a credible threat to sue over a broader range of contracting relationships. This in turn would provide SMEs with the type of security of exchange that is a necessary (albeit not sufficient) condition for inducing them to enter into cross-border transactions with strangers.

Part 2 sketches out the CESL's reliance on the concepts of trade usage and good commercial practice. Part 3 summarizes contemporary and historical evidence relating to the existence of relatively uniform usages of trade that are co-extensive with the extent of trade in American merchant communities. Part 4 explores whether the CESL can achieve its goals if usages and good commercial practices in the Internal Market turn out not to be uniform. Part 5 considers whether the flanking measures recommended by the Commission to support the implementation of the CESL are likely to overcome the problems with the instrument identified in this essay. Part 6 concludes.

2. The jurisprudence of the CESL

The CESL's jurisprudential approach relies heavily on the concepts of trade usage and good commercial practice to interpret contracts and define the parameters of traders' legally enforceable agreements. It provides that B2B contracts include not only the contract's written terms and the terms supplied

by its own mandatory provisions,¹ but also any “usage which [the traders] have agreed should be applicable”, and any “usage which would be considered generally applicable by traders in the same situation as the parties”.² When disputes over interpretation arise, the CESL directs courts to look to a variety of contextual considerations – including trade usage – to give meaning to contractual provisions and fill contractual gaps.

The CESL provides that usages may not override either specially negotiated contract provisions³ or its own mandatory provisions.⁴ However, usages and practices may be invoked to invalidate standard contractual provisions that either “grossly deviate from good commercial practice” or are “contrary to good faith and fair dealing”.⁵ Any standard-provisions that are enforced under the CESL will automatically be construed against the drafter. In addition, any term relating to interest on late payments may also be invalidated if it “grossly deviates from good commercial practice”.⁶

The CESL also relies indirectly on usages and practices by placing great emphasis on the concept of reasonableness and the non-waivable obligation of good faith. It provides that what is “to be expected of or by a person, or in a particular situation”,⁷ is to be determined with reference to “reasonableness”. Reasonableness is to be objectively determined by looking at “the circumstances of the case”, as well as the “usages and practices of the trade or professions involved”.⁸ Similarly, in B2B contracts, good faith is given meaning by looking to “good commercial practice in the specific situation concerned”.⁹ The duty of good faith also requires traders to act in ways that evidence “consideration for the interests of the other party to the transaction”, and it plays a key role in defining both the contours of the CESL’s duty to cooperate¹⁰ and the parameters of the CESL’s pre-contractual duty to disclose information.

Despite its reliance on trade usage and good commercial practice, the CESL does not define either term. It also fails to specify whether courts should look to local or only transnational usages. Unlike the Convention on the International Sale of Goods (“CISG”), which binds traders to any “usage of which the parties knew or ought to have known and which *in international*

1. Commission’s *Proposal for a Common European Sales Law* (“CESL”), Art. 66.

2. *Ibid.*, Arts. 66, 67, 68.

3. *Ibid.*, Art. 67.

4. *Ibid.*, Art. 67(3).

5. *Ibid.*, Art. 86.

6. *Ibid.*, Art. 170.

7. *Ibid.*, Art. 5.

8. *Ibid.*

9. *Ibid.*, Preamble, Principle 31.

10. *Ibid.*

trade is widely known and observed”,¹¹ the CESL binds traders to “any usage which would be considered generally applicable by transactors in the same situation as the parties”.¹² It is therefore unclear whether the CESL would be interpreted to include both local and international usages.

The CESL is also silent on important and potentially outcome-determinative legal questions related to the invocation of usages in commercial litigation. Some of these questions, such as the way usages are to be proven (which varies across the Internal Market),¹³ would likely be left to the law of the relevant forum. In contrast, any substantive-law-related issues that are within the scope of the CESL – such as what to do when usages in the buyer and seller’s markets conflict, the standards for imputing knowledge of usages to market participants, and how to discern what it means for a usage to be used to “interpret” as opposed to “override” a contract provision – would be determined “autonomously”, meaning “on the basis of the underlying principles and objectives [of the CESL] and all its provisions”.¹⁴

Before exploring the consequences of the CESL’s reliance on trade usage and good commercial practice for its ability to meet its articulated goals, it is useful to review the available empirical evidence bearing on whether the types of usages the CESL and the Code reference exist in American merchant communities.

