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The Economics of Private Law Harmonization

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*by John Linarelli**

Tom Cruise, playing the part of Maverick in *Top Gun*, described a fictional aerial encounter involving many hostile fighter jets as a "target-rich environment." Similarly, the harmonization literature is a "theory-rich" environment, where it seems that if one theory does not fit, another stands ready. Support for harmonization exists in the normative economics of the efficiency properties of legal rules. Harmonization critics tend to rely on positive economics and the tools of political economics to assess how the law-making process affects the content of law.[1]

I support harmonization skeptically. We cannot say whether private law harmonization is good or bad as a general proposition. The question is whether a particular harmonization project produces Pareto efficiencies, based on the particular institutions producing the law. We should refocus on improving the design of institutions so that inefficiencies are mitigated.

NORMATIVE ECONOMICS TENDS TO SUPPORT HARMONIZATION

All economic theory begins with an intuition about the world. Ask a practicing lawyer whether, other things being equal, transactors would be better off if there were a single law and judiciary; whether an international transaction would involve less risk if it had more of the institutional attributes of a wholly domestic transaction—and the answer would undoubtedly be yes.

The information problems in international commercial transactions are substantial. Absent reputation or a relationship to provide information about the quality of promises, contract parties face an adverse selection problem.[2] Protective measures such as letters of credit and bills of lading partly alleviate information problems but are costly and themselves depend on stable law or merchant practice. That parties adopt such protective measures does not detract from the point that improvements in the law facilitate exchange and make the measures less important to the extent they serve as substitutes for law.

International transactions operate efficiently within the framework of a single set of international default rules. Because information and monitoring problems are inherent in contracting at long distances across borders, the probability of loss in international contracting tends to be higher, other things being equal, than in local contracting, thus making more complete contracts rational.

Parties will be uncertain as to which default rules apply. What gap fillers does "the law" specify in an international transaction? Absent an international convention or a contractual choice of law, the answer is uncertain.[3] As a result, parties must necessarily

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[1] *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 27 (5th ed. 1998); Alan Sykes, *Comparative Advantage and the Normative Economics of International Trade Policy*, 1 J. INT'L ECON. L. 49 (1998) (distinguishing normative and positive economic analysis).

[2] Adverse selection arises when one party knows more about the quality of the subject matter of the exchange than the other, as a result of which the less informed party cannot assess quality and thus risks accepting poor quality. *See* Avery W. Katz, *Informality as a Bilateral Assurance Mechanism*, 98 MICH. L. REV. 2555, 2557–58 (2000).

[3] The economics of default rules has not yet been systematically applied to international contracting, where more than one legal system is involved. *See* Michael Whincop & Mary Keyes, *Putting the "Private" Back into Private International Law: Default Rules and the Proper Law of the Contract*, 21 MELBOURNE U. L. REV. 515 (1997) ("Most research analysing the properties of default rules assumes a domestic or national setting.").

fill more gaps than in a situation where only the law of a single jurisdiction applies. Moreover, domestic legal systems may not specify default rules in problem areas in international transactions.

The need to fill relatively more gaps in crossborder transactions may have a relatively greater adverse effect on small firms, for which high transaction costs are prohibitive and cannot be spread across many transactions.[4] Traders in small states with small markets suffer even more disproportionately because they must engage in crossborder contracting relatively more often than their counterparts in large states with large markets.[5] For a common market, substantial legal divergence of the sort present in Europe but not in the United States makes little sense.

CHOICE OF LAW IS EFFICIENT IN LIMITED SITUATIONS

A choice of law clause is a gap filler. It fills the gap because the parties have no legal system in common.[6]

The ability to choose law contractually presupposes low transaction costs and the ability to engage in Coasian bargaining to an efficient result. Choice of law is a solution only where the parties can at low cost obtain information about the laws of various countries. Legal diversity proponents beg the question. Heightened congruence between legal systems decreases the transaction costs of learning about a legal system and actually facilitates choice of law.

If parties could bargain to an efficient selection of legal rules to govern their transaction, their menu of choice would be increased if they could also choose an international set of rules, which might reflect majoritarian rules applicable to international transactions. The experimentation argument also applies to restatements and conventions.

