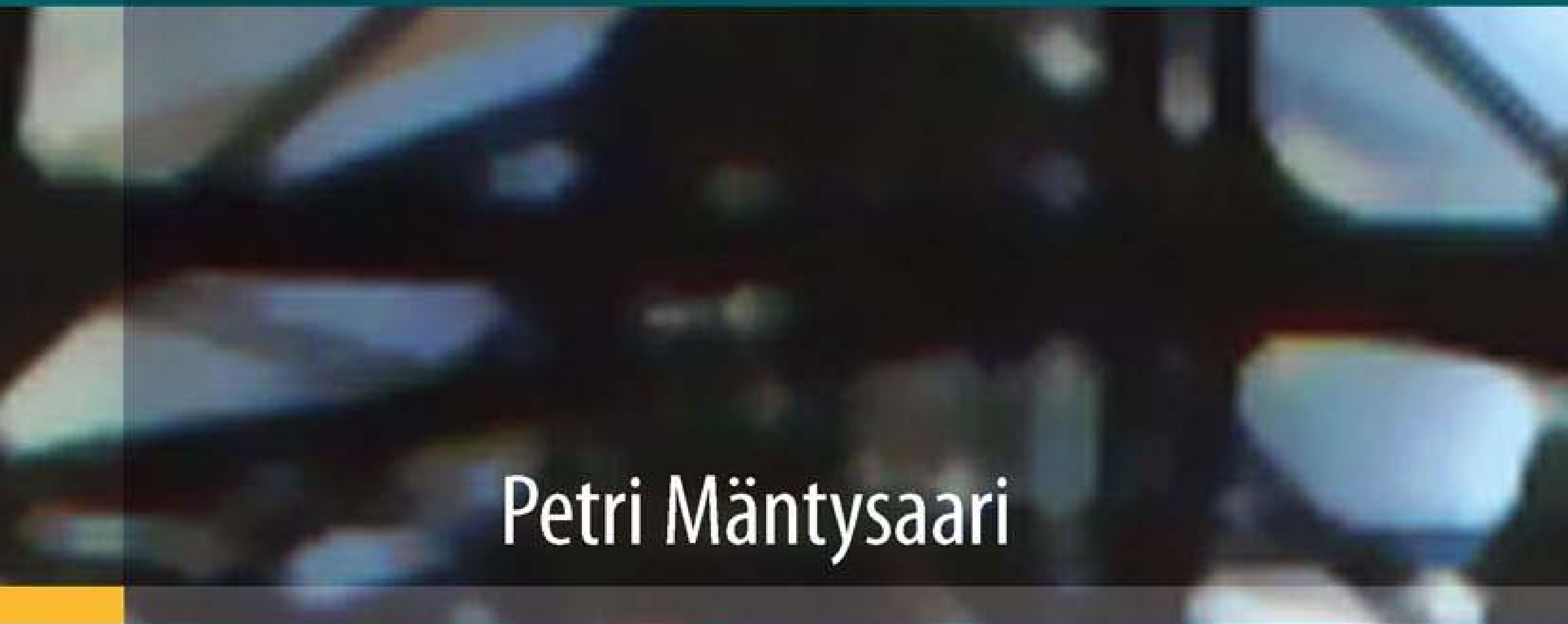

Petri Mäntysaari

The Law of Corporate Finance: General Principles and EU Law

Volume II: Contracts in General

Springer

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Table of Contents

1 Introduction ... 1
1.1 Investments, Generic Contracts, Payments ... 1
1.2 Particular Contract Types ... 1
1.3 Examples of Topics ... 2
1.3.1 The "Perfect Contract" ... 2
1.3.2 Payment Obligations ... 4
1.3.3 Nexus of Contracts ... 5

2 Contracts in General: The Legal Framework ... 7
2.1 Introduction ... 7
2.2 The Legal Framework: General Remarks ... 9
2.2.1 Introduction ... 9
2.2.2 Platforms, Market Practice, Contract Models ... 9
2.2.3 Governing Law ... 14
2.2.4 Choice of Legal Background Rules ... 16
2.3 The Legal Framework: EU Contract Law ... 16
2.3.1 Introduction ... 16
2.3.2 The Law Governing the Contract ... 17
2.3.3 Approximation of Contract Laws ... 20
2.4 Fixing the Legal Framework ... 26
2.4.1 Introduction ... 26
2.4.2 Documentation ... 27
2.4.3 Choice of Governing Law ... 29
2.4.3 Limiting the Scope of Substantive Provisions of Law ... 31
2.5 Choice of Core Commercial Terms ... 34
2.5.1 Introduction ... 34
2.5.2 Definition of Performance ... 36
2.5.3 Price and Payment Obligations ... 38
2.5.4 Performance, Price, Cost, Risk ... 39
2.5.5 Economic Efficiency and the Choice of Terms ... 40
2.5.6 Management of Agency, Loyalty, Non-competition ... 45
2.5.7 Business Outsourcing ... 45

3 Management of Legal Risk: General Remarks ... 47
3.1 Legal Risks ... 47
3.2 Risks Managed by Legal Means ... 48

4 Risks that Relate to the Country's Legal System 49
4.1 Introduction 49
4.2 Laws Not Enforced (Lack of the Rule of Law) 49
4.3 Change of Law 54
4.4 Flexibility of Law 56
4.4.1 General Remarks 56
4.4.2 Community Law 58
4.4.3 Differences Between Member States 62
4.4.4 Mitigation of the Flexibility of Law Risk 66
4.5 Mandatory Provisions 74

5 Risks that Relate to the Statements of the Parties 75
5.1 Introduction 75
5.2 Interpretation of Contracts 76
5.2.1 Introduction 76
5.2.2 Interpretation of What People Say or Do 80
5.2.3 Traditional Canons of Interpretation 82
5.2.4 Real Method of Interpretation 91
5.2.5 Mitigation of Risk 105
5.3 Terms Not Binding 114
5.3.1 Introduction 114
5.3.2 Non-conformity with Mandatory Rules 115
5.3.3 Different Types of Mandatory Rules: Introduction 121
5.3.4 Fraud 122
5.3.5 Unfair Contract Terms Under Community Law 123
5.3.6 Unfair Contract Terms Under Member States' Laws 130
5.3.7 Mitigation of Risk Caused by Mandatory Rules 137
5.3.8 Particular Remarks on Standard Form Contracts 141
5.3.9 Mitigation of Risk in Other Areas of Law 149
5.4 Binding Terms Not Enforceable 155
5.4.1 Introduction 155
5.4.2 Recognition and Enforcement of Judgments 155
5.4.3 Availability of Specific Performance 155
5.5 Binding Terms Too Rigid 157
5.5.1 Introduction 157
5.5.2 Community Law 158
5.5.3 Member States' Laws 159
5.5.4 Mitigation of Risk 164
5.5.5 Particular Remarks on Material Adverse Change 171
5.6 Contract Terms Become Binding 179
5.6.1 Introduction 179
5.6.2 Mitigation of Risk 180

6 Management of Counterparty Risk 187
6.1 Introduction 187
6.2 Counterparty Corporate Risk 188

6.2.1 Introduction ... 188
6.2.2 Community Law and Member States' Laws ... 188
6.2.3 Mitigation of Counterparty Corporate Risk ... 208
6.3 Counterparty Commercial Risk ... 214
6.3.1 Introduction ... 214
6.3.2 Community Law and Member States' Laws ... 215
6.3.3 Management of Counterparty Commercial Risk ... 215

7 Management of Information ... 239
7.1 Introduction ... 239
7.2 Information Duties ... 240
7.3 Substance ... 243
7.3.1 Core Obligations ... 243
7.3.2 Provisions that Influence Core Obligations ... 244
7.3.3 Secondary Duties ... 249
7.4 Separate Information Duties ... 249

8 Payment Obligations: Introduction ... 251
8.1 Traditional Payment Obligations ... 251
8.2 Other Forms of Payment Obligations ... 252

9 Payment Obligations: Traditional Legal Questions ... 253
9.1 Introduction ... 253
9.2 Money, Currency, Governing Law ... 253
9.3 Principle of Nominalism ... 255
9.4 Money as Money or a Commodity ... 256
9.5 Interest ... 256
9.5.1 Introduction ... 256
9.5.2 Fixed Rates, Floating Rates, the Eurosystem ... 256
9.5.3 Contract v Mandatory Law ... 259
9.6 The Performance of Monetary Obligations ... 264
9.6.1 Introduction ... 264
9.6.2 Payment ... 265
9.6.3 Finality, Conditionality, Revocability, Recourse ... 268
9.6.4 Set-off ... 270
9.6.5 Netting ... 275

10 Generic Forms of Payment Obligations ... 281
10.1 Introduction ... 281
10.2 Legally Not Enforceable Cash Flows ... 281
10.3 Legally Enforceable Payment Obligations ... 282

11 Management of Counterparty Credit Risk ... 287
11.1 Introduction ... 287
11.2 Choice of the Form of Payment Obligations ... 288
11.3 Choice of the Time of Payment ... 292

11.4 Transferability 298
11.4.1 Introduction 298
11.4.2 Basic Legal Aspects Relating to Transferability 299
11.5 Enforceability of the Transfer 303
11.5.1 Introduction 303
11.5.2 Assignment of Receivables 305
11.5.3 Transfer of Negotiable Instruments 311
11.6 The Use of Credit Enhancements 312
11.6.1 Introduction 312
11.6.2 Management of Counterparty Commercial Risk 315
11.6.3 Securing Obligations by the Value of Assets 326
11.6.4 Payment Obligations of a Third Party 359
11.7 Hedging 376
11.7.1 Introduction 376
11.7.2 Hedges Linked to the First Transaction 378
11.7.3 Netting, Close-out Netting, Set-off 379
11.7.4 Derivatives 380
11.8 Credit Risk Transfer in General 393
11.8.1 Introduction 393
11.8.2 Incentive Issues: Risk Shedder's Perspective 396
11.8.3 Incentive Issues: Risk Taker's Perspective 397
11.8.4 Tranching 400

12 Other Contract Types 403
12.1 Introduction 403
12.2 Multi-Party Contracts 403
12.3 Islamic Finance 409
12.3.1 General Remarks 409
12.3.2 Basic Principles 410

References 415

1 Introduction

1.1 Investments, Generic Contracts, Payments

According to Volume I, contracts are one of the five *generic legal tools* used to manage cash flow, risk, agency relationships, and information. Many *investments* are therefore based on one or more contracts.

Obviously, the firm should draft good contracts. Good drafting can ensure the same intended cash flow with reduced risk. Bad drafting can increase risk.

This volume attempts to deconstruct contracts used by non-financial firms and analyse them from a cash flow, risk, agency, and information perspective. The starting point is a *generic contract*, i.e. a contract which does not belong to any particular contract type (Chapters 2–7).

This volume will also focus on *payment obligations*. Payment obligations are characteristic of all financial instruments, and they can range from simple payment obligations in minor sales contracts and traditional lending contracts (Chapters 8–11).

1.2 Particular Contract Types

A number of *particular contract types* have been discussed in the other volumes of this book. (1) A certain party's investment contract can be another party's *funding* contract. Particular investment contracts will therefore be discussed in Volume III in the context of funding. (2) Many contracts are necessary in the context of *business acquisitions* discussed in Volume III. (3) *Multi-party* contracts are common in corporate finance. The firm's contracts with two or more parties range from syndicated loans to central counterparties' contracts. Such contracts will be discussed both in Chapter 12 and Volume III. (4) Many contracts with *information intermediaries* – such as auditors or providers of investment advice – or contracts relating to information were discussed in Volume I.

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1.3 Examples of Topics

1.3.1 The “Perfect Contract”

The topics of this book can be illustrated by three examples: the “perfect contract”, the nature of payment obligations, and the theory of the firm as a nexus of contracts.

Mix. What would be the “perfect contract” from the perspective of the firm? The firm has various commercial objectives depending on the context. A good contracts lawyer can identify the legal objectives of the firm, identify the available legal ways to reach them, design a contract in the light of the commercial objectives of the firm, and ensure that the other party accepts its terms. However, it is impossible to draft a contract that would be optimal for all contract parties regardless of their identity, the context, and the governing law.

The starting point is that each contract is unique, because each firm can be expected to act in its own self-interest in the circumstances. For example, it is not the purpose of an individual firm to allocate resources in the socially optimal way.

The firm needs a mix of contracts. For example, whereas some of the firm’s contracts provide for flexibility, part of the firm’s contractual framework should be rigid for risk management purposes. Moreover, each contract can consist of flexible and rigid elements.

Some general remarks can nevertheless be made as an introduction to the issues that will be discussed in this volume.

Define contents. First, an investment contract facilitates an investment. The firm should generally invest in projects that yield a return greater than the minimum acceptable hurdle rate. The contract can help the firm to define cash flow and the terms of the exchange of goods in advance. It will also help the firm to define its risk exposure, to exclude certain risks, and to choose the risk level that it is prepared to accept. This can require different things at different stages of the contract cycle.

In addition to (a) agreed terms, the contract is typically governed by (b) legal background rules (default rules) that apply to the particular contract type as well as (c) legal background rules that apply to contracts generally. Contract parties therefore use (1) practices designed for the particular contract type in question and (2) practices designed for contracts generally.

Manage information. Second, before the conclusion of a binding contract, the management of information plays an important role.

The firm will try to pick good contract parties and avoid bad ones. Obviously, the firm cannot do this without useful information. On the other hand, the gathering and analysis of information can be expensive, and information may not always be available and verifiable.

The other party will need information for its own decision-making purposes. However, the firm may not want to reveal too much. It may not want disclose confidential information – and perhaps not even non-confidential information – unless it regards the other party as a potential contract party.

Such factors will influence the mechanism used by the firm to screen contract parties and the choice of steps that lead to a binding contract.

In a mass transaction, the firm will use standardised processes and, possibly, automatisation to gather sufficient information about its potential customers. The firm will also use standard form contracts. In contrast, business acquisition contracts and important financial contracts are typically individually negotiated. Information will be disclosed and the contents of the contract will be determined gradually according to the following or similar steps: "cheap talk"; non-disclosure agreement; letter of intent or commitment letter; signing (and conditions precedent to closing); and closing. The contract becomes binding at closing.

It goes without saying that the firm will need information about the individually negotiated terms of the contract before the contract becomes binding. As the firm will need to define return and risk, the firm will also need some information about the legal background rules. The interaction of the agreed terms and the governing law or laws will play an important role.

The terms of the contract can be based on a "platform" or standard terms, and they can to a varying degree be individually negotiated. Typically, the firm can determine the parties' rights and obligations more precisely, if it excludes the application of dispositive provisions of law. Mandatory provisions of law force the firm either to adapt the transaction so that it does not fall within their scope, or to compliance. In many areas of law, the existence of mandatory provisions forces the firm to organise a compliance function (for compliance, see Volume I).

Define maximum and minimum obligations. Third, at a more concrete level, the firm should define at least its maximum obligations and the other party's minimum obligations in advance.

As regards *the firm's* own obligations, the firm will try to define them precisely and require a "cap". In order to reduce legal risk, the firm often tries to exclude the application of dispositive provisions of law. If the firm's own obligations are open, the firm will try to qualify them. The firm will use a different technique for the *other party's* obligations. The firm often tries to determine the other party's minimum obligations (and its own minimum rights) and require a "floor". As the firm does not always have full information about its legal needs, the firm may try to ensure that the other party's obligations are complemented by provisions of mandatory and dispositive law. The firm may also propose the use of open terms in addition to the exact "floor".

The core commercial terms of the contract will set out the division of the most important performances. They will always include the characteristic performances, and may include even some ancillary performances. From an economic perspective, the contents of the core commercial terms should depend on who is the "least-cost avoider". The allocation of work can typically be expected to depend on which of the parties will be more likely to bear the responsibility for each performance at a lower cost, and risk should basically be allocated in the same way.[1]

Manage agency. Fourth, the firm always tries to manage the agency relationship between the parties in advance. The contract may contain several mechanisms

1 See Coase R, The Problem of Social Cost, J L Econ 3 (1960) pp 1–44.

designed to change the behaviour of the other contract party, ensure that the contract party will fulfil its obligations, and reduce agency costs.

Popular ways to mitigate agency problems include: clear contract terms and standards; decision-making rights such as ratification rights; transparency; alignment of interests (incitements); remedies (sanctions, indemnities); simultaneous performance (Zug-um-Zug, cash against delivery) or asking the other party to fulfil its obligations in advance; various forms of credit enhancements; avoiding "hold-up" situations; and an exit option.

After the conclusion of the contract, the firm may also be able to verify previously unverifiable information. For example, a new employee can be employed for a trial period. A new supplier will be asked to deliver small amounts before the buyer will agree on long-term deliveries. The contractor of a production system may agree to a construction/installation period followed by a testing period, the outcome of which will decide whether the delivery will be accepted and the buyer will pay the rest of the purchase price.

The use of remedies is an important way to manage agency. The sanctions should be effective. Typically, the obligations of the other party (such as "representations", "warranties", and "covenants"), the definition of "events of default", and the sanctions triggered by the occurrence of an event of default form a whole. The firm may prefer the sanctions to be cumulative (where the other party is the party more likely to fail to fulfil its obligations) or exclusive (where the firm is the party more likely to breach the contract). The firm tries to ensure that it has an option rather than a legal duty to invoke the agreed sanctions and that it will not be deemed to have waived its rights when it has not used them.

Manage the risk of changed circumstances. Fifth, in a "perfect contract", the firm will also have addressed the risk of changed circumstances. For example, the contract may have a short maturity instead of a long one, or the firm may combine open contract terms with dynamic terms, i.e. contract terms showing how the contents of the open terms must be fixed. The contract can provide for regular termination. Such a clause can be complemented by information covenants, a material adverse change clause, a force majeure clause, and/or a hardship clause.

1.3.2 Payment Obligations

All investment contracts contain payment obligations. As the *components* of payment obligations can be combined in different ways, one can identify different *types* of payment obligations and a *taxonomy* of payment obligations.

Different types of payment obligations can be used in different ways to ensure that the fundamental legal objectives of the firm (management of cash flow, risk, agency, and information) will be met.

For example, where the firm must pay a certain amount of money on a certain date, it can ensure that it will have liquidity on that date by agreeing on a matching fixed payment obligation of a third party. Contingent payment claims can be used to mitigate risk caused by the fact that the parties cannot have perfect information about future events. Contingent payment claims can also be used to mitigate agency problems by aligning the monetary interests of the principal and the agent.

While payment obligations can be used as legal tools to solve problems, they can also create new problems. This can be illustrated by the following examples. (a) An *intertemporal transfer* of value through time enables the debtor to obtain funding. However, this means that the lender will be exposed to a *credit risk*. The parties can use various kinds of credit enhancements to mitigate the credit risk. (b) The *transferability or negotiability* of claims means that the claim can be transferred. They are ways to manage some risks. On the other hand, they can increase other risks such as the debtor's *agency risks* or *counterparty commercial risk* (section 6.3). (c) The use of *contingent* claims can help a risk shedder to transfer many risks to a risk taker. On the other hand, contingent claims can be legally complicated and subject to a high *legal risk*.

1.3.3 Nexus of Contracts

The firm obviously cannot function without an extensive contractual framework. The firm can use contracts to change the behaviour of its contract parties.

Compared with many other behaviour-changing mechanisms, contracts have their own peculiar characteristics. First, contracts can be enforced against the parties. When the firm uses a contract to change the behaviour of its contract party, the contract can be enforced against the firm as well. Second, the contract is a legal concept. The firm must act in a certain way before a legally enforceable contract comes into existence. Third, the contractual relationship consists of more than the agreed terms. To a large extent, it is regulated by legal background rules. Fourth, the legal background rules and the terms of the contract must be interpreted before they can be applied. Fifth, the legal characteristics of contracts give rise to particular legal risks.

There is a difference between the contractual framework in the legal sense and the theory of a corporation being a "nexus of contracts". The nexus-of-contracts theory of corporations exists in economics or the economic theory of law (law and economics).[2] It says absolutely nothing about whether a relationship between two parties consists of rights and obligations that can be enforced by the court.

The purpose of this book is to discuss agreements that can create legally enforceable rights and obligations.

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[2] Alchian AA, Demsetz H, Production, Information Costs, and Economic Organization, Am Econ R 62 (1972) pp 777–795; Jensen MJ, Meckling WH, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, J Fin Econ 3 (1976) pp 305–360; Zingales L, In Search for New Foundations, J Fin 55(2000) pp 1623–1653.

2 Contracts in General: The Legal Framework

2.1 Introduction

The core of contract law consists of three components: (1) a sanction system which can be applied when a party to a contract does not fulfil its contractual obligations (section 6.3); (2) basic requirements as to form and enforceability (section 5.6); and (3) rules on legal capacity, representation, agency, and similar matters (section 6.2; for the management of information, see Chapter 7 and Volume I).

The enforcement of contracts requires the existence of a sanction system. The sanction system gives an incentive to comply with contractual obligations. Although it is not the only legal mechanism to change the behaviour of the other party (for the management of agency, see Volume I), the availability of sanctions is the most fundamental legal reason to use contracts in the first place. In civil law countries, specific performance and damages are the basic remedies of the aggrieved party in the event of breach of contract. There are fundamental differences between civil law countries and common law countries regarding specific performance. In addition, punitive damages awarded in the US are not part of the laws of the Member States of the EU.

The basic requirements as to form and enforceability are roughly the same in all developed countries. The same can be said of defences to enforcement. (a) The parties must possess legal capacity to enter into contracts. (b) There must be an agreement. According to the traditional rule, an agreement consists of an offer and an acceptance. One party must have offered to enter into a legal agreement, and the other must have accepted the offer. (c) The contract must be in whatever form the law requires. For example, some contracts must be in writing, or evidenced in writing, or signed by certain people. (d) Common law jurisdictions typically require consideration, whereas civil law jurisdictions do not. (e) A further requirement is that the contract must be legal and must not infringe fundamental public policy objectives. (f) For example, the apparent consent of both parties must be genuine. This may require the absence of fraud.

Moreover, there are rules setting out what actions, information, and other circumstances are attributable to a party who is represented by others. Where a party is a legal entity, the persons representing it must have had power to act on its behalf. Agency and representation can require the simultaneous application of rules belonging to different areas of law (company law, contract, law, the law of representation and agency).

The legal framework of a contractual relationship. The legal framework of a contractual relationship consists of: mandatory provisions which cannot be dero-

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gated from by choosing the law of another country to govern the contract; mandatory provisions of the governing law; agreed terms, and dispositive provisions of the governing law applicable to the extent that the parties have not agreed otherwise.

Cash flow, performances. The legal framework is designed to regulate what the parties must do. For this reason, it enables a party to determine cash flow and the terms of the exchange of goods and/or services.

In addition, the legal framework influences risk by influencing the behaviour of the parties and the variance of their performances. The legal framework therefore gives information about what the parties are likely to do.

Risk. Although contracts are a way to manage risk, contract terms do not always lead to the intended outcome. Moreover, contracts create new risks (see Chapters 4–6).

It is normal to distinguish between *legal* risks and *other* risks. However, most risks are affected by legal considerations in a contractual relationship.

For example, documentation risk, liquidity risk, credit risk, and many other risks depend on the applicable contract, collateral, and insolvency laws. In practice, many contributory legal risks have not been identified as legal risks at all. This is one of the factors making legal risk less quantifiable than other risks.

One can also distinguish between *endogenous* risks and *exogenous* risks. Endogenous risks are caused by possible actions or inactions of the contracting parties. Counterparty risk belongs to this category (see especially section 6.3). Exogeneous risks are caused by the possibility of changing external circumstances such as alterations in prices, demand or costs in the relevant industry or in the broader economy, for which neither party is responsible (section 5.5). The firm normally manages both endogenous and exogenous risks.

Information. The parties' views about the intended cash flow, the intended performances of the parties, and perceived risk depend on information. Large parts of contract law deal with information in one way or another.

For example, problems caused by information asymmetries can be mitigated in several ways. (a) The firm can address the problem of adverse selection by finding a way to equalise access to information (verification, inspections) and to shift the risk of loss to the party with the better information (warranties). (b) A third party can be brought into play. It is normal to employ intermediaries that produce and/or verify information, and to shift at least part of the risk to the intermediary.

Principal-agency relationships. A contractual relationship gives rise to an agency relationship. There is a risk that the contract party will not fulfil its obligations as agreed. The firm will therefore have to manage counterparty commercial risk (section 6.3). The management of counterparty commercial risk is even more important in long-term contracts.

2.2 The Legal Framework: General Remarks

2.2.1 Introduction

To obtain better information about the legal framework and to define its contents more precisely, the firm will choose: the *governing law*; the *contract model*; the substantive legal rules which work as legal *background rules* (default rules); and the *contract terms* which complement the default rules. The contract model and the governing law influence the conduct of the firm's representatives.

Substantive rules determine the obligations of the parties, the more precise contents of their obligations, the consequences of performance and non-performance, the modification of obligations, and so forth. There are more substantive legal rules for traditional contracts for exchange (such as the sale of goods) than for contracts for cooperation (such as sole distributorship). The former also tend to be more detailed than the latter. Substantive rules on various forms of cooperation are often open or vague and leave plenty of room for interpretation.

Typically, substantive legal rules contain: (a) rules that apply to contracts in *general*, and rules applicable to *specific* contract types (such as insurance contracts, contracts for the carriage of goods, contracts between a company and its shareholders, and so forth); (b) rules that may be *opted out* by the parties (dispositive rules, some mandatory rules), and rules that may *not* be opted out by them (some mandatory rules); as well as (c) rules that may be *opted in* by the parties (through choice of law or adapting the contractual relationship to fall within their scope).