3. Usage in American commercial communities

3.1. Historical evidence

In the late nineteenth and early twentieth centuries, trade associations in US merchant industries characterized by the preconditions usually associated with the emergence of custom – namely, social or geographical homogeneity and repeat transactions across small groups – sought to codify their trading customs into written sets of contract default rules that could be used to resolve disputes in their private, merchant-run arbitration tribunals. Studies of these codification attempts revealed that consensus concerning the content of usages relating to even the most basic aspects of trade either did not exist or

11. CISG, 9(2) (emphasis added).

12. CESL, Art. 67(2).

13. See Schmitthoff, *International Trade Usage* (Institute for International Business Law and Practice, 1987).

14. CESL, Art. 4.

existed only in highly geographically localized areas that were not co-extensive with the extent of trade.¹⁵

In the hay industry, for example, prior to the adoption of Trade Rules in 1907, “packing, shipping and handling hay was an irregular business. There were no established customs to govern, and every transaction was typical of the parties engaged in it”.¹⁶ Hay merchants did not even agree on the meaning of the term “bale” of hay. Some contended that it was a measure of size. Others maintained it was a measure of weight. Across markets, and even within some local markets, different meanings were attributed to the term. As one participant observed, “[t]he large bales of New York and New England means a different bale from the large bale in the Western States . . . In Chicago at present there is a lack of clear definition of small bales”.¹⁷ More generally, the minutes of the industry’s annual meetings reveal that while there were some highly localized usages, both trade practices and the meaning of common trade terms varied widely between localities.

Similarly, in the grain industry, prior to the adoption of trade association drafted Trade Rules, usages varied both within and between local markets. Even local associations found it necessary to codify their usages in an effort to promote common understanding of trading terms. Practices varied so widely that “a high probability existed that a dispute would arise whenever grain was traded outside local markets”.¹⁸

Even in the geographically concentrated textile industry, centered on New York’s Worth Street, variations in practices and disputes over the meaning of core trade terms impeded the functioning of the market. Traders did not even agree on the meaning of common terms like “seconds”, and practices regarding the grace period for late delivery varied widely. Disagreement was so widespread that it took the industry over eighteen years to reduce its usages to written rules and standard-form contracts.¹⁹ The results of this long effort were the Worth Street Rules, which continue to govern most textile transactions today. These rules contain some provisions that apply across the trade, as well as separate lists of customs that apply only to particular subdivisions.²⁰ Even within this very concentrated market, different market

15. Bernstein, “The questionable empirical basis of Article 2’s incorporation strategy: A preliminary study”, 66 *University of Chicago Law Review* (1999), 709, hereinafter “*Questionable*”.

16. National Hay Association, *Report of the Eighteenth Annual Convention* 3 (NHA: 1911).

17. Bernstein, *op. cit. supra* note 15, 730–735.

18. Gordon, *A Century of Agricultural Abundance Through Free Enterprise* (NGFA, 1996), p. 49.

19. Bernstein, *op. cit. supra* note 15, 730–735.

20. Worth Street Rules (1936).

segments had very different ways of doing business and attached different meanings to commonly used terms.

In sum, in these and other industries, what began as an effort to codify existing customs, devolved into a process of quasi-legislative rule making. Committees of merchants, loosely informed by variant merchant practices, actively sought to establish and promote certainty and uniformity in trade practices by promulgating and trade rules and/or standard-form contracts that contained what they viewed as the most desirable, not the most widely used, terms.

3.2. *Evidence from modern-day Texas*

The results of the historical case studies are consistent with the findings of a study of trade usages in the contemporary cattle feed market around Amarillo, Texas.²¹ This market is characterized by all of the preconditions typically associated with the emergence of usages. The firms surveyed were all members of either the Texas Grain and Feed Association or the Texas Cattle Feeders Association. They all did a great deal of their business within Texas, much of it within a relatively small local area.²² Firm members considered themselves part of a close-knit social group and their contracting relationships tended to be long-standing and repeat.²³ Yet the study found that even within this highly localized market, unwritten practices varied widely with respect to aspects of trade where the Code looks to usage to determine the meaning of agreements.

For example, although transactors agreed that a grace period for late payment was common, there was no consensus about the length of the “reasonable” grace period.²⁴ There was also no consensus about whether (or in what circumstances) the tender of non-conforming goods with a price adjustment would be acceptable,²⁵ or about how a price adjustment should be

21. This survey was conducted and designed by Martha Van Heitsma and Virginia Bartot of the Small Survey Lab at the University of Chicago. The raw data and research protocols for the study are on file with the author (“NORC Survey”).

