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Conclusion

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The fifteen contributions from the members of the Economic Impact Group (EIG) covered many of the main themes of the academic DCFR, certainly as regards contract law. The first part of this conclusion revisits basic principles which came through the various contributions and underpinned the work of the EIG. The second part briefly reviews the outcomes reached in each of the contributions. The third part draws more general conclusions arising from the contributions seen together.

1. Basic principles

1.1. *Function of contract law from an economic perspective*

Well-functioning legal institutions are needed for a free market economy to operate properly. In order for individuals to benefit from the gains of trade, there need to be well-defined property rights that are also enforced, for example. Other aspects of the legal system need to be developed as well: liability law (for protecting individuals and ownership against intrusion), competition law (to avoid the deadweight losses associated with monopolies), bankruptcy laws, etc. Within this general system, contract law determines the rules for how sets of claims can be traded against each other.

From an economic perspective, the basic benefit of contracts is that they allow individuals and market parties to make binding commitments. Within game theory, a basic distinction is made between cooperative and non-cooperative games. In a cooperative game, individual players can make binding commitments and coalitions of players can enter into binding contracts. In a non-cooperative game, neither is possible. As the well-known prisoners' dilemma shows, in a non-cooperative game, players may end up in an outcome that is inefficient. With contracts, an efficient outcome becomes feasible and stable. Contracts thus allow players to reach more efficient outcomes. The rules of contract law govern who can sign contracts, what type of contracts can be signed, under what conditions a contract is established, which contracts will be externally enforced, and what can be done, or what will happen if one of the parties, or both, violate the contract.

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Contracts may be especially useful when the exchange involves a time element. In such situations, for an efficient outcome to be reached, it may be necessary that one of the parties makes an investment first, to be followed by an investment of the second party. If the first investor cannot trust the second one to make the investment, he or she might be inclined not to make the first one, and an efficient outcome will not be reached. Again, a contract may change the incentives in such a way that it becomes in the second player's best interest to co-invest after an investment of the first. In this case, the investment of the first player is "protected", and an efficient outcome can result.

A similar argument applies to insurance contracts. A contract in which a risk-neutral party insures a risk-averse player against the risk of an accident can benefit both players: the insured pays a premium in return for compensation from the insurance company when the accident occurs. Since *ex post*, the insurance company may have an incentive not to pay compensation, a contract that commits the insurance company to do so may be needed in order to realize the mutual gains from trade.

In short, access to contracts induces a different game. Contract law allows the players to change the rules of the game, thereby inducing equilibrium outcomes that are to their mutual advantage, that is, are more efficient. Contract law determines in what way the game may be changed. As such, contract law influences what can be achieved and what not. Specific rules may be needed in order to reach efficient outcomes. In this respect, certain systems of contract law may perform better than other. As one system may function better than another, the inquiry then turns to finding the best contract law system, that is, that system that guarantees efficient outcomes in most of the cases, or at least in those cases that are encountered in practice.

Here, it is important to mention three considerations. First of all, unlimited "freedom of contract" (allowing parties to conclude any contract that they would want) may not be the best system. The reason is that a contract between two parties may impose negative externalities on third parties, and, as such, while being beneficial for the two parties concerned, may influence the third party negatively and reduce total efficiency instead of increasing it. Secondly, as stated at the outset, contract law should be viewed in the context of the entire legal and institutional system that supports trade and other forms of social interaction. The various parts of the system are interdependent: which contract law is optimal may depend on the state of liability law, property law, etc. Thirdly, a similar remark applies to other characteristics of the environment, such as personal preferences and endowments. Contract law responds to the trading opportunities (and associated potential problems) that arise; different opportunity sets may induce different systems of contract law that are "optimal".

1.2. *Methodology and the efficiency standard*

Most of economics is based on "methodological individualism": the analysis starts from individual agents and their personal interests (and resulting incentives), while outcomes resulting from the interaction between these individuals are judged according to how these individuals value them. The individuals each have preferences over outcomes, and an outcome is said to be *Pareto efficient* if there is no other outcome that is preferred by all individuals. In a context of "general equilibrium", economists typically work with this Pareto efficiency criterion. It should be noted that Pareto efficiency leaves distributional issues out of consideration. Alternatively put, there are typically many Pareto efficient outcomes. For example, assume that all individuals, in addition to all kinds of other things, also value money, and that they prefer more to less. In this case, if *X* is a Pareto efficient outcome and *Y* differs from *X* only in that individual 1 gives € 1 to individual 2, then also *Y* will typically be Pareto efficient. The two outcomes *X* and *Y* cannot be compared under the Pareto criterion: individual 1 prefers *X*, while individual 2 prefers *Y*.

In cases of "partial equilibrium" (when the emphasis is on individual transactions or on single markets), it is frequently assumed that preferences are "quasi-linear", that is, that all individuals value money is exactly the same way, hence, that money can be used to transfer utility from one individual to another. In such a case, the utility $u_i(X)$ that individual *i* attaches to the outcome *X* can be viewed as equivalent to the monetary value that *i* attaches to *X* and an outcome *X* is Pareto efficient if and only if there is no other outcome *Y* such that $\sum_{i=1}^{n} \mathrm{u_i(Y)} > \sum_{i=1}^{n} \mathrm{u_i(X)}$. In other words, for quasi-linear preferences, Pareto efficiency corresponds to maximizing the utilitarian social welfare function. This assumption of utilitarianism is maintained in most of the contributions in this volume.