Whereas *mandatory* rules of law leave parties no option but to adapt their behaviour (through avoidance or compliance), *dispositive* rules are merely default rules in the sense that they govern the contractual relationship only if the parties are not deemed to have agreed otherwise. The existence of dispositive rules can reduce transaction costs and make the drafting of contracts easier, because the parties only need to determine the essential terms of the contract and do not need to agree on every single aspect of their contractual relationship.

2.2.2 Platforms, Market Practice, Contract Models

The choice of the legal framework is influenced by transaction costs. In order to reduce transaction costs, the firm often uses pre-formulated agreements, master agreements, or a legal platform.

Market practice and global players Market practice influences transaction costs. The higher cost of adopting contract practices not used by other market participants – and the higher legal risk inherent in untried contract practices – can force the firm to use pre-formulated terms, contract models, and contract platforms shared by many market participants.[1]

[1] See, for example, Day JFS, Taylor PJ, Loan Documentation in the Market for UK Corporate Debt: Current Practice and Future Prospects, JIBL 12(1) (1997) p 8.

Many global players such as international law firms and accounting firms have access to the same intra-firm know-how in all countries in which they do business. This can reduce the production costs for advice and increase the global players' market share.

Standardisation. Market practice and the existence of global players can increase the degree of legal standardisation, i.e. the degree to which legal work rules, policies, and operating procedures are formalised and followed. With standardisation, legal processes become routine.

For example, market practice can force the firm to choose the law of a certain country. In many financial contracts, the choice of English or New York law can make it easier to access the widest range of potential participants.[2] Parties to privately-negotiated derivative transactions commonly select English law as the governing law and submit to the jurisdiction of English courts (this is one of the two alternatives under ISDA's industry standard form master agreement, the other being New York law and the New York courts, see section 11.7.4).

Like standardisation in general, legal standardisation can bring many benefits. Standardisation will enable the firm to reduce variability in its processes. This can help the firm to reduce uncertainty and costs. Standardisation can also help to improve the quality of the firm's legal processes and legal framework. Compliance is easier, if the same task performed by different people will not give different results; this will require that the best way of carrying out a legal process is documented in detail and that the process is followed.[3]

The drawback of legal standardisation is that legal processes and the legal framework will not be perfectly suited to the situation unless the transaction is a simple mass transaction. Furthermore, the legal framework might not be optimal for the parties, as standardisation is partly driven by external forces such as external regulation and the market. For example, Anglo-American practices might be used in a domestic transaction between two Finnish companies as market practice even when it would be possible to use cheaper domestic practices. There can also be a tradeoff between lower transaction costs achieved by standardisation and higher legal risk in an untypical situation. Finally, standardisation can hamper innovation.

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2 See Yescombe ER, Principles of Project Finance. Academic Press, San Diego London (2002) § 10.7.1; Diem A, Akquisitionsfinanzierungen. C.H. Beck, München (2005) § 28 number 11.

3 See Karandikar H, Nidamarthi S, Implementing a platform strategy for a systems business via standardization, Journal of Manufacturing Technology Management 18 (2007) pp 267–280. The authors identify the following steps in an engineering case: step one – create consensus on internal benefits and customer value; step two – agree on guiding principles; step three – create sales strategy; step four – technical implementation (deciding on the level of standardisation, common coding for standards, IT system for cataloging and sharing the standards, creation of standards, definition of work processes for usage of standards); step five – use standards; step six – performance measurement; step seven – sustain and apply standards across projects.

Platforms. A legal platform is a standardised legal framework that allows market participants and the providers of related services to interoperate without special arrangement.

The use of a legal platform is necessary when the firm tries to benefit from a liquid market. For example, a fair degree of standardisation in contracts is needed to ensure liquidity in traded instruments.

The use of a legal platform is not restricted to traded financial instruments. Generally, if many firms decide to use the same legal platform, positive network effects may follow.[4] There is a positive feedback cycle if the use of the framework is likely to lead to further use.

Where the firm decides to use a legal platform, some costs are incurred up front. After that, it is relatively cheap to use the same platform, and repeated use increases return after the initial investment.

For example, de facto standardisation of international swaps and derivatives documentation (by ISDA) has reduced transaction costs and made swaps and derivatives more attractive to banks' customers.

There are well-known technological platforms such as the standard for electricity transmission and right-hand (or left-hand) drive. There can also be competing platforms. In EU competition law, the existence of competing platforms is generally regarded as desirable.[5] However, sometimes the market for technological platforms is a winner-take-all contest in which the winner is not necessarily determined by the ultimate merits of the winning platform.[6]

As in the area of technology, the interaction of increasing returns and network effects can help to make the battle of legal frameworks into a winner-take-all contest. For this reason, the use of, for example, New York or English law as a platform does not necessarily say much about the quality of New York or English law compared with the laws of a third country.

In addition to the freedom to choose the governing law of the contact[7] and the existence of global players, increasing returns and network effects probably belong to the factors that have contributed to the increasing popularity of standard form agreements, the use of Anglo-American documentation practices, and the

4 See Lemley MA, McGowan D, Legal Implications of Network Economic Effects, Cal L Rev 86 (1998) pp 479–611.

5 See Case T-201/04 Microsoft v Commission [2005] ECR II-1491 paragraph 1153: "The Court further notes that it cannot be ruled out that third parties will not want the de facto standardisation advocated by Microsoft but will prefer it if different platforms continue to compete, on the ground that that will stimulate innovation between the various platforms."

6 The theory of increasing returns in economics has been popularised by Brian Arthur. See Arthur WB, Increasing Returns and Path Dependence in the Economy. U Mich P, Ann Arbor (1994). Concepts on increasing returns were used during the antitrust case brought by the US Department of Justice against Microsoft.

7 See also Eidenmüller H, Kampf um die Ware Recht, FAZ, 26 March 2009 p 8.

choice of New York or English law as the governing law in many financial transactions.

The popularity of New York or English law in financial transactions can be readily explained by the sheer size of the US and British capital markets compared with the capital markets of other countries.

It should be clear that English law is not "better" than the laws of many other established Member States of the EU (see section 4.4.3) although it is used as a platform.

The same can be said of linguistic platforms. The English language is the new *lingua franca* in cross-border commerce in Europe. In the past, educated people spoke French. Before that, the leading languages were Latin and Greek. Few people would argue that the English language is the language of international commerce "because it is better than French, Latin, and Greek".

Many countries praise their own legal systems for marketing reasons. For example, a brochure published by the Law Society of England and Wales[8] praises the law of England and Wales, and a German brochure praises German law.[9]

The existence of legal platforms reduces the flexibility of contract practice. An increasing number of firms end up using the same legal platform. For example, if Anglo-American documentation practices become a worldwide legal platform, their use is likely to decrease the flexibility of contract practices worldwide and increase certain legal risks.

Legal platforms can thus have an effect that resembles the effect of mandatory provisions of law. Niamh Moloney wrote about the regulation of investment intermediaries as follows: "Regulation imposes burdens on investment intermediaries in terms of resources … and in terms of the restrictions it imposes on their freedom of action. The proactive regulation of intermediaries also carries with it the problem of moral hazard: the risk that investors exercise less care than they otherwise would in the belief that regulation removes the need to take care in making investments or dealing with investment intermediaries by guaranteeing the reliability and soundness of investment intermediaries. Regulatory techniques beyond disclosure also ultimately limit investor choice … by regulating market entry and controlling the behaviour of investment intermediaries and access to particular investments."[10]

The Anglo-American contract model. Firms increasingly use standard practices based on the Anglo-American model of contract law.[11]

Documentation based on the Anglo-American contract model is lengthier and more complex than documentation drawn up in the traditional continental European way: (1) large parts of the applicable law are repeated in the contract (boilerplate clauses); (2) the contract contains clauses for nearly everything that can go wrong in the performance of contractual obligations; and (3) the contract contains

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[8] England and Wales: The jurisdiction of choice.

[9] Law - Made in Germany.

[10] Moloney N, EC Securities Law. OUP, Oxford (2008) pp 344–345.

[11] There are some historical differences between UK and US contract practice, See, for example, Phillips J, Runnicles J, Schwartz J, Navigating trans-atlantic deals: warranties, disclosure and material adverse change, JFRC 15(4) (2007) pp 472–481.

very detailed provisions on the performance of these contractual obligations. For example, the contract contains a large number of definitions.[12]

The Anglo-American model has influenced the structure of commercial contracts. In a large transaction, a long-term contract based on the Anglo-American model typically contains clauses on the following or similar issues: the separation of signing and closing (section 5.6.2 below); conditions precedent to closing (section 5.6.2); representations (section 6.2.3);[13] warranties (section 2.5.2); covenants (or undertakings) (section 11.6.2);[14] events of default (section 6.3.3); remedies (section 6.3.3); notices (section 6.2.2); assignment (section 11.4); governing law (section 2.3.2); and dispute resolution (section 4.4.4).

Adaptation. Each firm tries to standardise its products, processes and business practices (its business system) to reduce costs and risk. The standard legal framework used by the firm is designed for its own business system. Plenty of standardisation is market-driven.

The opposite of standardisation is inter-party adaptation. Whereas the firm's standard legal framework is typically based on the firm's own standard business system, commercial adaptation by the firm will result in the adaptation of the firm's legal framework as well. There is likely to be more adaptation the deeper the business relationship becomes. The degree of adaptation and the choice of the party that will have to adapt more depend on the characteristics of the firms involved. In a relationship between a large customer and a small supplier, the customer is unlikely to adapt much.

In economic literature,[15] buyer-seller adaptations have been defined as behavioural or structural modifications, at the individual, group or corporate level, carried out by one organisation, initially designed to meet the needs of one other organisation (Brennan and Turnbull).

[12] See Lundmark T, Common law-Vereinbarungen – Wortreiche Verträge, RIW 3/2001 p 187. See also Kiener R, Lanz R, Amerikanisierung des schweizerischen Rechts – und ihre Grenzen, 'Adversarial Legalism' und schweizerische Rechtsordnung, ZSR 2/2000 pp 155–174.

[13] In English M&A practice, sellers resist giving representations in addition to warranties (see Volume III). In German contract law, Zusicherungen might contain elements of conditions precedent, representations, warranties and covenants. See Diem A, Akquisitionsfinanzierungen. C.H. Beck, München (2005) § 21 numbers 1–8. For an introduction to how to adapt the US contract model to German law in the context of business acquisition, See, for example, Triebel V, Anglo-amerikanischer Einfluß auf Unternehmenskaufverträge in Deutschland - eine Gefahr für die Rechtsklarheit? RIW 1998 pp 1–7.

[14] In German contract law, covenants would be called "Auflagen". Diem A, Akquisitionsfinanzierungen. C.H. Beck, München (2005) § 22 number 1.

[15] Brennan R, Turnbull PW, Adaptive Behaviour in Buyer-Supplier Relationships, Industrial Marketing Management 28 (1999) pp 481–495. For an introduction to adaptation, see, for example, Hagberg-Andersson Å, Adaptation in a Business Network Cooperation Context. Publications of the Swedish School of Economics and Business Administration Nr 169, Helsinki (2007).

Adaptation is often needed to take a business relationship further. The relationship cannot be very deep if neither party will need to adapt.[16]

Adaptation can increase transaction costs and legal risk, as a party typically has more information about its standard business system than about adapted ones, and more information about its own standard legal framwork than about individually negotiated frameworks. However, adaptation can also help the participating firms to design a legal framework for their particular situation, mitigate problems caused by the standardised legal framework, and reduce overall costs.

2.2.3 Governing Law

It is not sufficient to agree on the core commercial terms of the contract. Core terms are just part of the legal framework. The firm cannot draft the contract in any meaningful way unless it has at least a basic understanding of the rest of the legal framework. The legal background rules (default rules) depend on the applicable choice of law rules designating the governing law.

Choice of law rules. When ascertaining the applicable laws, the firm should first determine the countries the courts of which might be asked to enforce or interpret the contract. This is because each judge applies the choice of law rules of the jurisdiction where the forum is located (lex fori), and the contents of choice of law rules may depend on the jurisdiction.

Moreover, different aspects of the case (for example, contractual matters v tort) may be governed by the laws of different countries, because different issues are governed by different choice of law rules. For this reason, the judge would classify the issue (for example, as one of contract rather than one of tort) before applying the choice of law rules applicable to the issue in question (for example, the choice of law rules that apply to contractual matters). The firm should do the same in order to apply the right choice of law rules.

Choice of law. The firm may choose the law that governs some aspects of the project (choice of law clause or governing law clause) but must adapt to the rules that govern the project in other respects.

The freedom of choice can depend on the area of law and the characterisation of the issue. For example, there is often freedom to choose the law applicable to contractual obligations in commercial contracts. However, the same level of freedom does not exist in other areas of law. In the absence of freedom to choose the governing law, the parties will have to take the choice of law rules for granted and adapt to the substantive rules.

Differences between contract laws. It can make sense to determine the contents of the governing law in advance, because there can be fundamental differences depending on the governing law. For example, there are differences between the

[16] Brennan R, Turnbull P, Wilson D, Dyadic adaptation in business-to-business markets, European Journal of Marketing 37 (2003) pp 1636–1665.

laws of continental European countries (civil law countries) and common law countries.[17]

There is a difference in approach. In civil law countries, statutes are constructed broadly. In common law countries, there is a tradition of narrow construction of statutes.[18]

There is a difference of style. In civil law countries, laws and contracts tend to contain general principles and open rules, which make them shorter. In common law countries, laws and contracts are typically longer and richer in detail. They tend to contain a long list of definitions.

The concept of good faith plays a major role in civil law countries.[19] However, the concept of good faith is not part of traditional common law.[20]

As regards remedies, courts in civil law countries routinely grant specific performance by ordering parties to perform their contracts.[21] In common law systems, however, courts regard specific performance as an "extraordinary" remedy, to be granted only when an award of damages would not be adequate.[22]

There is a difference relating to penalty clauses (section 6.3.3). Penalty clauses are generally acceptable in civil law countries. In common law countries, however, courts refuse to enforce provisions imposing penalties unless they are disguised as "liquidated damages".[23] This helps to explain why the CISG is silent on penalty clauses.[24]

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[17] For a helpful introduction, see Farnsworth EA, A Common Lawyer's View of his Civilian Colleagues, Louisiana L R 57 (1996) pp 227–233.

[18] This difference explains, for example, the wording of CISG Article 7(2). Article 7(2) contains the civil law view and recognises the common law view.

[19] In Germany, § 242 BGB requires parties to observe "Treu und Glauben". See also Article 7(1) of the CISG.

[20] See, for example, Teubner G, Legal Irritants: Good Faith in British Law or How Unifying Law Ends Up in New Divergences, Modern L R 1998 pp 11–32; DCFR, Outline Edition (2009), Introduction, paragraph 72.

[21] See CISG Article 46(1): "The buyer may require performance by the seller of his obligations unless the buyer has resorted to a remedy which is inconsistent with this requirement."

[22] This has been recognised in CISG Article 28: "If, in accordance with the provisions of this Convention, one party is entitled to require performance of any obligation by the other party, a court is not bound to enter a judgement for specific performance unless the court would do so under its own law in respect of similar contracts of sale not governed by this Convention."

[23] The CISG is silent on penalty clauses.

[24] Miller L, Penalty Clauses in England and France: A Comparative Study, ICLQ 53 (2004) pp 79–106: "… the most cursory of examinations reveals the diametrically opposed theoretical positions of contemporary legal orthodoxy in France and England …"

2.2.4 Choice of Legal Background Rules

The firm may not change the scope or contents of the legal background rules. However, the firm may influence their application by adapting the project and the contract.

By project adaptation, the firm can avoid the application of the laws of a certain country, or the application of certain substantive norms of the governing law. Such opt-out will simultaneously mean opt-in, as the project will always be governed by laws.

By contract adaptation, the firm can decide to what extent the contract will be governed by the laws of a certain jurisdiction, and to what extent the contract is governed by certain substantive laws of the governing law. In other words, it is often possible to choose between opt-in and opt-out.

As the contract reflects the project and sets out its terms, project adaptation will normally require contract adaptation. Contract adaptation can lead to project adaptation. On the other hand, the governing law clause and the dispute resolution clause do not automatically require project adaptation.

2.3 The Legal Framework: EU Contract Law

2.3.1 Introduction

Legal developments in the EU have had a mixed effect on the firm's chances to ascertain cash flow and risk in advance.

Governing law. Community law makes it easier to choose both the law that governs contractual obligations and the dispute resolution (jurisdiction) clause. This is the main way to help firms improve the quality of the legal framework of the contract under Community law.

Party autonomy. In Member States' contract laws, party autonomy dominates. The limits are seen as exceptions. However, the erosion of party autonomy was the trend in the 20th century. Party autonomy is restricted in consumer legislation and labour law. It can be constrained by provisions belonging to other fields of law such as competition law, securities markets law, and the regulation of the technical specifications of products.

Differences. There are differences between Member States' laws. This is not always a problem. Differences in dispositive contract laws are not a problem for firms, because firms can make them disappear by drafting. Differences in mandatory rules can be a problem, because firms must adapt to mandatory rules. Whether the differences are problem for consumers depends on the extent of cross-border consumer transactions.

Harmonisation, new layer to the legal framework. If the mandatory substantive provisions were similar, it would be easier and less costly to draft new contract documentation to be used in many countries, and less costly to monitor the need to update standard documentation. The harmonisation of dispositive provisions could reduce transaction costs at the time of contracting by providing for a common linguistic and legal platform.

To some extent, the main principle of freedom to choose the governing law is therefore complemented by the harmonisation of the substantive provisions of Member States' laws.

However, the EU has adopted a "piecemeal" approach to harmonisation in the area contract law. The harmonisation of laws by means of directives does not extend to the area of general contract law.

In any case, substantive Community law adds a further layer to the legal framework. It is a basic rule of Community law that a directly effective provision of Community law always prevails over a provision of national law.

National preferences. In spite of the legal developments in the EU, the techniques of contract drafting still reflect national preferences, national contract laws, national rules on the interpretation of contracts, and national contract models in general.

2.3.2 The Law Governing the Contract

Community law makes it easier to determine the governing law. The basic principles that govern choice of law clauses (and dispute resolution clauses) are relatively straightforward. It is possible to choose the law applicable to contractual obligations. This is also one of the basic ways to mitigate the flexibility of law risk (section 4.4.4).

Restrictions on the freedom to choose the law applicable to contractual obligations. However, Community law can, to some extent, limit the firm's freedom to choose the terms of the contractual relationship.[25]

First, the coordination of choice of law rules can restrict party autonomy in some cases. In particular, there can be special connecting factors according to rules that are normally regarded as choice of law rules (in other words, there are factors that connect the matter with a certain jurisdiction according to harmonised choice of law rules).

Second, the approximation of substantive laws can restrict party autonomy in some cases. There can be special connecting factors in the area of harmonised substantive law (in other words, there are factors that connect the matter with a certain jurisdiction according to harmonised substantive rules that are not normally regarded as choice of law rules).[26]

Third, the approximation of laws can result in the restriction of party autonomy in some cases. The scope of party autonomy depends on how much party autonomy remains after the substantive rules have been harmonised. The convergence

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[25] See Kieninger EM, Koordination, Angleichung und Vereinheitlichung des Europäischen Vertragsrechts, SZIER/RSDIE 4/2004 pp 484 and 496.

[26] Case C-381/98, Ingmar GB Ltd v Eaton Leonard Technologies Inc., ECR 2000 I-9305, paragraphs 24–26; see also Kieninger EM, Koordination, Angleichung und Vereinheitlichung des Europäischen Vertragsrechts, SZIER/RSDIE 4/2004 pp 494–495.

of mandatory rules would leave the firm less freedom to circumvent them by choosing the law of another country.

The second and third cases are examples of the typical EU approach to private law, which is to try to construct rules of universal application to achieve uniformity of results.

Choice of law rules that designate the applicable law. The first matter mentioned in the list is the coordination of choice of law rules. As regards contractual obligations in general, the governing law is designated by the provisions of the Rome I Regulation[27] which replaces the 1980 Rome Convention.[28] The Rome II Regulation applies to non-contractual obligations.[29]

Freedom of choice. The main rule under the Rome I Regulation is freedom to choose the governing law (Article 3).

Where the parties have not determined the law applicable to their contract, the contract is normally governed by the law of the country where the party who is required to effect the characteristic performance of the contract has his habitual residence (Article 4(2)).

In commercial contracts between firms, the most important exception to the main rule relates to mandatory rules that must be applied irrespective of the law otherwise applicable to the contract (Articles 3(3) and 3(4)).[30]

Mandatory rules. The main rule is that the court applies the mandatory contract law rules of the law that governs the contract.[31] However, the court may apply the mandatory rules of the law of another country in which all other elements relevant to the situation were located at the time of the choice.[32] Furthermore, the court may apply mandatory provisions based on Community law, where all other elements relevant to the situation at the time of the choice were located in one or more Member States, but the parties chose the law of a non-Member State.[33] There is also a rule on ordre public.[34]

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27 Regulation 593/2008 (Rome I).

28 The Rome I Regulation applies from 17 December 2009 to contracts concluded after the same date. Article 28 of Regulation 593/2008 (Rome I). Denmark is not bound by the Rome I Regulation. See recital 46. For the role of the Rome Convention, see Article 24. For existing international conventions, see Article 25.

29 Regulation 864/2007 (Rome II).

30 See also Article 9 on “ordre public”, the public policy of the forum.

31 Article 12(1) of Regulation 593/2008 (Rome I).

32 Article 3(3) of Regulation 593/2008 (Rome I): “Where all other elements relevant to the situation at the time of the choice are located in a country other than the country whose law has been chosen, the choice of the parties shall not prejudice the application of provisions of the law of that other country which cannot be derogated from by agreement.”

33 Article 3(4) of Regulation 593/2008 (Rome I): “Where all other elements relevant to the situation at the time of the choice are located in one or more Member States, the parties’ choice of applicable law other than that of a Member State shall not prejudice the application of provisions of Community law, where appropriate as implemented in the Member State of the forum, which cannot be derogated from by agreement.”

34 Article 9 of Regulation 593/2008 (Rome I).

The Rome I Regulation thus requires that "all other elements relevant to the situation" were located in another country or one or more Member States. Article 7(1) of the Rome Convention required only a "close connection".[35]

Other choice of law provisions of Community law that designate the applicable law. Community law lays down even other choice of law rules applicable in other areas of law. (a) There are many examples of the application of the principle of *home country* control in financial markets. A prospectus will be approved by the competent authority of the issuer's home Member State under that country's laws.[36] The public law that governs trading on a regulated market is that of the home Member State of the regulated market.[37] Issuers whose securities are admitted to trading on a regulated market must disclose information in compliance with their obligations under the laws of the home Member State of the regulated market.[38] (b) Sometimes the *territory* of a Member State is the connecting factor. For example, each Member State must apply the prohibitions and requirements provided for in the Directive on market abuse to actions carried out on its territory under certain circumstances.[39] Many other choice of law rules will be discussed later in this book in the context of different areas of law and particular contract types.

For example, a business acquisition can be governed by the laws of many countries. The parties may choose the law applicable to contractual obligations. The law governing contractual obligations can also govern pre-contractual disclosure duties. Company law aspects will nevertheless be governed by the law governing each participating company. In addition, title to the target's assets depends on the law of the place where the assets are located.[40]

Substantive provisions of Community law designating the applicable rules. Some substantive provisions of Community law have a similar effect as choice of law rules in that they designate the applicable rules. A number of sectoral EU directives contain substantive provisions designating the applicable rules without designating the governing law as such.

Some of these rules are well-known. For example, the Directive on takeover bids provides that the authority competent to supervise a bid shall be that of the Member State in which the offeree company has its registered office if that com-

[35] See, for example, Financial Markets Law Committee, Issue 121 – European Commission Final Proposal for a Regulation on the Law Applicable to Contractual Obligations ("Rome I") (April 2006).
[36] Article 2(1)(q) of Directive 2003/71/EC (Prospectus Directive).
[37] Article 36(4) of Directive 2004/39/EC (MiFID).
[38] Article 10(1) of Directive 2003/71/EC (Prospectus Directive).
[39] Article 10 of Directive 2003/6/EC (Directive on market abuse).
[40] See, for example, Merkt H, Internationaler Unternehmenskauf durch Erwerb der Wirtschaftsgüter, RIW 1995 pp 533–541.

pany's securities are admitted to trading on a regulated market in that Member State.[41]

Sometimes the firm can find the rules surprising.[42] For example, the First Company Law Directive can designate some rules applicable to the conclusion of contracts with a company (section 6.2.2),[43] and the Electronic Commerce Directive can designate some rules applicable to services provided by electronic means.[44]

Harmonisation of substantive rules. The third item mentioned at the beginning of this section is the approximation of substantive laws. The harmonisation of contract laws is limited to three main sectors: consumer contract law; financial services; and labour law.[45] The approximation of substantive laws will be discussed in the next section.

2.3.3 Approximation of Contract Laws

The approximation of contract laws is often regarded as an important task of the Community.

The role of contract laws has been described by some writers as follows: "Contract law is the core area not only for private law, but also of the internal market process. This can be explained by the fact that the fundamental freedoms are the basic tools of the Treaty in the internal market process and that they are designed to extend party autonomy across borders. The contract is the instrument of party autonomy. In the internal market, party autonomy means not only orthodox contractual freedom but also freedom to choose the law applicable and thereby also to do away in part with domestic mandatory law [Article 3(1) of the Rome I Regulation]. Among the fundamental freedoms, those related to contracts are more important, both practically and doctrinally, than those related to organisation. These are the freedom of movement of goods, the freedom to provide services and the freedom of capital movements [Articles 28, 49 and 56 of the EC Treaty]."[46]

In corporate finance, however, the firm tends to benefit from the existing approximation of contract laws only indirectly.