22. 90% of the respondents had 50% or more of their trading partners in Texas. 62% of the respondents had 75% or more of their trading partners in Texas. Among the Texas trading partners, 86% were based in the “Lubbock, Amarillo, Abilene, Wichita Falls” areas. NORC Survey, Responses to Question 7.

23. When firms were asked, “About how long do your contracting relationships usually last?” 54% answered more than 10 years, 32% answered five to ten years, 12% two to five years, and 2% less than two years. The number of trading partners each firm had was also relatively small, 55% had 27 or fewer feed trading partners. NORC Survey, op. cit. *supra* note 21.

24. See UCC 2-309(1), 1-204(2), and 1-204, comment 2. See also NORC Survey, cited *supra* note 21.

25. See UCC 2-508 and UCC 2-508 comment 2.

calculated when non-conforming goods were accepted.²⁶ There was also no uniform understanding of the meaning of the trade term “FOB”, or even what the acronym stood for.

The study also sought to explore merchants’ beliefs about the existence of trade usages. It asked: “When you use written contracts, or purchase and sale orders, are there some unwritten rules or customs or practices that you expect your trading partner to follow even though they are not explicitly written down?”²⁷ A majority of respondents, 65.3 percent, said there were such unwritten practices, and 91 percent of those who believed they existed thought that they were known and followed by everyone in the market. Nevertheless, most respondents who said usages existed were unable to provide examples. The only unwritten practice alluded to was the requirement that hay not be wet, a usage asserted by three respondents.²⁸

In sum, this small-scale study together with the findings of the historical studies suggests that contrary to the implicit assumptions in the CESL and the Code, uniform trade usages may not be anywhere near as common as these statutes’ drafters seem to assume. The historical studies also suggest that when usages do exist, they tend to be quite local in scope or general in form. This finding is consistent with recent work on the medieval law merchant, which demonstrates that “we lack evidence that [sales-related gap filling customs] became a uniform and universal part of the *lex mercatoria* other than, perhaps, at a very high level of generality. Instead, the evidence suggests that substantive customs remained geographically local or confined to a particular network of repeat players”.²⁹

26. In an attempt to explore whether usages relating to this aspect of trade existed, participants were asked how often they accepted lower quality goods when they were not required to do so by a term in their contract. 20.4% answered never, 20.4% said frequently, and 59.2% said sometimes. Although 92% of respondents said that a discount was reasonable when accepted goods were below the expected quality, there was no agreement about either the size of the discount or the method of determining it. 41.3% of the respondents said that the discount should be individually negotiated, 50% said it should be determined on a regional scale, and 8.7% on a national scale. NORC Survey, cited *supra* note 21.

27. NORC Survey, *supra* note 21.

28. *Ibid.*

29. Kadens, “The myth of the customary law merchant”, 90 *Texas Law Review* (2012), 1153.

3.3. *Internal market*

There are a number of reasons that usages may be no more uniform across the Internal Market than they are, or were, in American merchant communities.³⁰ For instance, some Member States have a long history of free-market capitalism, while others went through decades of communist or socialist rule. Socialist legal systems were generally hostile to looking to usages in contract disputes,³¹ given the desire of their technocratic traders and adjudicators for certainty, and their assumption that usages tended to reflect the preferences of the largest and most powerful economic actors.³² Although many of these countries have now created legal systems based on the civil law approach, commentators suggest that adjudicators in these countries remain particularly literal in their approach to interpretation.³³ The cultural differences among Member States might also have affected the evolution of usages, which generally differ across communities with different norms of honor, trust, and other-regarding responsibility.³⁴ Finally, usages in different countries will necessarily have evolved against the background of different types of legal systems,³⁵ whose rules and methods of discerning usages may well have influenced their evolutionary path.

Interestingly, across Europe, the variation in usages relating to contracts of carriage has long been explicitly recognized by the International Chamber of Commerce (“ICC”), the organization that promulgates and revises the widely-used Incoterms for international trade. The preamble to the Incoterms explains that because “the existing diversity of interpretation [of customs] is a constant source of friction in international trade leading to misunderstandings . . . every endeavor has been made to limit . . . references

30. Gillette, “The law merchant in the modern age: Institutional design and international usages under the CISG”, 5 *Chicago Journal of International Law* (2004), 168 (discussing theoretical reasons that beneficial international trade customs may not emerge).

31. Zwart, “The new international law of sales: A marriage between socialist, third world, common, and civil law principles”, 13 *North Carolina Journal of International Law and Commercial Regulation* (1988), 109 (during the period of communist or socialist rule, “[g]enerally East bloc countries do not give effect to trade usages, unless the parties explicitly agree to them and they do not violate statutory provisions”).