A final remark is in place on whether we should look at total welfare or consumer welfare. To a certain extent, this question is misleading. In the above discussion, we looked at individuals, and in the social welfare function, we looked at *all* individuals. Hence, we looked at total welfare. The distinction between total welfare and consumer welfare appears when, in partial equilibrium, the attention turns to actual markets; it plays a specific role in discussions in competition law. In such specific cases, one distinguishes between producers and consumers, and when one looks at consumer welfare, one looks at the sum of the utilities of the latter group only. One should, however, realize that profits are paid out as dividends to shareholders as well. What would be the justification of leaving out the well-being of the shareholders? The general perspective that we have taken recognizes that consumption is the ultimate aim of all production, and that shareholders ultimately are consuming as well. Total welfare is the appropriate welfare criterion, but in a well-specified model, there is no conflict between total welfare and consumer welfare.

2. Specific conclusions

2.1. *General aspects of contract law*

In her contribution on the function of European Contract law, Filomena Chirico shows that some basic issues concerning the DCFR – and in particular its contract law core – remain unanswered. While considerable attention has been devoted to the functions of a *European* contract law in the course of the debate on whether it is desirable to have such a law, surprisingly little was written or said on the function of contract law in general.

Yet without a shared understanding of the function of contract law, it will be difficult to reach any conclusion on the desirability of a project such as the DCFR. As it went through various iterations, the DCFR did not become clearer as to the functions of contract law.[1] Law and economics literature could have helped in that respect, as set out above. As to the higher-level question regarding the function of *European* contract law, law and economics literature also offers a methodology to assess whether and how the DCFR would indeed fulfil the functions which it is meant to fulfil, namely the improvement of the internal market. The mere fact that national contract laws differ is no sufficient justification; here as well, there are some trade-offs, and attention must be paid to externalities, transaction costs, economies of scale, local preferences and the costs generated by harmonization or unification.

In her second contribution, Filomena Chirico concentrates on the principle of good faith in the DCFR. While good faith is known in civil law systems and some functional equivalents can be found in common law systems, the notion remains vague and fragmented, especially as regards good faith outside of contractual relationships (pre-contractual duties). It is not the best candidate for harmonization at European level. In the DCFR, good faith is defined at Article I.-1:103, but there is no overarching good faith principle. Rather, the DCFR refers to good faith in various specific contexts throughout. In economic terms, good faith cannot be a mandatory rule, but rather a gap-filling tool that parties are free to contract around. In fact, this is implicitly recognised in other rules of the DCFR (Art. II.-9:101 for example), as well as explicitly stated in the Comments. The formulation should be made clearer and more explicit. A mandatory rule is justified only in specific cases where the risk of opportunism is structural (possible both in the pre-contractual phase and in the course of performance). However, such concerns are better addressed by more specific rules rather than a general principle.

In her contribution, Ann-Sophie van der Berghe found that the principle of non-discrimination as stated in the DCFR seems over-inclusive, failing as it does to distinguish between taste-based and statistical discrimination. In competitive markets, taste-based discrimination could be eliminated (or at least minimised) by market forces; acting against such discrimination can be justified under certain circumstances, but the intervention could seek to educate rather than prohibit. In contrast, statistical discrimination is generally efficient. The use of statistical proxies to guide decision-making reflects a trade-off between accuracy and information costs. A outright prohibition on both types of discrimination is likely to reduce the signalling function of certain – statistical – discriminatory forms of behaviour which are suitable to minimise costs for society (although this is an empirical question to be investigated – insurance, hairdressers, car dealers etc.). Against that background, the DCFR at Article II.-2:101 and ff. does not necessarily focus on the most injurious grounds of discrimination, and

[1] In the Christian von Bar et al., eds., *Principles, Definitions and Model Rules of European Private Law – Draft Common Frame of Reference (DCFR)*, Outline edition (Munich: Sellier, 2009), published after the contribution of Filomena Chirico was completed, the 'functions' and 'aims' have been replaced by a set of 'principles', comprising 'underlying' principles (freedom, security, justice and efficiency) as well as 'overriding' principles (protection of human rights, promotion of solidarity and social responsibility, preservation of cultural and linguistic diversity, protection and promotion of welfare and promotion of the internal market): see para. 15-22, pp. 13-17 and the discussion of the new 'Principles' section *infra*.

furthermore efficient statistical discrimination could still fall outside of the justification clause at Article II.-2:103.