Piecemeal approach. The firm benefits only indirectly because the EU legislator has adopted a problem-related "piecemeal" approach to the harmonisation of

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41 Article 4(2)(a) of Directive 2004/25/EC (Directive on takeover bids). See also Siems MM, The Rules on Conflict of Laws in the European Takeover Directive, ECFLR 2004 pp 458–476.

42 See, for example, Furrer A, Gestaltungsspielräume im Europäischen Vertragsrecht. Vier Thesen für die schweizerische Rechtspraxis, SZIER/RSDIE 4/2004 pp 515–516.

43 See Article 9 of Directive 68/151/EEC (First Company Law Directive).

44 Article 3 of Directive 2000/31/EC (Directive on electronic commerce). See, for example, Mäntysaari P, The Electronic Commerce Directive and the Conflict of Laws. The Case of Investment Services", JFT 3/2003 pp 338–380.

45 Grundmann S, Kerber W, Weatherill S, Party Autonomy and the Role of Information in the Internal Market – an Overview. In Grundmann S, Kerber W, Weatherill S (eds), *op cit*, pp 28–29.

46 *Ibid*, p 5.

contract laws. The piecemeal approach means that contract law provisions can be found in various sectoral instruments.

There is no across the board harmonisation, because the EU does not possess general regulatory power in the area of contract law. The EU can only intervene in case actual problems exist which require a solution at EU level.[47]

Most of such problems relate to consumer transactions (b-to-c). Consumer transactions are highly regulated and governed by mandatory laws. Mandatory provisions in Member States' contract laws generally make it more difficult to offer the same goods and services under the same or similar conditions throughout the single market. Some of the mandatory provisions are now based on EU legislation. When the EU sought to eliminate obstacles to the free movement of goods and services, it also dealt with mandatory provisions of contract law.

The piecemeal approach can cause problems for firms especially where an instrument of Community law contains abstract terms. Abstract terms may represent a legal concept for which there are different rules depending on the jurisdiction, and the absence of a uniform understanding in Community law of general terms and concepts may lead to different results in commercial and legal practice depending on the Member State.[48]

Furthermore, Community law often lays down minimum standards, and rules adopted by Member States going beyond the minimum harmonisation prescribed by Community law are divergent.[49] These questions will be discussed in the context of risk later in this book (for the flexibility of law, see section 4.4).

Commercial contracts. In general contract law, there is little EU legislation about commercial contracts between firms (b-to-b). Apart from sectoral rules, the laws governing commercial contracts are normally dispositive.

Commercial contracts are affected by sectoral legislation such as EU competition law, legislation relating to electronic commerce, legislation on minimum technical standards or minimum service standards, and the approximation of tax laws. In addition to Community law, there are international conventions on cross-border b-to-b transactions.

This means that the firm should adapt the contract documentation to the laws that govern the transaction. In the EU, firms generally need to work with more than one set of contract laws.

Community acquis on the obligations of contract parties. As said above, many directives contain provisions leading to the approximation of private law.[50] Some directives deal with rules on the creation of contractual obligations (i.e. the con-

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47 C-376/98 Germany v Parliament and Council [2000] ECR 2000 p I-2247 ("tobacco").

48 Communication from the Commission to the Council and the European Parliament on European Contract Law, COM/2001/0398 final, 11 July 2001. See also Kieninger EM, Koordination, Angleichung und Vereinheitlichung des Europäischen Vertragsrechts, SZIER/RSDIE 4/2004 p 503.

49 Communication from the Commission to the European Parliament and the Council, A More Coherent European Contract Law, COM/2003/0068 final, 12 February 2003, paragraph 50.

50 See the Commission's Communication of 11 July 2001. See also Kieninger EM, *op cit*, pp 487–491.

clusion of a contract, the form and the content of an offer, and the acceptance of an offer). There are also directives that specify the content of the information to be provided by the parties at different stages, in particular before the conclusion of a contract. Some directives cover rights and obligations of the contracting parties regarding the performance of contractual obligations (required performance, poor performance, and non-performance).

However, only some directives apply to commercial transactions between firms. The purpose of most directives that deal with the obligations of contract parties is to protect consumers. Therefore, it is necessary to study contract law directives in the context of some types of transactions (for example, when securitising consumer receivables), but not in the majority of corporate finance transactions.

For example, the following directives apply to *commercial* transactions: Directive 2000/31/EC (Directive on electronic commerce); Directive 1999/93/EC on a Community framework for electronic signatures; Directive 2000/35/EC on combating late payment in commercial transactions; Regulation 2560/2001 on cross-border payments in euro; Directive 97/5/EC on cross-border credit transfers; and Directive 86/653/EEC on the coordination of the laws of the Member States relating to self-employed commercial agents. See also Directive 2004/39/EC (MiFID).

The following directives are examples of directives applicable to *consumer* transactions: Directive 85/577/EEC to protect the consumer in respect of contracts negotiated away from business premises; Directive 97/7/EC on the protection of con-sumers in respect of distance contracts; Directive 2002/65/EC concerning the distance marketing of consumer financial services; Directive 93/13/EEC on unfair terms in con-sumer contracts; Directive 1999/44/EC on certain aspects of the sale of consumer goods and associated guarantees; Directive 2008/48/EC on credit agreements for consumers; Directive 90/314/EEC on package travel, package holidays and package tours; Directive 85/374/EEC on the approximation of the laws, regulations and administrative provisions of the Member States concerning liability for defective products; and Directive 1999/34/EC amending Council Directive 85/374/EEC on the approximation of the laws, regulations and administrative provisions of the Member States concerning liability for defective products.

Sectoral conventions. There are nevertheless international conventions in specific areas of commercial transactions (b-to-b). International conventions tend to focus on a narrow subject area and exclude other matters.

Among these conventions may be mentioned the 1980 Vienna Convention on Contracts for the International Sale of Goods (UN Sales Convention, CISG), the 1988 UNIDROIT Conventions on International Financial Leasing and International Factoring, the 2001 Cape Town Convention on International Interests in Mobile Equipment with its associated Aircraft Equipment Protocol, the UNCITRAL Convention on the Assignment of Receivables in International Trade, also concluded in 2001, and the 2002 Hague Convention on the law applicable to certain rights in respect of securities held with an intermediary.[51]

[51] See Goode R, Contract and Commercial Law: The Logic and Limits of Harmonisation, Electronic Journal of Comparative Law, vol 7.4 (November 2003).

International conventions help to standardise the law for the benefit of the entire EU, if all Member States of the EU accede to the convention in question or ratify it en bloc. Unfortunately, there are many areas of international law in which several multilateral conventions coexist, each with a different selection of signatories from the EU. Such conventions are inclined to cement legal differences within the EU along new dividing lines instead of creating legal unity.

Such international conventions include, for example, the Council of Europe's 1993 Lugano Convention on Civil Liability for Damage Resulting from Activities Dangerous to the Environment, other international agreements from the realm of environmental liability, and the New York Convention on the Limitation Period in the International Sale of Goods, which is a parallel agreement to the CISG.

Sectoral conventions normally do not deal with matters that are fundamental for the system of private law in general. For example, they do not deal with the relationship between the law of obligations (Schuldrecht, Obligationenrecht)[52] and the law of property (Sachenrecht).

The CISG is an example of a convention that focuses on a narrow subject area. It is worth noting that it does not apply to the sale of rights and accounts receivable; many traditional corporate finance transactions will therefore not fall within its scope. Furthermore, the UK, Japan, and many other major countries have yet to adopt the CISG.

Convergence of contract laws. Although the general principles of contract law have not been harmonised by legislative instruments adopted by the institutions of the EU, the trend is towards increasing convergence, as can be seen from the large number of international conventions and general international initiatives in this area.

The trend towards convergence began a long time ago. Contract law belongs to the oldest and most fundamental areas of law. Countries that belong to the same legal family typically share the same general principles of contract law. The main distinction in Europe is between continental European countries (which largely adopted Roman law) and Anglo-Saxon countries (which continued to apply their own common law). Many principles applied in continental Europe are based on Justinian's Digest (published in 533) that was itself intended as a unified body of law. The civil codes of continental Europe were originally designed to unify private law in each country that adopted them, and previous codes typically influenced the work on later codes in other countries.

In addition, sale of goods law has historically been the model for general contract law, and general contract law has been the model for the general law of obligations.

[52] The continental European concept of the "law of obligations" covers branches of law such as contracts, torts and enrichment. These branches of law are considered to be separate in the common law tradition. This continental European tradiotion is based on Roman law (see Gaius' Institutiones):

The law of the sale of goods has been the subject of comparative law[53] and the unification of law internationally. For example, the Nordic countries unified their sale of goods laws in the early 20th century.[54] In 1930, the International Institute for the Unification of Private Law (UNIDROIT) decided to proceed with the preparation of a uniform law on the international sale of goods under the auspices of the League of Nations. One of the driving forces behind this idea was Professor Ernst Rabel, who was inspired by Nordic contract laws, among other things. This unification effort resulted in the convening of a diplomatic conference at The Hague in 1964. The conference adopted two uniform laws, one on the international sale of goods (ULIS) and the other on the formation of contracts for international sales, annexing them to two international conventions. The number of Contracting States nevertheless remained very small. In 1968, the UNCITRAL started work on the reform of these conventions. This work subsequently led to a draft Convention on the International Sale of Goods in 1977.

The CISG has been the basis of international incentives regarding the unification of general contract law in recent years. The provisions of the UNIDROIT Principles for international commercial contracts and the Principles of European Contract Law (PECL) are often literally the same as the provisions in the CISG.

In many countries, these developments have influenced work on the reform of both the sale of goods laws and general contract laws. For example, the Nordic sale of goods statutes were modernised before the end of the 20th century.[55] There was also a large reform of the German Civil Code (BGB) in 2001. Some of the BGB's earlier provisions on the sale of goods and general contract law were replaced by new provisions that are closer to the principles of the CISG and, in effect, the Nordic sale of goods laws.

European civil code. As regards general contract law, firms cannot at the moment choose any "neutral" Community-wide contract code. Existing sectoral conventions are complemented by a number of private and international initiatives.

The Commission on European Contract Law (under the chairmanship of Professor Ole Lando) formulated a set of contract principles for Europe. Parts I and II were published in 1999 and Part III in March 2003. In parallel, UNIDROIT produced its Principles of International Commercial Contracts.[56] There was a certain degree of common membership of the two groups and a high degree of similarity in the two texts. The two sets of principles are not legally binding instruments, but they are frequently used as an indication of the best rule for a particular situation and they have been applied in many arbitration proceedings and in some judicial decisions.[57]

The work of the Lando Commission was absorbed into the wider project being undertaken by the Study Group on a European Civil Code and the European Research Group on the Existing EC Private Law (Acquis Group).

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53 See Rabel E, Das Recht des Warenkaufs I-II (1936 and 1958).

54 Finland adopted in effect the provisions of the Swedish Sale of Goods Act.

55 With the exception of Denmark.

56 UNIDROIT Principles of International Commercial Contracts 1994. The second edition was published in 2004. UNIDROIT Principles of International Commercial Contracts 2004.

57 Goode R, Contract and Commercial Law: The Logic and Limits of Harmonisation, Electronic Journal of Comparative Law, vol 7.4 (November 2003).

There are different opinions as to whether a European civil code would be necessary.[58] After two resolutions of the European Parliament, the Council requested the Commission to investigate the need for a code. In July 2001, the Commission issued a Communication on European contract law.[59] In February 2003, the Commission produced its Action Plan.[60] In a third communication, the Commission rejected the idea of a European contract code.[61] The Action Plan suggests a mix of non-regulatory and regulatory measures. The aim of the Action Plan is to produce "a Common Frame of Reference" (CFR) by 2009, establishing common principles and terminology in the area of EU contract law. However, it is not the Commission's intention to propose a "European civil code" harmonising the contract laws of Member States.

Action Plan. So, in February 2003, the Commission adopted a Communication which laid down a draft Action Plan, consisting of the following measures: actions to increase coherence between the various contract law instruments (for example, through the adoption of a Common Frame of Reference, CFR); promotion of the adoption of Standard Terms and Conditions (STC) for use throughout the EU rather than in a single member state; and further reflection on the opportunism of a non-sector specific contract law instrument.

In October 2004, the Commission adopted a Communication setting out the Commission's follow-up to the 2003 Action Plan.[62] It outlines how the CFR will be developed to improve the coherence of the existing and future acquis communautaire, and sets out specific plans for the parts of the acquis relevant to consumer protection. It also describes planned activities concerning the promotion of EU-wide STC.

Common Frame of Reference. The adoption of the CFR by the Commission is foreseen for 2009. The Commission has not given much information about the contents of the CFR.[63] In any case, the main goal of the CFR is to serve as a "tool box" for the Commission when preparing proposals, both for reviewing the existing acquis and for new instruments. To that aim, the CFR could be divided into three parts: fundamental principles of contract law; definitions of the main relevant abstract legal terms; and model rules of contract law. The CFR is intended to draw on the Community acquis and on best solutions found in Member States' legal orders. The legal nature of the CFR is not yet clear. The Commission considers that the CFR would be a non-binding instrument.

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[58] See Kieninger EM, Koordination, Angleichung und Vereinheitlichung des Europäischen Vertragsrechts, SZIER/RSDIE 4/2004 pp 486–487 and 493.

[59] Communication from the Commission to the Council and the European Parliament on European Contract Law, COM(2001) 398 final, 11 July 2001.

[60] Communication from the Commission to the European Parliament and the Council, A More Coherent European Contract Law, COM(2003) 68 final, 12 February 2003.

[61] Communication from the Commission to the European Parliament and the Council - European Contract Law and the revision of the acquis: the way forward, COM(2004) 0651 final, 11 October 2004.

[62] *Ibid*.

[63] See Lando O, Der Aktionsplan der EG-Kommission zum europäischen Vertragsrecht, RIW 1/2005 p 3.

A large number of legal scholars from many countries have participated in the process of trying to identify the contract law acquis communautaire. In 2008, the European Research Group on the Existing EC Private Law (Acquis Group) published the Principles of the Existing EC Contract Law.[64] In 2009, the Study Group on a European Civil Code (Study Group) and the Acquis Group published the Draft Common Frame of Reference (DCFR). The DFCR is an academic text and a possible model for a political CFR. A political CFR would not necessarily have the same coverage and contents as the academic DCFR.[65]

Standard Terms and Conditions. The second measure sought to promote the development by private parties of Standard Terms and Conditions for EU-wide use.

The use of standard terms does not require the harmonisation of contract laws. A party can draft them unilaterally. At the other extreme, one could opt for the creation of procedures for autonomous agreements under which representatives of parties to standard types of contracts can agree upon model contracts containing fair ancillary terms. This could make it easier for firms to use standard terms of business in cross-border trade with confidence.[66] Furthermore, such agreements could reduce transaction costs for customers, and customers might benefit from "fair terms".

However, the use of such standard terms would hamper innovation and mean that the contractual framework would not be optimal without adapting the firm's business activities to it. Competition law may limit these activities as agreements or concerted practices to use STC may in some cases be incompatible with EU competition rules.[67]

2.4 Fixing the Legal Framework

2.4.1 Introduction

It is always important for the firm to regulate cash flow and the performances of the parties in advance, as the firm cannot make informed and rational decisions about investments without defining their terms.

Agreed terms, legal background rules. In order to fix the terms of the contract in advance, the firm must choose both the agreed terms and the applicable legal background rules.

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[64] See Jansen N, Zimmermann R, Restating the Acquis Communautaire? A Critical Examination of the 'Principles of the Existing EC Contract Law', Modern L R 71 (2008) pp 505–534.

[65] DCFR, Outline Edition (2009), Introduction, paragraph 6.

[66] Collins H, The Freedom to Circulate Documents: Regulating Contracts in Europe, ELJ 10 (6) (2004) pp 787–803.

[67] See Commission Notice, Guidelines on the applicability of Article 81 of the EC Treaty to horizontal cooperation agreements (2001/C 3/02), particularly section 6 (agreement on standards).

Incomplete contracting. Incomplete contracting increases legal and other risks. Incomplete contracting means the failure of the agreement to define the rights and obligations of the parties in all possible circumstances, so that one or both parties find the agreement unsatisfactory after the occurrence of an event. This is more likely to happen where the contract fails to address a moral hazard or enables the other party to take advantage of an unanticipated situation.[68]

For many reasons, contracts are nevertheless often left incomplete (for living with risk, see also Volume I). First, a party will accept a certain risk in order to make a profit. Second, there are transaction costs. Third, the parties may have insufficient information. Fourth, a party might not even be particularly interested in all circumstances. As a "boundedly rational decision-maker", a party typically prices only a limited number of circumstances.[69] Fifth, although the parties might be aware of a possible situation in which they have conflicting interests, they might be unable to agree on a contractual solution ex ante.

Long-term contracts. It would be particularly important to regulate cash flow and the parties' performances in long-term projects with many contract parties. For many commercial and legal reasons, it is difficult to pull out of such contracts. It can be difficult to transfer the invested capital to other uses. Contract parties may have to remain in the relationship for a minimum period of time in order to reap the returns of investment. Furthermore, early termination would adversely affect not only the contract parties, but also those who are involved in, or dependent on, the project's completion.

2.4.2 Documentation

In all contracts other than mass transactions, it is normal to use individually negotiated contract terms. Individually negotiated contract terms normally contain at least the core commercial terms setting out the characteristic performances of the parties.

However, the use of individually negotiated contract terms and nothing else can lead to delays in finalising the contract because of difficulties in reaching agreement, and the other party to the contract may be unwilling to accept all individually negotiated terms.

For this reason, the firm tends to use pre-formulated contract terms (model terms, general contract terms, standard form contracts). Pre-formulated contract terms can complement individually negotiated terms in standard situations, and special provisions will only have to be negotiated in special cases.

Pre-formulated contract terms. The use of pre-formulated contract terms may reduce legal risk and transaction costs by reducing the need to negotiate and analyse each new contract term separately.

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68 BIS, CGFS, Credit risk transfer, January 2003 p 18.

69 Korobkin RB, Bounded Rationality, Standard Form Contracts, and Unconscionability, U Chic L R 70 (2003) pp 1203–1295.

These terms can thus be more detailed and more suitable for the contract than the background rules provided by the law. They can even be more suitable than individually negotiated terms, because the other party does not want to accept all proposed terms.

The party using the pre-formulated contract terms is naturally tempted to choose terms that best suit its own interests. For many reasons, pre-formulated contract terms can be one-sided.

First, a contract party tends to be "boundedly rational" and price only certain circumstances. This can enable the firm to include favourable terms not priced by its contract party.[70]

Second, differences relating to investment in information enable the firm to benefit from asymmetric information about the legal framework. Where the firm uses pre-formulated contract terms, the firm has made an up-front investment in legal drafting and analysis. After the initial investment, the firm can use the same legal framework at low cost. For the other party, analysing the legal framework would cause one-off costs without similar future savings. This gives the other party an incentive to pay less for legal drafting and analysis and accept a higher degree of legal uncertainty.

Third, the use of pre-formulated contract terms is a way to signal to the firm's contract parties and even competitors that it would be expensive to negotiate the terms of the contract separately.

As a result, the firm's customers may prefer to accept pre-formulated terms in order to reduce some of the direct transaction costs, and the use of pre-formulated contract terms can increase transaction costs for parties who prefer to negotiate terms separately.[71] The firm may be able to smuggle one-sided terms into the contract. Pre-formulated contract terms often include clauses that seek to exempt the firm from liability or limit the firm's liability.

Model terms, standard form agreement. Model terms and standard form agreements are pre-formulated contract terms drawn up by various organisations to be used by many market participants.

Master agreements. Master agreements can be individually negotiated or standard form agreements.

A master agreement sets forth the terms and conditions that apply to all or a defined subset of transactions between the parties. Future transactions between the parties are made subject to the master agreement. The parties can use confirmations which include commercial terms and supplement the master agreement.

One key benefit of using a master agreement is that it reduces the inefficiencies associated with negotiating legal and commercial terms transaction by transaction. Furthermore, the master agreement may be less one-sided compared with a party's own general contract terms.

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70 *Ibid*.

71 Gilo D, Porat A, The Hidden Roles of Boilerplate in Standard Form Contracts: Strategic Imposition of Transaction Costs, Segmentation of Consumers and Anticompetitive Effects, Mich L R 104 (2006).

Some master agreements are standard form agreements. They often contain two parts, i.e. the body and schedule. The body contains the terms that will apply to all covered transactions and the relationship generally. Parties negotiating a standard form master agreement generally agree to the terms contained in the body without amendment, but frequently add special provisions in the schedule to reflect the particular circumstances of a contract party or the contract party's jurisdiction.

Benefits of standardised terms. Both parties can benefit from the use of standardised terms, although there is a risk that the terms do not fully reflect the differences of contract parties and transactions.

For example, corporate *borrowers* may prefer standardisation in loan documentation because of consistency in contract terms such as covenants and events of default. Such consistency can reduce internal monitoring costs for the borrower and reduce the risk of accidental default or default due to trivial reasons.

A *bank* with a large and varied corporate customer base might find it economically efficient to use highly standardised, relatively simple documentation for the large number of term loans of relatively small amount that in numerical terms represent the bulk of its loan book.

At the other extreme of a bank's corporate lending book are a relatively small number of very *large loans* made to large companies. It would be more difficult to standardise the documentation governing such lending, because contracting cost reductions arising from standardisation might be offset by the expected costs resulting from potentially large credit losses.[72]

Incorporation of pre-formulated contract terms. Pre-formulated contract terms will not be binding unless they have been incorporated into the contract. There are special rules on the incorporation of pre-formulated contract terms (section 5.3.8).

2.4.3 Choice of Governing Law

Typically, the firm will choose both the governing law and the dispute resolution mechanism.

Effect of the location of the forum on the governing law. Since different countries can apply different choice of law rules, the bringing of proceedings in one country instead of another might mean that the court ends up applying the substantive laws of country A instead of country B. This could open the door for "forum shopping" by the other party. Forum shopping means that the plaintiff brings proceedings in a jurisdiction whose choice of law rules designate the more favourable substantive rules or generally the more favourable outcome. In order to prevent forum shopping by the other party, the firm combines a dispute resolution clause (an arbitration clause or a forum clause) with a choice of law clause (limiting the applicable substantive law to that mentioned in the clause).

[72] Day JFS, Taylor PJ, Loan Documentation in the Market for UK Corporate Debt: Current Practice and Future Prospects, JIBL 12(1) (1997) pp 9–10.

Choice of law. The firm can choose the law of a certain country for many reasons. In the EU, the firm would normally prefer the laws of its home country (the jurisdiction it is familiar with). Sometimes the parties choose a legal framework normally used in similar transactions. In both cases, the choice of the law of a certain country will influence transaction costs. For example, the law of a certain country can be part of a legal platform (section 2.2.2). Furthermore, the choice of the law of a certain country will influence the flexibility of law, the flexibility of interpretation of contracts, and legal risk (section 4.4.4).

Requirements as to form. The choice of the law of a certain country and the choice of the international jurisdiction of courts or the jurisdiction of an arbitral tribunal must fulfil certain requirements as to form.

An agreement on the international jurisdiction of courts must be made in writing under the Brussels I Regulation (Article 21).[73] An arbitration agreement must be made in writing under the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (Article II.1–2).

According to the Rome I Regulation, the choice of the law of a certain country "must be made expressly or clearly demonstrated by the terms of the contract or the circumstances of the case".[74] Like the Rome Convention that preceded it, the Rome I Regulation thus recognises the possibility that the court may, in the light of all the facts, find that the parties have made a real choice of law although this is not expressly stated in the contract.[75]

Reduction of legal risk. The obvious benefit of the choice of law clause and the dispute resolution clause is that the firm can choose a legal framework it is familiar with and ascertain the contents of the legal framework with reasonable accuracy. This can reduce legal risk.

The firm should not give the court or arbitrators discretion to choose the governing law, because this would increase legal risk. A particular risk is that some arbitration rules allow arbitrators to choose the governing law by applying the law they consider appropriate (voie directe)[76] rather than by applying choice of law rules (voie indirecte).[77]

Effect of the location of the forum on interpretation. The location of the forum can also have an effect on the interpretation of the contract.

The contract can be interpreted more literally in some countries than in others, and in some countries courts are less likely to look beyond the wording of the con-

[73] Regulation 44/2001 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (Brussels I). There is also a regulation on insolvency proceedings with cross-border implications.

[74] Article 3(1) of Regulation 593/2008 (Rome I).

[75] Giuliano M, Lagarde P, Report on the Convention on the law applicable to contractual obligations, OJ C 282, 31.10.1980, pp 1–50.

[76] For example, Article 17(1) of the ICC Rules and Article 59(1) of the WIPO Rules. France: Article 1496 NCPC. Germany: § 1051(2) ZPO ((limited voie directe). The Netherlands: Article 1054(2) CCP. Switzerland, Article 187(1) PIL.

[77] For example, Article 33(1) of the UNCITRAL Rules and Article 16(1) of the Vienna Rules.

tract to determine its meaning than in other countries (for the flexibility of law risk, see section 4.4).

