What Can Be Wrong With an Option?
An Optional Common European Sales Law as a Regulatory Tool

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A couple of months ago, the European Commission proposed a regulation for an optional Common European Sales Law (CESL). This proposal marks a milestone in the development of European contract law. It would give businesses and consumers the option to submit particular transactions to a genuinely European contract law regime. The distinct characteristic of the proposal is the CESL’s optional character. Businesses and consumers may use the CESL regime, but they are not forced to do so. At first glance, introducing the CESL as an optional regime seems to be a policy move that is both smart and difficult to criticize: What can be wrong with an option? Is it not the case that all market participants strictly prefer to have one more legal product available that they can choose?

This paper addresses these questions. It looks at an optional CESL as a regulatory tool. Based on the European regulatory objectives in contract law the paper investigates the case for an optional CESL. It then goes on to spell out the design of an efficient optional CESL. Finally, it analyzes the flaws in the current design as reflected in the Commission’s proposal, and it attempts to answer the question whether the flawed design really matters. Here, the potential influence of the CESL on legal scholarship and further European policy initiatives with respect to contract law is of particular importance.

The main points of the paper may be summarized as follows: An optional CESL can be a sensible regulatory tool to achieve (i) some level of harmonization and the associated transaction costs savings plus network benefits and at the same time (ii) subject the CESL to a market test. However, whether these goals will actually be
achieved depends on the specific option design conditions and the content of the option. The CESL option which is currently on the table is harmful. The Draft CESL (DCESL) is a defective product. It might nevertheless become a success on the European market for contract laws or be at least highly influential as a reference text. Hence, a lot is wrong with this option.

I. European regulatory objectives in contract law

Assessing the merits of an optional CESL as a regulatory tool is assisted by a clear picture of the European regulatory objectives in contract law. The European Commission discusses these objectives in the reasons given for its proposal, but the Commission’s account is both unbalanced and unsophisticated.

1. Reducing contract-law-related transaction costs in cross-border trade

Differences in contract law work as a ‘tax’ on cross-border-transactions, especially in B2C relations (Wagner 2002). Hence, reducing contract-law-related transactions costs in cross-border trade is an important European regulatory objective. Harmonization and standardization of contract law rules reduce transaction costs and create network benefits (Klausner 1995). However, empirical relevance of these effects is unclear. First, other barriers to cross-border transactions, such as languages differences, delivery problems, litigation in a foreign forum, and enforcement in a foreign jurisdiction, may be as important impediments to cross-border transactions as contract law differences. Second, the extent of any harmonization/standardization benefits depends on the degree of harmonization/standardization. This raises the problem of what can be called ‘hidden diversity’: Contract law practice in different countries might well be very different even though the paper rules are identical. Third, the one-time switch costs to a new harmonized/standardized regime may be significant especially for SMEs. Hence, the transaction-costs-related argument for contract law harmonization in Europe rests on a weak empirical basis.

2. Producing and selecting efficient contract laws

Another important European regulatory objective in contract law is to produce and select efficient contract law regimes. Private law rules cannot sensibly be employed to
achieve redistributive goals (Shavell 1981, Kaplow/Shavell 1994). The European Commission is much less clear and specific on this issue, however. On the one hand, the Commission believes that contract law rules should be attractive to businesses. It fails to specify, though, what makes contract law rules attractive to them. On the other hand, the Commission repeats time and again that a high level of consumer protection is desirable. The Commission does not appreciate, however, that consumer protection rules trigger costs for businesses and, as a consequence, raise prices. Consumers are not interested in as high a protection level as possible; they are interested in a protection level that is worth the associated costs to them. This implies differentiation.

If producing and selecting efficient contract laws is an important regulatory objective, then this sends a signal of caution with respect to harmonization/standardization affords. If we ‘get it wrong’ we run the risk to produce significant negative welfare effects. These are higher than under a system of regulatory competition that is characterized by a diversity of rule systems, some of which may be more, some of which less efficient.