2.2. *Formation and interpretation of contracts*

According to Mitja Kovač and Gerrit de Geest in their joint contribution, the rules of the DCFR on the duty to disclose information (Articles II.-3:101 and ff.) and on contract formation as it relates to informational defects (Articles II.-7:201 and ff.) are generally consistent with economic analysis. That conclusion is in part based on a reading of the provisions together with the accompanying comments; a number of key provisions (Articles II.-3:101 on the duty to inform and II.-7:201 on mistake) would gain from being worded more precisely, in line with those comments. Furthermore, a number of provisions require a showing of materiality, i.e. that a party would not otherwise have contracted (if she had better information, at Article II.-7:204, if there had been no mistake, at Art. II.-7:201). The filtering function of such a requirement would be more efficiently achieved with other means: procedural rules (to discourage nuisance litigation) or fine-tuning the remedies (for example allowing only damages and not the possibility to avoid the contract in minor cases). Finally, Kovač and de Geest conclude that there is no need for separate doctrines on mistake, fraud, misrepresentation or latent defect — all that is needed is a duty-to-inform doctrine.

As regards the interpretation of contracts, Geerte Hesen and Robert Hardy set out how, in contract theory, transaction and enforcement costs and information asymmetries can lead parties not to conclude complete contracts, which would provide for every possible future state of the world. Incomplete contracts imply that interpretation is needed to fill in the gaps in the contract. Law and economics literature puts forward a number of different interpretation rules. If is the starting assumption is that parties want to make complete contracts, a textual or objective rule ("plain meaning", "four corners" of the agreement) would be more efficient. If on the other hand it is assumed that parties make incomplete contracts, a contextual or subjective inquiry into the intent of the parties could be preferable. In addition, the choice of default rule (majoritarian, hypothetical standard, penalty) affects the outcome considerably. The DCFR, at Articles II.-8:101 and 8:102, retains a subjective interpretation rule which is at variance with the practice of international transactions, where the textual or objective rule which usually prevails. Other interpretation rules at Art. II.-8:104 and 8:107 are more in line with what law and economics literature would predict.

Information asymmetries are also central to the regulation of standard contract terms, according to Hans-Bernd Schäfer and Patrick Leyens. Indeed, contrary to what is often assumed, market power does not provide an economic justification for judicial control of standard contract terms. Rather, the party which receives standard terms will typically not be willing to incur the information cost of reviewing them, in view of the limited gain expected from that operation. Competition in the formulation of standard terms will accordingly not work, with the risk of a race to the bottom. Intervention would be justified in the presence of such a market failure. Against that background, the judicial control of standard contract terms should not extend to terms which the parties have negotiated, and Article II.-9:403 DCFR should be formulated accordingly. The exclusions at Art. II.-9:406 (compulsory terms, subject-matter of contract, price) are also in line with economic analysis. However, the differentiated tests applicable to consumer and business contracts at Art. II.-9:403 and 9:405 respectively are difficult to justify: the information asymmetry rationale set out above applies to both with equal force. It would have been preferable simply to put a cap on the contractual value of business contracts for which standard terms are reviewable, on the ground that above a certain contractual value it is worth it for a business to incur the information costs linked to assessing the standard terms. In order not to give adverse incentives to the party formulating standard terms, judicial control should lead to the nullity of the term as against the receiving party, as is provided at Art. II.-9:408. Judicial adjustment of terms so as to reduce them to the greatest burden still acceptable to the receiving party (salvatory reduction) is efficient only in the limited areas where the legality of the standard term is not clear to the party stipulating it.

2.3. *Performance of contracts*

Among the main issues of contract law, performance of contracts has received much attention lately, with the adoption of EC-level legislation touching upon key elements of contract performance – at least as regards sales – and reforms in some major legal systems (Germany). Law and economics literature on the topic is also quite diverse. The contributions of Gerrit de Geest, Anthony Ogus and Urs Schweizer all touched upon different aspects of contract performance.

At the outset, as Anthony Ogus points out in his contribution, the case for harmonising the principles of contractual damages as remedies is weak. There are clear differences in local preferences, and they affect distributional issues, which are best left at national level (similarly to taxation). At the same time externalities and cross-border transaction costs so not seem to play a big role. There are, however, economic arguments in favour of providing a set of default principles that parties could choose, or else guidelines to which courts may refer in interpreting national laws.

As a general starting point, it is clear from all contributions that from an economic perspective, remedies for breach are not important because of the necessity to compensate or to restore rights, but in so far as they give ex ante incentives to enter into efficient contracts and to perform efficiently, i.e. in a way that increases the welfare of the parties and of society. In particular, law and economics has developed the notion of 'efficient breach': if circumstances change such that the parties no longer attach the same value to the performance of a contract, then at a certain point the performance of the contract is no longer welfare-enhancing (value is destroyed overall). From a welfare perspective, it is then more efficient that the contract is not performed.

According to Gerrit de Geest in his contribution, in the 'efficient breach' zone, in principle no remedy should be awarded for non-performance, save in limited circumstances. In contrast, in the 'efficient performance' zone, three remedies could be available in order to give sufficient *ex ante* incentives not to breach: specific performance, substitute performance and expectation damages. Specific performance is applicable only in very few cases, and in practice substitute performance is the superior remedy, with expectation damages for the remaining cases. The DCFR seems to follow the law and economics literature with a provision which comes close to the efficient breach rule at Article III.-3:302(3) and III.-3:104 (in cases where production costs have increased markedly) and III.-3:301 (where the utility to the creditor has decreased). In cases where a breach is efficient, the rules found at Articles III.-3:701 and III.-3:104 are also in line with law and economics analysis. Similarly, in cases where performance is efficient, the solutions found at Articles III.-3:302 and III.-1:110 are adequate. However, Article III.-1:110 (3)(d), which imposes upon contract parties a duty to renegotiate in good faith before one of them can proceed to terminate a contract, is superfluous (parties can always negotiate if this is more efficient) and at worst harmful (parties have an incentive to play a game of chicken and waste time).