For example, English courts are likely to interpret the wording of contracts more literally compared with German courts (section 5.2.4). In New York, the courts follow the "four corners" rule fairly strictly; the New York court would thus not look beyond the wording of the contract to determine its meaning where the contract is unambiguous at first sight. In countries where the rule of law is weak, the wording of the contract will also play a weaker role in determining the outcome of the litigation compared with countries that uphold the rule of law.

2.4.3 Limiting the Scope of Substantive Provisions of Law

The firm cannot determine cash flow and risk unless it can determine the contents of the rights and duties of the parties. This can be difficult, because there is a vast body of law in all countries. The firm must therefore do something to clarify the contents of these rights and duties. The three main legal ways to do this include: choosing the law; repeating the law; and derogating from the law.

Choosing the law. First, choosing the law of one country to govern the contract can exclude the application of the substantive provisions of another country's laws (for choice of law, see above), and adapting the project so that it falls within the scope of one set of substantive norms can exclude the application of another set of norms.

This will nevertheless not be enough to give sufficient information about the substantive provisions that apply under the governing law.

Repeating the law. Second, the firm could in principle repeat the law in the contract documentation.

This is done especially in common law jurisdictions where legal background rules are to a large extent based on judge-made law. For the sake of clarity, large parts of the applicable law are repeated in so-called boilerplate[78] clauses. This is one of the reasons why documentation based on the Anglo-American contract model is lengthier and more complex than traditional continental European documentation.

There is no similar need to repeat the law in civil law jurisdictions with clearer legal background rules, because the parties can specify the essential terms of the contract and rely on statutory law for the rest. As a consequence, traditional continental European contracts tend to be brief and concise compared with Anglo-American contracts.

Setting out the core terms. Third, the contract can set out the core terms. The parties can derogate from the dispositive rules of the law that governs the contract.

[78] The term "boilerplate" refers to how steam boilers were made from heavy steel plate. They were stamped from a common pattern, rolled, and riveted together. The routine usage of pre-typed, pre-printed terms and conditions was considered similar to the stamping of a boiler's steel shell.

The parties cannot derogate from mandatory rules. The firm can either adapt the transaction so that it does not fall within the scope of the mandatory rules, or comply with them (for compliance, see Volume I).

Therefore, differences in the dispositive rules of different countries are not a problem for an international firm, because the firm can produce a standard set of terms unilaterally. Differences in the mandatory rules can be a problem.

The firm can choose from a pool of basic drafting techniques when designing the core terms. The choice of drafting technique depends on the nature of the contract and the firm's main obligations.

(a) If the firm is the "obligor" or "debtor", i.e. the party that has the duty to render the characteristic performance, the firm typically needs to define its obligations as exactly as practicable. If the firm does not know how to perform its obligations under the contract, it is more likely that sanctions for breach of contract will be used against the firm.

(b) For this reason, the "obligor" or "debtor" often uses clauses that first exclude its obligations generally and then state its remaining obligations exactly. It is important to exclude obligations that might be based on the background rules of the governing law. It would not be enough for the firm merely to state its obligations. If the firm merely states its obligations without excluding other possible obligations, it will be difficult to determine the nature and scope of all the firm's legal obligations and the firm will be exposed to a higher legal risk.

In practice, this technique can be applied, for example, in the following way: "The Firm shall not be liable for any loss or damage caused to the other party. However, the Firm shall be liable for …" In this clause, the firm first excluded its obligations generally and then accepted a limited obligation. The same technique could also be applied as follows: "Disclaimer of warranty. Unless specified in this agreement, all express or implied conditions, representations and warranties, including any implied warranty of merchantability, fitness for a particular purpose or non-infringement are disclaimed, except to the extent that these disclaimers are held to be legally invalid." This clause would be complemented by express contract terms setting out the warranty obligations of the firm.

(c) If the firm is the "obligor" or "debtor", the firm typically wants to define the maximum scope of its own obligations (cap). The firm may also want to reduce the variation of its performances. For example, a supplier can prefer to limit the overall amount of deliveries during the term of the contract as well as the maximum and minimum daily, weekly, or monthly deliveries.

(d) In addition, it is normal for the "obligor" or "debtor" to qualify its contractual obligations. For example, the firm may restrict its obligations only to the use of "reasonable efforts", or the firm may use: a cancellation clause (giving it a general power of termination); a force majeure clause (excusing it on the occurrence of specified types of events); or a disclaimer clause (restricting its liability for breach).

(e) If the firm is the "obligee" or "creditor", i.e. the party to whom the obligation is owed, the firm typically wants to define the minimum scope of the other party's obligations. However, the firm can leave the maximum scope of the other party's obligations open.

For example, the bank is the main “obligee” or “creditor” under a credit agreement after the funds have been transferred to the debtor. Therefore, it would be normal for a bank to accept the following clause: “All remedies of any party under this Agreement, whether provided herein or conferred by statute, civil law, common law, custom or trade usage, are cumulative and not alternative and may be enforced successively or concurrently.” A bank could also use the following clause: “No remedy conferred in this Agreement upon the holder of any Note is intended to be exclusive of any other remedy, and each and every such remedy shall be in addition to every other remedy conferred herein or now or hereafter existing at law or in equity or by statute or otherwise.”

On the other hand, the vendor of goods would normallly prefer the following clause: “The remedies set out in this Agreement shall be the only remedies available to the parties for breach of contract.” This is because the vendor is the main “obligor” or “debtor” under an agreement for the sale of goods after the buyer has paid up.

Derogating from the law. The firm should of course really derogate from the law. However, many common contract practices do not have the intended effect. Depending on the governing law, the effect of the following clauses would often be misunderstood in continental European contract practice:

- An “entire agreement” clause (sections 5.2.3 and 5.2.5) will not always exclude the application of dispositive provisions of contract law. Dispositive provisions of contract law apply to the extent that parties have not agreed otherwise and can therefore complement the “entire agreement”. Furthermore, the clause does not prevent the interpretation of the contract.
- An “X Act does not apply” clause will not exclude the application of dispositive provisions of contract law. Even where such a clause were permissible as such, both the contract and the legal background rules would still have to be interpreted. Substantive provisions of law influence the interpretation of contracts (section 5.2), and the substantive provisions of “X Act” normally reflect the general principles of the private law.
- A clause according to which a party “gives no warranties” will not always exclude the application of warranty provisions under the governing law. Again, where a party does not give any particular warranties, the agreement can be complemented by dispositive provisions of law. It would be more effective to exclude warranties completely and then set out the exact warranties that the party will actually give.
- A “no warranties” clause does not have to exclude the scope of indemnities (section 6.3.3) under the governing law at all. It would be more effective to exclude all indemnities completely and then set out the exact indemnities that will apply.

2.5 Choice of Core Commercial Terms

2.5.1 Introduction

It goes without saying that the firm is in the business of choosing the core commercial terms of contracts. The core commercial terms determine much of the firm's cash flow and risk.

Scope of core commercial terms. The core commercial terms depend on the transaction. Some general remarks can nevertheless be made. The contract typically contains terms on: characteristic performances; payments; costs; risk; and the management of agency (for contract models, see section 2.2.2; for debt contracts, see Volume III).

Characteristic performance. The performances that are characteristic of the transaction will always be covered by the core commercial terms. There are obligations that are essential if a contract is to be entered into at all.

Payment obligations. Payment obligations always belong to the core commercial terms of investment contracts. Most contracts create or can create payment claims and payment obligations (monetary obligations). The firm will have to choose payers and payees, how the sums to be paid will be determined, when the sums will be paid, and the modalities of payment. There are many forms of payment obligations (for a taxonomy of payment obligations, see Chapter 10).

Division of costs. Core commercial terms will often address the division of costs. This can be done in different ways (section 2.5.3).

Distribution of risk. The distribution of risk is often covered by the core commercial terms. The terms that lay down the characteristic performances of the transaction will regulate the distribution of risk indirectly, because each party is responsible for the performance of its own obligations. In addition, the contract often contains express terms on the distribution of risk.

Increased loyalty. Increased loyalty obligations are core commercial terms in many contract types with a high risk of abuse of a party's performance.

For example, a licensee may regard it as essential that the licensor grants a licence and promises exclusivity. A licensee might never take a license on any other basis. A licensor will not grant a license unless the licensee agrees to make payments and only use the license in a certain way.

Management of agency. Generally, a contract party wants to ensure that the other party does what it has promised to do. For this reason, the contract contains at least basic information (contract terms as such), reward (price), and sanction mechanisms (remedies for breach of contract). The other party should obtain financial rewards for complying with its obligations, and non-compliance should not go unpunished (section 6.3.3).

Other core terms. Other core terms depend on the transaction and will be discussed in the context of particular contract types. (a) In any case, the contract will set out the *parties* and may state whether third parties can benefit from it (privity of contract, third-party beneficiaries). (b) Many financial contracts contain terms on the *transferability* of claims or assignability of the contract as a whole. (c) In multi-party agreements, the parties will normally address the question of *joint or several* liability. (d) In Europe, the firm's own *limitation of liability* clauses typically exclude the liability for indirect or consequential loss or damage. The firm should exclude *punitive* damages at least where it does business in the US. However, as functional equivalents of punitive damages can be awarded even in Europe, they should be excluded generally.[79] (e) International contracts typically set out the exclusive *governing law* and the exclusive *jurisdiction* of courts or an arbitral tribunal.

Conflicting interests. It can be difficult to draft these core terms, because the parties typically have conflicting interests. For example, a purchase order drafted by the buyer might contain the following terms that would not be acceptable to the seller:

- the buyer will pay in the future (extension of credit, use of the vendor as a source of funding);
- the buyer will own all intellectual property rights (assignment of property rights other than to the purchased goods);
- the buyer may change quantities without penalty (this would make it more difficult to assess costs);
- time is "of essence" (in practice, this might increase remedies available to the buyer in the event of late delivery);
- the buyer may change specifications (this would make it more difficult to assess costs);
- the goods must be free from all defects (this is normally not the case; the buyer would gain access to remedies for breach of contract even where the goods are of normal quality);
- warranties of merchantability and fitness for a particular purpose (the seller typically does not have this information because the seller knows about normal uses but not about particular uses);
- open-ended acceptance of delivery (this would make it possible for the buyer to delay payment and force the seller to do additional work);
- risk of loss will remain with the seller until the buyer has accepted the delivery of the goods (this would be likely to delay acceptance);
- right to terminate after shipment (this would make termination expensive);
- unlimited liability;
- liability for consequential damages (the potential scope of this liability would be very wide); and

79 For Swiss law, see Dasser F, Punitive damages: Vom "Fremden Fötzel" zum "Miteidgenoss"? SJZ 96 (2000) pp 101–111. For English law, see Rookes v Barnard [1964] AC 1129, [1964] 1 All ER 367. For restrictions on the recognition of foreign judgments or arbitral awards, see Article 34(1) of Regulation 44/2001 (Brussels I) and Article V(2) of the 1958 New York Convention.

- duty to obtain insurance protection (only the buyer knows about its own risk exposure).

Drafting of core commercial terms. There are popular legal practices that will be applied when drafting core commercial terms. In all contracts, the firm should determine the content and the maximum and minimum scope of its own obligations and of the obligations of the other party.

2.5.2 Definition of Performance

In contracts for the exchange of physical goods or for the purchase of services, and even in other contracts, the definition of the characteristic performance belongs to the core commercial terms. There are different ways to define performance.

One of the basic distinctions is that performance can range from a result to mere work done. It is normal in Europe to distinguish between obligations to produce a particular result (Werkvertrag, obligation de résultat) and obligations only to use reasonable care and skill (Dienstvertrag, obligation de moyens).

Result. Performance is ordinarily defined as a result in contracts for the sale of goods. In a technical investment project, the supplier of a result may promise to deliver, for example: (a) a commercial result (the commercial viability of the project included); (b) a technical system (without warranting the commercial viability of the project); or (c) one or more technical components (without promising that the components form a working technical system).

The agreed warranties normally reflect the agreed performance. The following four clauses illustrate how warranties can reflect these three basic forms of result (a, b and c). At the same time, the operational risk of the buyer (the firm making the investment decision) decreases from (c) to (a) and changes into a counterparty risk:

- (c) “Supplier warrants to Firm that the Equipment and Materials furnished shall be free from defects in material and workmanship and shall conform to and perform in accordance with the Specifications.” “Supplier makes no other express warranties, any implied warranties, including warranties as to marketability or fitness for a particular purpose.”
- (b) “Vendor may supply hardware and software from time to time for use in connection with the products.” “Vendor is not required to ensure that such hardware and software is compatible with the products.”
- (b) “Vendor may supply hardware and software from time to time for use in connection with the products. Vendor may designate that certain hardware and software are capable of operating compatibly with products, but such designation means only that the hardware or software appears to meet the necessary requirements of the products. Vendor is not required to ensure that such hardware

and software is compatible with the products, but Vendor must show due effort that Vendor has taken steps to assure compatibility."

- (a) A Plant Operation and Maintenance Agreement could include the following clauses: "The Operator shall be responsible for the operation and maintenance of all components of the Facility and shall perform all necessary services to meet these requirements ..." "The Operator warrants that it will utilise its best efforts to operate and maintain the Facility at an Annual Availability equal to or greater than 85%."

This technique is not limited to sales contracts or technical investment projects. For example, pension fund trustees for Unilever, an Anglo-Dutch conglomerate, sued its fund managers for negligence in London's High Court in 2001. The trustees claimed that there was an agreed benchmark which the fund managers had breached.

The fund managers claimed that the fund managers had underperformed the benchmark for British equities by over ten percentage points between January 1997 and March 1998. They further argued that the contractually agreed performance target had been to beat the benchmark by one percentage point, and that a performance floor of three percentage points below the benchmark had been set for any four consecutive quarters. The pension fund trustees thus argued that the fund managers had had an obligation to achieve a result. The fund managers, in their defence, said that neither performance target nor floor had been guaranteed, and they could not have meant that the fund would never perform outside the range in a given period. The fund managers thus argued that there was only an obligation to apply reasonable care and skill.

The agreed performance will also influence the modalities of the verification of compliance. This can be illustrated by contracts for the sale and installation of investment goods such as factories, production equipment or computer systems (see section 6.3.3).

Work. Alternatively, the performance of the other party can consist of work done. In this case, the benchmark relates to the behaviour of the other party, not the result. This technique is commonly used in contracts for the provision of advice or management services.

In 2008, HSH Nordbank, a provincial German bank, filed a suit to seek repayment of losses on a portfolio of collateralised debt obligations structured and managed by UBS, a Swiss international bank. HSH Nordbank claimed that their investment should have been managed conservatively and that UBS acted against their interests in its management of the investment.[80] In particular, HSH Nordbank claimed that alleged "fraudulent acts and wilful breaches of duty" by UBS led to a $275 million fall in the value of a portfolio of credit derivatives sold to it and managed by the Swiss bank.[81]

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80 See Benoit B, Simonian H, HSH to sue UBS over subprime losses, Financial Times, 25 February 2008 p 17.

81 Wilson J, HSH lawsuit claims UBS 'acted fraudulently', FT.com (Financial Times), 26 February 2008.

If the firm buys just work rather than the intended result, it is more difficult for the firm to assess return. If the firm transfers this risk to the other party by buying the intended result instead of mere work, the firm will normally have to pay more.

2.5.3 Price and Payment Obligations

There are many ways to agree on the price payable for the performance of the other party and on other payment obligations. The parties have plenty of discretion when designing payment clauses.

Payment obligations in general. Payment obligations can be divided into six basic categories (section 10.1): (1) legally unenforceable cash flows (absence of a duty to pay); (2) payments known in advance; (3) variable payment obligations; (4) payments whose amount depends on the value of an asset; (5) payments that depend on the occurrence of an event; and (6) options. Finally, there is a category that consist of (7) a combination of payment obligations that belong to two or more categories.

Price. As the parties have plenty of discretion when designing payment clauses, they can determine the price payable for the performance of the other in many ways. For example, the price can be fixed or variable. The preferences of the firm depend on: the role of the firm in the contractual relationship (typically, the buyer or the seller, or the lender or the borrower); the nature of the performance; and whether the firm has, as principal, the power to align interests through incentives.

If the firm is the buyer and pays a fixed price, it is easier for the firm to assess costs. At the same time, it becomes more important for the supplier to assess its own costs.

If the firm is the buyer, the firm can also choose a variable price. (a) For example, the price can depend on the scope or quality of the supplier's performance. This can be a way to give the other party more effective incentives to fulfil its obligations. In some cases, a variable price can make it easier for the firm to determine its costs. For example, a sales contract can provide that the purchased goods will be at the disposal of the firm at a given date and guarantee the supplier payment of the specified amount at the agreed date, but the price may be adjusted to reflect the firm's costs where the supplier fails to deliver them at that date or where the goods do not meet the agreed specifications. The firm may also be entitled to compensation or penalties. (b) A variable price can also reflect variation in the buyer's income. For example, the parties may agree that the price of raw materials or components can be reduced if the market price of the end-product is reduced. This would be a way to transfer commercial risk from the buyer to the seller.

The price can be a combination of fixed and variable elements. For example, an employment agreement can provide that the employee is guaranteed to receive the same basic pay and that the basic pay is not related to performance. The basic pay can be complemented with a performance related pay which enables the firm to reward employees' performance on an individual basis.

A commercial loan agreement would contain a similar choice between a fixed and a variable interest rate (section 9.5.2).

Allocation of costs. The parties may regulate the distribution of costs in to main ways.

First, the allocation of *duties* typically implies the allocation of costs. The main rule is that a party will fulfil its obligations at its own cost. In the absence of a contractual obligation, a party cannot force the other party to reimburse its costs.

Costs can also be hidden. For example, loan contracts give rise to: costs of preparing the contract (costs of brokerage, legal advice, administration and the costs of the parties to the contract becoming informed about each other and the matters being contracted for); costs of ensuring performance under the terms of the contract (the lender must incur the costs of monitoring contract performance, for example, by monitoring financial covenants; the borrower must incur direct costs of contract performance, for example, interest costs, and the direct and indirect costs caused by compliance with covenants); and costs associated with non-performance (agreed remedies, renegotiation and rewriting costs, bankruptcy costs).[82]

Second, there can be *particular clauses* on the allocation of costs. Incoterms provide several common examples of such contract terms. The contract may also set out that a party may pass on certain costs to the other contract party.

For example, in project finance, the project agreement may set out the operating costs and provide that the project company will be compensated for additional operating costs as they arise.[83]

2.5.4 Performance, Price, Cost, Risk

The core terms setting out each party's performance, price, and the allocation of costs function simultaneously as core terms allocating *risk* between the parties.

This can be illustrated by a simple sale of goods transaction. The buyer is typically concerned about the good, the price, and when the good will be in the buyer's possession. The buyer is not concerned about what it takes to manufacture the good or how much it costs to produce it, because such risks are not be borne by the buyer.

A similar allocation of costs and risk can be achieved even in more complicated transactions such as outsourcing. For example, a car manufacturer and the manufacturer of a production line for the production of cars may agree to use the "pay of production" method.[84]

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[82] See, for example, Day JFS, Taylor PJ, Loan Documentation in the Market for UK Corporate Debt: Current Practice and Future Prospects, JIBL 12(1) (1997) pp 7–14.

[83] Yescombe ER, Principles of Project Finance. Academic Press, San Diego London (2002) § 10.6.1.

[84] Noack HC, Bezahlt wird mit jeder einzelnen Karosserie, FAZ, 23 October 2007 p 26. See also Preuß S, Fertigungsprozesse wandeln sich: Warum ein Paketdienst gerne auch Autositze baut und sich trotzdem treu bleibt, FAZ, 19 October 2007 p 20.

The vendor will then be (a) responsible not only for the delivery and installation of the production line but also for operation and maintenance and (b) paid on the basis of cars manufactured on that production line. The Economist described how Rolls-Royce, a maker of jet engines, sells "hot air" out the back of an engine: "Instead of selling airlines first engines and then parts and service, Rolls-Royce has convinced its customers to pay a fee for every hour that an engine runs. Rolls-Royce in turn promises to maintain it and replace it if it breaks down."[85]

The parties can also agree on risk and revenue *sharing*. For example, particular risk and revenue sharing programmes can be an important way to raise external funding.

Rolls-Royce has used Risk and Revenue Sharing Partner programmes (RRSP) in order to develop new engines and have recourse to external financing.[86]

Lawyers' contingency fees are a particular example of the interrelation between performance, price, cost, and risk.

Contingency fees can help the client: to identify a lawyer that has an incentive to achieve a result even where the parties only agree on work done (less informed private customers are likely to need contingency fee arrangements more than better informed business customers and important repeat customers are); to transfer costs and financial risk to the lawyer (less wealthy private customers are likely to need this function more than business customers are); and generally to filter cases that are worth pursuing (a lawyer working on a contingency fee basis has an incentive to screen cases and to pick those that he can win).[87] – Contingency fees are not as common in Europe as they are in the US. Their use is restricted both in the UK and Germany,[88] although the application of the general "loser pays" principle in Europe would make it even more important for a client to find a good lawyer who can win the case.

2.5.5 Economic Efficiency and the Choice of Terms

The next question is how the parties' respective obligations should be allocated. Which party should be responsible for what? Again, the allocation of rights and duties depends on the transaction. Some general remarks can nevertheless be made.

Economic efficiency. The invisible hand of competition gives the firm an incentive to choose a legal framework that leads to a more efficient allocation of economic resources and increases wealth. In the long run, the firm can end up using a

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85 Britain's lonely high-flier, The Economist, January 2009.

86 See Case T-210/01, General Electric Company v Commission of the European Communities [2005] ECR II-5575.

87 See, for example, Grunewald B, Winter S, Sollte der Rechtsanwalt nach dem Erfolg bezahlt warden? FAZ, 25 March 2008 p 23.

88 For German law, see BVerfG, judgment of 12 December 2006 - 1 BvR 2576/04. It was held in this judgment of the Federal Constitutional Court that contingency fees (Erfolgahonorare) must be permitted in some cases.

legal framework that allocates functions to the "least-cost-avoider". When this happens, the legal framework can produce a net overall benefit for affected parties or a net reduction in overall costs.

Allocation of functions in place and time. These functions can relate to physical or immaterial activities. For example, in a contract for the sale of a machine, someone may have to manufacture the machine and take care of its carriage to the destination where it will be used by the buyer. These are physical activities. On the other hand, someone should bear the risk of loss or damage to the machine during its carriage. This is an immaterial activity.

Such functions can also relate to risk. There are physical risk management activities (such as the physical packing of the machine and keeping the machine safe during its carriage). In addition, there are immaterial risk management activities (for example, someone should take out an insurance policy in case something goes wrong).

All of these functions produce costs. The firm can choose a legal framework that ensures that the responsibility for each function is borne by the least-cost-avoider.

In other words, the firm can try to ensure that a certain physical aspect is done by the party able to do it at a lower cost, and shift risk to the party that can bear it at the lowest cost to the firm. This can also be the firm itself.

This can be illustrated by the following example. An industrial firm invests in a new machine manufactured by another industrial firm. Which party should arrange for carriage of the machine to the buyer? The parties would be better off if this obligation were allocated to the party able to arrange for carriage at a lower cost. A large industrial firm can often obtain better terms for the carriage of goods compared with a small industrial firm.

A second example is the *cost-plus contract*. Kenneth Arrow described how cost-plus contracts can work for the military establishment: "When production costs on military items are highly uncertain, the military establishment will pay, not a fixed unit price, but the cost of production plus an amount which today is usually a fixed fee. Such a contract could be regarded as a combination of a fixed-price contract with an insurance against costs. The insurance premium could be regarded as the difference between the fixed price the government would be willing to pay and the fixed fee. Cost-plus contracts are necessitated by the inability or unwillingness of firms to bear the risks. The government has superior risk-bearing ability and so the burden is shifted to it. It is then enabled to buy from firms on the basis of their productive efficiency rather than their risk-bearing ability, which may be only imperfectly correlated."[89] Whereas fixed-price contracts can result in overpaying, the problem with cost-plus contracts is that they create incentives for the contractor to be inefficient.

Legal background rules. Basically, the firm should: obtain sufficient knowledge of the legal rules that govern the project; exclude the application of rules that do not

[89] Arrow KJ, Economic Welfare and the Allocation of Resources for Innovation. In: Nelson R (ed), The Rate and Direction of Inventive Activity: Economic and Social Factors. Princeton (1962) pp 609–625. Arrow was awarded the Nobel prize in economics in 1972.

allocate obligations to the least-cost-avoider; and choose terms that do allocate obligations to the least-cost-avoider.

However, it can be costly for the parties to obtain information and to ensure that a function is allocated to the least-cost-avoider through mutual bargaining alone.[90] Contracts are often left incomplete (section 2.4.1), or they allocate costs to the wrong party.

In principle, the legal background rules applicable to the contract could assign each obligation to the right party, i.e. the least-cost-avoider. In practice, this is rarely the case. A certain rule may have been designed to work well in a typical situation and a large number of contracts, but it has not been designed to work well in the context of any particular contract.

Allocation of risk, information. The choice of terms that allocate risk depends on the information that the firm uses as a basis for its decision-making.

For example, the firm can agree to bear the risk of a harmful event occurring if the firm knows that the harmful event will not occur or if the firm is remunerated for bearing the risk. The firm can agree to pay the other party for bearing the risk where the firm does not know whether the harmful event will occur or knows that it will occur.

