

# **Is the Common Frame of Reference on contract law proposed by the European Commission an inspired idea or a distraction?**

Due to divergences in national legal systems within the European Union, it is argued that this appears as a barrier to trade and causes transaction costs and lowers economic trade and welfare, in particular by creating legal uncertainty. As a possible solution it is considered the unification or harmonization of the diverging national laws. However, the present debate on unification of the European contract law shows that a number of companies do not regard the diversity in laws as an impediment to trade. The European Commission undertook the initiative on the creation of a 'Common Frame of Reference' (CFR) and review of the *acquis*. The CFR is proposed to be a handbook of principles, definitions and model rules of contract law, based on best solutions in existing European Union and national laws.

It is presumed that such harmonization of European Contract Law would replace the 27 systems of national contract law with a single European Contract Code. Perhaps it could solve a lot of questions. But the next issue arises – is this harmonization is necessary?

The present paper starts with a brief outline of CFR, its goals and content as envisaged by the European Commission. I shall then continue to discuss the relationship between CFR and international commercial law, the points of convergence and divergence in the CFR, UNIDROIT and other international commercial law principles. Further, I briefly survey the existence of mandatory rules in the CFR and in international commercial law generally and the interface between the optional instrument and mandatory national laws. Finally, I submit some conclusions as to the necessity of European contract law harmonization, in particular CFR.

## **I. The concept of CFR in European Contract Law**

### **1. CFR – a Definition. The CFR as a new idea or a renewal of old thinking**

First of all CFR stands for Common Frame of Reference. The issue of harmonization of European contract law through the CFR is addressed at the European level and at present time is highly discussed.

The idea of CFR emerged from a process of statements, papers and consultations commencing in 1999 with a request by the Council of Ministers in Tampere for an “overall study” on the need to approximate the civil legislation of Member States “as regards substantive law .... in order to eliminate obstacles to the good functioning of civil proceedings”.

After consultation, a Commission Action Plan in 2003<sup>1</sup> mooted the idea of a CFR to “provide for best solutions in terms of common terminology and rules, i.e. the definition of fundamental concepts and abstract terms like ‘contract’ or ‘damage’ and of the rules that apply, for example, in the case of non-performance of contracts” and, secondly, “to form the basis for further reflection on an optional instrument in the area of European contract law.”

Parliament and Council endorsed the idea, and the CFR was set in motion by a further Commission document dated 11 October 2004 “European Contract Law and the revision of the *acquis* - the way forward”<sup>2</sup> followed by a Call for Interest<sup>3</sup> likewise ostensibly related to the improvement of the *acquis*.

### **2. The goals and contents of a CFR**

On the question of what the CFR will look like, the Action Plan gave some broad hints that the CFR would not be just a set of definitions: the Action Plan seemed to envisage a statement of rules<sup>4</sup>.

The CFR would “aim to identify best solutions, taking into account national contract laws (both case-law and established practice), the European *acquis* and relevant international instruments, particularly the UN Convention on Contracts for the International Sale of Goods Act of 1980 (CISG)” and “The structure envisaged for the CFR .... is that it would first set out common

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<sup>1</sup> 2003/C 63/01.

<sup>2</sup> COM(2004) 651 final.

<sup>3</sup> 2004/S 148-127525.

<sup>4</sup> Action plan, paras. 62-63

fundamental principles of contract law, including guidance on when exceptions to such fundamental principles could be required. Secondly, those fundamental principles would be supported by definitions of key concepts”. Thirdly, these principles and definitions would be completed by model rules, forming the bulk of the CFR. A distinction between model rules applicable to contracts concluded between businesses (B2B) or private persons and model rules applicable to contracts concluded between a business and a consumer (B2C) could be envisaged”. Consumer and insurance contracts might be the subject of specific focus.<sup>5</sup>

It is argued that not all Member State would agree to a European contract code to replace national laws. There are more questions about the optional instrument, however. One is whether it should be a system that the parties must opt in to; or one that will apply if they do not opt out, as with the CISG where international sales are concerned. The answer must be linked to the second major question: should it apply only to cross-border transactions within the EU or also to domestic transactions? It would be acceptable to permit parties to choose the optional instrument even for domestic transactions if they so wish — but that they should have to make a positive choice, rather than be bound by it unless they opt out. The latter would pose too large a threat to national laws.