In his contribution, Anthony Ogus looks at which standard should be used to measure contractual damage awards: expectation, reliance or opportunity cost. In line with the 'efficient breach' theory, Article III.-3:702 DCFR provides for expectation damages as a default rule, i.e. the creditor is put in the position where it would have been if the contract had been performed. However, law and economics literature outlines circumstances where expectation damages might be inadequate. For instance, the creditor might have difficulties in monitoring performance, in which case punitive damages, going beyond the expectation standard, are necessary to cure incentive problems which could arise on the side of the debtor. Except for the allowance for penalty clauses and liquidated damages at Article III.-3:710, the DCFR does not acknowledge that issue. Conversely, under certain circumstances, it is more efficient to depart from the expectation damage standard and award less to the creditor. Firstly, the creditor is meant to mitigate losses after the breach (the loss becomes then the opportunity cost to the creditor); Articles III.-3:705-707 are in line with economic analysis in this regard, Secondly, the creditor should take precautions to ward off the risk of breach, while not going beyond what it reasonable: the rule of Article III.-3:704 deals with the case of failure to take preventive steps. Article III.-3:703 DCFR, by limiting recovery to foreseeable damages, gives an incentive for the disclosure of information and for a limitation of reliance expenditure by the creditor. The treatment of penalty clauses in the DCFR is ambivalent: on the one hand, Article III.-3:710(1) allows penalty clauses, recognizing that they make economic sense, as a signalling device (as to the reliability of the promisor) and as an insurance (for the non-pecuniary value of performance, for example). Yet paragraph 2 of the same rule is problematic because, by enabling courts to reduce "grossly excessive" damages, it takes away such signalling function without qualification and without putting it in the correct context (of market failures in negotiating the clause or contractual externalities, for example).

In his contribution, Urs Schweizer analyses these provisions with the help of a game-theoretical model, where the debtor has to decide on whether and how to perform a contract, and where the decision on performance has an impact on the payoff for the debtor, but also for the creditor. The sum of both payoffs is the social surplus, which is maximized for a level of performance which may or may not coincide with what is stipulated in the contract. By affecting the payoffs, the law can give an incentive to the debtor as to whether and how to perform. Using that model, it can be shown that the expectation standard for damages at Article III.-3:702 DCFR is efficient, albeit that practical difficulties are likely to result in a downward bias in damages awards, which distorts the incentives of the debtor. Article III.-3:601 offers an alternative, in that the creditor may opt to reduce the price proportionately to the decrease in value, in view of inadequate performance. 'Decrease in value' is left indeterminate: is it the subjective willingness to pay of the creditor (which is hard to assess) or something more objective? That remedy is superfluous if it exists in addition to damages; in the absence of damages, it may lead to distortions. Instead of the decrease in value, it would have been more efficient to refer to a hypothetical bargaining (as in Articles III.-3:513 and VII.-5:103) as the standard for the price reduction. On the creditor's side, the requirement to mitigate losses (Article III.-3:705) is not necessary to achieve efficient incentives for the creditor, but it is not harmful. The ability to obtain damages may generate excessive reliance incentives; accordingly, it is efficient to allow the debtor to excuse non-performance at Article III.-3:104. However, that provision refers to a vague 'impediment beyond the debtor's control' instead of simply excusing non-performance whenever it is not profitable, which would have given efficient incentives to the creditor as well. As regards termination of contracts, the finely-tuned provisions of Articles III.-3:502 and 3:503 – with the distinction between fundamental and non-fundamental breaches (and the additional notice period in the case of the latter) – are hard to justify from an economic perspective; a simple right to terminate for non-performance would have been equally efficient. Finally, with the help of his model, Schweizer also shows that the law should allow for compensation (if only partial, based on statistics) in cases of uncertain causation (including loss of a chance); the DCFR is silent on this point.

2.4. *Termination of contracts*

In his contribution, Mitja Kovač examines the general rules on the termination of contracts – by agreement or by unilateral notice – found at Articles III.-1:108 and III.-1:109 DCFR. As a starting point, from an economic perspective, it is sensible not to allow parties to terminate contracts unilaterally, but rather to use the principles developed concerning contractual performance (the concept of "efficient breach" set out above). Indeed, allowing for termination risks increasing transaction costs, encouraging opportunistic behaviour, destroy incentives to contract and generally cause inefficiencies; these conclusions hold in particular for fixed-term contracts. Termination as a default rule makes economic sense in two cases only: for long-term relational contracts (more below in the contribution of Gomez) and if parties themselves provide for termination in their contract. Accordingly, Article III.-1:108 is in line with law and economics literature by allowing parties to agree on termination. Article III.-1:109, which governs termination by notice (unilateral), suffers from two shortcomings, however: it contains no requirement of good faith or other requirement which would act as a brake on opportunism and cheating, and furthermore the criteria to assess the length of the notice period could be clarified by referring to the time required to recoup specific investments, cease to incur reliance expenses, etc.