Table 2.1 Examples of Contractual Allocation of Risk and Information

The firm…	…knows that the event will occur.	…knows that the event will not occur.	…does not know it but the event will occur.	…does not know it but the event will not occur.
…bears the risk that an event will occur	No uncertainty, loses unless gets paid for bearing the risk.	No uncertainty, benefits if gets paid for bearing the risk.	Uncertainty, loses unless gets paid for bearing the risk.	Uncertainty, benefits if gets paid for bearing the risk.
…does not bear the risk that the event will occur	No uncertainty, benefits unless pays the other party for risk transfer.	No uncertainty, loses if pays the other party for risk transfer.	No uncertainty, benefits unless pays the other party for risk transfer.	Uncertainty, loses if pays the other party for risk transfer.

In contract law, knowledge about whether the event will or will not occur can trigger a de facto obligation not to benefit from such a piece of superior information (see Volume I). First, benefiting from information asymmetries is constrained by fraud rules. Second, depending on the governing law, failure to disclose the event may amount to breach of duty of care, fiduciary duties, duty to act in good faith, duty to be loyal towards the other party to the contract, and similar obligations.

Allocation of risk, the future. It is characteristic of long-term contracts that circumstances may change. Market prices may suddenly increase, inflation may rise, and performance may become more onerous.

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90 See Griffiths A, Contracting with Companies. Hart Publishing, Oxford and Portland, Oregon (2005) p 17.

The parties typically have different capacities and incentives to anticipate the risk of changed circumstances or respond to it.

The firm might try to allocate the risk of changed circumstances to the party that can bear it at the lowest cost to the firm. There are various ways to achieve this.

First, the parties can *fix* the core rights and duties of the parties once and for all. But if the parties do this, the firm might be exposed to a higher commercial risk. The firm typically mitigates this risk by using far-reaching limitation of liability clauses, force majeure clauses, hardship clauses, material adverse change clauses, and other clauses that deal with the risk of a change in circumstances (section 5.5.5).[91]

Second, the firm can leave specific contract terms more *open* (section 5.5.4). For example, the firm can agree on an adjustment mechanism, such as cost-plus pricing or a broader index scheme, a renegotiation clause, and third-party dispute resolution techniques. The firm can also use option-to-abandon techniques. As information that affects risk emerges only incrementally over time in long-term contracts, investment projects can be structured to provide more or fewer moments when the current state of information about prospects can be assessed and go/no go decisions made. Increasing the number of such moments for the benefit of the firm makes it easier for the firm to manage risk.[92]

The acceptable level of openness can depend on the identity and business culture of the contract party. In some countries, business culture favours consensus and win-win situations. In other countries, confrontation and the maximisation of a party's own benefits is the norm.

In a confrontational business culture, too much openness is likely to be used against the firm. The well-known dispute between Belarus and Russia over gas is an example of a confrontational business culture.

In 2006, there was a a long-term contract between Belarus and Gazprom for the import of gas. Belarus paid $47 per 1,000 cubic metres. Now, Gazprom is not only Russia's state-owned gas monopoly. It is also an instrument of Russian foreign policy. Before the termination of the contract on 31 December 2006, Gazprom said that the price would increase to $200 unless Belarus ceded control of its distribution network, including a valuable transit pipeline which supplies gas to Poland and Germany. Russia threatened to cut supplies to Belarus. Belarus answered by threatening to disrupt Russian gas supplies to Western Europe. Both nations accused each other of blackmail over the dispute. Belarus finally agreed to pay $100 per 1,000 cubic metres of gas, below the $105 demanded by Russia.

This can be contrasted with the collaborative Japanese business culture. A company like Toyota often seeks long-term co-operation with its suppliers.

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91 See Berger KP, Renegotiation and Adaptation of International Investment Contracts: The Role of Contract Drafters and Arbitrators, Vanderbilt J Transn L 36 (2003) p 1350.

92 Gilson R, Goldberg V, Klausner M, Raff D, Building foundations for a durable deal, Financial Times, Mastering Transactions, October 12, 2006.

Toyota shares information with its suppliers, asks its suppliers for advice, and gives its suppliers advice on how to produce things better. The collaborative approach is the trend in outsourcing.[93]

The firm can also reduce commercial risk by using financial instruments to hedge against risk. This is not always feasible. For example, it is difficult to obtain insurance protection for exogeneous risks (section 2.1).

Moral hazard, prevention of hold-up. A further factor that influences the choice of core commercial terms is the need to mitigate the risk of moral hazards. For example, the firm tries to mitigate vulnerability to a form of exploitation that transaction cost economists call "hold-up".

The risk of hold-up is high where the firm is contemplating a long-term investment project that is not possible without co-operation with a certain party (a supplier or a customer) but must commit to an up-front investment that is more valuable as part of the investment project than it would be in any alternative use. Once the firm is committed to this up-front investment, a supplier may try to charge an exorbitant price, or a customer may exercise its monopoly power to force down the price or transfer his demand elsewhere.

Because of the risk of hold-up, the firm might not be willing to commit itself to any investment unless the interests of parties that are in a position to exploit the firm have been aligned with those of the firm's.

In principle, the firm can agree on price and other core terms of their co-operation in advance. This would nevertheless not be enough to reduce the risk of hold-up.

Payment terms and the distribution of costs can be a way to reduce this risk. For example, if production equipment is required solely for one particular customer, the cost would normally be reimbursed by that customer.[94] A similar technique to prevent hold-up is to structure the other party's payments to coincide with the firm's investments. This technique is generally used in large construction projects and when machines or equipment are built to the specifications of the customer. In practice, it is often complemented by the use of demand guarantees (section 11.3).

It is more expensive to start mitigating the risk of hold-up after the upfront investment has already been made. For example, western European countries have invested heavily in the import of Russian gas, and their economies are to a large extent dependent on gas deliveries from Russia. To mitigate the risk of hold-up, those countries would need large-scale investment in alternative sources of energy.

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93 Survey: Logistics. Manufacturing complexity, The Economist, June 2006.

94 Coase R, The Conduct of Economics: The Example of Fisher Body and General Motors, J Econ Man Strat 15 (2006) p 259.

2.5.6 Management of Agency, Loyalty, Non-competition

A contract typically gives rise to an agency relationship. Managing this agency relationship is an important aspect of risk management in general (Volume I) and the management of counterparty risk in particular (section 6.3 and Chapter 10).

There are contract types in which one party has a particularly high incentive to abuse the performance of the other. Such contracts will therefore not be concluded without particular obligations that protect the interests of the other party.

For example, particular loyalty obligations and non-competition obligations belong to core terms in many relational contracts such as exclusive distribution agreements, licencing agreements, subcontracting agreements, and business consulting agreements, and they can be particularly important in strategic alliances.[95]

Non-competition clauses are typically constrained by competition laws (section 5.3.9; generally, see Volume I; for acquisitions, see Volume III).

2.5.7 Business Outsourcing

Business outsourcing is a well-known alternative to transfer risk and costs. It can also be used as a corporate governance tool. These questions were already discussed in Volume I.

[95] For strategic alliances, see Boyd SR, Strategic Alliances – From Strategy Development to Exit: In-house Counsel's Role and Perspective. In: PLI, Structuring, Negotiating & Implementing Strategic Alliances 2006, Corporate Law and Practice Course Handbook Series (2006). At pp 193–196, Boyd explained the firm's non-competition policies, rationale, and best practices.

3 Management of Legal Risk: General Remarks

3.1 Legal Risks

Good drafting practices can help the firm to agree on the same cash flow with a lower exposure to risk. Bad drafting practices increase the firm's exposure to legal risk and – as legal considerations contribute to other risks and influence the behaviour of the firm's contract party – even its exposure to other risks.

In investment contracts, legal considerations affect risk in one way or another. There are both legal risks and risks typically managed by legal means (for a definition of legal risk, see Volume I). Different legal risks can be mitigated in different ways.

General, transaction-specific, contributory. One should distinguish between various legal risks on the basis of to what extent they are caused by the legal system. There are: (a) general legal risks (that are dependent on legal considerations rather than other considerations); (b) transaction-specific legal risks (legal risks that are also transaction-specific); and (c) contributory legal risks (legal considerations that increase or decrease other risks).

The existence of contributory legal risks can be illustrated by counterparty risk. Counterparty risk is reduced if there is a legally binding and enforceable contract and the counterparty has contractual incentives to comply with its terms. Counterparty risk is therefore dependent on the legal aspects of the contract.

A further example is market risk and country risk. Countries with a sound and competition-friendly legal system tend to do well.[1] Market risk and country risk are therefore partly dependent on the quality of laws.

As legal risks can be general or contributory, "legal risk" as a whole is hardly quantifiable. For the same reason, it is hardly possible to disclose "legal risk" as a whole in any meaningful way.

On the other hand, particular legal risks can be quantifiable, and many other typical risks are regarded as quantifiable although they contain contributory legal risks.

Legal risks caused by the legal system or the parties. One should also distinguish between different legal risks on the basis of to what extent they are caused by the parties. One can distinguish between legal risks that are not party specific, legal risks that depend on the conduct of the parties (like the risk inherent in the

[1] World Bank, From Disintegration to Reintegration: Eastern Europe and the Former Soviet Union in International Trade (2006).

P. Mäntysaari, *The Law of Corporate Finance: General Principles and EU Law*,
DOI 10.1007/ 978-3-642-03055-0_3, © Springer-Verlag Berlin Heidelberg 2010

interpretation of contracts, section 5.2), and legal risks that are inherent in the identity of the parties (like counterparty corporate risk, section 6.2).

3.2 Risks Managed by Legal Means

In addition to legal risks, there are risks that are managed by legal means. For example, a contractual relationship always creates a counterparty risk (the risk that the other party does not perform its obligations as expected). Where cash flow is based on a payment obligation, the firm can be exposed to a counterparty credit risk (the risk that the counterparty will not settle obligations either when due or at any time thereafter) or a liquidity risk (the risk that the counterparty will settle obligations late). If a commercial bank is used for money settlements between contract parties, the firm may be exposed to a settlement bank risk (failure of the bank could create credit and liquidity risks for the firm).[2] – All these claims are based on the terms and conditions of the contract. The risk exposure of the firm depends on the contract terms.

Management of risk. How the risks can be managed by legal means depends on the type of risk and the transaction. Legal risks cannot be managed effectively unless they have first been identified. General, transaction-specific and contributory legal risks are not mitigated in the same way.

Sometimes the ways to mitigate different types of risk are mutually exclusive and the firm must choose which risks to mitigate. For example, it is possible that the effect of one form of legal risk could be mitigated by the choice of English law (section 5.2.5); at the same time, the effect of another form of legal risk could be mitigated by the choice of German law (section 4.4.4). Clearly, the firm cannot at the same time choose both English and German law to govern the same issues.

The firm will typically want to eliminate risks or mitigate their effects. On the other hand, the firm also wants to be exposed to some risks in order to make a profit. The firm's risk management policy will determine: the risks to which the firm wants to be exposed; which legal tools the firm will use in different contracts; and how the firm will use them (for risk management, see Volume I).

2 BIS, Committee on Payment and Settlement Systems, Recommendations for Central Counterparties, CPSS Publications No. 64 (November 2004), 3.1.

4 Risks that Relate to the Country's Legal System

4.1 Introduction

Legal uncertainty is an important source of legal risk. *Legal risks* can be divided into three main categories: general legal risks; transaction-specific legal risks; and contributory legal risks. *General legal risks* can be divided into two categories: (1) risks inherent in the country's legal system and law in general; and (2) risks that relate to how efficiently the firm manages such risks.

There are a number of risks inherent in the country's *legal system*. They range from the lack of rule of law to the flexibility of law. In the EU, the most common forms of legal risks belonging to this category are: the risk that the law will subsequently change; and the risk caused by the flexibility of law.

In addition to project adaptation (section 2.2.4), the main legal ways to *mitigate* these risks include: choosing the physical location of activities; choosing the governing law; and choosing the dispute resolution mechanism.

4.2 Laws Not Enforced (Lack of the Rule of Law)

The organisation of economic activity through voluntary exchange requires a legal framework provided by the government ("the rules of the game"). The firm would generally benefit from a relatively stable legal and regulatory environment. The firm needs at least: the enforcement of contracts voluntarily entered into, general legislation that allows for private ownership and adequately protects private investment; the interpretation of such rights; the provision of a monetary framework; and mechanisms to cure market imperfections.[1]

The rule of law is generally upheld in the established Member States of the EU and other highly developed countries such as the US, Canada and Japan. Most of the contemporary law in established market economies is derived from the civil law of continental Europe and the common law of England. According to their traditions, the purpose of law is to free life from arbitrary action and decision and to provide redress against them. All of the world's largest financial centres are characterised by having honest courts and competent administrators.

[1] See Friedman M, Capitalism and Freedom, U Chic P (1961), Chapter II.

P. Mäntysaari, *The Law of Corporate Finance: General Principles and EU Law*,
DOI 10.1007/ 978-3-642-03055-0_4,

There can be problems even in developed countries. For political reasons, the rule of law is not always upheld. In Russia, the Yukos case and the Sakhalin-2 case raised concerns about the rule of law and signalled to foreign companies that the state will have control over any significant energy project. European cross-border mergers and acquisitions provide a further example. Even in some Member States, the rule of law will not always prevail when foreigners try to acquire local companies. Furthermore, few countries are free from corruption.

Most people in the world nevertheless live in countries where the absence of the rule of law can be a problem. The absence of the rule of law is particularly striking in rogue states, dictatorships, and many developing countries.

For example, whereas the Nordic countries are democratic societies with a very low level of corruption and a working legal system, Zimbabwe is at the other end of the scale. Comparing the quality of Nordic legal systems and the legal system of Zimbabwe would not make any sense without taking into account the extent to which the rule of law is enforced.[2]

The rule of law as part of Community law. The need to protect the rule of law has been recognised both in international law and in Community law.

Under customary international law, foreign investors are entitled to a certain level of treatment, and any treatment that falls short of this level gives rise to responsibility on the part of the state. Bilateral and multilateral investment treaties between different countries often provide that each country must ensure fair and equitable treatment to the property of the nationals of other countries.[3]

Under the World Trade Organisation (WTO) agreements, countries cannot normally discriminate between their trading partners. The most-favoured-nation (MFN) treatment is one of the basic principles of the WTO.[4] The WTO agreements also provide for "national treatment", i.e. treating foreigners and locals equally.[5]

The WTO agreements aim to support fair competition in intellectual property (TRIPS), services (GATS), and agriculture (Agriculture Agreement). Fair competition cannot exist without laws that are enforced.

For example, the enforcement of intellectual property rights laws and agriculture were the two major hurdles to Russian accession to the WTO. The lack of protection of intellectual

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2 See, for example, Rose C, Måling af aktionærbeskyttelse i et komparativt perspektiv – en kritik af La Porta, de-Silanes, Shleifer og Vishny, NTS 2007:1 pp 94–107.

3 See Yannaca-Small C, Fair and Equitable Treatment Standard in International Investment Law, OECD, Directorate for Financial and Enterprise Affairs, Working Papers on International Investment, Number 2004/3, September 2004; Yannaca-Small C, "Indirect Expropriation" and the "Right to Regulate" in International Investment, OECD, Directorate for Financial and Enterprise Affairs, Working Papers on International Investment, Number 2004/4, October 2004.

4 Article 1 of the General Agreement on Tariffs and Trade (GATT); Article 2 of the General Agreement on Trade in Services (GATS); and Article 4 of the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS).

5 Article 3 of GATT; Article 17 of GATS; and Article 3 of TRIPS.

property rights and failure to enforce existing rights enabled AllofMP3, a Russian-based online music download site, to become one of the biggest sites of its kind in the world, although its business model was based on piracy and would not have been permitted in other developed countries.

Member States of the EU must comply with the Community acquis. Acquis communautaire consists of primary and secondary legislation, legal instruments adopted within the second and third EU pillars, the jurisprudence of the European Court of Justice (and Court of First Instance), Community policies and the general principles of Community law.

The European Community is a community based on the rule of law. Its institutions are subject to judicial review of the compatibility of their acts with the EC Treaty and with general principles of law. Individuals are entitled to effective judicial protection of the rights they derive from the Community legal order, and the right to such protection is one of the general principles of law stemming from the constitutional traditions common to the Member States.[6]

The European Court of Justice (ECJ) has developed a doctrine that rules of Community law may be derived not only from treaties and legislation but also from the general principles of law. These principles are derived from various sources. The most important of them include the Community Treaties and the legal systems of the Member States.[7] The general principles of law adopted by the ECJ include, in particular, the protection of fundamental human rights, the principle of legal certainty, the principle of proportionality, the principle of equality, the principle of the right to a hearing, and legal professional privilege.[8] For example, the principle of equal treatment prohibits comparable situations from being treated differently and different situations from being treated alike, unless such treatment is objectively justified.[9]

Member States of the EU are also members of the Council of Europe (COE). The Council of Europe is distinct from the EU, but no country has ever joined the EU without first belonging to the COE. One of the COE's most significant achievements is the European Convention on Human Rights and Fundamental Freedoms (ECHR).

The Convention was adopted in 1950 and came into force in 1953. It sets out a list of rights and freedoms that states are under an obligation to guarantee to everyone within their jurisdiction. States and individuals may refer alleged violations by contracting states of the rights guaranteed in the Convention to the European Court on Human Rights.

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6 See, for example, Case T-160/03, AFCon Management Consultants v Commission of the European Communities, judgment of the Court of First Instance 17 March 2005, paragraph 39.

7 Hartley TC, The Foundations of European Community Law, Fifth Edition. OUP, Oxford (2003) pp 133–134.

8 *Ibid*, pp 135–157. In the area of private law, the four principles of freedom, security, justice, and efficiency underlie the DFCR.

9 Case T-160/03, AFCon Management Consultants v Commission of the European Communities, judgment of the Court of First Instance 17 March 2005, paragraph 91.

Two kinds of rights can be highlighted: property rights and party autonomy. There would be hardly any investment if *property rights and ownership* were not respected.[10] The ECHR protects even a legal person's right to peaceful enjoyment of its possessions.[11]

The European Court of Human Rights has held that peaceful enjoyment means a right both to use possessions in accordance with their purpose and to dispose of them.[12] Property rights are not restricted to tangible property but include even intangible assets such as licences[13] and crystallised debt claims.[14] The Multilateral Agreement on Investment provides that "investment" means any kind of asset owned or controlled by an investor, including, among others, loans and contractual claims.[15]

In practice, the protection of property rights can be eroded by other public policy objectives. For example, new German legislation for the rescuing of banks enables the bank's board to issue shares to the state (Soffin) without asking the shareholders for permission.[16]

In addition, *party autonomy* is part of the fundamental freedoms in Europe. It is part of the general principles of the EU, included in the notion of free market economy as well as general freedom of action.[17] It might even result from Article 8 of the 1950 ECHR (right to respect for private and family life). Party autonomy is also the most basic principle of Member States' contract laws,[18] although party autonomy and freedom of contract are subject to legal constraints.[19]

In addition to the general principles of Community law, there is a growing body of Community legislation for the Internal Market. It is nevertheless to be noted that it is not unusual for Member States to fail to implement Community law correctly

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[10] See Vellas P, International Project Finance: Lenders' Protection Against Expropriation and Force Majeure Risks, JIBLR 19(11) (2004) pp 432–439.

[11] ECHR Protocol 1, Article 1.

[12] Marckx v Belgium A/31: (1979) 2 E.H.R.R. 330.

[13] See, for example, Tre Traktorer AB v Sweden A/159: (1989) 13 E.H.R.R. 309; Fredin v Sweden A/192: (1991) 13 E.H.R.R. 784.

[14] See, for example, Agneessens v Belgium (1988) 58 D.R. 63.

[15] The Multilateral Agreement on Investment, Negotiating Text, OECD, 24 April 1998, Chapter II, paragraph 2.

[16] Gesetz zur Beschleunigung und Vereinfachung des Erwerbs von Anteilen an sowie Risikopositionen von Unternehmen des Finanzsektors durch den Fonds „Finanzmarktstabilisierungsfonds - FMS". See, for example, Zuck R, Der Aktionär darf enteignet, aber nicht entmachtet werden, FAZ, 18 March 2009 p 23; Commerzbank-Vorstand vor Zitterpartie, FAZ, 19 march 2009 p 15.

[17] See Joined Cases 133–136/85 "Berlin-Butter" [1987] ECR 2289. See also Coester-Waltjen D, Constitutional Aspects of Party Autonomy and Its Limits – The Perspective of Law. In: Grundmann S, Kerber W, Weatherill S (eds), *op cit*, p 42. In Germany and many other Member States, this principle is constitutionally guaranteed as part of personal freedoms. For German law, see Article 2(1) of the Basic Law (Grundgesetz); see also Article 14(1). For English law, see the Human Rights Act 1998.

[18] DCFR Princ. 3.

[19] See Article 8(2) of the ECHR.

and on time. There are also relatively big disparities between Member States in implementing and applying these rules.

The Internal Market Scoreboard published by the Commission in July 2004 shows that Denmark, Spain, Finland and the UK have a good record of implementing Directives on time. Some Member States lag behind. France has the worst transposition record of the EU-15 countries, followed by Greece, Germany, Italy and the Benelux countries. France compounds this by taking the longest to remedy delays in transposition. Big disparities also exist in the number of infringement procedures against Member States for misapplication of Internal Market rules. Italy has the most infringement cases against it, followed by France. France and Italy together account for almost 30% of Internal Market infringement cases. There is correlation between these rankings, Transparency International's Corruption Perceptions Index 2008,[20] and the ease of doing business index published by the World Bank (Doing Business 2009).[21]

Many of the Member States of the EU have ratified the OECD Anti-bribery Convention,[22] and corruption is illegal in all Member States.[23] However, while the laws prohibiting corruption are enforced effectively in some countries, it is more widespread in others. The Nordic countries belong to the least corrupt countries in the world. There are problems in particular in Greece and Italy, and many of the countries that used to belong to the communist block face very serious problems.

Mitigation of the risk caused by the lack of rule of law. A serious firm requires a reasonably stable legal and regulatory environment in order to operate.[24] Legal risks resulting from the lack of such an environment cannot be eliminated by legal means available to the firm, but there are some typical legal means to mitigate them through contracts.

The more the contract allocates important things to be done outside a jurisdiction that does not uphold the rule of law and inside a jurisdiction that does uphold it, the more stable the regulatory environment becomes.

Both physical and immaterial functions can to some extent be moved to countries that respect the rule of law. (a) For example, a warehouse that supports the

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[20] The least corrupt countries (ranked from 1 to 180): 1 Denmark, New Zealand, Sweden, 4 Singapore, 5 Finland, Switzerland, 7 Netherlands, 11 Luxembourg, 12 Austria, Hong Kong, 14 Germany, Norway, 16 Ireland, United Kingdom, 18 Belgium, USA, 23 France, 28 Spain, 32 Portugal, 47 Hungary, 55 Italy, 57 Greece.

[21] Easiest to do business (ranked from 1 to 155): 1 Singapore, 2 New Zealand, 3 United States, 4 Hong Kong, 5 Denmark, 6 United Kingdom, 7 Ireland, 10 Norway, 14 Finland, 17 Sweden, 19 Belgium, 21 Switzerland, 22 Estonia, 25 Germany, 27 Austria, 31 France, 41 Hungary, 48 Portugal, 49 Spain, 50 Luxembourg, 65 Italy, 96 Greece.

[22] OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions.

[23] For German law, see the Penal Code (Strafgesetzbuch, StGB), in particular § 333 StGB (Vorteilsgewährung), § 331 StGB (Vorteilsannahme), § 11 StGB (definition of "Amtsträger"), § 108 e StGB (sale or purchase of votes, "Abgeordnetenbestechung"), and § 299 StGB (Bestechlichkeit und Bestechung im geschäftlichen Verkehr).

[24] See, for example, Yescombe ER, Principles of Project Finance. Academic Press, San Diego London (2002) pp 209–211.

sale of the firm's products in one country can be physically located in a neighbouring country that upholds the rule of law. This can be one of the reasons why many warehouses that support exports to Russia are physically located in the neighbouring Finland where they benefit from a more stable legal environment. (b) It can be relatively easy to locate immaterial functions to one country instead of the other. Money can easily be deposited and payments made in a country that upholds the rule of law instead of a country that does not. The firm should also take into account the fact that payment and settlement systems can be unreliable in a country with bad laws (section 9.6).

The firm can also ensure that the legal framework of the project is that of a country that upholds the rule of law. First, the firm can ensure that the investment contract is governed by the laws of a country with good laws. Second, the firm can ensure that related financing contracts are governed by the laws of a country with good laws. International financing contracts are often governed by English or New York law (platform, section 2.2.2). Third, the firm can ensure that these contracts contain a forum clause or arbitration clause that provides for the resolution of disputes in a country that upholds the rule of law. For example, international trade contracts often provide for arbitration in a neutral place like Paris (ICC),[25] Geneva or Zürich (the Geneva and Zürich Chambers of Commerce).[26] Like London, these cities can provide a highly-developed legal infrastructure for international commercial arbitration. International trade contracts with Eastern European countries often provide for arbitration in Vienna or Stockholm.[27]

4.3 Change of Law

Change of law is a risk that firms face especially in long-term contracts. Changes in law may take place through new legislation, new regulations under existing laws, or new interpretations of the law by courts.

As all aspects of the investment project are or can potentially be governed by laws, changes in law can affect cash flow and risk in many ways. For example: changes in contract law can make some contract terms unenforceable or insert new implied terms into the contract; changes in competition law can increase competition and reduce income; changes in tax law can reduce net income; and changes in

[25] The ICC recommends the following model clause: "All disputes arising out of or in connection with the present contract shall be finally settled under the Rules of Arbitration of the International Chamber of Commerce by one or more arbitrators appointed in accordance with the said Rules."