32. Bainbridge, “Trade usages in international sales of goods: An analysis of the 1964 and 1980 Sales Conventions”, 24 *Virginia Journal of International Law* (1984), 619.

33. See e.g. Jan Smits (Ed.), *The Need For a European Contract Law: Empirical and Legal Perspectives* (Europa, 2005).

34. See e.g. Bernstein, “Opting out of the legal system: Extralegal contractual relations in the diamond industry”, 21 *Journal of Legal Studies* (1992), 115 (exploring the ways that the usages of the diamond trade are influenced by Jewish law and social ties among members of local trading networks).

35. See Smits, *op. cit.* *supra* note 33, 157 (noting the existence of “four types of national contract law regimes within the European Union”).

to custom to the absolute minimum”.³⁶ The Chamber’s guide to using the Incoterms emphasizes that “frequently parties to a contract are unaware of the differences of trading practice in their respective countries”, and advises traders “to ascertain if there are any particular customs of the port . . . because these customs are quite different in different ports and may create surprises for the uninformed party”.³⁷

4. Can the CESL meet its goals given its jurisprudence?

Given the possibility that the drafters of the CESL were mistaken in their assumptions about the existence and/or uniformity of trade usages and good commercial practices, it is also important to consider whether, if trade practices in fact vary across the Internal Market, the CESL is likely to achieve its goals.

4.1. *Reducing transaction costs*

A core objective of the CESL is to reduce the contract-law related transactions costs faced by SMEs considering entering into cross-border trade, including the cost and difficulty of getting legal advice about the content of another country’s contract law, the cost of litigating abroad, and the difficulty of agreeing on the foreign law to be applied. The CESL, however, is unlikely to greatly reduce any of these costs and may even increase some of the costs it explicitly seeks to reduce.

The Cost of Learning About Foreign Contract Law. In promulgating the CESL, the European Commission sought to reduce the cost and difficulty of learning foreign contract law, which it viewed as a significant barrier to trade. However, the CESL is unlikely to do this even if it is widely adopted. Given the vagueness of the CESL, its use of terms common in national legal systems (yet defined somewhat differently within each of them) and the likely emergence of the same type of “homeward trend” that emerged in the interpretation of the CISG – in which national courts implicitly draw on their own law when interpreting vague provisions – learning about the content of foreign substantive law will continue to be both necessary and important to transactors doing business under the CESL.³⁸

36. *Incoterms* (ICC: 1980), “Introduction”.

37. ICC, *Guide to Incoterms* (2010), 21.

38. See e.g. DiMatteo et al., “The interpretive turn in international sales law: An analysis of 15 years of CISG jurisprudence”, 34 *Northwestern Journal of International Law and Business* (2004), 299, (giving examples of homeward trend in the interpretation of the CISG), Ferrari,

One area where a “homeward trend” is particularly likely to emerge is in relation to trade usage. The CESL does not define the terms trade usage or good commercial practice. It does not even specify whether its provisions are limited to international usages or also include local usages. It also fails to provide rules dealing with conflicts of usages, or to specify the methods by which usages can be established. Even if these issues are resolved in the manner the CESL directs – that is, autonomously, in accordance with its “underlying principles and objectives”³⁹ – transactors would be well advised to become familiar with the underlying national law and decisional history in the forum.

As one prominent commentator noted in connection with the CISG, the practical reality of a “homeward bias” transforms some localized customs into “international” ones”.⁴⁰ A similar type of decisional bias might result from the CESL’s invocation of standard-like considerations, such as good faith, that have more precisely worked out meanings under the contract law of other countries. As a consequence, traders contracting under the CESL will still need to bear the cost of learning not only the CESL, but also the meaning of its core terms under the forum’s law. In addition, even if these substantive considerations turned out to be unimportant, anyone litigating in a foreign forum would need to bear the cost of learning the forum’s procedures.

In the long run, the transaction costs of doing business under the CESL may decrease as judicial decisions sent to the central repository come to provide CESL-specific guidance on the meaning of its standard-like terms, the existence of relevant usages, and the meaning of terms with variant meanings across the Internal Market. This process, however, is likely to be slow. At present, the CESL may only be used in transactions where at least one trader is an SME. When a suit involves a question on which no CESL-specific guidance is available, the SME will face a lower expected recovery than it would if the law were certain, and will still bear the costs of disputing. As a consequence, because the transactions entered into by SMEs tend to be smaller than those entered into by larger companies, the cost of disputing will often exceed the expected recovery, so decisional law interpreting the CESL is likely to evolve quite slowly.