Perhaps the strongest argument for an optional instrument, at least if it is employed on an opt-in basis, is simply this: if parties wish to use such an instrument, what grounds do we have to stop them? Those who argue against unification of the community law often give as a reason the preservation of freedom to choose a particular system of law that suits the needs of the transaction. Exactly the same argument supports the creation of an optional instrument. And if gradually the optional instrument comes to displace national laws, it will be as the result of more or less conscious choice by the users of the law.<sup>6</sup>

The idea to create a unified legal system in Europe is not a new one. When we study how the Romans unified Europe, the parallels soon become obvious. The Romans developed a system of laws, courts and administrative skills to manage their empire. Today, Roman law forms the basis of

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<sup>5</sup> Lord Jonatan Mance. Is Europe aiming to civilise the Common Law? *European Business Law Review*, 2007; 18 (1) p.77-100.

<sup>6</sup> Hugh Beale. The Development of European Private Law and the European Commission’s Action Plan on Contract Law. *Juridica International* 10 (2005).

legal codes in France, Italy, Latin American countries—and the EU, as well as much international law.<sup>7</sup>

With the age of reason came widespread moves towards individual national codification, then the French Revolution and the new Code. In this respect it is could not be considered as a renewal of thinking.

Already, in the second half of the nineteenth century a countermotion to the described nationalization of commercial law emerged. Its proponents suggested establishing a world private law by means of multilateral treaty harmonization under international law. However, more than 100 years of experience have shown that this strategy is hardly successful.<sup>8</sup>

This brings me to a conclusion that the new effort undertaken by a Commission is likely to be successful as well.

## **II The relationship between the CFR and international commercial law. The points of convergence and divergence in the CFR, UNIDROIT and other international commercial law principles**

### **1. The relationship between the CFR and international commercial law**

Regardless of the term ‘Private International Law’, reference usually is made to conflicts of laws, interchangeably used with the expression ‘choice of law’. From this follows that each nation state developed its own conflict of rules.

During the 1990s, two codifications of private law, the UNIDROIT Principles of International Commercial Contracts and the Lando Commission’s Principles of European Contract Law (PECL), emerged in the domain of contract law. Both codifications not only attempt to function as model laws but also propose, as a formulation of general legal principles, to be available both to contractual parties by means of choice of law and to courts in their interpretation of contracts and state private law.<sup>9</sup>

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<sup>7</sup> Civilization Past & Present, Wallbank, 6th edition, pp. 87–88.

<sup>8</sup> Graf-Peter Calliess The making of transnational contract law Indiana Journal of Global Legal Studies.2007.

<sup>9</sup> Ibid.

First, there is a question of contracts between parties in different jurisdictions. Private international law allows the parties, broadly speaking, to choose which law shall govern their contract and lays down rules to determine which law shall apply if the parties have not made a choice. An alternative is to use a third national system for example, English law has been adopted very widely as the law governing international transactions between parties who have no other connection with England. If both parties are in fact familiar with English law as well as with their own law, they may well be a good solution; but one or even both of them may not have that familiarity.

Some parties seek to avoid this problem by agreeing that their contract shall be governed by the *lex mercatoria* or “internationally accepted principles of commercial law”. Another issue arises – what is the modern law of *lex mercatoria*? What principles of commercial law are internationally accepted?

An even more obvious solution is for the parties to specify a particular internationally agreed set of rules, preferably one that represents a balance between the different systems, as the law to govern their contract. The prime example is the United Nations Convention On Contracts For The International Sale Of Goods, 1980 ( CISG ).

In terms of content, the model rules that are envisaged by the annex to *The Way Forward* seem to be the equivalent of the rules of the PECL. Sections I and III–VII follow very closely the scheme of the PECL, not only parts I and II but also Part III. Part III deals with a number of topics that either are applicable not only to contract claims but other areas of law or were omitted from the earlier work. Annex I of *The Way Forward* includes most of the former but not the latter.

This suggests that the core of the CFR will be general principles of contract law, the infrastructure on which rules governing specific contracts are built. Thus, it seems that the rules may have to deal specifically with consumer contracts in general. That will be quite a contrast to the PECL, which do not have specific consumer provisions.<sup>10</sup>

The question is where should border be set between national codes and a European Contract Law? The CISG and the PECL give different answers: While the CISG is rather restrictive,

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<sup>10</sup> Hugh Beale. The Development of European Private Law and the European Commission’s Action Plan on Contract Law. *Juridica International* 10 (2005).

excluding from its scope questions concerning the validity of contracts or agency questions; these questions are included in the PECL.<sup>11</sup>

## **2.The necessity to create CFR and possible duplication of the international commercial instruments**

CISG provide coherent and internationally recognized body of law to govern transactions between parties involved in the international sale of goods. It is not just a codification of trade usages , but attempt to harmonize the different approaches to contract law internationally. In this sense there is no point to create a similar instrument in Europe which is separate and distinct from the CISG. First, the CISG applies to contracts of sale concluded between Member States of the EU and in international trade. And further which of the instruments would play major role remains unclear. Since a Member State ratified CISG, is bound by that treaty based on a principle *pacta sunt servanda*. What if the new instrument would differ considerably from CISG? This brings us to the words of Article 27 of the Vienna Convention on the Law of Treaties:

“A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty”.