[26] The Chambers of Commerce of Basel, Berne, Geneva, Lausanne, Lugano, Neuchâtel and Zurich have adopted the Swiss Rules of International Arbitration.

[27] According to the Arbitration Rules of the Arbitration Institute of the Stockholm Chamber of Commerce. See, for example, Müller R, Das Gas und die Stockholmer Schiedsrichter, FAZ, 6 January 2009 p 2.

operating requirements such as employment, health, safety and environmental rules can increase operating costs.[28]

Mitigation of the change of law risk. The firm cannot eliminate the risk of a change of law. The firm may be able to mitigate its effects before the conclusion of the contract. The ways to do this depend on the transaction.

It is not normally necessary to address this risk in extremely short-term contracts such as simple contracts for the sale of goods. In such contracts, the firm that buys the goods accepts the risk of subsequent changes in law.

It is normal to address this risk in long-term contracts such as loan agreements, shareholders' agreements or distribution contracts. For example, the agreement can contain a "material adverse change" clause (section 5.5).

The events that constitute "material adverse changes" according to the wording of an MAC clause often include "changes in the interpretation of the law".[29] This is because, depending on the governing law, one might argue that an adverse decision by a court affecting the project's costs, rights, revenues, or risks does not change the law, but only correctly interprets it as it stands.

The parties can agree on the *allocation* of the cost effects of a change of law. In project finance, for example, the parties normally agree that increased costs will be passed on to the person paying for the product or service under the project contract.[30] *Renegotiation* clauses may generally be used to increase the flexibility of the contractual framework and to make it more dynamic in case a country changes its laws (section 5.5).[31] It could be legally more difficult to use particular *stabilisation* clauses designed to freeze the legal situation at the time of the conclusion of the contract (clause de gel),[32] and it could be difficult to find *insurance* coverage for this type of risk.

The effect of Community law. Community law has increased the frequency of changes in Member States' laws in two ways: First, there is an increasing amount of Community law and changes in existing Community law. Second, Member States must comply with Community law and implement it.

On the other hand, Community law has also made the direction of changes more predictable. The direction of changes is towards an "ever closer union"[33] and increasing approximation of Member States' laws. Changes in Community law

28 See Yescombe ER, *op cit*, § 10.6.

29 *Ibid*, § 10.6.1, § 10.7.1.

30 *Ibid*, § 10.6.1. However, while this position is generally accepted where the changes in law are specific to the industry concerned, if the change is of a more general nature there is less of a market consensus on how this should be treated.

31 See Berger KP, Renegotiation and Adaptation of International Investment Contracts: The Role of Contract Drafters and Arbitrators, Vanderbilt J Transn L 36 (2003) pp 1360–1361.

32 See Kropholler J, Internationales Privatrecht, 4. Auflage. Mohr Siebeck, Tübingen (2001) p 443 (§ 52 II d); Berger KP, *ibid*, pp 1360–1361.

33 First recital of the EC Treaty.

rarely come as a surprise, because the legislative process of the Community is relatively transparent.

The European Court of Justice has played a very important role in the development of new rules. The ECJ gives preliminary rulings when requested to do so.

In principle, the issues that may be referred to the ECJ are of three kinds: the interpretation of a provision of Community law; the effect of such a provision in the national legal system; and, in the case of a measure passed by the Community itself, the validity of such a provision (Article 234 of the EC Treaty).[34]

In practice, the ECJ has often changed the law while supposedly interpreting it. The decision-making of the ECJ is to a large extent based on policy. In order to promote European integration, the ECJ pursues the following policies: (1) strengthening the Community (and especially the federal elements in it); (2) increasing the scope and effectiveness of Community law; and (3) enlarging the powers of Community institutions.[35]

4.4 Flexibility of Law

4.4.1 General Remarks

It can be difficult to draw a line between changes in law and changes in the interpretation of law on one hand and the normal *flexibility of law* on the other. From the perspective of the firm, these two situations are nevertheless different. While changes in law seldom affect very short-term contracts (laws change ex post, i.e. after the conclusion of the contract and normally after its performance), the inherent flexibility of law affects all contracts (it exists at all times; i.e. before, during, and after the conclusion of the contract).

Causes of the flexibility of law. The flexibility of law is caused by the general nature of law. Legal systems are multi-layered. Laws must be interpreted.[36] Different people can interpret laws in different ways. There can also be special reasons for the flexibility of law in specific areas of law. One of them is that many commercial contract types are largely unregulated.

People. Law is not an exact science. Although it is possible to predict the contents of law at a sufficiently high level of generality, it is often impossible to predict how exactly another person would apply the law to the facts of the case, especially where the case is a hard one. There is always a *tolerance zone* for acceptable opinions about law (see below).

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[34] See, for example, Hartley TC, The Foundations of European Community Law, Fifth Edition. OUP, Oxford (2003) p 63.

[35] *Ibid*, p 80.

[36] As US Supreme Court Justice Oliver Wendell Holmes explained, legal advice is often just a prediction of what a judge and jury will do in a future case. Oliver Wendell Holmes Jr, The Path of Law, Harv L R 10 (1897) p 457.

Multi-layered legal systems. The fact that legal systems are multi-layered can make it more difficult to interpret law in a reliable way.

Legal systems are multi-layered because: law appears in legislative texts; law appears also in court decisions in which judges apply laws in each individual case and dispute; and there is a legal dogmatic layer that helps to make sure that legal regulations are consistent and do not cancel each others' effects. In addition to the "textual layer", the "legal dogmatic layer", and "the layer of judge-made law", it is nowadays normal to recognise the layer of fundamental constitutional rights.[37]

Member States' laws are already multi-layered. Community law creates an additional (multi-layered) level. There can also be an international or "global" level. In addition to these levels, there can be regional or cultural levels.

For example, international sales are very often governed by the CISG (the United Nations Convention on Contracts for the International Sale of Goods). There is thus an international level in sales. When interpreting provisions of the private law of a Nordic country, it is acceptable to take into account how similar provisions have been interpreted in the other Nordic countries. There is thus a regional and cultural level influencing the interpretation of private law in the Nordic countries.

General interpretational issues. The fundamental cause of the flexibility of law is the problem of interpretation. The most important factors that make interpretation more difficult include: (a) the openness of law; (b) the uncertainty of legal methodology; and (c) the divergence of ideas about rightness or justice.[38]

The openness of law is caused by many things. First, some factors arise from the language of law. Words can be ambiguous, and concepts can be vague. It is typical of legal statutes to use rather general terms. Second, some factors follow from the structure of the legal system. The mass production of regulations can lead to complexity and inconsistencies. On the other hand, the use of general terms in order to avoid very special and detailed regulations can also increase the openness of law.

Uncertainty in legal methodology means that there is no method that in each case would lead to one single answer. Furthermore, law cannot be interpreted without value-judgments, and flexibility is partly caused by subjective and diverging ideas about rightness or justice.

General concepts and principles. As said above, one of the reasons that make laws and their interpretation flexible is that legal systems normally rely on the use of general concepts or principles such as "good faith" or "gute Sitten". These general concepts or principles can be of different generality. Their purpose is often to add more flexibility to the legal system.

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[37] Pokol B, The Concept of the Multi-Layered Legal System.

[38] See Alexy R, Dreier R, Statutory Interpretation in the Federal Republic of Germany. In: MacCormick N, Summers RS (eds), Interpreting Statutes. A Comparative Study. Dartmouth (1991) pp 74–78.

The use of general principles is regarded as part of the civilian tradition of continental Europe.[39]

For example, the articles of the French Civil Code were written as broad principles that cover many situations and may comprise new developments in society. In Germany, § 242 BGB lays down a general principle of good faith (Treu und Glauben) that has been used to adapt the law of obligations to changing social developments. Its extremely wide scope ranges from the mutual relationship of many group companies to the mutual relationship of two contract parties.

Commercial contracts. In commercial contracts, a conflict between legal regulation and commercial reality is likely to increase the flexibility of law. Contract laws have often been drafted with traditional contracts for exchange in mind. Traditional exchange contracts are "discrete" one-time transactions. However, many exchange contracts are "relational" contracts under which parties collaborate over an extended period of time.[40] In addition, traditional contract law rules have been designed for traditional two-party transactions between independent parties (one buyer and one seller, or one debtor and one creditor), whereas modern firms operate in networks, and their transactions can be multi-party transactions.

4.4.2 Community Law

Community law influences the flexibility of law risk. In the EU, the flexibility of law is caused by factors relating to Community law, factors relating to how Community law is combined with Member States' domestic law, and factors relating to Member States' domestic legal systems. The effect of Community law will be discussed first.

General remarks. As said above, there is not much Community legislation about commercial contracts in general. There is nevertheless some important sectoral legislation. For example, EU competition law plays an important role in commercial contracts, and a wide range of laws can affect the commercial viability of the project in some way. Therefore, Community law can be relevant in many investment projects.

If Community law is relevant under the circumstances, it is likely to increase the flexibility of national law in a number of ways, because: Community law adds a further layer to the legal framework; it makes the interpretation of Member States' laws subject to the interpretation of Community law; and the provisions of Community law and their relevance in the circumstances must be interpreted in each Member State.

The interpretation of Community law. One of the factors increasing the flexibility of law in the Member States is the need to interpret Community law. The interpretation of Community law can be far from easy.

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[39] See also DCFR Intr. 72.

[40] See Gordon RW, Macaulay, Macneil, and the Discovery of Solidarity and Power in Contract Law, Wis L Rev 1985 p 565.

Article 249 of the EC Treaty lists five different categories of legal acts that may be adopted by Community institutions (regulations, directives, decisions, recommendations and opinions) and contains a short statement of their characteristics. A regulation lays down general rules that are binding both at the Community level and at the national level. Directives and decisions differ from regulations. They are not binding generally. They are binding only on the person (or persons) to whom they are addressed. Directives may be addressed only to Member States, but decisions may also be addressed to private citizens. Furthermore, directives are binding only "as to the result to be achieved" and leave to the national authorities "the choice of form and methods".[41]

The measures adopted by Community institutions should be mutually consistent, but this is not always the case. The existence of a complicated hierarchy of legal acts can increase the risk of inconsistencies between legal acts belonging to different categories. In addition, the increasing use of the piecemeal approach to harmonisation can result in inconsistencies between different acts belonging to the same category.[42]

There are also three further complications relating to the nature of legal acts mentioned in Article 249 of the EC Treaty.[43] First, the formal designation of an act is not always a reliable guide to its contents. A directive may thus leave very little choice as to form and methods. Second, the differences between the various categories are not as great as might appear from the Treaty provisions. According to the judgments of the ECJ, directives are in reality closer to regulations, because they can directly confer rights on private citizens (see below), although they are addressed to Member States. Third, the ECJ has ruled that the list in Article 249 EC is not exhaustive.

In addition to these complications, the decision-making of the ECJ is to an important extent based on policy. Occasionally, the Court will ignore the clear words of the Treaty in order to attain a fundamental policy objective: the promotion of European integration.[44]

International law may sometimes play a role. According to the case-law of the ECJ, Community legislation must, so far as possible, be interpreted in a manner that is consistent with international law, in particular where its provisions are intended specifically to give effect to an international agreement concluded by the Community.[45]

The autonomous interpretation of concepts. The uniform application of Community law and the widespread use of abstract concepts belong to things that can cause problems and increase the flexibility of law.

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[41] See, for example, Hartley TC, The Foundations of European Community Law, Fifth Edition. OUP, Oxford (2003) pp 103–104.

[42] This has been recognised by the Commission. See Communication from the Commission to the Council and the European Parliament on European Contract Law, COM/2001/0398 final, 11 July 2001, paragraph 35.

[43] Hartley TC, *op cit*, pp 103–104.

[44] *Ibid*, pp 79–80.

[45] See Cases C-61/94 Commission v Germany [1996] ECR I-3989, paragraph 52; C–341/95 Bettati [1998] ECR I-4355, paragraph 20.

The acts adopted by EU institutions should be interpreted in the same manner and produce the same effects in all Member States. The ECJ has stated that the need for uniform application of Community law and the principle of equality require that the terms of a provision of Community law which makes no express reference to the law of the Member States for the purpose of determining its meaning and scope must normally be given an autonomous and uniform interpretation throughout the Community.[46]

However, the uniform application of Community law and the use of abstract concepts can create problems for national courts.[47] First, the same term can mean different things in different directives. Differences between provisions in directives can be explained by differences in the problems which those directives seek to solve. One cannot, therefore, require that a term applied to solve a certain problem is interpreted and applied in precisely the same manner in a different context to solve a different problem. Second, abstract terms may represent a legal concept for which there are different substantive norms in each Member State (and which therefore does not mean the same thing in different Member States), and legislation adopted by Member States to implement EU directives refers to domestic legal concepts. The absence of a uniform understanding in EC law of general terms and concepts may lead to different results in commercial and legal practice depending on the Member State.

The interpretation of Community law in the Member States. Generally, three questions related to Community law make the interpretation of Member States' laws more complicated in national courts: Should Community law play a role in the interpretation of a provision of national law? How should Community law be interpreted in the circumstances? How should the provisions of national law be interpreted in the light of Community law?

Direct effect. It is a basic rule of Community law that a directly effective provision of Community law always prevails over a provision of national law.[48] If direct effect is given to a provision of Community law, that provision is applied by the national court as part of the law of the land. A provision of Community law has direct effect if: the provision is clear and unambiguous; it is unconditional; and its operation is not dependent on further action being taken by Community or national authorities.[49]

Furthermore, some legal acts confer rights on individuals.[50] Some of the provisions of the EC Treaty are directly effective. As said above, a regulation lays down general rules which are binding also at the national level. In addition, direc-

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46 Case 327/82 Ekro [1984] ECR 107, paragraph 11; Case C-287/98 Linster [2000] ECR I-6917, paragraph 43, Case C-357/98 Yiadom [2000] ECR I-9265, paragraph 26; Case C-170/03 Feron [2005] Feron [2005] ECR I-2299, paragraph 26; Case C-43/04, Finanzamt Arnsberg v Stadt Sundern, judgment of 26 May 2005.

47 See Communication from the Commission to the Council and the European Parliament on European Contract Law, COM/2001/0398 final, 11 July 2001, paragraphs 36–39.

48 Case 26/62, Van Gend en Loos [1963] ECR 1.

49 Hartley TC, *op cit*, pp 197–198.

50 For the effect on risk, see, for example, Kieninger EM, Koordination, Angleichung und Vereinheitlichung des Europäischen Vertragsrechts, SZIER/RSDIE 4/2004 p 497.

tives often confer rights on individuals. It is clear that individuals can rely on some directives against a Member State.[51] On the other hand, directives are not directly effective between individuals.[52]

The duty to interpret national law in conformity with Community law. In principle, the Court has consistently held that a directive cannot of itself impose obligations on an individual and cannot therefore be relied upon as such against an individual.[53] It follows that even a clear, precise and unconditional provision of a directive seeking to confer rights or impose obligations on individuals cannot of itself apply in proceedings exclusively between private parties.

According to case-law,[54] the obligation of a Member State to achieve the result envisaged by a directive is binding on all of its authorities under Article 10 of the EC Treaty (duty to take all appropriate measures). This obligation is therefore binding on the courts for matters within their jurisdiction,[55] and there is a duty to interpret national law in conformity with Community law.

When a national court applies national law, the court must interpret it, so far as possible, in the light of the wording and the purpose of the directive concerned in order to achieve the result sought by the directive.[56] For example, when a directive contains open clauses, it does not mean that their definition would be delegated to national courts.[57] – The division of competence between the ECJ and national courts raises further questions.[58]

As a rule, *all* national law must be interpreted in conformity with Community law. The principle that national law must be interpreted in conformity with Community law especially concerns domestic provisions enacted in order to implement

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51 26/62 Van Gend en Loos v Administratie der Belastingen [1963] ECR 3. See Case C-91/92 Faccini Dori v Recreb, ECR 1994 I-3325 paragraph 27.

52 Case C-91/92 Faccini Dori v Recreb, ECR 1994 I-3325.

53 See, inter alia, Case 152/84 Marshall [1986] ECR 723, paragraph 48; Case C-91/92 Faccini Dori [1994] ECR I-3325, paragraph 20; and Case C-201/02 Wells [2004] ECR I-723, paragraph 56.

54 Since the judgment of 10 April 1984 in Case 14/83 Von Colson and Kamann [1984] ECR 1891, paragraph 26. For more recent cases, see Cases C-397/01 to C-403/01 Bernhard Pfeiffer and others [2004] ECR I-8835, paragraph 110.

55 See, for example, Case C-106/89 Marleasing [1990] ECR I-4135, paragraph 8; Faccini Dori, paragraph 26; Case C-126/96 Inter-Environnement Wallonie [1997] ECR I-7411, paragraph 40; and Case C-131/97 Carbonari and Others [1999] ECR I-1103, paragraph 48.

56 See, to that effect, for example, the judgments cited in Von Colson and Kamann, paragraph 26; Marleasing, paragraph 8, and Faccini Dori, paragraph 26. See also Case C-63/97 BMW [1999] ECR I-905, paragraph 22; Joined Cases C-240/98 to C-244/98 Océano Grupo Editorial and Salvat Editores [2000] ECR I-4941, paragraph 30; and Case C-408/01 Adidas-Salomon and Adidas Benelux [2003] ECR I-12537, paragraph 21.

57 Case C-240/98 Océano Grupo Editorial and Salvat Editores [2000] ECR I-4941; Case C-168/00 Simone Leitner v TUI Deutschland GmbH & Co. KG [2002] ECR I-2631. Kieninger EM, Koordination, Angleichung und Vereinheitlichung des Europäischen Vertragsrechts, SZIER/RSDIE 4/2004 pp 500–501.

58 See Case C-237/02, Freiburger Kommunalbauten GmbH v Baugesellschaft & Co. KG / Ludger Hofstetter and Ulrike Hofstetter [2004] ECR I-3403, paragraphs 19–23.

the directive in question. However, it does not entail an interpretation merely of such provisions. The court must consider national law as a whole in order to assess to what extent it may be applied so as not to produce a result contrary to that sought by the directive.[59]

The duty to interpret national law in conformity with Community law also affects the application of interpretative methods recognised by national law.

The principle of interpretation in conformity with Community law requires a national court to do whatever lies within its jurisdiction, having regard to the whole body of rules of national law, to ensure that a directive is fully effective.[60] When hearing a case between individuals, a national court is required, when applying the provisions of domestic law adopted for the purpose of transposing obligations laid down by a directive, to consider the whole body of rules of national law and to interpret them, so far as possible, in the light of the wording and purpose of the directive in order to achieve an outcome consistent with the objective pursued by the directive.[61]

EU-wide legal rules as legal irritants. Community law can increase the flexibility of Member States' laws also by creating "legal irritants" that make the interpretation of existing law more difficult (for the effect of Community law on legal risk, see Volume I). For example, legal instruments adopted by the institutions of the EU forced the UK to insert rules on "good faith" into UK law. As this "legal transplant" had not been part of UK law in the past, it became a legal irritant, "a fundamental irritation which triggers a whole series of new and unexpected events" (Teubner).[62]

4.4.3 Differences Between Member States

In addition to the effect of Community law on the interpretation of national laws, the flexibility of Member States' laws is increased by other factors.

Multi-layered legal systems. Legal systems are multi-layered. Although the same layers can be found in all Member States, each layer is of varying importance in different Member States. The importance and function of these layers of law can be observed in all Member States, but in different proportions.

In all Member States, law is primarily a collection of legislated texts. In *continental* Europe, the relatively abstract and open provisions of codified law have nevertheless made it necessary to use a concretising legal layer. This concretising

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59 See, to that effect, Carbonari, paragraphs 49 and 50.

60 See, to that effect, Marleasing, paragraphs 7 and 13.

61 For recent cases see Cases C-397/01 to C-403/01, Bernhard Pfeiffer and others v Deutsches Rotes Kreuz, Kreisverband Waldshut eV, judgment of 5 October 2004, paragraph 119; Case C-196/02, Vasiliki Nikoloudi v Organismos Tilepikinonion Ellados AE, judgment of 10 March 2005, paragraph 73; Case C-456/98, Centrosteel Srl v Adipol GmbH [2000] ECR I-6007, paragraph 16.

62 Teubner G, Legal Irritants: Good Faith in British Law Or How Unifying Law Ends Up in New Divergencies, Modern L R 61 (1998) pp 11–12.

legal layer can be found in legal doctrine and judicial precedents, as has been expressly stated in the Swiss Civil Code (Schweizerisches Zivilgesetzbuch, ZGB).[63]

There are differences in continental Europe concerning the importance of these layers. (a) The doctrinal layer is of high importance in the German legal system and in the continental legal systems that belong to the German legal family. (b) The layer of judicial precedent is of marked importance in the Scandinavian countries and Germany.[64]

This can be contrasted with the situation in England and countries influenced by England's *common law* system. In these countries, high courts have been allowed to create judge-made law. As judge-made law is more specific and concrete, it has been less necessary to use a doctrinal layer or a concretising body of judicial precedents. Judicial precedent has instead functioned as a method of independent regulation. Statutory rules have been influenced by the specific and concrete style of judge-made law. As a reaction to the practice of the courts to interpret statutory rules literally, the legislators have issued detailed provisions rather than general and abstract principles.

In the absence of general and abstract principles, it may be difficult to interpret law in the event that there are still no specific and concrete rules. This is one of the causes of the ambiguity of common law.[65] The ambiguity of common law has substantial costs, as was pointed out by Easterbrook and Fischel:[66] "One is risk. A party cannot know, until long after the fact, whether he will be found in violation of the law. Firms that disclose what they think appropriate for investors may be surprised to learn, a few years later, that they did not disclose enough things or the rights things. This is a needless risk, and greater risk increases the firm's cost of capital. Investors would be better off if the risk could be reduced without any corresponding reduction in the prospects of the firm. Investors would pay for certainty, and they could be better off even if the price of certainty included the cost of disclosure that would be 'excessive' if risk were of no concern. Litigation also is expensive. Litigants spend more, because settlements are harder to strike, when there is more risk. Securities issues often are quite large, and the stakes of fraud litigation are correspondingly large. Thus resources invested in litigation could be immense. Everyone might gain if firms and investors could find some way to reduce the amount of litigation. If, for example, it were possible to create an administrative mechanism to determine in advance whether some disclosure is adequate, the total costs of disclosure could fall. Again investors might be better off, even if the cost of the administrative system included disclosure that would be excessive in a world of no-cost litigation."

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63 Article 1 ZGB.

64 See Alexy R, Dreier R, Precedent in the Federal Republic of Germany. In: MacCormick DN, Summers RS (eds), Interpreting Precedents. A Comparative Study. Aldershot, Dartmouth (1997) pp 17–64. La Torre M, Taruffo M, Precedent in Italy. In: MacCormick, Summers (eds) (1997) pp 141–188. Peczenik A, Bergholz G, Statutory Interpretation in Sweden. In: MacCormick, Summers (eds) (1997) pp 293–314.

65 In the case of CEL Group Ltd. v Nedlloyd Lines UK Ltd. [2004] 1 Lloyd's Rep 381, [2003] EWCA Civ 1716, [2004] 1 LLR 381, Lord Justice Carnwath explained what judges do when interpreting common law.

66 Easterbrook FH, Fischel DR, The Economic Structure of Corporate Law. Harv U P, The USA (1991) p 302.

Other factors that cause differences in the flexibility of law. The level of the flexibility of law varies depending on the Member State. Differences are caused by factors that range from membership in a legal family to legal culture. A large number of questions influence the flexibility of law.

Table 4.1 Questions Influencing the Flexibility of Law

Country

How big is the country?	There is more legal activity and less flexibility in a large country than in a small country.
How long legal traditions does the country have?	Long legal traditions decrease the flexibility of law.
How old are its laws?	Old laws are typically less flexible than new laws because they have been interpreted more often.
Does the whole country share the same legal culture? To what extent are there different legal cultures in the country?	The existence of many legal cultures can increase the flexibility of law.
To what legal family does the country belong?	Law is more flexible in some legal families than others. For example, the purpose of equitable principles is to make common law flexible.

Legal Regime

How much legal regulation is there?	The complete lack of regulation means that law is not flexible (there is no regulation), the existence of some regulation increases the flexibility of law, the existence of a large body of regulation is combined with less flexibility, and overregulation can again increase the flexibility of law where the legal system is too complicated.
How many layers of legal regulation are there?	A high number of regulatory layers can increase the flexibility of law due to problems relating to the interpretation of law.
To what extent are legal regulations general or specific?	General rules increase the openness and flexibility of law.
To what extent are legal regulations mandatory or dispositive?	It is easier to mitigate the risk caused by the flexibility of dispositive rules.
How common is it to derogate from the wording of statutes?	The liberal interpretation of statutes can increase the flexibility of law.

Precedents

How many precedents are there?	The lack of precedents can increase and the existence of a solid body of precedents can decrease the flexibility of law.
How binding are these precedents?	Binding precedents are likely to decrease the flexibility of law compared with precedents that do not have to be followed.
How common is it to derogate from precedents?	The more common it is, the higher the flexibility of law.

Legal Practitioners

How competent are the country's judges and legal practitioners?	The existence of competent judges and legal practitioners decreases the flexibility of law.
To what extent are specialist courts or specialist dispute resolution systems used in the country?	The existence of specialist courts decreases the flexibility of law.
To what extent is there an expert culture?	The existence of an expert culture decreases the flexibility of law.