It is also important to note that even if SMEs or their trading partners choose the CESL to govern their contracts, SMEs will still have to obtain legal advice about foreign law to comply with tax and licensing procedures, a process that

“Homeward trend and lex forism despite uniform sales law”, 13 *Vindobona Journal of International Law, Commercial Law & Arbitration* (2009), 15–42 (“Unfortunately, however, courts do not always comply with this mandate to interpret the CISG autonomously... a ‘homeward trend’ is discernible, at least by some courts.”); Gillette, op. cit. *supra* note 30.

39. See *supra* note 14 and accompanying text.

40. Gillette, op. cit. *supra* note 30, 170.

the Eurobarometer identified as a much larger barrier to trade than either the cost or difficulty of finding out about foreign contract law. In thinking about the legal advice costs that might be saved by the CESL, it is therefore important to focus on the marginal cost to a trader of getting legal advice about foreign contract law when he is already getting it about other aspects of a country's legal and regulatory requirements.

Finally, in assessing the CESL's effect on the cost of learning foreign law, it is important to note that while the Commission maintained that without the CESL the cost of cross-border trade increases proportionately to the number of countries in which an SME does business,⁴¹ data suggest that this is not the case. A 2008 study found that 82 percent of cross-border contracts contained a choice of British, Swiss, or US law, with 54 percent selecting British law.⁴² An SME seeking to do business in a number of countries could therefore incur the costs of learning only three sets of national laws, and still be able to engage in robust cross-border trade. In addition, because these national legal systems have a well-developed decisional law, there will be more certainty about how cases will be decided. SMEs may therefore prefer to contract under these sets of laws unless and until a well-developed case law interpreting the CESL emerges. As noted above, this is likely to occur quite slowly, especially if the CESL remains restricted to transactions in which one party is an SME.

The Cost of Learning Usages. The CESL's drafters overlooked the fact that by making usages and good commercial practices binding on traders, traders considering entering a new market will have to make potentially costly inquiries into whether unwritten usages and practices are similar in their trading partner's location/market, and if they are not, will have to bear the cost of learning the usages of their trading partner's market and negotiating over whose usages should apply.

These inquiries are also likely to be impeded by the differences in language and culture that the Eurobarometer and other studies identified as barriers to trade for SMEs.⁴³ Indeed, it is not even clear how a trader dealing in a foreign market for the first time can accomplish this task. Knowledge of unwritten usages is typically acquired through trading experience or business ties in the community. SMEs who have not previously engaged in cross-border trade – precisely the entities that the CESL is trying to encourage to enter international markets – are not likely to have either the trading experience or

41. See European Commission, Proposal for a Regulation of the European Parliament and of the Council on a Common European Sales Law: Explanatory Memorandum (2011) (hereinafter, "*Explanatory Memorandum*"), 3.

42. Stuart Popham, *The View of European Business: Survey Results* (2008), p. 6.

43. *Explanatory Memorandum*, cited *supra* note 41, 2.

business-ties that will enable them to obtain this information.⁴⁴ Local competitors, seeking to maintain their market position, are unlikely to share this information. Traders on the opposite side of the chain of production and distribution might be similarly reluctant to do so, or might be tempted to shade it to the advantage of their side of the market. As a consequence, by making it necessary for transactors to bear the cost of learning foreign usages, the CESL may create barriers to entry for SMEs for whom the cost of investigating foreign usages is likely to be large relative to the profit they will make trading in any one foreign market.

In sum, the weight the CESL gives to usages and practices, together with the likely effects of homeward trend mean that traders will still need to bear the cost of learning about foreign law and procedure. They will therefore continue to negotiate fiercely over choice of forum, as forum selection will continue to strongly affect the value of their cross-border contracts.

The Cost and Difficulty of Litigating Abroad. Although the CESL seeks to reduce the transactions costs associated with litigating abroad, it seems unlikely to do so. The CESL's provisions are highly fact, context, and usage specific, and are to be interpreted and applied through the lenses of reasonableness, good faith, and fair dealing. Litigation is therefore likely to remain costly wherever it is conducted. Moreover, when larger companies contract with SMEs under the CESL, they remain just as likely to insist on choice-of-forum clauses specifying their home jurisdiction. SMEs will therefore still be faced with the significant costs of proving facts at a distance and obtaining legal advice about the forum's procedural rules and, for the reasons articulated above, some of its substantive law as well.