Thus, the conflict between international law and community law in this regard may arise.

A controversy in the relationship between the UNIDROIT Principles and the European Principles are also unavoidable. Here we face a risk that they will compete with one another or whether they may co-exist while serving different purposes. The UNIDROIT Principles have proved to be extremely successful. What is even more significant - the great majority of orders of the Principles have come from circles such as international law firms, corporate lawyers, chambers of commerce, arbitration courts and the like, which are the kind of potential users to whom the Principles are mainly addressed.

The most significant divergency between the two instruments appears right from the outset. In the Preamble of the UNIDROIT Principles it is stated that they set forth "general rules for *international commercial contracts*", whereas the European Principles "are intended to be applied as *general rules of contract law in the European Community*" (Article 1.101)(1). It means that,

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<sup>11</sup> Structural Elements of the Austrian Civil Code. Martin Schauer. The Architecture of European Codes and Contract Law. Kluwer Law International. 2006. p.102.

while the UNIDROIT Principles are confined to "international" and "commercial" contracts, the European Principles apply to all kinds of contracts, including transactions of a purely domestic nature and those between merchants and consumers. On the other hand, the territorial scope of application of the UNIDROIT Principles is universal, while that of the European Principles is formally limited to the member States of the European Union.

Parties and arbitrators, it is argued, will be faced with two entirely equivalent, and therefore competing, instruments.<sup>12</sup>

In these circumstances, the Commission should fully acknowledge the important work going on the other *fora*, e.g. NGOs, on the improvement often the law on international commercial transactions and standard contracts used in such transactions, and should avoid duplication<sup>13</sup>.

Similarly, individual national legal traditions should be respected. In addition, they provide a diversity that enhances the prosperity of the EU. The common law of England and Wales, for example, in the international choice of law in a wide range of commercial matters including finance, insurance and shipping.<sup>14</sup>

### **III Mandatory and non-mandatory rules in the CFR and in international commercial law**

In this part of the essay I will focus on the principle of freedom of contract and in particular on the role of mandatory and non-mandatory rules in general relationships between the optional instrument and mandatory national laws.

#### **1. The importance of non-mandatory model rules**

Default rules play a very important role, although they are not mandatory and thus can be set aside by contractual clauses. Default rules are very useful, as they enable parties to make contracts without spelling out all the terms of a contractual relationship that are not yet determined by mandatory law, whereas the absence of default rules would oblige them to do so in every single case. This saves a lot in terms of transaction costs.

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<sup>12</sup> Michael Joachim Bonell . The UNIDROIT Principles of International Commercial Contracts and the Principles of European Contract Law: Similar Rules for the Same Purposes?26 Uniform Law Review (1996) 229-246.

<sup>13</sup> The Harmonization of European Contract Law. Implications for European Private Laws, Business and Legal Practice. Ed. By Stefan Vogenaur and Stephen Weatherill. Hart Publishing, 2006, p.195

<sup>14</sup> Ibid. p.246.

Default rules also oblige the parties to be more transparent: when they deviate from default rules, they have to make that clear - first of all, to each other. Especially in view of the harmonisation of contract law in Europe, default rules also have in an important function for mandatory consumer contract law.

In discussing the restrictions on party autonomy and freedom of contract, we should not forget that the very first function of contract law is not to impose certain forms of behaviour but, rather, to enable certain forms of behaviour, to enable parties to exchange goods and services in the marketplace.<sup>15</sup>

While the Convention on the Law Applicable to Contractual Obligations of 1980 (Rome Convention) gives autonomy to the parties, it marginally limits the autonomy through Article 3. If the parties did not chose the national law applicable to their agreement, then Article 4 of the Rome Convention applies the law of the place of the business or establishment of the party that is to perform the relevant characteristic performance.<sup>16</sup>

## **2. Freedom of contract and party autonomy**

The main idea of the freedom of contract is that the parties are free to set those rules aside in their contract and, once they have done so, these legal rules do not bind them.