Integrity and Independency

How independent are judges and legal practitioners?	Their independence decreases the flexibility of law.
Are judges likely to favour certain parties?	This would increase the flexibility of law.
To what extent are courts collegiate organs and to what extent do judges sit alone?	The use of sole judges is likely to increase the flexibility of law.
How strong is the perceived path dependency by lawyers and judges?	Strong path dependency decreases the flexibility of law.
To what extent is there corruption in the society?	A low level of corruption decreases the flexibility of law.

For example, *Germany* is a federal country, but its legal culture is relatively homogeneous in all states from Bavaria to Schleswig-Holstein. Germany is also a relatively *large* country, for which reason it has a large body of laws, a large legal market, a large number of academics, a large amount of legal scholarship, and plenty of competition at all levels. A uniform and comprehensive legal education obligatory for all German jurists contributes to a strong and established expert culture. Germany belongs to the German legal family. German legal culture builds on long traditions and a core of relatively old code-type laws. Laws are generally designed to provide a high degree of predictability; detailed statutory provisions are often complemented by an enormous number of precedents and publications.[67] German legal culture is to a high degree characterised by the systematising achievements of legal doctrine. The German legal methodology is relatively uni-

[67] See, for example, Maxeiner JR, Standard-Terms Contracting in the Global Electronic Age: European Alternatives, Yale J Int L 28 (2003) pp 155–156.

fied, and it includes generally acknowledged rules, principles and forms of statutory interpretation and gap-filling. German judges share the same legal education as other jurists and are highly influenced by scholarly writings; the rulings of higher courts often resemble scholarly writings in their style.[68] – As a result, the general flexibility of law risk is lower than in Finland.

This is because *Finland* is a relatively *small* country. It has therefore a smaller body of laws, a smaller legal market, a smaller number of academics, a smaller amount of legal scholarship, and less competition at all levels. There is a uniform and comprehensive legal education obligatory for all jurists, but Finnish jurists have traditionally seen themselves as generalists rather than specialists. Finland belongs to the Nordic legal family, and legal arguments are often supported by sources from other Nordic countries. The core of archaic code-type laws has to a large extent been replaced by modern statutes. – As a result, the general flexibility of law risk can be expected to be higher than in Germany.

4.4.4 Mitigation of the Flexibility of Law Risk

Methods

The inherent flexibility of law cannot be eliminated. The main rule is that the firm is itself responsible for any adverse effects of the flexibility of law.

However, there are perhaps five main ways for the firm to mitigate this risk. Three of them relate to the size of the risk (choice of law clause, dispute resolution clause, derogation from law, fulfilment of legal requirements in advance), the fourth to its allocation (transfer of risk to the other party or an information intermediary), and the fifth to information (obtaining information). It is characteristic of the flexibility of law risk that information about law (statements about law) can reduce the risk only to some extent.

Governing law. First, the firm can choose the governing law. The flexibility of law risk can be mitigated through a choice of law clause.

The firm can avoid the choice of a jurisdiction the laws of which are unclear or obscure and choose a jurisdiction with established rules and practices. For example, the firm should not designate non-state rules such as "lex mercatoria" or "the general principles of international commercial law", or the UNIDROIT Principles for International Commercial Contracts. Clauses that designate non-state rules are sometimes difficult to interpret by reason of their extreme vagueness or breadth. The court would most likely hold that the contract remains to be governed by the law designated by the provisions of international private law. This would make the legal framework even more confusing.[69]

In addition, it is standard practice for financing contracts to be governed by the law and jurisdiction of a developed country if the borrower is located in a develop-

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[68] See Alexy R, Dreier R, Statutory Interpretation in the Federal Republic of Germany. In: MacCormick DN, Summers RS (eds), Interpreting Statutes. A Comparative Study. Aldershot, Dartmouth (1991) pp 117–118.

[69] See also PECL Article 1.101.

ing country. Many financing contracts are thus governed by English or New York law or the law of another creditor-friendly country even if other project contracts are, for commercial or political reasons, governed by local law.[70]

In arbitration proceedings, the flexibility of law would be increased by a clause according to which the arbitrators could decide "ex aequo et bono", i.e. according to what they feel is fair. The flexibility of law risk can thus be mitigated by not vesting the arbitrators with the powers of such amiables compositeurs.

Some jurisdictions contain parallel civil-law structures, and the firm might be able to choose the structure with the lowest flexibility of law risk. For example, international and national situations can be governed by different statutes with the possibility of opt-in and opt-out.[71]

In most cases, a lawyer in a large western European country would know the main rules applicable to national situations better than the exceptions to these main rules applicable to international situations; on the other hand, the lawyer would probably know the rules that apply to international situations better than the contents of foreign law. It is therefore normal for a lawyer to exclude the application of the CISG, if it means that the domestic rules of that lawyer's country will apply, but apply the CISG, if the alternative would be to apply foreign law. The lawyer would thus prefer the following ranking: (1) domestic rules; (2) the CISG; and (3) foreign law. This would partly reflect the perceived flexibility of law risk, because the application of domestic rules in a large western European country (with plenty of case-law and many text-books and commentaries in the local language) is likely to be subject to a lower flexibility of law risk than the application of the CISG (with less case-law and literature in the local language). On the other hand, the exclusion of foreign law and the choice of the firm's domestic law normally reflects commercial reasons, the lack of information about foreign law, or the lack of rule of law in the foreign country, rather than the flexibility of foreign law as such.[72]

Dispute resolution. Second, the firm can mitigate the flexibility of law risk by a dispute resolution clause.

The firm should keep the following four general things in mind: (1) The dispute resolution clause should support the choice of law clause. The choice of the law that governs the contract should be valid and enforceable according to the law of the place where disputes will be settled. (2) The adjudicators should be competent as regards the substantive provisions of the governing law. It is therefore normal to choose court or arbitration proceedings in the country whose laws govern the contract. This will also support the choice of law clause, because judges and arbi-

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70 See Yescombe ER, Principles of Project Finance. Academic Press, San Diego London (2002) p 214.

71 See, for example, CISG Article 6: "The parties may exclude the application of this Convention or, subject to article 12, derogate from or vary the effect of any of its provisions."

72 The regulation of the sale of goods in Finland provides an example of the effect of the flexibility of law. Before 1987, the law of the sale of goods had not been codified. As a result, foreign firms were unwilling to accept the choice of Finnish law as the governing law, and foreign law tended to prevail. This was one of the reasons why the Sale of Goods Act was passed in 1987.

trators prefer to apply the laws of their own country and may end up applying familiar rules regardless of the law chosen by the parties.[73] (3) The firm can choose arbitration instead of court proceedings. An arbitration clause allows each contracting party to avoid the national courts of the other and enables the parties to turn to specialised arbitrators who are capable of dealing with particular contract types. – On the other hand, arbitration proceedings can also increase the flexibility of law. Court proceedings are normally public, and the parties have access to a large body of prior judgments. This enables the parties to find out how the court would interpret the law. It is more difficult to predict the behaviour of arbitrators who lack a similar public track record. (4) The adjudicators should apply a due process and uphold the principle of rule of law. It is worth noting that the firm can to some extent choose the procedural rules applied by an arbitral tribunal. If the contract contains an arbitration clause, it also typically contains a clause that refers to the Rules of Arbitration of the International Chamber of Commerce or to a similar arbitration mechanism.

The choice of the governing law of the contract and the dispute resolution clause can depend on many things:

- In practice, the firm might choose the courts of its *own country* in order to mitigate the risk of being discriminated against and to reduce its own litigation costs.
- A likely *defendant* would not choose a dispute resolution clause that provides for court proceedings in a place known to favour plaintiffs, but a firm likely to become the *plaintiff* in future proceedings would probably be better off if the dispute resolution clause provided for court proceedings in a plaintiff-friendly place.
- In many cases, the party most likely to be sued for breach of contract (and the party that prefers to avoid plaintiff-friendly jurisdictions) is the party who is to effect the *characteristic performance* of the contract (in sale of goods: the vendor), because more things can go wrong in the performance of such obligations.
- If the firm is the party that *pays money* for the characteristic performance, the firm should probably choose litigation or arbitration in a place that favours plaintiffs, because the breach of payment obligations is normally relatively easy to prove, and the breach of other obligations can be harder to prove.
- Where the main remaining obligation is the other party's obligation to *pay money*, the speed of proceedings and the enforceability of the judgment can be more important than plaintiff-friendliness, as non-payment is easy to prove.

Derogation from governing law. Third, the firm can mitigate the flexibility of law risk by derogating from the governing law and choosing contract terms that are less flexible (section 2.4.3).

[73] See Jäntera-Jareborg M, Svensk domstol och utländsk rätt. Skrifter från juridiska fakulteten i Uppsala 53. Iustus Förlag, Uppsala (1996) p 317.

Transfer of risk to the other party. Fourth, the firm can to some extent transfer the flexibility of law risk to the other party to the contract. The other party's *performances* (obligations) that do not directly affect cash flow or the firm's risk exposure can be made "law neutral" by linking them to the governing law.

This technique can be illustrated by the following two clauses: (1) "The Counterparty is responsible for complying with all laws both foreign and domestic." (2) "The Counterparty shall only use the documentation in a manner that complies with all applicable laws in the jurisdictions in which the Counterparty uses the documentation."

The firm can allocate the *cost* of this risk without allocating (other) performances. The firm can do this by: anticipating the range of possible events; linking these events with certain rights or obligations of the parties; and passing the risk on to the other party. For example, the contract may sometimes include a "hold harmless" clause:

Such a clause could look like this: "Indemnification. The Counterparty shall indemnify, defend and hold harmless the Firm from and against, and shall reimburse the Firm for, all losses, damages, liabilities, costs and expenses, including interest, penalties, court costs, taxes and reasonable attorneys' fees and expenses (but not punitive damages except to the extent awarded by a court of competent jurisdiction in respect of a third party claim), imposed upon or incurred by the Firm as a result of …"

Furthermore, the firm can *qualify* its obligations by combining an exact maximum limit (cap) with a link to the governing law in order to decrease the value of this obligation. The firm can also *define* its rights by combining an exact minimum floor with a link to the governing law in order to increase their value.

For example, the following three clauses are based on such principles: (1) "All obligations of the Firm are subject to US export control laws" (obligations qualified). (2) "The Firm will pay an additional 1.5% (or the amount required by law, whichever is lower) in the event that …" (maximum limit, obligations qualified). (3) "In addition to any other remedies available in equity or law to the Firm, failure by the Counterparty to comply with any of the terms and conditions in this Agreement shall give the Firm the right to …" (rights cumulative).

Information, information intermediaries. Fifth, one of the most common ways to mitigate this risk is to buy information from an external legal adviser.

However, because of the inherent flexibility of law, it can often be difficult to determine whether a statement about the contents of law is true or false. The probability that the statement is true depends on how the statement is formulated.

If the statement is formulated in a very general way, it can be true with high probability. An example: "Normally, lawful contracts are valid and binding, depending on what being valid and binding means." On the other hand, very specific statements are often true with lower probability: "This contract is valid and binding."

Furthermore, it can be difficult to assess the likelihood of future events such as how a court would decide a certain case. A factor that tends to lower the probability of a very specific statement being true is that legal regulations and contracts are often untested in court. The following is an example of a statement that is true with lower probability in relative terms: "This contract is valid and binding, and a court would enforce it according to its terms."

This also tends to keep statements more general or qualified: "This contract is valid and binding, and a court would enforce it according to its terms. This is nevertheless subject to normal rules on procedure, evidence, insolvency, and the customary discretion available to the court."

If the legal opinion is qualified, the probability that the statements are true is increased, but their usefulness is reduced.

Tolerance zone for legal opinions. In addition, the inherent flexibility of law leads to the inherent flexibility of statements about its contents and to what can be called a tolerance zone for statements about law. As some statements are true with higher probability than other statements depending on who makes the statement and how the statement is formulated and qualified, there will always remain a zone for opinions that are regarded as sufficiently accurate. The location and size of this tolerance zone vary depending on the circumstances.

For example, there are different legal sub-cultures. The size and location of the tolerance zone in the legal landscape may depend on whom the firm asks for information or who expresses the opinion.

One of the practical consequences of the tolerance zone is that it is seldom meaningful for a client to sue a lawyer for breach of contract after the lawyer has lost a case. A legal opinion given by a law firm is not necessarily wrong although a judge would later come to another conclusion, provided that what the law firm did was within the tolerance zone for law firms in the circumstances.[74]

Transfer of risk to a third party. It would be difficult for the firm to buy protection against the flexibility of law risk. For example, insurance protection is not available against the flexibility of law risk.

Different Drafting Traditions in the Member States

In all Member States, the firm could, in principle, mitigate the flexibility of law risk by using the same legal tools. In practice, however, the way these tools are used depends partly on the governing law. For this reason, there are also differences between Member States' drafting traditions.

Differences in the use of legal tools. As discussed above, the firm can mitigate the flexibility of law risk by derogating from the governing law (section 2.4.3). In common law countries, this would require many and relatively detailed contract terms. In civil law countries, however, the same result could be achieved by relatively brief and concise contract terms.

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[74] Even if it were not within the tolerance zone, it would be difficult to hold the law firm liable for malpractice, negligence or breach of contract, if the law firm applied the normal work process. See section 2.5.2 and Volume I.

Different styles of legal regulation. One of the fundamental reasons behind these different drafting traditions is the style of legal regulation in each country (section 4.4.1). Different styles of legal regulation encourage the firm to choose different legal tools or use the same legal tools in slightly different ways depending on the governing law.

In common law countries, judge-made law plays a more important role than in civil law countries. Both judge-made law and statutes are relatively specific and concrete. This is one of the factors that has made contracts very detailed as well.

In civil law countries, statutes typically lay down general principles, which are designed to cover a large number of situations, and specific rules, which cover specific situations that belong to the core area of the statute. The general principles and the specific rules can be either mandatory or dispositive. Because of this legislative style, contracts can be relatively brief and concise. It is normally sufficient to specify only the most fundamental terms of the contract and its core commercial terms. The contract can be complemented by the statutory background rules.

There are also differences as to how the firm can determine the contents of legal rules from which it possibly wants to derogate, or rather, the range of likely outcomes should the contents of these rules be determined by the court ex post. The study of legal doctrine (commentaries, books, articles) would probably have a higher relative weight in Germany compared with England, and the study of judicial precedent (case-law) would have a higher relative weight in England compared with Germany.

Community Law: Governing Law and Dispute Resolution

As said above, the choice of the governing law and a dispute resolution system belong to the legal tools that can help to mitigate the flexibility of law risk. The basic principles that govern dispute resolution and choice of law clauses are relatively straightforward in the EU. It is relatively easy for the firm to draft a binding dispute resolution clause and choose a forum that will uphold the choice of the governing law. (a) As regards the international jurisdiction of courts in civil and commercial matters, the underlying principle is that of the mutual recognition of judgments. The rules on the international jurisdiction of courts are thus complemented by rules on the recognition of foreign judgments. The recognition of foreign arbitral awards is based on the New York Convention. (b) Also the freedom to choose the governing law is relatively clear in the EU. On the other hand, the approximation of laws may limit the freedom to choose the applicable rules, if the Member States share the same rules.

The international jurisdiction of courts. The main rule under the Brussels I Regulation is that persons domiciled in a Member State shall, whatever their nationality, be sued in the courts of that Member State.[75]

The Lugano Convention is applied instead of the Brussels I Regulation between the Community and Switzerland, Norway, and Iceland. The old Lugano Convention will be replaced by the new Lugano Convention. The revised Lugano Convention was signed on 30

[75] Article 2(1) of Regulation 44/2001 (Brussels I).

October 2007 in Lugano. The provisions of the new Lugano Convention are aligned with the Brussels I Regulation.

There are nevertheless some exceptions to the main rule. One of the exceptions is *prorogation* of jurisdiction, i.e. agreement on the jurisdiction of a certain court or courts. The Brussels I Regulation thus contains rules on jurisdiction clauses (but not on arbitration).

The Regulation provides that "if the parties, one or more of whom is domiciled in a Member State, have agreed that a court or the courts of a Member State are to have jurisdiction to settle any disputes which have arisen or which may arise in connection with a particular legal relationship, that court or those courts shall have jurisdiction". The jurisdiction of that court (or those courts) is exclusive unless the parties have agreed otherwise.[76]

The Brussels I Regulation also contains rules as to form of such prorogation agreements: "Such an agreement conferring jurisdiction shall be either: (a) in writing or evidenced in writing; or (b) in a form which accords with practices which the parties have established between themselves; or (c) in international trade or commerce, in a form which accords with a usage of which the parties are or ought to have been aware and which in such trade or commerce is widely known to, and regularly observed by, parties to contracts of the type involved in the particular trade or commerce concerned".[77] Any communication by electronic means which provides a durable record of the agreement is equivalent to "writing".[78]

Other exceptions to the main rule range from the *alternative jurisdiction* of two or more courts[79] to the *exclusive jurisdiction* of other courts in special cases.[80]

The recognition of judgments. The provisions on the international jurisdiction of courts are complemented by provisions on the recognition of judgments. Where the Brussels I Regulation applies, a judgment given in a Member State must be recognised in the other Member States without any special procedure being required.[81]

Insolvency. The Brussels I Regulation does not cover insolvency. The international jurisdiction of courts in insolvency proceedings with cross-border implications is covered by a special regulation.[82]

Arbitration. Neither does the Brussels I Regulation cover arbitration.[83] However, the Member States are contracting states of the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards.

The New York Convention is the most important multilateral treaty on international arbitration. It requires courts in contracting states to recognise arbitration agreements in writing (Article II.1–2) and to refuse to allow a dispute to be liti-

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76 Article 23(1) of Regulation 44/2001 (Brussels I).
77 Article 21(1) of Regulation 44/2001 (Brussels I).
78 Article 21(2) of Regulation 44/2001 (Brussels I).
79 See especially Article 5 of Regulation 44/2001 (Brussels I).
80 See, for example, Articles 15 and 22 of Regulation 44/2001 (Brussels I).
81 Article 33(1) of Regulation 44/2001 (Brussels I).
82 Article 1(2)(c) of Regulation 44/2001 (Brussels I); Article 3(1) of Regulation 1346/2000 on insolvency proceedings.
83 Article 1(2)(d) of Regulation 44/2001 (Brussels I).

gated before them when it is subject to an arbitration agreement (Article II.3). It also requires courts to recognise and enforce foreign arbitral awards (Article III).

Convention on Choice of Court Agreements. In the future, the New York Arbitration Convention might be complemented by a multilateral treaty on prorogation contracts and the recognition of judgments. Adopted by the Hague Conference on Private International Law in 2005, the Convention on Choice of Court Agreements will establish rules for enforcing private party agreements regarding the forum for the resolution of disputes, and rules for recognising and enforcing the decisions issued by the chosen forum. The Convention will apply in contracting states that have ratified it.

The new Convention will govern international business-to-business agreements that designate a single court, or the courts of a single country, for the resolution of disputes ("exclusive choice of court agreements"). Consumer contracts and purely domestic agreements will not be covered by the Convention.

The Convention sets out three basic rules about exclusive choice of court clauses and an optional fourth rule about non-exclusive clauses: (a) the court chosen by the parties in an exclusive choice of court agreement has jurisdiction (article 5); (b) if an exclusive choice of court agreement exists, a court not chosen by the parties does not have jurisdiction, and must decline to hear the case (article 6); (c) a judgment resulting from jurisdiction exercised in accordance with an exclusive choice of court agreement must be recognised and enforced in the courts of other countries that are parties to the Convention (article 8); and contracting states may declare that their courts will recognise and enforce judgments given by courts of other contracting states designated in a non-exclusive choice of court agreement (article 22).

Uncontested claims, enforcement order, order for payment. The Brussels I Regulation is complemented by two regulations which simplify the collection of uncontested debts and claims.

The purpose of Regulation 805/2004[84] is "to create a European Enforcement Order for uncontested claims to permit, by laying down minimum standards, the free circulation of judgments, court settlements and authentic instruments throughout all Member States without any intermediate proceedings needing to be brought in the Member State of enforcement prior to recognition and enforcement."[85]

Regulation 1896/2006[86] sets up a simplified system for collecting uncontested debts between Member States by creating a European order for payment procedure.

The law governing the contract, the rules applicable to the contractual relationship. As said above, the firm should choose the applicable rules in order to determine its contractual rights and duties, and the firm should choose the applicable law in order to mitigate risks relating to the legal system (such as the flexibility of law risk).

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84 Regulation 805/2004 creating a European Enforcement Order for uncontested claim.

85 Article 1 of Regulation 1346/2000. See also Article 5 of Directive 2000/35/EC.

86 Regulation 1896/2006 creating a European order for payment procedure.

The freedom to choose the governing law is one thing, and the freedom to choose the applicable rules is another thing. The choice of the governing law normally designates the applicable rules. This question is nevertheless a more complicated in the EU.

Community law can limit the firm's freedom to choose the applicable rules in three main ways.[87]

First, the coordination of choice of law rules might restrict party autonomy in some cases. The freedom to choose the governing law could be restricted by special connecting factors (i.e. factors that connect the matter with a certain jurisdiction according to choice of law rules).

Second, the approximation of substantive laws might restrict party autonomy in some cases. The freedom to choose the governing rules could be restricted by special connecting factors in the area of substantive law that has been harmonised.[88]

In other words, there can be sectoral directives containing substantive provisions that designate the applicable rules. Sometimes the firm can find such provisions surprising.[89] For example, the First Company Law Directive can designate some rules applicable to the conclusion of contracts with a company,[90] and the Electronic Commerce Directive can designate some rules applicable to services provided by electronic means (Article 3).[91]

Third, the approximation of laws might result in the restriction of party autonomy in some cases. The scope of party autonomy is dependent on the amount of party autonomy that remains under substantive laws after they have been harmonised. The harmonisation of contract laws is nevertheless limited to specific sectors (see below).

4.5 Mandatory Provisions

The existence of mandatory provisions of law can make certain contract terms or the contract as a whole void or unenforceable, or lead to the modification of the contract. It is also possible that the parties are not deemed to have reached agreement in the first place because of mandatory provisions as to form. In some rare cases, the other party may have a mandatory right to withdraw from the contract.[92] These questions will be discussed in the next chapter.

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[87] See Kieninger EM, Koordination, Angleichung und Vereinheitlichung des Europäischen Vertragsrechts, SZIER/RSDIE 4/2004 pp 484 and 496.

[88] Case C-381/98, Ingmar GB Ltd v Eaton Leonard Technologies Inc. [2000] ECR I-9305, paragraphs 24–26; see also Kieninger EM, *ibid*, pp 494–495.

[89] See, for example, Furrer A, Gestaltungsspielräume im Europäischen Vertragsrecht. Vier Thesen für die schweizerische Rechtspraxis, SZIER/RSDIE 4/2004 pp 515–516.

[90] Article 9 of Directive 68/151/EEC (First Company Law Directive).

[91] Article 3 of Directive 2000/31/EC (Directive on electronic commerce). See, for example, Mäntysaari P, The Electronic Commerce Directive and the Conflict of Laws. The Case of Investment Services, JFT 3/2003 pp 338–380.

[92] See, for example, DCFR II. – 5:101.

5 Risks that Relate to the Statements of the Parties

5.1 Introduction

In all contracts, part of the general legal risk relates to the parties' statements rather than the legal system as a whole or laws in general. In addition to the risk inherent in the interpretation of contracts (section 5.2), the risks that relate to the statements of the parties include the risk that terms are not binding as intended (section 5.3) and even the risk that some terms may become (section 5.6) or remain binding (section 5.5). Sometimes terms are binding but not enforceable by legal means (section 5.4).

Freedom of contract. The freedom of contract means the freedom of a party to choose to enter into a contract on whatever terms it may consider advantageous to its interests, or to choose not to.

Both mandatory and dispositive law have interfered in the contractual relationship. Where the parties disagree on the existence or contents of contractual obligations, their mutual relationship is less likely to be interpreted according to the will of one or more parties and more likely to be interpreted according to legal background rules.

Interpretation. All parties interpret contracts. In the case of a dispute, contracts will typically be interpreted by outsiders and not by the persons who drafted them. Even if the contract were valid and binding and enforceable according to its terms, the statements made by the parties' representatives might not always lead to such contractual obligations or terms they had in mind.

Contract not binding. Normally, the firm wants a good contract to be binding according to its terms. For many reasons, contract terms are not always binding. For example, some contract terms might be incompatible with mandatory provisions of law, or a standard form contract might not have been incorporated properly.

Contract binding. In some cases, the firm would be better off if the contract or some of its terms were *not* binding. For example, the firm may require better information before it is prepared to accept the contract (section 5.6), or changed circumstances may make the contract unprofitable ex post (section 5.5).

For the reader. The following section starts with a rather lengthy account of the interpretation of contracts (sections 5.2.1–5.2.4). The way contracts are interpreted is one of the key issues that influence drafting, and interpretation rules can be seen in a new light when the perspective is that of the firm as their "user". Some read-

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ers might nevertheless prefer to move directly to section 5.2.5 which deals with the mitigation of risk.

5.2 Interpretation of Contracts

5.2.1 Introduction

Contracts are the most important way to regulate the intended cash flow and the exchange of goods, choose the preferred risk level, manage principal-agency relationships, and regulate information by legal means. The flexibility of interpretation increases risk. On the other hand, better management of the interpretation risk can ensure the same cash flow with lower risk. The firm should therefore make the outcome of interpretation more predictable and precise (i.e. reduce its variance ex ante).

A contract term cannot be enforced without interpreting it. The firm should interpret its draft contracts in advance. After contracting, it may become necessary to interpret the contract in order to determine: how to comply with its terms; whether there is a breach of contract; or whether there is a valid and enforceable contract in the first place. The court is the last instance to interpret the contract.