Together, these costs may continue to make litigation in a foreign forum very costly for an SME even if the CESL is the governing law. More generally, in exploring the effect of cost barriers to SMEs engaging in cross-border trade, the Commission focused primarily on *ex ante* contracting costs such as the costs of negotiating over the choice of law and forum as well as the cost of drafting agreements that conformed to various national laws. Although the Eurobarometer identified the cost of litigating in a foreign jurisdiction as important to traders' decisions about whether to transact abroad, there is nothing in the CESL designed specifically to deal with this barrier. The lack of attention to the cost of *ex post* disputing might be due to the arguments made by defenders of the CISG who pointed out that while the CISG was vague and might lead to high litigation costs, this was offset by its other benefits given

44. One exception would be traders in commodities which are often traded within and across countries on the basis of usages and practices codified by trade associations, such as the England based Liverpool Cotton Exchange and the Grain and Feed Trade Association, that have worked together to achieve a great deal of uniformity over the past decades.

that only a small percentage of cases go to litigation. However, this analysis overlooks an important consideration: if prospective litigation costs are large enough, traders will not have a credible threat to sue, and if such a threat is absent, there will not be the security of exchange that is necessary to encourage transactions among strangers.

Conclusion. Many of the transactions costs the CESL creates are also likely to be borne by traders doing business under either the CISG or most of the national laws of Internal Market countries. The drafters of the CESL completely ignored the possibility that some of the *commonalities* across European sales laws (English law excepted) – rather than the *differences* among them – might create barriers to SMEs engaging in cross-border trade. The Commission's lack of interest in this subject is reflected in the choice of questions included in the Eurobarometer. Although the Eurobarometer surveyed transactors' views on the importance of *differences* in laws as a barrier to trade, it did not include questions seeking to explore whether any of the similarities among these systems – most notably their reliance on usages, practices and broad equitable principles that involve fact intensive inquiries – might themselves be a common impediment to cross-border trade.

4.2. *Certainty and cooperation*

The CESL seeks to foster the creation and maintenance of cooperative cross-border contracting relationships. It even imposes a duty on traders “to cooperate with each other to the extent that this can be expected for the performance of their contractual obligations”.⁴⁵ However, the uncertainty created by the CESL's highly contextualized adjudicative approach is likely to undermine rather than facilitate the creation and maintenance of cooperative contracting relationships.⁴⁶ This effect is likely to be especially pronounced in transactions among SMEs who, as compared to larger firms, tend to use less complete contracts and rely more heavily on the governing contract default rules.

When traders do business for the first time and are considering the prospect of future contractual relations, they will each look closely at the actions of the other in an attempt to determine whether he is, broadly speaking, a cooperator or a defector. In making this assessment, they will compare their partner's actual performance to his promised performance and consider whether it is close enough to reflect a genuine effort to cooperate. If they conclude their

45. CESL, Art. 3.

46. For a general discussion of the reasons that clear rules promote cooperation better than vague standards see Dixit and Naebuff, *Thinking Strategically: The Competitive Edge in Business, Politics, and Everyday Life* (Norton, 1993).

partner is a cooperator, they will likely do business again. However, if they conclude their partner is either a defector or more likely to be a defector than other available partners, they are unlikely to deal with that partner again. When both traders enter into the relationship seeking to cooperate, cooperation is more likely to emerge when their agreement is clear and they share a common understanding of the scope of their respective rights and duties. This common knowledge provides a clear standard against which they can evaluate one another's performance and desirability as a trading partner.

Once established, a cooperative contracting relationship is most likely to be maintained if each transactor responds to cooperation with cooperation, and defection with either termination of the relationship, or, if he believes the breach to have been inadvertent, some type of defection more limited in time or scope (a tit-for-tat strategy). In contexts where both transactors wish to maintain their trading relationship, the greatest threat to their doing so is the possibility that one or both of them will mistakenly classify an act of cooperation as an act of defection and thereby set off a retaliation or a series of retaliations that will lead to the breakdown of their relationship.

The CESL's jurisprudence, together with its provision of standard-like rather than rule-like default provisions, decreases the likelihood that cooperative contracting relationships will arise, and increases the risk that established relationships will breakdown. Under the CESL the obligations of the parties turn on so many different considerations that even traders who want to cooperate and are committed to accurately assessing the behaviour of their contracting partners may make frequent errors. In addition, as the ICC recognized in connection with contracts of carriage and as the study of merchant practice in Texas confirmed with respect to sales contracts, traders tend to assume that others share their views about commercial practices, even when practices actually vary across the relevant market. The fact that traders assume their trading partners share their understanding of the content of usages means that when assessing one another's actions, they will each rely on their own understanding of the relevant usages and simply assume that the other shares this understanding. This, in turn, will likely lead to acts of cooperation being misinterpreted as acts of defection, thereby leading to the frequent breakdown of even mutually beneficial contracting relationships. In sum, when viewed against the background of the conditions needed to support cooperation, the CESL – like other national laws that rely heavily on trade usages and other context specific factors – is quite undesirable.