II. The case for an optional CESL

An optional CESL would introduce vertical regulatory competition (RC) in European contract law: There would be RC between the contract laws of the member states (MS) and the European contract law. Such vertical RC would supplement horizontal RC between the contract laws of the MS. Horizontal RC is a well-established phenomenon under the framework of the Rome I Regulation (Eidenmüller 2011a). The interesting feature about an optional CESL and vertical RC is that the EU, being a regulator for horizontal RC, would at the same time assume the role of a competitor with respect to the contract law products that we find on the market and can be chosen.

Making the case for an optional CESL requires dealing with at least two questions: First, can we achieve the regulatory objectives stipulated above with RC? Second, do we need vertical RC for this purpose? In the following, I am going to deal with these two questions in turn.
1. Why RC in contract law?

In section I.1., reducing contract-law-related transaction costs in cross-border trade was specified as an important European regulatory objective. Whereas a harmonization/standardization directive of the EU would clearly foster that goal, RC does so only indirectly, if at all: Market forces may lead to an equilibrium in which a particular legal product achieves a dominant status. However, it may well be the case that RC does not lead to such an end point or that only a suboptimal level of harmonization/standardization is achieved by RC. This is a problem, but probably not a significant one. Given that the empirical basis for harmonization as a means to save on contract-law-related transaction costs is weak, one may well tolerate a suboptimal harmonization level brought about by RC.

The main advantage of RC as a regulatory tool in European contract law seems to lie in the fact that it is a mechanism that is conducive to producing and selecting efficient contract laws. RC can be characterized as a ‘discovery procedure’ (Hayek) for the best legal product. It utilizes distributed information resources, and it can account for different regional preferences in various jurisdictions (Grundmann/Kerber 2006), for example regarding consumer protection levels, the construction and interpretation of contracts, or the influence of good faith and fair dealing on contractual rights and obligations. RC appears to submit contract law rules to a market test, thereby making sure that the rules foster the interests of the affected parties. Hence, RC might also be viewed as a mechanism that counteracts potential public choice failures on the federal level.

However, there are two important caveats that must be added to this assessment of RC. First, choice and market success of a ‘package’ of rules tells little about the efficiency of particular rules within the package. In other words: RC with respect to a rule set is confronted with a significant bundling problem. Second and more importantly, whereas businesses might be expected to engage in sophisticated contract law arbitrage, such is clearly not the case with respect to consumers. Consumers don’t engage in contract law arbitrage for at least two reasons. Even if consumers behaved completely rational, the cost/benefit calculus of arbitrage would be negative. For them, it simply doesn’t pay to research different contract law regimes with respect to how
they affect their legal position in various circumstances (Rühl 2011). Factors such as price, reputation of the contract partner, and trust are much more important regarding how a particular transaction influences the welfare of consumers compared to the position under the applicable law. Moreover, it is by now received wisdom that consumers cannot be assumed to behave as completely rational agents. They are making various systematic mistakes that also prevent them from choosing contract laws sophisticatedly (Eidenmüller 2011b).

All in all, then, RC might be defended as a regulatory tool that, in principle, works towards the selection of efficient contract laws. However, this general assessment certainly does not apply to B2C transactions. In such transactions, the choice mechanism may be impaired by significant market failure. As an aside, I should like to add that even in B2B transactions information/transaction costs for informed choices might get very high, especially for SMEs, relative to the benefits that might be obtained by smart choices. Hence, even for some SMEs, the cost/benefit calculus of contract law arbitrage may be negative.

2. Why a 28th model by the EU?

Defending RC as a regulatory tool to promote important regulatory objectives with respect to European contract law does not suffice for making a case for an optional CESL. For that it must be shown why a 28th model by the EU is necessary, i.e., why vertical RC is an important regulatory tool with respect to European contract law. After all, market actors can already choose between 27 different contract law regimes. Why is it desirable or even necessary to have a 28th legal product created by the European Union itself?

