

**NOVEMBER 2010**

**FINANCIAL MARKETS LAW COMMITTEE**

**ISSUE 97 – EUROPEAN CONTRACT LAW**

**A European Commission Consultation on Contract Law: UK Government Call for  
Evidence and Views to Inform its Response**

The logo for the Financial Markets Law Committee is a light blue, tilted rectangular box containing the text "Financial Markets Law Committee" in a dark blue, sans-serif font. The text is arranged in four lines, following the tilt of the box.

Financial  
Markets  
Law  
Committee

**c/o Bank of England  
Threadneedle Street  
London EC2R 8AH  
[www.fmlc.org](http://www.fmlc.org)**

**FINANCIAL MARKETS LAW COMMITTEE****ISSUE 97 – EUROPEAN CONTRACT LAW**Working Group Members:

Lord Hoffmann	FMLC Chairman
Michael Brindle QC	Fountain Court
Roger Brown	British Bankers' Association
Lorraine Charlton	Association for Financial Markets in Europe
Charles Clark	Linklaters LLP
Lord Mance	The UK Supreme Court

FMLC Secretariat:

Joanna Perkins	FMLC Director
Jane Higgins	FMLC Legal Assistant

**CONTENTS**

Introduction	4
Constitutional Basis for Enacting a European Contract Law	5
Legal Uncertainty Generated by Any New Legal System	9
Substantive Legal Uncertainties Arising From the DCFR	10
Conclusion	11

## 1 INTRODUCTION

- 1.1 The role of the FMLC is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.
- 1.2 This Paper, therefore, does not comment on policy issues other than as necessary to deal with issues of potential uncertainty or misunderstanding.
- 1.3 The FMLC considers that the development of a European contract law (whichever form this might take) is an area in which legal uncertainty is very likely to be created. This response does not attempt to identify all the possible uncertainties that might arise (given the size of the Draft Common Frame of Reference (the “DCFR”), this task would be a very substantial one). Instead, we identify three particular types of legal uncertainty that may arise, as follows:
  - a. possible challenges to the constitutional basis for enacting a European contract law;
  - b. legal uncertainties of the type that might arise in connection with the introduction of any new body of law; and
  - c. substantive legal uncertainties arising from the content of the DCFR.
- 1.4 The FMLC’s experience is that legal certainty is of fundamental importance to the functioning of the financial markets. To take an example, participants in the financial markets require an appropriate legal opinion to be given on a contract in order for the contract terms to be treated as binding for regulatory, capital and risk purposes. If, for example, there is uncertainty about the legal effect of a given term (such as close-out netting) this uncertainty will be reflected in a qualification to the legal opinion. In the case of close-out netting, the uncertainty about the enforceability of that term will impact not only on the institutions party to that trade (for example, by requiring them to account for their positions on a gross rather than a net basis), but also on the other institutions with exposure to those parties. In this way, legal uncertainty about a contractual term can quickly have a widespread effect on trade in the financial markets.

1.5 While established legal systems typically used to govern transactions in the financial markets feature their own areas of uncertainty as case law develops or new legislation is introduced, market participants typically have a high level of confidence in the certainty provided by those legal systems. The introduction of a new system (whether as an optional instrument or a mandatory instrument) carries a real risk of introducing both an initial period of “bedding down” uncertainty and an ongoing period of uncertainty as divergent interpretations of the rules emerge. A new system based on the DCFR would also carry with it the risk of substantive uncertainties arising from rules which do not give market participants a high degree of confidence that contracts will be enforced in accordance with their terms.

## **2 CONSTITUTIONAL BASIS FOR ENACTING A EUROPEAN CONTRACT LAW**

2.1 Doubts about the constitutional basis for either an optional or mandatory instrument have been well rehearsed elsewhere (and, indeed, recognised by the European Parliament itself).<sup>1</sup> Even without analysing the merits of the possible constitutional bases, it is apparent that uncertainty exists as to the legal basis for enacting such an instrument. Nonetheless, we briefly examine below the principal possible sources of constitutional power below.