All European legal systems contain non-mandatory rules. They can be found in civil codes, specific statutes and in case law. Especially, in most European legal systems the largest part of the general law of obligations (including the law relating to all contracts: general contract law) is non-mandatory. Moreover, all civil codes contain specific rules relating to specific contracts like sale, rent, services et cetera. Many of these rules are non-mandatory as well.<sup>17</sup> However, there are not many non-mandatory rules which are exactly the same in all Member States. Indeed, there are also many divergences.

Finally, an argument in favour of non-mandatory rules may also be derived from a historical perspective. Many of the existing non-mandatory rules in both civil codes and the common law

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<sup>15</sup> Matthias E. Storme. Freedom of Contract: Mandatory and Non-mandatory Rules in European Contract Law. <http://webh01.ua.ac.be/storme/Storme-Juridica.pdf>.

<sup>16</sup> Erauw, Johan Observations about mandatory rules imposed on transatlantic commercial relationships. *Houston Journal of International Law* • Wntr, 2004 • Transatlantic Business Transactions: Choice of Law, Jurisdiction, and Judgments.

<sup>17</sup> Martijn W. Hesselink. Non-Mandatory Rules in European Contract Law . ERCL 1/2005.

have had a very long history. They may be regarded as practical experience, as experience with regard to perceived fairness, or with regard to perceived efficiency (the presumed intention of the parties). They were often developed, in Roman law, with regard to specific disputes, and they were then refined in a long tradition, the most part of which was international.

In no legal system is it necessary to state explicitly in the contract that it deviates from a certain non-mandatory rule. Nevertheless, a party who does not want a certain non-mandatory rule to be applicable to her contract needs to make sure that she has actually excluded its applicability through the contract. In other words, non-mandatory rules often are *de facto* mandatory.

A possible conclusion on these facts could be that if all legal systems contain a comprehensive set of – not only mandatory but also – non-mandatory rules, then the European legal system should also contain such a set of non-mandatory rules – a ‘hard code’ alone does not suffice. However, one could equally well conclude that non-mandatory rules are sufficient where they already exist, on the national level, and that no European code with non-mandatory rules is needed. From a constitutional perspective the main question is whether the constitution – in this case the European Treaties, and perhaps soon the Constitutional Treaty – provides a legal basis for European non-mandatory rules.<sup>18</sup>

In case of cross-border transactions, rules of private international law such as the Rome Convention, or international instruments such as the CISG, contain coordinating or harmonising mechanisms in the case of conflicts on applicable law, always respecting party autonomy as far as possible<sup>19</sup>.

The importance of freedom of choice in contract law has been stressed by the ECJ in the *Alsthom case*. It insisted that “the parties to an international contract of sale are generally free to determine the law applicable to their contractual relations and can thus avoid being subject to French law”<sup>20</sup>. And further, if a party is free to avoid a member-state rule restricting its freedom in contract with regard to applicable liability rules as in *Alsthom*, there is no place and no reason for Community law intervention. This implies that there is really no need for the EU to adopt

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<sup>18</sup> Martijn W. Hesselink. Non-Mandatory Rules in European Contract Law . ERCL 1/2005

<sup>19</sup> Rome Convention, art.3, art.7

<sup>20</sup> Case C-339/89 *Alsthom Atlantic v. Compagnie de Construction Mechaniques Sulzer*, 1991 E.C.R. I-107.

“facilitative” contract law rules because this is left to the parties themselves (or the jurisdiction which is applicable to their contract).<sup>21</sup>

In the next part, I will first present the benefits of diversity. After these have been examined, the commercial practice of the contractual parties will be discussed. Finally, there will be submitted the necessity of creation of CFR and the sensitive issue as to the Commission’s competence in this regard.

## **IV The arguments against the creation of CFR**

### **1. Diversity of Legal systems**

Within the EU, there are at least four types of contract law regimes. First, every member state has its own national contract law, which implies that there now 27 of such national systems within the EU. Next to these national regimes, there is a set of rules on contract law of European origin. This set consists of a rapidly increasing amount of directives issued by the EU. Third, there is the international regime created by the CISG. This regime is not specifically European but it certainly does play an important role within the EU. Finally, there are – within several countries – regional variations of the national model (UK). The 27 member states of the EU all have their own contract law regime. This implies that each national legislator has its own national courts to deal with contract cases. There is at present no highest European authority that could provide binding contract law rules outside the competence of the EU. These four types can be distinguished on basis of common history, the sources of law recognized and the predominant mode of legal thought.<sup>22</sup>

In addition to the national and European systems of contract law, there is the international regime created by the CISG of 1980. Even if the CISG is applicable, this does not mean that the whole relationship between the parties is governed by it. On the contrary: in many respects national law (applicable in accordance with the rules of private international law) remains of importance.<sup>23</sup>

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<sup>21</sup> Norbert Reich. A Common Frame of Reference (CFR) – Ghost or host for integration? ZEPR- Diskussionpapier 7/2006.p.16.