If transaction costs are high or externalities are present, Coasian bargaining is impracticable, and the Hobbes Theorem applies instead.[7] Contractual choice of law either does not occur, or is inefficient if it does. In such a situation, parties should have the confidence to rely on default rules. In the absence of harmonization, conflict of laws principles select the default rules. Conflict rules are not tailored to select efficient default rules for international transactions and the institutional problems in structuring them to do so seem insurmountable. Conflict rules would have to compel courts of multiple jurisdictions and arbitrators to coordinate the following: Assess what sort of rule should apply in the dispute consistently with economic theories on default rules; and direct the decisionmaker to the right jurisdiction to supply the rule.

In addition, if transaction costs are high enough to preclude choice of law, they are likely high enough to preclude choice of forum, and choice of forum rules thus would have to point the parties to the forum that would do the assisting and directing. This asks too much of conflict principles.

Contract parties use choice of forum and arbitration clauses to locate their disputes outside of jurisdictions whose mandatory laws they disfavor. Parties will each bargain for rules to maximize their share of the surplus of the transaction, not to maximize efficiency.

[4] ICC Comments on the "Communication from the European Commission to the Council and the European Parliament on European Contract Law," COM(2001) 398 final, Oct. 15, 2001.

[5] *Id.*

[6] The dichotomy between harmonization and diversity is not as stark as conceptualized. Framing the question whether law is harmonized or not runs the risk of missing the essential elements of how law is produced and how it has evolved in various states. Even common law jurisdictions like England have experienced "codification" or "rationalization" by Blackstone, Coke, and others. There is a long history of cross-fertilization between western legal traditions. U.S. courts have used restatements liberally; in prior centuries they cited English law. The question could more properly be reframed as: What kind of harmonization is preferred? Legal diversity is a continuum. It does not manifest itself in the law in action as an either/or proposition. Taken to its logical conclusion, legal diversity is a tautology, as it would mean total decentralization, a purely theoretical situation.

[7] *See* Robert Cooter, *The Cost of Coase,* 11 J. LEGAL STUD. 1 (1982).

They do not care about the effects of their choice on third parties or, absent repeat play, on the other party to the transaction. They may try to circumvent efficient law, such as antitrust law.

DISTRIBUTIONAL CONCERNS AND CHOICE OF LAW

When information asymmetries exist, legal diversity makes the more knowledgeable party better off. That party may be more legally sophisticated, a larger company, a merchant instead of a consumer. The problem is exacerbated when the transaction involves a "legal product," such as an insurance policy, where consumers choose between different products based on different law.[8]

Legal diversity shifts costs to weaker parties. Consider the Rome Convention (Convention).[9] European firms argue that because they must bear the costs of local regulation under the Convention, this increases their costs and decreases exchange opportunities for consumers.[10] They prefer country of origin regulation, which shifts costs to consumers. Firms are in a better position to learn and comply with EU member states' laws, particularly as those laws are increasingly harmonized via directive and regulation, than are consumers, who would have to become familiar with the laws of each of the member states where the firms are based from which they buy goods and services. European consumers lack the confidence to purchase from firms located in other member states because they do not know what they are buying. The transaction costs of distinguishing good from poor quality promises are prohibitive and adverse selection arises. Choice begs the question: It makes little sense unless laws are already substantially converged.

POLITICAL ECONOMICS HAS NOT PRODUCED GENERAL PREDICTIVE THEORY

Critics examine the kinds of rules that private legislatures make, classifying them as Model 1 rules (objective, bright-line rules, such as speed limits); Model 2 rules (abstract rules vesting discretion in decisionmakers), and Model 3 rules (a combination of 1 and 2).[11] They contend that when interest group power is *strong*, a private legislature comprised of technocratic elites will produce Model 1 rules, and that when interest group pressure is *weak*, it will produce Model 2 rules that depart from the status quo whether or not the change improves the law.

The qualities of legal rules made by private legislatures are no different from the qualities of legal rules made by public legislatures. Whether private legislatures produce Pareto-efficient law is not a question that can be answered by a general proposition. It depends on the institutions in question and the kinds of incentives they create for lawmakers. Complex commercial legislation tends to involve a mixture of all three rule types.