### **Mandatory Instrument**

2.2 Article 114 of the Treaty on the Functioning of the European Union (“TFEU”) provides for measures to be adopted “for the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their object the establishment and functioning of the internal market”. While it is clear that, were a mandatory instrument to be adopted, this would have the effect of approximating Member States’ contract laws, it is not clear (i) that this would contribute to the functioning of the internal market; or (ii) that such an action would be consistent with the principles of subsidiarity and proportionality.

---

<sup>1</sup> See “The Common Frame of Reference: an optional instrument?” <http://www.europarl.europa.eu/studies>

- 2.3 In order for the enactment of such an instrument to be possible under Article 114, it would be necessary to show that the internal market is not functioning optimally in some way, and that the introduction of a European contract law would ameliorate the problem identified. While the Commission has identified certain problems—that some businesses refuse to sell cross-border, for example—it has not provided evidence that these problems are caused by divergences in national contract law. Indeed, the Green Paper cites the statistic that in 61% of cross-border e-commerce offers consumers were not able to place an order mainly because businesses refused to serve the consumer’s country, while the report from which this statistic is taken highlighted that this was largely due to technical problems or payment options not being available, rather than due to divergent contract laws.<sup>2</sup> Other contributing factors might include language barriers, divergent packaging requirements, delivery pricing, divergent procedural requirements relating to claims and so on. It is not obvious that such problems would be solved by a European contract law. Even if such evidence can be provided that divergences between national contract laws are a barrier to trade and that this barrier would be removed by a European contract law, it would only justify measures relating to consumers and small and medium enterprises (“SMEs”).
- 2.4 Article 352 TFEU provides power to adopt measures which are necessary to attain one of the Treaty objectives where the Treaties do not otherwise provide the power. This wider power, whilst requiring the consent of the Parliament, the Commission and unanimity in the Council, might provide a wider basis for adopting a European contract law. We note however, that the provision explicitly requires the measures to be necessary to achieve one of the Treaty objectives, and that the uncertainties highlighted above in relation to Article 114 would therefore apply equally.
- 2.5 Moreover, if a lack of cross-border trade is identified and correctly attributed to divergences in national contract law, it is not clear that a mandatory European contract law is the most appropriate way of resolving this. In the FMLC’s view,

---

<sup>2</sup> See [http://ec.europa.eu/consumers/strategy/facts\\_en.htm#E-commerce](http://ec.europa.eu/consumers/strategy/facts_en.htm#E-commerce)

there is a risk that such a measure (whichever Treaty article is used as a basis for adoption) would be inconsistent with the principles of subsidiarity and proportionality. In respect of consumers, measures such as the Consumer Rights Directive and a revision of the current legislation regarding E-commerce are arguably a more appropriate forum for addressing such issues and would not involve the replacement of Member States' entire bodies of contract law (even if restricted to cross-border transactions). In respect of businesses, an optional instrument (or indeed simply publication of the DCFR) would achieve the same aims with less impact on Member States' national laws: businesses who wished to contract subject to the terms of the DCFR would be free to do so and those that wished to use an established legal system would also be free to do so. In this way, the demand for a uniform code can be tested in the market place.

### **Optional Instrument**

- 2.6 Article 114 has most frequently been suggested as a possible basis for an optional instrument. It is, however, difficult to see how an optional instrument could be said to have the purpose of approximating Member State's laws. If the European contract law is recognised as a model of sound legal principles and clear drafting, it may be that Member States' legal systems will over time adopt parts of the code and therefore become more similar. However, this is at best an indirect side-effect of the law.
- 2.7 Alternatively, Article 352 has been put forward as a basis for an optional instrument. For the reasons highlighted above in relation to a mandatory instrument, the FMLC considers that there is uncertainty as to whether there is sufficient evidence to show that an optional law is necessary to enhance the functioning of the internal market. Without firmer evidence that such a law is necessary, the FMLC considers that legal challenges to an instrument based on Article 352 are a real possibility. Article 81 TFEU provides that

“the Union shall develop judicial cooperation in civil matters having cross-border implications, based on the principle of mutual recognition of judgments and of decisions in extrajudicial cases. Such cooperation may include the

adoption of measures for the approximation of the laws and regulations of the Member States.”