One of the most innovative elements of the DCFR remains its treatment of service and commercial contracts. Fernando Gomez assessed the provisions concerning commercial agency, franchising and distributorship at Articles IV.E.-1:101 and ff., and in particular the rules on termination and eventual compensation, usually the most vexed legal issues in such long-term relationships. Economics analyses these relationships as relational contracts, where the open-endedness of the relationship changes the incentives of the parties (it becomes an infinitely repeated game). In such relationships, termination (including the threat thereof) is both a powerful disciplining tool and a potential expropriation mechanism. Indeed, empirical evidence shows that when legislation imposes restrictions on termination, incentives are distorted: one observes more terminations, and for more trivial reasons. In particular, restrictions on termination for non-verifiable instances of breach are objectionable. In addition, when it comes to compensation upon termination, Article IV.E.-2:303 provides for damages (expectation interest) if no reasonable notice is given. In practice, if compensation is not linked to some behaviour of the terminating party which amounts to a breach (typically, opportunistic or hold-up behaviour), then the availability of compensation distorts the incentives of parties during the life of the contract. Article IV.E.-2:303 seems to aim at protecting "general investment" (not specific to the relationship), as opposed to specific investment (which is exposed to the risk of opportunistic behaviour and hold-up). However, economic analysis predicts that it is unnecessary and even detrimental to protect general investment, because parties will likely deal with it (absent transaction costs, as it seems the case) and the will of the parties may be different from what the law imposes (hence a mandatory rule will reduce efficiency – except if bounded rationality is present). Protecting specific investment, especially if it is cooperative (carried out for the benefit of both parties), is however efficient, and there expectation or reliance damages perform better than gain-based liability as set out at Article IV.E.-2:305 DCFR. The DCFR represents a welcomed systematisation, as compared to the Commercial Agents Directive: for example, the DCFR eliminates the reference to franchising, for which empirical data contradicts the approach of the Directive. However, reliance on the *acquis* does limit the added value of the DCFR, which could otherwise have offered an opportunity to improve the choices made in the Directive (unsatisfactory outcome of a compromise between national systems). The Directive seeks to protect commercial agents, a policy objective which is not necessarily appropriate in the context of franchising or distributorship. It is acknowledged, however, that full systematisation is a very difficult task, given the state of the research.

2.5. *Specific areas of contract law*

Although a project group was in charge of developing Principles of European Insurance Contract Law (PEICL), these principles were ultimately not included in the DCFR. In his contribution, Tomas Kontautas assesses the PEICL. As a starting point, the failure to include insurance contracts in the DCFR is likely to increase transaction costs because cross-border insurance contracts do not take place in a vacuum but in relation to other cross-border contractual relationships which may, ideally, refer to the DCFR. In general, the PEICL seem to ignore that insurance contracts fulfil an essential economic function. The PEICL approach seems to be too legalistic, often aiming just at the protection of one party without due regard to the consequences of the legal rules on behaviour of other parties and, hence on the effectiveness of the rules themselves as well as on the efficiency of the final outcome. For instance, for large-risk insurance contracts, mandatory limitations (inspired by consumer protection) are not justified, and the PEICL are then better used as a default set. Furthermore, the economic function of insurance contracts includes risk allocation. This should be stated in the definition of insurance contracts, in order to make clear to judges that interpreting the contract in favour of the insured has effects not only on the insurer, but also on society. Finally, the disclosure duties of the policyholder are fundamental and should be strengthened in the draft, including all intentionally withheld information, even beyond the questions explicitly asked by the insurer. The PEICL also introduces duties on the part of the insurer (as to the scope of coverage). The strategic interactions between parties as to reciprocal disclosure of information may give rise to opportunistic behaviour.

In their contribution, Kati Cseres and Hanneke Luth examine how the DCFR fares as regards consumer protection. After all, the set of EC directives which inspired the work of the Acquis Group (which then fed into the DCFR) are mostly concerned with consumer law. It is interesting to assess whether and how the consumer protection objectives of the original directives survive in the more general DCFR. Cseres and Luth first note the discrepancy between the principles which are supposed to underpin the DCFR (contractual freedom) and the paternalistic approach behind the provisions concerning information duties, right of withdrawal and standard contract terms. There is no clear model of consumer behaviour which informs these consumer-related provisions: are consumers to be protected because they are weak or because they suffer from information asymmetries? Are consumers fully rational (as neo-classical economics would assume) or is their rationality bounded (as newer strands of research in behavioural economics would hold)? For instance, Article II.-3:102 DCFR refers to the disclosure of information "as the average consumer needs in the given context to take an informed decision on whether to conclude a contract", without further explanation. As a consequence, the rules actually included in the DCFR do not seem to be based on the analysis of the relevant trade-offs, including the identification of market failures and the costs of consumer protection. For one, the definition of 'consumer' at Article I.-1:105 DCFR avoids the trap of excluding businesses acting outside of their trade, but it could be more focused on the key issue, namely information asymmetries. Similarly, the right of withdrawal is generalized at Article II.-5:101 and ff., but it is not clear that a generally defined right is adequate in all situations (the market failure might vary from one situation to the other), raising the possibility that consumer remedies might be too generous in certain cases, thereby opening the door to opportunistic behaviour from consumers.