One argument might be that the EU has a unique capacity to develop a superior legal product. That argument, however, is quite disingenuous. As I am going to demonstrate briefly in section IV., the DCESL is a clearly ‘defective’, inefficient product. The drafting process was certainly not designed to benefit from independent expert input and produce good (efficient) law. The law-making process at EU level in general is susceptible to horse-trading and political compromise. It is not geared
towards finding technically ‘best’ solutions. Hence, the EU does not possess a unique
capacity to develop a superior legal product.

A second argument that might be advanced to justify vertical RC in European
contract law would point to the fact that a 28th model could function as a ‘neutral
reserve order’ with an EU ‘seal’. The situation might be compared with the one that
we currently witness with respect to European company law. Here, the European
Company (Societas Europaea, SE) vertically competes with company law forms of the
MS. Empirical research has demonstrated that the SE is popular especially in Eastern
Europe. Its European image is an important driver for companies to reincorporate as an
SE (Eidenmüller/Engert/Hornuf 2009, Eidenmüller/Lasák 2011). Event studies show
that capital markets view such reincorporations positively, even though the results are
not statistically significant so far (Eidenmüller/Engert/Hornuf 2010).

Similar to the SE, a 28th European contract law model designed by the EU,
being available in all European languages, might become popular especially in MS
with less developed contract law regimes. In addition, the neutral European seal of an
optional CESL might establish a ‘focal point’ and enhance the popularity of such a
regime in general. This consideration can count as at least some justification for
introducing vertical RC with a European contract law, even though this justification is
not a very strong one.

III. Designing an efficient optional CESL

On the basis of the analysis in section II., the case for an optional CESL must be
considered to be weak at best. RC may not lead to the desired level of harmonization,
consumers don’t engage in contract law arbitrage, and there are no compelling reasons
why there should be vertical contract law competition in Europe on top of the existing
horizontal contract law competition between the contract laws of the now 27 MS. If
one nevertheless embarks on introducing an optional CESL on that basis, what would
and should be the design principles for an efficient optional CESL?
1. Creating a level playing field with MS’ contract laws

The analysis in section II.2. has shown that an optional CESL would have a certain competitive advantage vis-à-vis the contract law regimes of the MS simply by reason of it being a European regime. Given this competitive advantage, it is all the more important that the design conditions for an optional CESL make sure that otherwise a level playing field is created with MS’ contract laws, i.e., that the RC established is a fair competition. This implies, first, that opting into the CESL should be possible by standard contract terms. Second, opting in should be available for all types of transactions: B2B, B2C, C2C, domestic and international. Third, given that consumers don’t engage in sophisticated contract law arbitrage, an optional CESL needs to include mandatory consumer protection provisions. The preferential law approach that is characteristic for the current Rome I regime – home-state protection under Art. 6(2) Rome I Regulation – could be relinquished if it were also relinquished for horizontal RC between the contract law systems of the MS – which cannot be expected, however. Alternatively, one might argue that the optional CESL should be exempted from the preferential law approach if the CESL affords consumers protection by an efficient regime. That would be the protection level that is in the interests of the consumers, and it would give an optional CESL only a small competitive advantage vis-à-vis the MS’ contract laws.

2. Setting a ‘market standard’

A second design principle for an efficient optional CESL would be to at least try and implement only rules that are presumptively efficient, i.e. welfare enhancing, thereby setting a ‘market standard’. Whereas MS may experiment, the EU should not (Eidenmüller 2011a). The European law maker should include in an optional CESL only provisions that are market-mimicking in the sense that rational actors would have agreed on them had they been able to bargain at no costs (Klöhn 2012). The European lawmaker should also strive to avoid doctrinal inconsistencies and contradictions. Setting a market standard in that sense is important especially because of the difficulties of agreeing on legal rules on the European level. Reforming a system that
was found to be inefficient is at least as difficult as agreeing on applicable rules in the first place. Hence, it is all the more important to ‘get it right’ from the very beginning.