- 2.8 With respect, we suggest that the use of Article 81 as a basis for an optional law is misplaced. Article 81 is generally understood to refer to procedural matters rather than adoption of a substantive body of law: the article refers, for example to the recognition of judgments, service of judicial documents, training for the judiciary etc. The FMLC is not aware of any instances of this Article having been used as the basis for the adoption of substantive European laws and respectfully suggests it does not provide a sound basis for adoption of an optional code in this instance.
- 2.9 Article 169 TFEU has also been suggested in some circles as providing a possible basis. However since this article only refers to protection of consumers, the FMLC does consider that it is a possible candidate for a wider-ranging instrument than one dealing only with consumers.
- 2.10 In the FMLC’s view, there is a real possibility that, if an optional or mandatory instrument is enacted on the basis of one of the Treaty Articles considered above, market participants (and Member States) will be hesitant to use the law for fear that it was invalidly enacted. It is likely that a legal challenge to the constitutional basis of the law would be brought, causing further uncertainty pending resolution of such a challenge.
- 2.11 Could this uncertainty be resolved? The principal options would appear to be:
- (i) to amend the Treaty to explicitly confer the power to create such an instrument. Given the political processes required in each Member State to authorise such an amendment, it is doubted whether this is a realistic option; or
  - (ii) to adopt the draft common frame of reference in a less expansive form, for example as a toolbox for European legislators.

### **3 LEGAL UNCERTAINTY GENERATED BY ANY NEW LEGAL SYSTEM**

- 3.1 The introduction of any new law generates uncertainties: typically these might be questions about the meaning of a particular term or provision. These arise under



new UK and European legislation as much as legislation enacted elsewhere, and arise despite comprehensive consultation being carried out prior to enactment of the legislation. The impact of such uncertainty varies: in many cases, over a period of time market practice adopts a way to minimise the impact of the uncertainty, or it is resolved by case law, regulatory guidance or amending legislation. Generally, the uncertainty created by enactment of new legislation (however clearly drafted) is considered to be an acceptable side-effect of enacting new laws.

- 3.2 Importantly, within an established national legal system, uncertainties and questions of interpretation can often be resolved or, at any rate, reduced by drawing upon the existing jurisprudence and traditions of that legal system.
- 3.3 However, in the case of the enactment of an entirely new code of law, across 27 jurisdictions at once, the impact of transitional uncertainty is much greater, particularly if it is to be an autonomous system independent of any one country's existing system (and therefore without recourse to existing jurisprudence or developed academic writings). It is likely to take much longer for a consistent interpretation to develop across 27 Member States. Indeed, there is a significant risk of divergent practices arising as each jurisdiction adopts a slightly different interpretation of a given provision (drawing from, for example, their own divergent interpretations of a similar legal concept, such as "good faith"), thus engendering legal uncertainty not only in each member state but also by creating the potentially false impression of consistency as between member states.
- 3.4 As an example of the transitional uncertainty that is likely to arise, the FMLC highlights that, following the introduction of the new Dutch Civil Code in 1992, there was uncertainty as to the effect of Code provisions, including for example provisions relating to security.<sup>3</sup> The process of developing a body of jurisprudence accompanying the new Code is still, the FMLC understands, ongoing, some 18 years after its introduction.

---

<sup>3</sup> See Section 3:248 Dutch Civil Code

#### **4 SUBSTANTIVE LEGAL UNCERTAINTIES ARISING FROM THE DCFR**

4.1 We do not attempt to exhaustively identify all the possible sources of uncertainty which would arise if the DCFR were adopted more or less in its current form as an instrument of European law. Other commentators have, however, identified many uncertainties in the DCFR. We merely highlight one or two examples of potential uncertainty below.