2.6. *Non-contractual liability*

In their contribution, Assunção Cristas and Nuno Garoupa venture into the boundary between contract law and tort law, an issue where legal systems are known to diverge. In law and economics literature as well, the models used to analyse contract and tort go out from different assumptions. Cristas and Garoupa look at a number of flashpoints. First of all, contractual breaches can result in injury to third parties. In a case where repair work is badly executed but the prejudice becomes manifest only when the good is in the hands of a subsequent buyer, the DCFR would direct the subsequent buyer to sue the seller. Economic analysis would rather leave the door open to a suit against the repairperson as well, depending on transaction and monitoring costs for the quality of the repair. Secondly, if a third party induces a breach of contract, the concept of 'efficient breach' discussed earlier would be decisive: if the induced breach is efficient, the law should not punish it. Only inefficient breaches should be deterred. At Article VI.-2:211, the DCFR does not make that distinction, and allows liability for any inducement to breach a contract. Thirdly, a number of situations are quasi-contractual in nature (including pre-contractual dealings). In these situations, the DCFR (see Articles II.-3:301, II.-7:214, VI.-2:210 read with VI.-7:214) provides for reliance damages, which are the second-best solution (the first-best being impracticable). Fourthly, a contractual breach can also qualify as a tort as between the two contractual parties: this is the famous *cumul* issue. Here economic analysis would advocate caution in using tort liability to upset the agreement of the parties, considering that the price internalized the possibility of loss. Any *ex post* benefit in allowing cumul would have to be offset against these *ex ante* effects.

The last contribution, by Pierre Larouche, assesses first whether the law of non-contractual liability is a good candidate for harmonization or unification. In line with most of the law and economics literature, the answer should be no. The internal market and rights-based arguments advanced to support harmonization are not convincing. Subsequently, the contribution looks more closely at a central element of the system of tort law of Book VI DCFR, namely the use of the concept of 'legally relevant damage' to place *a priori* limits on non-contractual liability (and in particular, to exclude liability for pure economic loss). As a preliminary matter, the comparative method apparently used in Book VI DCFR, and in particular for the elaboration of 'legally relevant damage', is deficient. It is a mere superimposition of the very different devices used in German and English law, without regard for the underlying policy choices. The open-endedness of English tort law is jettisoned, and French law seems altogether ignored. What is more, developments in European level seem to have played no role in what is a European project: the ECJ has expressly and repeatedly stated that any *a priori* exclusion of pure economic loss from liability for breaches of EC law would violate EC law. The DCFR is thus at odds with EC law. In substance, the use of *a priori* limitations on liability through the concept of 'legally relevant damage' has no significant effect on welfare. It is so complex that it cannot produce any strong incentive to reach the appropriate level of care. It does not lead to more efficient loss-spreading either; more recent economic analysis no longer considers that pure economic loss is essentially private and not social loss. It does not either reduce the cost of administering tort law, since it is too elaborate to allow expeditious administration. Furthermore, any gain is probably cancelled out by the loss of flexibility and accuracy which ensues when the legislature tries to map out the scope of liability law *ex ante* in detail. In the end, no efficiency or welfare gain follows from the introduction of an *a priori* limit such as the concept of 'legally relevant damage' at the DCFR; at the very least, the specific rules of Article VI.-2:201 to 2:211 should be taken out, and unmeritorious cases should be filtered with the usual concepts of accountability and causation instead.

3. General conclusions

The aim of the Economic Impact Group was to investigate specific parts of the DCFR, as opposed to producing an additional collection of essays on the pros and cons of a harmonized or unified European private law. At the end of the exercise, a number of trends emerge, from which useful general conclusions can also be drawn.

The analysis conducted within the Economic Impact Group played out at two levels. The first one is the choice of the optimal regulatory level (whether to harmonise certain elements of the law or not); the other one is the choice of the optimal design of the rules. Economic analysis can contribute to both levels.

Starting with the first level (appropriateness of harmonization or unification at European level), contributors were generally reserved about top-down approaches (not to mention European-level codification). In this respect, the oft-cited transaction costs arising from different national legal systems in cross-border transactions are important but at the same time they are only one of the relevant concepts used in economic analysis.[2] A full analysis takes into account the costs and benefits, both of the current situation and of any harmonization or codification. The current state may impose costs by way of cross-border externalities and transaction costs due to divergence, but at the same time it may provide benefits in respecting local preferences[3] or allowing for dynamism and experimentation in the development of the law (which benefits society as it searches for the optimal law). Similarly, while harmonization or unification may bring benefits by removing the costs of divergence or reaching economies of scale in the production of law, it can also generate costs to adapt local systems, induce distortions in the coherence of local systems, produce hidden divergence despite superficial harmonization and ultimately fail to attain its objectives.