Conclusion. Traders doing business under the CESL might be able to get around its lack of clarity and standard-like default rules by drafting clear and detailed contracts designed to provide the type of contracting framework that will promote cooperation. SMEs, however, are likely to find it prohibitively

costly to do so. In theory this cost could be reduced if an SME were able to use a single CESL-governed standard-form contract for all of its cross-border transactions. However, the CESL subjects the terms of standard-form agreements to additional scrutiny that may undermine their effectiveness. Provisions that are not in accordance with good commercial practices (practices which, as discussed above, may vary from country to country) can be invalidated and standard-provisions, even if enforceable, will always be construed against their drafter. In addition, even if clear contracts that can support cooperation are used, if a dispute requiring third-party adjudication nonetheless arises, litigation costs are likely to remain significant as one or both traders can still introduce evidence of usages, practices, pre-contractual negotiations, or other elements of the contracting context to give meaning to their contracts terms or add additional usage-supplied obligations. As a consequence, even if such contracts increase the likelihood of cooperation, they will not necessarily decrease the cost of disputing and may still leave the SME without a credible threat to sue. By removing this threat, the CESL removes the fundamental precondition to transactions between strangers, namely security of exchange.

5. The likely effect of the CESL's flanking measures

Despite its hostility toward trader-drafted standard-form contracts, the European Commission adopted a flanking measure to encourage groups of experts to “work closely with all relevant stakeholders to help develop ‘European model contract terms’ for specialist areas of trade or sectors”.⁴⁷ The idea was to encourage the creation of terms that SMEs and others engaged in cross-border trade could use at a low cost, terms that would have the additional advantage of becoming clearer over time as opinions interpreting them were sent to the central repository. Indeed, in the US in the late nineteenth and early twentieth centuries when industry trade associations sought to encourage cross-country exchange, their efforts to do so by providing standard contractual terms were very successful, particularly in commodities industries like lumber and grain.

If the process for creating European Model Contract Terms is carefully structured, this flanking measure should further the CESL's goals. The standard contracts/provisions drafted by industries could also codify those usages and practices that are, in fact, widely recognized and observed, thereby

47. Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: A common European sales law to facilitate cross-border transactions in the single market (2011), 11.

reducing or eliminating the costs of proving their content and resolving conflicts between local usages in litigated cases.

The adoption of largely standard contracts/provisions would also reduce misunderstandings and therefore both increase the likelihood that commercial cooperation would arise and decrease the likelihood that cooperation once established would break down. These contracts/provisions could also be drafted to cover a great many contingencies, thereby reducing the need to rely on the vague default standards set out in the CESL. Moreover, if the provisions in these contracts were vetted in advance by the Commission and deemed to be consistent with good commercial practice, reasonableness and good faith, it might also be possible to eliminate some of the more costly and uncertain inquiries required by the CESL.

Given the lack of a successful public model for government encouragement of standard contract terms, the Commission looked to examples of *privately* drafted model contracts and model terms – such as those created by Orgalime (an association of EU engineers), the London-based Grain and Feed Trade Association, and the Liverpool Cotton Exchange – to assess its promise. The Commission also suggested that these efforts be studied so it could begin to develop a set of “best practices” for the creation of such contracts/provisions. This is a sensible suggestion because the rules creation and updating procedures that were adopted by these groups as well as by US trade associations that created enduring and widely used contracts/provisions, share a number of common features that the Commission would do well to encourage industry working groups to replicate. For example, many of these groups adopted voting structures that effectively give small firms veto power over proposed rules as well as mechanisms for updating the rules in response to new market conditions or problems identified in adjudicated cases. More generally, understanding and identifying the pre-conditions for the creation of successful contracts/rules may also assist the Commission in identifying those industries that should not be encouraged to engage in these efforts.

