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Chirico, F.; van Damme, E.E.C.; Larouche, P.

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The Draft Common Frame of Reference (DCFR): A Giant with Feet of Clay

- [Authors](#)
- [Authors and affiliations](#)
- Filomena Chirico
- Eric van Damme
- Pierre Larouche[Email author](#)
- Filomena Chirico
 - 1
- Eric van Damme
 - 2
- Pierre Larouche
 - 3

[Email author](#)

1. 1.European CommissionBrusselsBelgium
2. 2.Tilburg School of Economics and ManagementTilburg UniversityTilburgThe Netherlands
3. 3.Tilburg Law SchoolTilburg UniversityTilburgThe Netherlands

Chapter

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Abstract

This chapter summarizes the lessons drawn from the work of the Economic Impact Group (EIG), a part of the CoPECL Network of Excellence funded by the EU to prepare a Draft Common Frame of Reference (DCFR). First, it revisits basic principles which are central to the work of the whole group. For one, contract law is not just about remedying market failures; it is fundamentally a basic condition for markets to exist at all. Moreover, law and economics analysis looks for Pareto-efficiency and total welfare, without taking distributional considerations into account. Second, it draws general conclusions from contributions to the EIG. As regards the first question before the EIG (desirability of harmonization at European level), the costs of harmonization have been downplayed, so that the case for harmonization has probably been exaggerated, certainly as regards areas such as a non-contractual liability where the DCFR cannot simply be an optional regime. As regards the second question assessed by the EIG (appropriateness of the provisions chosen in the DCFR), the work of the EIG reveals shortcomings: among others, rules have been formulated without a complete assessment of their rationales and the ex-ante impact of the DCFR has been ignored. The drafters of the DCFR could have derived more added value from an economic analysis of their work than they seemed to acknowledge. Accordingly, while the DCFR is a momentous work of scholarship, it rests on fragile foundations.

Filomena Chirico is an official at the European Commission, Directorate General Competition (DG COMP). Her contributions reflect her views and not those of the European Commission. At the time of her contribution to the project, she was Assistant Professor, and a member of the Tilburg Law and Economics Centre (TILEC). Eric van Damme is Professor of Economics, and a founding director of TILEC, Pierre Larouche is Professor of Competition Law, Tilburg Law School, Tilburg University, and a founding director of TILEC. A version of this chapter was published as the conclusion of Pierre Larouche and Filomena Chirico, eds., *Economic analysis of the DCFR—The work of the Economic Impact Group within CoPECL* (Munich/Oxford: Sellier European Publishing, 2010) 319–332.

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This chapter arises from the work of the Economic Impact Group (EIG).¹ The law and economics scholars regrouped in the EIG delivered contributions on many of the main themes of the academic DCFR, certainly as regards contract law. The first part of this chapter revisits basic principles which came through the various contributions and

underpinned the work of the EIG. The second part draws more general conclusions arising from the contributions seen together.

3.1 Basic Principles

3.1.1 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.

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 others. 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. Second, 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. Third, 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”.

3.1.2 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 in 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 $\sum_{i=1}^n u_i(Y) = \sum_{i=1}^n u_i(Y) > \sum_{i=1}^n u_i(X) = \sum_{i=1}^n u_i(X)$. 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.

3.2 General Conclusions

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 harmonize 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 preferences³ 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 (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.

Second, 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.

Third, 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 behavior *ex post*, but also (and perhaps more importantly) that they affect behavior *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 signaling 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 behavior 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 behavior of private parties, in particular the way the law influences that behavior through incentives, expectations, etc. is downplayed.

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 toward ‘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.

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.

Footnotes

1. [1.](#)

Larouche and Chirico [2010](#).

2. [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. [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.

4. [4.](#)

See on this issue Hesselink [2006](#), 143–170.

5. [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. [6.](#)

DCFR, Principles at pp. 57 and ff.

7. [7.](#)

Ibid., para 1.

8. [8](#).

Ibid.

9. [9](#).

Ibid., para 54.

10. [10](#).

Ibid., para 55–57.

11. [11](#).

Ibid., para 3. Other types of market failure (information asymmetries, prohibitive transaction costs) are not mentioned.

12. [12](#).

Ibid., para 22. Including references to law and economics literature would have enhanced the discussion.

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1. Hesselink MW (2006) The politics of a European civil code. Kluwer Law International, The Hague, pp 143–170 [Google Scholar](#)
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Table of contents

- [Chapter](#)
- [Abstract](#)
- [3.1 Basic Principles](#)
- [3.2 General Conclusions](#)
- [Footnotes](#)
- [References](#)
- [Copyright information](#)
- [About this chapter](#)

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