In the area of contract law, much depends on the legal status of the DCFR. Of course, the DCFR can be a reference tool, a restatement without binding force, in which case the discussion is moot. If the DCFR is an optional instrument – a 28th legal system in the EU – the downsides of harmonization or unification, as described above, are less likely to arise. At the same time, the benefits will probably also be smaller. In a dynamic perspective, however, an optional DCFR might contribute to creating the momentum necessary for bottom-up convergence to occur, through regulatory competition or other mechanisms whereby legal systems are subject to pressure to change and improve

[2] In its Communication on European Contract Law and the revision of the acquis: the way forward, COM(2004)651 final (11 October 2004) at 11, the Commission concludes from available studies that “there are no appreciable problems arising from differences in the interaction between contract law and tort law in the different Member States”.

[3] These local preferences must be ‘genuine’, in the sense that the preferences expressed by local decision-makers might be a result of path dependency or government failure (rent-seeking) at local level instead of reflecting the actual preferences of the local population.

(impact assessments, law reform exercises, proportionality test in constitutional or EC review, etc.).

In other areas, such as non-contractual liability (Book VI), but also other areas of non-contractual obligations (Books V and VII) or in property matters (Books VIII to X), the choices are starker. These areas of law do not lend themselves so easily to optional regimes, given that they are concerned with situations where the actions of individual impose costs or provide benefits on third parties without the latter having consented. The DCFR in these areas can then either remain an invaluable reference resource, or be enacted as mandatory law. In the latter case, as outlined above, it is open to question whether harmonization or unification will truly be beneficial at this stage in the evolution of European private law.

Moving now to the substance of the DCFR, the contributions show that for a significant number of the rules and principles under study, the DCFR is in line with law and economics analysis. For instance, the rules on formation and interpretation of contracts, on performance, on termination are by and large in line with economic theory, when properly interpreted. However, the formulation of these rules may sometimes support a different interpretation, which may result in inefficient outcomes.

Nevertheless, three lines of criticism remarks emerge from the contributions. The first is more benign in nature, but the last two are fundamental.

First of all, in many cases, recourse to the commentary is necessary to establish that a provision is in line with economic analysis (assuming that the provision is interpreted in line with the commentary). Only in the commentary is the rationale of the rules made explicit; in the light thereof, one can then see that it is consistent with economic analysis. Given that the commentary is less normative than the rules of DCFR, some of the insights currently in the comments could be moved into the text of the rules so as to achieve greater clarity and reduce risk of inefficient interpretation. Such was the case for Articles II.-3:101 (duty to inform), II.-7:201 (mistake) and III.-3:104 (excuse for non-performance). Article II.-3:101, in particular, is tautological on its face: parties will reasonably expect what the law tells them is indeed reasonable to expect. Of course, the comments provide more precise criteria (referring to the costs of generating the information). Greater attention to law and economics literature in the drafting groups would have allowed for these provisions to be drafted more sharply.

Secondly, on a number of occasions, the rules found in the DCFR seem to have been formulated without a complete assessment of their rationales, which economic analysis would have made possible. For one, the provisions on discrimination at Articles II.-2:101 and following do not distinguish between taste-based and statistically-based discrimination, whereas economic analysis shows the difference between the two forms of discrimination and why as a matter of public policy it would be advisable to treat them differently. A similar problem arises as regards liability for interference with contractual obligations, at Article VI.-2:211, where the DCFR fails to distinguish between cases of efficient breach and efficient performance. The rules of compensation for termination of long-term contracts at Article IV.E.-2:303 also ignore the distinction between general investments and relationship-specific investments. Conversely, for the control of standard terms, consumer and business contracts are subject to different tests (Articles II.-9:403 to 9:405), whereas the policy concern underlying the control of standard terms (information asymmetry) is similar. With respect to consumer-related provisions and to non-contractual liability, contributors have also noted that the DCFR does not seem to be based on a clear policy line, whereas the available policy choices were set out in the law and economics literature.

Thirdly, the drafters of the DCFR seem to have been oblivious to the *ex ante* impact of the DCFR. Yet law and economics analysis demonstrates consistently and repeatedly that legal provisions not only enable a normative judgment on behaviour *ex post*, but also (and perhaps more importantly) that they affect behaviour *ex ante*, by creating expectations and shaping incentives. These expectations and incentives must be factored into the design of the law, lest the law cause more harm than good. For instance, while in principle economic analysis would support expectation damages for contractual breach (see Article III.-3:702), difficulties in monitoring performance and enforcement mean that it might be necessary to increase expectation damages in order to keep the debtor incentivized to perform the contract. Similarly, while it might seem sensible *ex post* to reduce excessive penalty clauses (Article III.-3:710(2)), the rule is too broadly formulated and it risks depriving penalty clauses of their signalling function. The rules on termination are especially problematic in this respect. One contributor pointed out that the duty to renegotiate in good faith before requesting a court to terminate a contract (Article III.-1:110(3)(d)) could give an incentive to parties to play wasteful games. Another noted that the rules on termination with notice (Article III.-1:109) do not prevent opportunistic behaviour and cheating. As regards the termination rules for long-term, relational contracts (agency, franchising, distributorship) at Article IV.E.-2:303, a third contributor found the same flaw: in the absence of any requirement that the terminating party behaved opportunistically before the other party is entitled to compensation, the incentives of the parties are distorted. A fourth one found that the distinction between fundamental and non-fundamental breaches, in the specific termination rules of Articles III.-3:502 and 3:503, was hard to justify.