The Commission should, however, be careful when assessing the magnitude of the impact this flanking measure will have on the volume of cross-border trade in the Internal Market. A large number of industries and industry sectors have already developed such standard contracts for use in cross-border trade. It is therefore unclear how many additional industries would choose to either create these provisions or revise their existing provisions in response to the flanking measure. In addition to reviewing the existing contracts/terms to see if they should be entitled to deference, the Commission would need to look carefully at the procedural process and structure of the groups that drafted

them, an inquiry which is likely to be costly, complex, and require input from economists.⁴⁸

If this flanking measure results in widely used contractual forms, its very success might undermine the desirability of the CESL. The experience of US trade associations that have created such forms and also provided arbitration tribunals to resolve disputes arising under them suggests that when an industry creates a set of standard contract provisions that are clear, complete, and reflect the terms that transactors would have agreed to had they been able to costlessly negotiate and draft individual terms, industry members will want the terms of their contracts to be strictly enforced. They will not want adjudicators to look to good faith, elements of the contracting context, oral communications, practices of the parties, and parol evidence – all considerations that would be central to CESL-governed litigation. Association-run arbitration tribunals tend to employ a very formalist approach to adjudication, an approach that gives no weight at all to the practices of the parties, imposes no duty of good faith or fair dealing, looks to usages only to fill gaps (narrowly construed), and enforces the terms of agreements even if doing so seems unfair in the individual case. This suggests that if the flanking measure is successful, traders may prefer to be governed by the law that will give the greatest weight to their written agreements. They may also prefer to have their disputes resolved by industry-expert arbitrators. Traders in general, and SMEs in particular, may therefore find it desirable to opt for ICC or trade association arbitration under English law. This speculation is supported by the long-standing preferences of the international grain and cotton trades, which have created standard contracts/provisions for cross-border trade, as well as industry sponsored arbitration tribunals (operating under British Law) in London to resolve disputes arising under them.⁴⁹

Even if the flanking measure is successful, transactors in industries that do not create standard-provisions will be faced with having their transactions governed either by a national law or the CESL. In many situations, however, an industry's failure to create these standard provisions, will indicate that there is no agreement on standard terms or practices, so firms in industries would also be better off being governed by a legal system that unlike the CESL does not rest on the assumptions that usages exist or that traders have reached a cross-border consensus on the meaning of good commercial practices.

48. See Cooter, "Structural adjudication and the New Law Merchant: A model of decentralized law", 14 *International Review of Law and Economics* (1994), 215.

49. Liverpool Cotton Exchange and the GAFTA. Other industries that have opted for their standard contracts to be enforced this way include the International Meat Trade Association, the International Federation of Oils, Seeds and Fats Association.

6. Conclusion

In sum, the considerations discussed here suggest that if the Commission wants to increase the volume of cross-border trade involving SMEs and to facilitate cooperative contracting relationships, it should create an EU wide optional instrument that is the polar opposite of the CESL and most existing EU laws. It should create an instrument with a menu of clear, detailed, contract rules that will be interpreted and enforced without reference to context, usages, practices and good faith, a set of rules based on the jurisprudential approach reflected in the common law of New York. Although such a suggestion is distinctly out of step in the context of European harmonization efforts, recent research in the United States reveals that businesses prefer their non-sales contracts to be governed by formalistic New York law rather than CESL-like California law.⁵⁰ Similarly, the reluctance of Internal Market traders to contract under the *lex mercatoria*, the UNIDROIT Principles, or the CISG,⁵¹ together with the widespread preference for English law, suggests that businesses might welcome rather than oppose the creation of such an optional set of rules. Such an option might be particularly useful for traders entering into new relationships in which they do not know much about their partner's reputation, practices, or understanding of trade usages. Over time, as traders acquired this information about one another, if the adjudicative approach currently in the CESL proved more desirable, they could always opt to contract under one of the many national laws with the characteristics they desire. This would enable them to obtain the benefit of not only the jurisdiction's laws, but also the interpretive history that clarifies them. More generally, adopting such an instrument might help create new trading relationships, and, if it turns out to be consistent with traders wishes' across a wider range of trading relationships – as the New York Law versus California Law studies suggest it might – it could set off just the sort of race to the top in the provision of trader-to-trader contract rules across the EU envisioned by defenders of inter-jurisdictional competition.

50. Miller, "Bargains bi-coastal: New light on contract theory", 31 *Cardozo Law Review* (2010), 1475; Eisenberg and Miller, "The flight to new work: An empirical study of choice of law and choice of forum clauses in publically-held companies' contracts", 30 *Cardozo Law Review* (2009), 1457.

51. See Drahozal, "Contracting out of national law: An empirical look at the New Law Merchant", 80 *Notre Dame Law Review* (2011), 523; Dasser, "Mouse or monster? Some facts and figures on the *lex mercatoria*", in *Globalisierung und Entstaatlichung des Rechts* (Mohr Siebeck, 2008).