<sup>22</sup> Edited by Jan Smith . The Need for a European Contract Law. Empirical and Legal Perspectives. Europa Law Publishing, Groningen 2005.P.157.

<sup>23</sup> Ibid. p.161.

## **2. Commercial practice of the contractual parties**

Most major law firms and commercial parties have their own standard terms of business which they seek to use in the transactions which they conclude. The meaning of these terms is a matter of great significance to them. Although there are undoubtedly differences between these standard terms, their similarities tend to be greater than their differences. The most rules of contract law in national laws are default rules; they apply unless they are excluded by the terms of the contract. Mandatory rules, at least in the commercial context are relatively few. Thus it is the terms of the contract, rather than the rules of law, that play the principal role in the regulation of the relationship between the parties.

The claim that the standard terms to be found in modern commercial contracts are of great significance for legal practice is an important one in terms of current debate on the harmonization of contract law. Moreover, these terms are often used not only for domestic transactions but also for international or cross-border transactions.<sup>24</sup>

It is difficult to disagree with the statement of Professor Sir Roy Good, made in his response to the 2001 Communication:

“Contract law is a major part of the law of obligations. In any given country it is shaped by the structure and philosophy of that country’s entire legal system, its culture, its language and its tradition. The divergences among European states are so great that it is difficult to see how any Member state could accept the imposition of a uniform contract law. “<sup>25</sup>

## **3. Legal grounds of the European Commission to create CFR**

Another very important issue in this respect is whether the Commission has necessary power to take this action. The principle of subsidiarity in Article 5(2) of the EC Treaty clearly states that:

“The Community shall act within the limits of the powers conferred upon it by this Treaty and the objectives assigned to it therein.

In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States

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<sup>24</sup> Edited by Jan Smith . The Need for a European Contract Law. Empirical and Legal Perspectives. Europa Law Publishing, Groningen 2005.P.161.

<sup>25</sup> Response to COM (2001), para.11.

and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community.

Any action by the Community shall not go beyond what is necessary to achieve the objectives of this Treaty. ‘

Having analysed the above statements, in many respects measures undertaken by a Commission are not considered as necessary and could be achieved by the Member States and business community.

## **V Conclusions**

My vision of the given problem could be regarded as too critical but having examined this issue I come to the following conclusions.

The creation of CFR would not be a reasonable and necessary solution to resolve problems arising from diversity of national legal systems in European contract law.

Moreover, the party autonomy and freedom of a contract remain of importance. Major companies and law firms have a well-elaborated and approved by a long-term commercial practice business terms and principles in domestic and international transactions.

The Commission's aspirations on a creation of CFR as an optional instrument and its further development into the European contract code failed to be an inspired idea.

Even if a consensus on a text is agreed by a majority of State Members, it is unlikely that such consensus is reached in all Member States due to major legal, political and cultural sensitivities involved. This brings us to a next question. If some countries adopt such an instrument as CFR and others – do not, how the trade relationships between such Member States to be regulated? And further, if adopted I do not see how the impediments to trade will be prevented. If the law is to be unified, the cultural, language and others barriers will continue to exist. I presume that in a described situation it will pose more difficulties in trade than arise from the diversity of national laws.

Having examined the relevant provisions of the EC Treaty, the issue is whether the Commission has enough power in creation of CFR is still open and furthermore could be considered as a violation of the principle of subsidiarity in Article 5(2) EC Treaty<sup>26</sup>. From this follows that there is no clear conceptual and legal basis for this.

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<sup>26</sup> Consolidated Version of the Treaty Establishing the European Community, 2002 O.J.(C 325).

According to the party autonomy, the contracting parties will decide upon the rules that regulate relationships between them if any gaps exist in their commercial transactions. There is no need for European Commission to intervene in such contractual relationships.

Therefore, from the point of view of efficiency the CFR on contract law proposed by the European Commission poses a number of questions and controversies which would not be answered in the near future. A potential overlap between international commercial instruments and CFR might take place. In no way they could be ignored or neglected. There is no need to reiterate and duplicate already existing instruments in the sphere of commercial law and create similar instruments for basically the same purpose.

The statements as to the 'optional instrument' turn us to a finding that it is hardly reasonable to undertake such a huge and expensive project that is unlikely to be supported by the majority and which would have to be non-mandatory in any case.