3. Improving implementation conditions

A third design principle for an efficient optional CESL relates to the implementation conditions of such a legal regime. The current legal environment in Europe is not ready for the introduction of a CESL. Introducing a CESL without creating ‘hidden diversity’ requires significant changes in European legal education, European legal scholarship, the qualification of judges, etc. These changes don’t come overnight. They take time. Also, the existing European judicial system is not ready for handling complicated sales law cases on a massive scale. Referring cases to the ECJ for seeking guidance on the interpretation of the CESL is a much too cumbersome system. Specialized European private law courts would have to be introduced in order to make the CESL work in practice.

IV. The current flawed design of an optional CESL

If one checks the current design of an optional CESL as proposed by the European Commission against the background of the design criteria developed in section III above, it immediately becomes clear that the Commission’s proposal does not meet any of these criteria. The design of an optional CESL as proposed by the European Commission is clearly flawed.

1. Opting into the CESL is difficult

The European Commission has made it quite difficult to opt into the CESL regime, and it has severely restricted the scope of the option. In B2C transactions, opting into the CESL is not allowed in the standard terms of a business. Rather, an explicit individual agreement is required on the basis of the consumer being informed about the CESL’s effects on his or her legal position by a standard information leaflet. This is very bad news for businesses because they face the prospect of a split market with CESL customers and non-CESL customers and, as a consequence, higher instead of lower transaction costs regarding cross-border trade (Eidenmüller/Jansen/Kieninger/Wagner/Zimmermann 2012). Further, domestic
contracts and B2B contracts of non-SMEs may be brought under the CESL regime on the basis of the Commission’s proposal only if a MS exercises a respective option in Art. 13 of the proposed regulation. Finally, consumers retain their home-state protection under national law according to Art. 6(2) Rome I Regulation despite a CESL choice (Eidenmüller/Jansen/Kieninger/Wagner/Zimmermann 2012, Stadler 2012). The European Commission believes otherwise (see Recital 12 of the proposed regulation) but its reasoning is clearly flawed and violates fundamental principles of private international law. As a consequence, any transaction costs savings associated with harmonization/standardization will also be severely limited. They are even further reduced by Art. 3(3) and Art. 9 Rome I Regulation that guarantee the application of MS’ contract laws in case of transactions that relate only to a MS that is different from the MS whose law has been chosen or allow the application of internationally mandatory rules (Whittaker 2011).

2. The proposed CESL is a defective product

Second, the proposed CESL clearly is a defective product. The main reason for this assessment is the fact that it contains many mandatory and inefficient consumers’ rights. To give just a few examples: The proposed CESL burdens businesses with overbroad information duties that don’t help consumers but rather negatively impact on their decisions (Grigoleit 2011); the proposed CESL contains unjustified rights of withdrawal for consumers – this is true, for example, with respect to distance selling transactions in which only an optional but not a general right of withdrawal can be justified (Eidenmüller 2011c); the proposed CESL contains an unqualified consumer-buyer’s right to reject purchased goods that is not subject to a seller’s right to cure (Eidenmüller/Jansen/Kieninger/Wagner/Zimmermann 2012); finally, the proposed CESL invalidates all limitations of sellers’ damage obligations (Eidenmüller/Jansen/Kieninger/Wagner/Zimmermann 2012). For each of these cases, a detailed analysis reveals the inefficiency of the solution adopted by the proposed CESL. However, these inefficiencies are not the only reasons for the DCESL to be a defective product. The CESL regime contains many regulatory gaps (see Recital 27)
that would create a lot of legal uncertainty – and hence costs – for those opting into this regime.

3. Implementation conditions are highly problematic

Finally, the proposed design of an optional CESL is flawed also because the implementation conditions of the new legal regime would be highly problematic. The European Commission does not consider any reform of the European judicial system nor does it mention how legal education, European legal scholarship, and the training of judges, etc. could or should be reformed to make the legal environment more conducive for the implementation of a European contract law system. The only implementation condition considered by the Commission is transparency of MS’ court decisions on the CESL. The Commission suggests that a data base of these decisions be set up that is accessible throughout the Union. This measure clearly falls short of what would be necessary in order for an optional CESL to become a practical success.