(i) The concept of “good faith and fair dealing”. Much has been written about the potential for uncertainty in connection with a concept of good faith. It suffices here to acknowledge that not only is there likely to be a divergence between the UK’s interpretation of the term and that of civil law jurisdictions, but also that even civil law jurisdictions sharing a common concept of good faith do not apply that concept in identical ways.<sup>4</sup>

(ii) The concepts of “fair dealing” and “reasonableness”, which occur frequently throughout the DCFR, raise the same opportunities for divergent interpretations across Member States.

4.2 In the above examples, certainty of drafting has been sacrificed in favour of the flexibility offered by undefined legal concepts. While this may be expected to achieve substantively fair results, it is less likely to achieve certainty of outcomes, particularly during the initial “bedding down” period.

4.3 In the FMLC’s view, the uncertainties identified above would represent a very significant obstacle to the efficient functioning of the financial markets. A mandatory instrument covering business-to-business contracts subject to all of the above uncertainties would be likely to create years of transactional uncertainty as legal opinions are qualified by reference to the uncertainties inherent in the new laws. Even a law limited to business-to-consumer contracts would be likely to impact the financial markets (through, for example, the securitisation of retail products subject to the new laws).

---

<sup>4</sup> See Musy, Alberto M. (2001) "The Good Faith Principle in Contract Law and the Precontractual Duty to Disclose: Comparative Analysis of New Differences in Legal Cultures" *Global Jurist Advances*: Vol. 1 : Iss. 1, Article 1.

- 4.4 An optional instrument would have less impact on the financial markets (since participants could presumably choose not to use the instrument if they wish) but, as we have highlighted above, we consider that there is significant uncertainty about the constitutional basis for adopting an optional instrument.

## 5 CONCLUSION

- 5.1 The FMLC questions whether there is sufficient evidence of the benefits that are expected to be achieved by the introduction of a European contract law to counteract the costs of legal uncertainties arising from the new law. For the reasons highlighted above, the FMLC does not consider that sufficient evidence has been shown that divergences between national contract laws are a barrier to cross-border trade. The FMLC questions whether many market participants are even aware of the differences between various Member States' contract laws. Indeed, the British Chamber of Commerce's 2008 report on barriers to growth for SMEs included a whole chapter on the barriers to international trade for SMEs, but divergences between national contract laws did not feature as one of the barriers.<sup>5</sup> The key barriers identified were language, culture, cost of research and difficulty in identifying local contacts. The FMLC would submit that, in addition to these barriers (which would not be removed by a European contract law), differences between the procedural rules in different jurisdictions for bringing a claim or enforcing a judgment are likely to represent a more significant hurdle to cross-border trade than substantive differences between contract laws. Even were a European contract law to be enacted, procedural differences may prevent any perceived barrier to trade being dismantled.

---

<sup>5</sup> Growing Pains: What is holding SMEs back? BCC, March 2008. Available at [www.britishchambers.org.uk/publications](http://www.britishchambers.org.uk/publications)

**FINANCIAL MARKETS LAW COMMITTEE MEMBERS<sup>6</sup>**

Lord Hoffmann (Chairman)

Sir John Gieve (Deputy-Chairman)

---

Andrew Bailey, Bank of England

Sir William Blair

Michael Brindle QC, Fountain Court

Charles Clark, Linklaters LLP

Simon Dodds, Deutsche Bank AG

Ruth Fox, Slaughter and May

Simon Gleeson, Clifford Chance LLP

James Grand, Freshfields Bruckhaus Deringer LLP

Ed Greene, Cleary Gottlieb Steen & Hamilton LLP

David Greenwald, Goldman Sachs International

Mark Harding, Barclays Bank plc

David Lawton, Financial Services Authority

Emil Levendoglu, HM Treasury

Sean McGovern, Lloyd's of London

Gabriel Moss QC, 3-4 South Square

Sir James Munby, The Law Commission

Ed Murray, Allen & Overy LLP

Steve Smart

---

Director: Joanna Perkins, Bank of England

---

<sup>6</sup> Note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only.