Claims of the superiority of legal diversity over harmonization have to be scrutinized through the lens of public choice theory. Public legislatures produce Model 1 rules in favor of interest groups when interest groups enjoy influence over public legislatures. Public legislatures produce Model 2 rules when they are unable to get Model 1 rules enacted.

[8] Jürgen Basedow, *The Case for a European Insurance Contract Code*, 2001 J. BUS. L. 569 (2001).

[9] The Rome Convention provides that unless the parties otherwise specify, consumer contracts are governed by the law of the consumer's habitual residence, and in no circumstances can choice of law deprive the consumer of the protection of the laws of her country of residence where that law is more favorable. Rome Convention on the Law Applicable to Contractual Obligations, June 19, 1980, art. 5, 19 ILM 1492 (1980).

[10] *See, e.g.*, London Investment Banking Association Comments on "Communication from the Commission to the Council and the European Parliament on European Contract Law," COM(2001) 398 final.

[11] Alan Schwartz & Robert E. Scott, *The Political Economy of Private Legislatures*, 143 U. PA. L. REV. 595, 605 (1994); Paul B. Stephan, *The Futility of Unification and Harmonization in International Commercial Law*, 39 VA. J. INT'L L. 743 (1999). Schwartz and Scott examine U.S. domestic institutions only, using the formal modeling techniques of positive political theory. Stephan extends the Schwartz and Scott analysis informally to international institutions.

Legal diversity can be a tool for protectionism. Whether or not an interest group will support or oppose harmonization depends on whether its members fear foreign competition and wish to maintain monopoly power through institutional advantages. The incentive to promote legal diversity may become an incentive to promote harmonization when the interest group is no longer concerned with maintaining legal differences because its members have opportunities to further their interests in other jurisdictions.[12] Lawyers in this respect are no different from bankers, insurers, telecommunications firms and other service providers.

Some criticize harmonization because private legislatures are not elected and specialists tend to dominate their membership. The entire public choice edifice is built upon the foundation that the public interest model of government fails to predict accurately why laws are made or why public policy takes the shape it does. Political economics does not analyze the legitimacy of government, but rather its efficiency. Whether a particular rule-making body is elected is only one of a number of institutional features that must be analyzed. Elected officials are subject to interest group pressures and voting markets, which may also result in the production of inefficient law. Political economists do not merely ask *whether* the members of a particular body are elected or appointed, but *how* they are elected or appointed.

PROPOSALS

Public choice theory has been used negatively, to critique harmonization, but not positively, to suggest institutional reform. Here are three suggestions:

- Require commentaries to demonstrate how the law is efficient.
- Randomly select scholars, practitioners, and jurists to review proposed laws. One eligibility requirement could be that the reviewer not be involved in harmonization projects. Make this a rule of professional responsibility.
- Develop international courts. Complaints about divergent interpretation of international conventions are arguments *for* harmonization. Applying the public choice perspective to its logical end, domestic courts lack institutional incentives to promote uniformity. We should work directly on institutional design rather than on trying to perfect harmonized texts, since absolute precision in language is an illusory goal.

THE BETTER PART OF HARMONIZING JURISDICTIONAL LAW

by Janet Walker[*]

A fine European thinker once said that courage is not bravery but knowing what is and is not to be feared.[1] From this we have derived the maxim, "Discretion is the better part of valor." Truer words have never been spoken. If the search for uniform solutions is a good (and not just an inevitable) thing, then ultimately, "Why (Not) Seek Uniform Solutions?" is a matter of understanding what should and should not be harmonized.

More recently, a fine American thinker said, "Legal scholars have a distinct capacity to shed insight on the relationship between lawmaking structures and the products of those structures. If we pick the right structures the outcomes we desire should follow."[2] These equally true words are those of Paul Stephan, who has made the important

[12] Basedow, *supra* note 8.

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[1] PLATO, PROTAGORAS.

[2] Paul B. Stephan, *The Futility of Unification and Harmonization in International Commercial Law*, 39 VA. J. INT'L L. 743 (1999).