In a sense, the work of the Economic Impact Group highlights and documents criticisms which have been levelled at the DCFR – and at a certain conception of private law scholarship – elsewhere in the literature. It has been said that privatists are prone to conceive of their work as ‘technical’ and devoid of policy and political dimension; it can be argued whether this is genuine belief or strategic positioning.[4] Privatists also tend to see private law in a vacuum, as a neutral instrument in the hands of private parties, including a few mandatory rules. The interplay between the law and the behaviour of private parties, in particular the way the law influences that behaviour through incentives, expectations, etc. is downplayed.

[4] See on this issue M.W. Hesselink, ed., *The Politics of a European Civil Code* (The Hague: Kluwer Law International, 2006), and in particular the eponymous contribution of the editor at 143-170.

By way of response to these criticisms,[5] the drafters of the DCFR have included a separate and more elaborate section on 'principles' in the final version of the DCFR.[6] According to that section, four principles underpin the whole of the DCFR: freedom, security, justice and efficiency. The 'principles' section reads very well, but it sometimes comes closer to an exercise in style than a real discussion of principles and policy orientations. In turn, each principle is shown to inform certain elements of contract law (Books II to IV DCFR), non-contractual obligations (Books V to VII) and property law (Books VIII to X). While it is acknowledged that the principles conflict with one another,[7] the presentation is anecdotal, noting that one principle sometimes wins, sometimes loses. So while the 'Principles' section is useful to understand the DCFR better, it paints a far too calm and rosy picture of private law, which belies that the section was written after the DCFR had been drafted, and not beforehand.

From an economics perspective, the most troublesome part of the 'Principles' section is the treatment of efficiency as a principle. While the inclusion of efficiency in the list is to be welcomed, the reluctance of the drafters towards 'efficiency' is unmistakable: it is "more mundane and less fundamental" than other principles, "but it is nonetheless important and has to be included".[8] When efficiency is discussed in greater detail later on, it is split between "efficiency for the purposes of the parties who might use the rules" and "efficiency for wider public purposes".[9] The former appears concerned with reducing transaction costs, as evidenced by the examples given (minimal formalities, minimal substantive restrictions, efficient default rules).[10] The latter type of efficiency is equated with the promotion of 'economic welfare'.

At the same time, efficiency concerns are present throughout the 'Principles' section without this being acknowledged explicitly. For instance, the justification for freedom of contract is based on efficiency, and externalities are invoked as the reason why contract law might intervene to restrict freedom of contract.[11] Furthermore, the principle of security as applied to contractual transactions, implies a trade-off between certainty and flexibility in the contractual rules, which is none other than the law and economics debate between rules and standards.[12] Finally, the principle of justice is said to imply that parties are not allowed to rely on their own unlawful, dishonest or unreasonable conduct, to take undue advantage of others or to make grossly excessive demands. Here as well, the discussion would have been bolstered and sharpened by pointing to economic concepts such as market power or hold-up and opportunistic behaviour.

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[5] And also as a consequence of the work of another CoPECL group led by the *Association Henri-Capitant* and the *Société de législation comparée*: see DCFR, Introduction at para. 11 and ff.
[6] DCFR, Principles at pp. 57 and ff.
[7] Ibid. at para. 1.
[8] Ibid.
[9] Ibid. at para. 54.
[10] Ibid. at para. 55-57.
[11] Ibid. at para. 3. Other types of market failure (information asymmetries, prohibitive transaction costs) are not mentioned.
[12] Ibid. at para. 22. Including references to law and economics literature would have enhanced the discussion.

In sum, the ‘Principles’ section evidences too narrow a view of the significance of economic analysis for an enterprise such as the DCFR. Economic analysis is concentrated under a separate ‘efficiency’ principle, which in turn is given a subsidiary role. The real value of law and economics is not so much at the normative level, but rather at the analytical level. Irrespective of the policy objective pursued, the law can be subjected to an economic analysis: freedom, security and justice can be more or less efficiently achieved, depending on the content of the law. It is the role of law and economics to point to inconsistencies in the design of the law and suggest how it could more efficiently reach its objectives.

The above remarks lead back to a key shortcoming of the DCFR, namely the lack of a solid methodological basis. Economic analysis was not used, and neither were the policy choices underpinning private law investigated in depth. In the absence of democratic legitimization for the drafting groups, in the end only a group of high-level legal specialists remain. Their expertise is beyond doubt, but it is not clear how they came to their conclusions and whether they applied the same methods consistently throughout. They produced a momentous work in putting together the DCFR, but it remains a fragile accomplishment.