V. Does the flawed design matter?

Do these shortcomings and flaws in the CESL design matter in the sense that there would be significant dangers if an optional CESL were enacted on the basis of the DCESL as proposed by the European Commission?

1. Market success of a defective product

The most severe danger, of course, is the scenario in which a clearly inefficient, and in that sense defective, optional CESL nevertheless becomes a market success. However, this is a highly unlikely scenario, at least on the basis of the provisions proposed by the European Commission (Eidenmüller/Jansen/Kieninger/Wagner/Zimmermann 2012). As already mentioned, choosing CESL in a business’ standard terms is impossible in B2C transactions. Moreover, the DCESL contains many inappropriate (mandatory) rules also for B2B transactions. This regime is distinctly unattractive for businesses, and it cannot be assumed that many would make use of the option as it has been tabled.

However, the rules for opting into the CESL might be changed during the legislative process. Also, the scope of the option might be extended. If a CESL choice
could be done in a business’ standard terms in B2C contracts, and if the CESL could be agreed upon with respect to all B2C and B2B contracts – domestic and international –, a market success of a defective CESL would become a real danger. If the *chapeau* rules were modified as mentioned, it might well happen that the potential transaction costs savings for businesses due to standardization might exceed the additional costs businesses have to face due to inefficient (consumer protection) rules. At some point in time, if enough businesses opt into the CESL regime, the contract law market might tip due to network effects, and the CESL might get entrenched as the dominant legal regime.

2. Establishment of a defective reference text

A market success of a defective CESL would be a highly problematic, albeit unlikely development. Are there any other dangers associated with the optional CESL as proposed by the European Commission? The UK Law Commission and the Scottish Law Commission believe that the answer to this question is No: “Even if the CESL is hardly ever used, no harm would be done”. Is this assessment correct?

There is a real danger that the CESL gets established as a focal point for academic scholarship, legal practice and political processes irrespective of its market success. In that sense, the CESL might become an influential ‘reference text’ (Eidenmüller/Jansen/Kieninger/Wagner/Zimmermann 2012). Costs will be sunk in the CESL that lead actors to push further. The ECJ might resort to CESL concepts as reflecting fundamental principles of European contract law. The European lawmaker in all likelihood would build on CESL concepts when legislating in related fields of European contract law. Enacting the CESL would create strong path-dependencies. It has already been mentioned how difficult it is to change legal products once promulgated on the European level. Hence, enacting the DCESL as it stands would cast in stone a defective legal product and establish a reference text with a potentially very high influence on academic discourse, legal practice and policy making with respect to European contract law. That would be a highly undesirable consequence.
VI. Summary

In this paper I have looked at the proposed optional Common European Sales Law as a regulatory tool. The main question that I have addressed is the following: What can be wrong with an optional CESL? The main results of the paper can be summarized as follows:

1. Important European regulatory objectives in contract law are (i) the reduction of contract-law-related transaction costs in cross-border trade and (ii) the production and selection of efficient contract laws.

2. An optional CESL introduces vertical regulatory competition (RC) in European contract law.
   a) RC might not lead to the desired level of harmonization. However, it can be a mechanism to select efficient contract laws – but certainly not with respect to B2C transactions.
   b) The case for introducing vertical RC with a European contract law is weak.

3. Design principles for an efficient optional CESL are: (i) creating a level playing field with MS’ contract laws; (ii) designing a ‘market standard’ (presumptively efficient rules); (iii) improving implementation conditions.

4. The current design of an optional CESL falls short on all three counts.

5. A market success of the current proposal, if enacted, is highly unlikely. Nevertheless, enacting the DCESL would be dangerous because it would entrench a defective reference text.