Contract and contract document. The contract is not the same thing as the contract document or its individual clauses. The contract document is regarded as evidence of a contract.

The existence of proper documentation can reduce risk. For example, it is more difficult to fulfil contracts that do not contain clear terms. Such contracts are often disputed ex post, and a third party (such as an arbitrator or judge), following established rules of contract interpretation (normative interpretation rules, canons of interpretation), may then have to decide the contents of the parties' obligations.

Governing law, substance, procedure, canons of interpretation. The law governing the interpretation of contracts is designated by the applicable choice of law rules (those of lex fori).

The law governing the interpretation of statements made by the parties should be distinguished from the law that governs the interpretation of contracts. For example, there is a distinction between substance and procedure.

In court proceedings, all *procedural* matters are governed exclusively by the law of the forum. The firm can choose the applicable procedural interpretation rules by choosing a dispute resolution clause which provides for litigation or arbitration in a certain jurisdiction (section 4.4.4).

Normally, the interpretation of *contracts* is governed by the law applicable to the contract. Interpretation is one of the matters that come within the scope of the law applicable to the contract under the Rome I Regulation.[1] When interpreting the contractual rights and obligations of the parties in the light of the statements of the parties, the court would thus apply the governing law of the contract.

1 Article 12(1)(a) of Regulation 593/2008 (Rome I).

Contracts can be interpreted in different ways depending on the governing law. The governing law designates the applicable canons of interpretation. If the governing law is changed, the interpretation of contract terms may change as well.

Substantive legal rules. In addition to procedural rules and the canons of interpretation that govern interpretation directly, the interpretation of contracts is influenced by substantive legal rules which can determine the result of interpretation directly or indirectly.

Substantive legal rules can influence the terms of the contract in a number of ways: substantive rules can be applied instead of the agreed terms (mandatory law); they can be applied to the extent that the parties have not agreed otherwise (dispositive law); the interpretation of the statements of the parties can be influenced by substantive rules (interpretation in the light of mandatory law or dispositive law); and they can be used to fill gaps in the contract. The last case is often called "completive interpretation" ("ergänzende Auslegung"). For example, the use of "implied obligations" in common law legal systems is a form of completive interpretation.[2]

Flexibility of interpretation. Like the interpretation of law, the interpretation of contracts is flexible in the sense that there can be variance of the results.

A contract can have different meanings to different persons. The parties may not even have intended that the contract would have only one meaning.

Generally, the firm is often happy with a contract although its interpretation is not perfectly clear. (a) This can be caused by the existence of transaction costs. It is possible that neither party knows what some of the clauses in the contract really meant if interpreted by the court ex post. (b) Many contracts are the result of lengthy and complicated negotiations. A compromise achieved by the parties is often better than not achieving any deal at all. (c) A firm can be tempted to use terms that it finds favourable even where it is not perfectly certain that the terms are enforceable in the legal sense. Even potentially invalid terms can, because of the possible risk of breach of contract, change the behaviour of the other party. (d) Everyday contracts are often made with little or no information about legal background rules.

The contents of the contractual relationship are flexible even in cases where the parties seem to agree on all contract terms. (a) It is very unlikely that the contract parties (or rather, their representatives) would have thought about all things belonging to the contractual relationship, about exactly the same things, and about the same things exactly in the same way. A person representing the firm is neither a clairvoyant nor a mind-reader. The representative of the firm is just as unlikely to be able to manipulate the other party's intentions by telepathy. (b) A contract party can be represented by many people, each with different ideas and each unable to read other representatives' minds. (c) Judges and arbitrators cannot know what the contract parties thought. Judges and arbitrators are just as human as other people. Clairvoyancy and mind-reading do not belong to their normal skills. (d) In

2 See, for example, Stölting C, Vertragsergänzung und implied terms. Eine rechtsvergleichende Untersuchung des deutschen und englischen Rechts. Sellier, München (2009).

cross-border contracts, the different cultural backgrounds of the parties tend to make it more difficult for the parties to understand each other.

Subjective and objective causes of flexibility. In addition to chance, the flexibility of the interpretation of contracts is caused by subjective factors and objective factors.

The *subjective* factors relate to the people who interpret contracts. They may contain matters like intelligence, character, values, and competence.

The factors that can better be described as *objective* rather than subjective include: the nature of the interpretation of what people say or do; the legal rules governing interpretation; the legal culture of the interpreter; and differences in the legal culture of different interpreters.

As regards such objective causes of the flexibility of interpretation, the nature of the interpretation of what people say or do is the same across different countries and cultures.

There are nevertheless differences regarding the legal rules governing interpretation (such as canons of interpretation and the role of substantive law). Some differences relate to legal culture. Otherwise identical contracts can be interpreted in different ways if the legal rules governing interpretation are different, and different interpreters that belong to different legal cultures can end up with different results when interpreting the same contract on the basis of the same evidence.

Member States' laws. The law plays an important role. The laws of all Member States provide for canons of interpretation, and each Member State has its own canons of interpretation. Many of the "classical" canons of interpretation are derived from Roman law (in particular, Justinian's Digest).[3]

Community law. Community law does not affect the interpretation of commercial contracts as such. The instruments adopted by EU institutions do not provide for any canons of interpretation as far as the statements of contract parties are concerned. However, Community law affects the contents of Member States' laws both directly and indirectly. There are also international conventions that may influence interpretation.

Interpretation of Member States' laws. Community law influences the interpretation of the Member States' substantive laws. The substantive provisions of the governing law can influence the interpretation of contract terms (section 5.2.4). Indirectly, the contents of Community law can thus influence the interpretation of contract terms as well.

Substantive provisions of Community law. Directly effective provisions of substantive Community law could, in principle, have a stronger effect on the interpretation of commercial contracts. However, few substantive provisions of Community law are designed to govern the contractual relationship between two undertakings.

For example, Article 81(1) of the EC Treaty prohibits certain agreements that restrict competition, and Article 81(2) provides that any agreements or decisions prohibited pursuant to

[3] See Zimmermann R, The law of obligations: Roman foundations of the civilian tradition. Clarendon Press, Oxford (1996).

Article 81 shall be void. The canons of interpretation of a Member State can provide that agreements should normally have a reasonable, lawful, and effective meaning. For this reason, a court that interprets the contract might find it reasonable to interpret the terms of the contract so that none of them breaches Article 81(1) of the EC Treaty.

International conventions. Some common rules can be based on international conventions. Sectoral conventions can contain special rules on the interpretation of contracts falling within their scope. The most important of these conventions is the 1980 UN Convention on the International Sales of Goods (CISG) that applies to international sales contracts (see below).

Other international instruments. The Draft Common Frame of Reference (DCFR), the Principles of European Contract Law (PECL), and the UNIDROIT Principles of International Commercial Contracts contain similar rules on the interpretation of the statements of the parties. Although not binding, they may affect the interpretation of contracts in the long run (see below).

Community law and the law governing interpretation. In addition to the applicable canons of interpretation, the interpretation of contracts depends on the governing law which designates the interpretation rules.

The Rome I Regulation provides that the law applicable to the contract will govern the issue of interpretation.[4] The parties may normally choose the governing law. However, the Rome I Regulation covers neither procedural nor evidential matters.[5] Once it has been decided that the issue is one of evidence or procedure, the effect of the exclusion is that the issue is governed by the law designated by the forum's national rules on private international law. All procedural matters (including evidence) are normally governed by the law of the forum (lex fori).[6]

The exclusion of evidence in the Rome I Regulation is not total, because two specific evidential matters, the burden of proof and proving a contract, are covered by the rules of the Convention to the extent that they are classified as contractual ones.[7] These questions are therefore governed by the law applicable to the contract.

Interpretation, canons of interpretation, real interpretation. An important cause of the flexibility of interpretation of contracts is the existence of differences between interpretation of what people say or do (section 5.2.2), traditional canons of interpretation (section 5.2.3), and the way the court interprets contracts in real life (section 5.2.4). When drafting contracts, the firm should take into account all aspects of interpretation in order to mitigate legal risk (section 5.2.5).

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4 Article 12(1)(a) of Regulation 593/2008 (Rome I).

5 Article 1(3) of Regulation 593/2008 (Rome I). According to the Giuliano and Lagarde Report, the exclusion of evidence and procedure in the Rome Convention required no comment. Giuliano M, Lagarde P, Report on the Convention on the law applicable to contractual obligations, OJ C 282, 31.10.1980, pp 1–50.

6 See North PM, Fawcett JJ, Cheshire and North's Private International Law. Thirteenth Edition. Lexisnexis UK, London (2004) pp 550, 67–68; see pp 595–596 for the difference between questions of fact and law.

7 Article 18 of Regulation 593/2008 (Rome I).

5.2.2 Interpretation of What People Say or Do

The risk inherent in the interpretation of contracts is caused by or could be defined as the flexibility (variation) of interpretation. The interpretation of contracts is always flexible, because the interpretation of any utterances and statements is flexible.

Everyday interpretation. The interpretation of utterances is part of everyday life. Normally, people interpret statements made by others in the course of negotiations in the same way as they discover the meaning of anything that a communicator tries to communicate. Also in law, a party's statements are usually interpreted in the same way as any things said or done in everyday life.[8] The everyday method of discovering the meaning of things said or done by the communicator has been called "the common sense principles of interpretation".[9]

Normative interpretation rules. There are some exceptions caused by legal rules and justified on policy grounds. Because of these exceptions, lawyers do not always interpret contracts in the same way as people who lack legal training do.[10]

Differences. The most fundamental difference between everyday rules on interpretation and legal rules on interpretation is that the latter are *normative*: they will basically be applied whether or not they comply with what is perceived by an individual as common sense.

Such legal rules can relate to: the legal relevance and relative weight of the intended meaning; the scope of the legally relevant context (for example, the admissibility of evidence); the relative weight of different forms of material on the basis of which the intended meaning is inferred; and the distribution of risk (for example, which meaning shall the court choose if either one of two meanings is possible according to everyday rules on interpretation).

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8 Mannai Investment Co Ltd v Eagle Star Assurance [1997] UKHL 19; [1997] AC 749; [1997] 3 All ER 352; [1997] 2 WLR 945 (House of Lords). Lord Hoffmann: "I propose to begin by examining the way we interpret utterances in everyday life. It is a matter of constant experience that people can convey their meaning unambiguously although they have used the wrong words. We start with an assumption that people will use words and grammar in a conventional way but quite often it becomes obvious that, for one reason or another, they are not doing so and we adjust our interpretation of what they are saying accordingly. We do so in order to make sense of their utterance: so that the different parts of the sentence fit together in a coherent way and also to enable the sentence to fit the background of facts which plays an indispensable part in the way we interpret what anyone is saying."

9 Kramer A, Common Sense Principles of Contract Interpretation (and how we've been using them all along), OJLS 23(2) (2003) pp 173–196.

10 Lord Hoffmann nevertheless said in an English case that "[a]lmost all the old intellectual baggage of 'legal' interpretation has been discarded" in English contract law (subject to one exception based on English procedural rules on evidence). Investors Compensation Scheme v West Bromwich Building Society [1997] UKHL 28; [1998] 1 All ER 98; [1998] 1 WLR 896.

Context and mutual context. As in everyday interpretation, linguistically decoded material[11] is complemented by pragmatically inferred material.[12] The context nevertheless limits the use of some forms of material.

In the interpretation of contracts, the context is often referred to as the surrounding circumstances, relevant circumstances, or factual background.[13] The contractual relationship changes the mutual context in some ways.

First, the nature of commercial contract documents may restrict the mutual context that an interpreter will use to find the apparently intended meaning. For example, contract documents are written, and there will be less mutual context concerning the location and immediate circumstances of the communication than there would be in the case of an oral communication.[14]

Second, the nature of commercial contract documents may also enlarge the mutual context that an interpreter will use to find the apparently intended meaning. For example, many contract documents are drafted by the parties' lawyers, and interpreters can attribute some of lawyers' knowledge and some techniques to each other, specifically knowledge of legal terminology and the technique of precise and careful drafting.[15]

Third, contract law can also regulate the relevant mutual context and allocate the risk relating to different aspects of this context whether or not the parties really have knowledge of these aspects. (a) For example, each party is presumed to have knowledge of the law; one is bound by law even if one does not know of it (*ignorantia legis non excusat*, "ignorance of the law is no excuse"). (b) There can also be other matters of which a party is deemed to have knowledge whether or not the party had such knowledge in fact. The most typical example of these rules may be the formalised disclosure of information to the public in some cases.[16] (c) There can also be differences as to the admissibility and relative weight of evidence in the interpretation of contracts; the most fundamental differences relate to the use of pre-contractual negotiations as evidence.[17]

Fourth, in the event of a dispute, contracts may be interpreted by the court (or an arbitral tribunal). (a) As the judge is not party to the contract, the judge cannot be considered a part of the apparently intended audience for the purposes of limit-

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11 For linguistic codes, see Kramer A, *op cit*, p 175.

12 For pragmatic inference, see *ibid*, p 175.

13 *Ibid*, p 178.

14 *Ibid*, p 179.

15 *Ibid*, p 180.

16 For example, Articles 3 and 9 of Directive 68/151/EEC (First Company Law Directive); Articles 1(1) and 6(1) of Directive 2003/6/EC (Directive on market abuse); Article 2 of Directive 2003/124/EC.

17 Kramer A, *op cit*, p 180: "There is a legal rule [in English law] that prohibits the admission of evidence of pre-contractual negotiations, which rule is thus inconsistent with the common sense principles of everyday interpretation. Unless this restriction can be justified on policy grounds, it should be abolished as it articially limits the process of pragmatic interpretation (through the use of mutual context), and thus prevents contracts being given the meaning that they were intended to take."

ing the relevant mutual context.[18] However, the judge determines the relevant mutual context. (b) In addition, the relevant personal context of the judge will influence his decisions either by law, due to the legal culture to which the judge belongs, due to the cultural background of the judge, or otherwise. For example, the court applies the procedural rules of the forum (lex fori) whether or not the parties are familiar with them; this is part of the relevant personal context of the judge. The judge will also have professional and personal values. The judge is likely to have the same professional or personal values regardless of the law that governs the contract or the procedure. An Iranian judge cannot be expected to assess evidence in the same way as a Swedish judge does even if they applied the same laws, because an Iranian judge and a Swedish judge do not share the same professional and personal values.

The objective principle, platform, mutual context. The principles that are collectively called "the objective principle" are present both in the "common sense principles" of interpretation and in the interpretation of contracts.[19]

The objective principle means that it is necessary to presume that the communicator and the interpreter did all the things that rational people were supposed to be doing in the communication process. Therefore, the communicator must presume that the interpreter will correctly apply the shared method of interpretation.

What is different when interpreting contracts is that the method of interpretation and the things that the communicator tries to communicate are even more closely connected than in everyday interpretation. The normative method of interpretation used by the court influences the way contracts are written. All informed parties are aware of this.

In a way, the method of interpreting contracts operates as a legal platform (section 2.2.2) presumed to belong to the mutual context of the parties (ignorantia legis non excusat). Due to these reasons, there is also more reason to assume that the communicator has optimally designed whatever information the communicator apparently tries to communicate.[20]

5.2.3 Traditional Canons of Interpretation

General Remarks

The contract laws of developed countries tend to contain similar technical interpretation rules:

- A contract is interpreted according to the "real intent" of the parties.

[18] *Ibid*, p 179.
[19] *Ibid*, p 177.
[20] For the assumption of rationality, the assumption that the communicator intends to communicate, the assumption of optimal design, and the assumption of normality, see Kramer A, *op cit*, pp 176–177 and 181.

- Provided that there is a binding contract, a contract is interpreted in order to give a reasonable, lawful, and effective meaning to all its terms.
- Negotiated terms take precedence over standard terms. Specific terms are entitled to greater weight than general terms. Unless a different intention is indicated, general words are given their commonly accepted meaning, and technical terms are given their normal technical meaning.
- Whenever reasonable, the indications of the intention of the parties are interpreted as consistent with each other and with any relevant course of performance, course of dealing, or usage of trade.
- Where a term or promise has several different possible meanings, it will be interpreted against the party who drafted the contract term or promise (contra proferentem).

Differences. However, there may be differences. They are normally caused by differences in the interpretation rules (canons of interpretation) or differences in legal culture. Differences in canons of interpretation and differences in legal culture are typically connected with differences in substantive laws. For example, the civilian judge and the common law judge may accept different types of arguments (see below).

CISG, PECL, DCFR. The CISG, the Principles of European Contract Law (PECL), and the Draft Common Frame of Reference (DCFR) contain canons of interpretation (see also section 2.3.3). Unlike the CISG, the PECL and the DCFR are neither binding nor based on government action, and they cannot constitute any usage by which the parties would be bound.[21]

At least in civil law countries, they provide information about the traditional canons of interpretation applied to contracts in general. All three provide for a so-called subjective-objective method of interpretation.

Usefulness of the CISG. The CISG can provide a brief introduction to the most basic canons of interpretation and the subjective-objective method.

Usefulness of the PECL. However, the relevance of the subjective-objective method should not be exaggerated. The subjective-objective method does not give a clear picture of how contracts are interpreted by the courts (section 5.2.4). In practice, the detailed special rules on interpretation set out by the PECL are more useful.

Such special interpretation rules have not been mentioned in the CISG. One may therefore ask whether they form part of the CISG.[22] It can be difficult to determine how the general principles on which the CISG is based would lead exactly to the same special interpretation rules. However, the canons of interpretation would normally be governed by the law applicable to the contract,[23] and the governing law will often provide for similar canons of interpretation as the PECL do.

[21] Compare CISG Article 9.
[22] CISG Article 7(2).
[23] Article 12 of Regulation 593/2008 (Rome I).

Usefulness of the DCFR. The Draft Common Frame of Reference (DCRF) is an alternative to the PECL. The PECL and the DCRF provide virtually the same information about the interpretation of contracts. The Study Group and the Acquis Group have also published a Table of Destinations and a Table of Derivations showing the relationship between the PECL and the DCRF.[24]

The CISG as a Shortcut

The canons of interpretation set out in the CISG are not mandatory, and the parties are free to exclude their application or derogate from them.[25] The main rule is that the contract is interpreted according to the understanding of the parties. The main rules can be found in Article 8 which deals with the interpretation and proof of agreements. Actually, there are no provisions on the interpretation of contracts as such. The interpretation of contracts is governed by provisions that lay down how unilateral statements and conduct of each party must be interpreted.

Subjective-objective method. The CISG provides for a subjective-objective method of interpretation.

First, CISG Article 8(1) lays down a *subjective* standard for interpretation: "For the purposes of this Convention statements made by and other conduct of a party are to be interpreted according to his intent where the other party knew or could not have been unaware what that intent was."[26]

Second, Article 8(2) provides for an *objective* standard - the standard of a "reasonable person" – where the subjective intent of the parties cannot be determined: "If the preceding paragraph is not applicable, statements made by and other conduct of a party are to be interpreted according to the understanding that a reasonable person of the same kind as the other party would have had in the same circumstances."[27]

In both cases, *all relevant circumstances* may be considered. This is stated in Article 8(3): "In determining the intent of a party or the understanding a reasonable person would have had, due consideration is to be given to all relevant circumstances of the case including the negotiations, any practices which the parties have established between themselves, usages and any subsequent conduct of the parties."

Any materials. The list of matters that may be relevant in determining either the meaning intended by the parties or the reasonable meaning of the contract is non-exhaustive. For example, the observance of good faith by the parties can be taken into account although it has not been mentioned in Article 8. Good faith can be

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24 Study Group on a European Civil Code and the Research Group on EC Private Law (Acquis Group), Principles, Definitions and Model Rules of European Private Law. Draft Common Frame of Reference (DCFR). Outline Edition. Sellier, Munich (2009) pp 101–130.

25 CISG Article 6.

26 PECL Articles 2:102 and 5:101(1) and (2); DCFR II.–8:101(1) and (2).

27 PECL Article 5:101(3); DCFR II.–8:101(3).

relevant in some cases, because the observance of good faith in international trade is one of the things promoted by the CISG.[28]

No order of preference. The main rule is that there is no order of preference as regards linguistically decoded material, pragmatically inferred material, and the context. No factor prevails over other factors as such.

In particular, the factors that may be considered are not limited to the “four corners of the contract”.[29] For example, preliminary negotiations can be taken into account in the interpretation of the contract. The use of “parol evidence” (section 5.2.4), i.e. evidence of the meaning of the contract outside the document itself, is permitted.

A merger clause (also known as an entire agreement clause or integration clause) inserted into the contract would not exclude the application of Article 8. A merger clause would thus not prevent the court from interpreting the contract on the basis of “parol evidence”. However, the parties can exclude the application of Article 8 or derogate from it by stating it expressly in the contract.[30] In this case, the effect of the merger clause would depend both on the governing law (to the extent that its effect is classified as a contractual matter) and the dispute resolution clause (to the extent that its effect is classified as a procedural matter).

Usage. Although there is no general order of preference, Article 9 provides that the parties are bound by usage. Article 9 also contains special rules on interpretation.

First, the parties are “bound by any usage to which they have agreed and by any practices which they have established between themselves”.[31]

Second, the parties are “considered, unless otherwise agreed, to have impliedly made applicable to their contract or its formation a usage of which the parties knew or ought to have known and which in international trade is widely known to, and regularly observed by, parties to contracts of the type involved in the particular trade concerned”.[32]

This is a further example of how the CISG promotes the observance of good faith in international trade.[33]

Freedom to modify contracts. Article 29 deals with the requirements for the modification and termination of contracts. This provision is based on the principles of freedom of contract and freedom from formalities.

The main rule is that any agreed modification or termination will be valid in whatever form it is made or contained; no consideration is necessary for any amendment to be valid (consideration is required in common law but not in civil law).

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[28] CISG Article 7(1).
[29] See also DCFR II.–8:101(1).
[30] CISG Article 6.
[31] CISG Article 9(1).
[32] CISG Article 9(2).
[33] See CISG Article 7(1).

On the other hand, if the parties have agreed to restrict their ability to modify or terminate a contract by requiring formalities for such actions, even that agreement is valid and enforceable.

There is an exception that protects the good faith of the other party. A party may be precluded by his conduct from asserting such a provision to the extent that the other party has relied on that conduct.[34]

The DCFR as a Shortcut

Like the CISG, the DCFR rules on the interpretation of contracts are a combination of the *subjective* and *objective* methods of interpretation. In addition, the DCFR not only provide for *general* interpretation rules (like the CISG) but also set out a large number of *special interpretation rules* (unlike the CISG). Furthermore, the DCFR rules of interpretation are not separated from the DCFR *rules of behaviour* such as the principle of good faith and the concept of "reasonableness".

The principle of good faith is used both as a rule of interpretation of the DCFR rules[35] and as a rule of behaviour,[36] and several specific rules of the DCFR can be seen as expressions of "good faith and fair dealing".[37] The concept of "reasonableness" is used in the same way as the principle of good faith. The PECL contain a large number of rules that make use of the concept of reasonableness, and there is also a connection between reasonableness and good faith. The PECL rules provide that "… reasonableness is to be judged by what persons acting in good faith and in the same situation as the parties would consider to be reasonable. In particular, in assessing what is reasonable the nature and purpose of the contract, the circumstances of the case and the usages and practices of the trades or professions involved should be taken into account".[38]

General interpretation rules. The DCFR rules on the interpretation of contracts thus contain both general rules on interpretation and special rules on the interpretation of various clauses.

The general rules address mainly the relative weight of the parties' intent and the scope of the relevant context on the basis of which the intent of the parties is determined.

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[34] CISG Article 29(2). In German law, this exception would be based on the principle of Mißbrauchseinwand. In common law, it would be based on the principle of estoppel.

[35] DCFR I.–1:102(3); PECL Article 1:106(1).

[36] DCFR III.–1:103; PECL Article 1:201(1).

[37] DCFR II.–3:301; PECL Article 2:301: the duty of a party not to negotiate a contract with no real intention of reaching an agreement with the other party. DCFR II.–3:302; PECL Article 2:302: the duty not to disclose confidential information given by the other party in the course of negotiations. DCFR II.–7:207; Article 4:109: the duty not to take unfair advantage of the other party's dependence, economic distress or other weakness. DCFR III.–3:202; III.–3:203(a); PECL Article 8:104: the right given to a debtor to cure a defective performance within the time allowed for performance. DCFR III.–3.302; PECL Article 9:102: the right to refuse to make specific performance of a contractual obligation if this would cause the debtor unreasonable effort and expense.

[38] DCFR I.–1:104; PECL Article 1:302.

First, the intention of the parties should be established. As a rule, the person interpreting the contract should look for the common intention of the parties: "A contract is to be interpreted according to the common intention of the parties even if this differs from the literal meaning of the words".[39] The contract should only exceptionally be interpreted according to only one party's intent: "If one party intended the contract, or a term or expression used in it, to have a particular meaning, and at the time of the conclusion of the contract the other party was aware, or could reasonably be expected to have been aware, of the first party's intention, the contract is to be interpreted in the way intended by the first party".[40] In effect, the DCFR and the CISG lead to the same result.[41]

According to the wording of the DCFR, the common intention of the parties prevails over the literal wording of the contract. The interpretation of the contract is thus not limited to the "four corners of the contract", and the "parol evidence rule" does not apply.

Second, an objective standard ("a reasonable person") is used if the parties' true intentions cannot be ascertained: "The contract is to be interpreted according to the meaning which a reasonable person would give to it … if an intention cannot be established …"[42] The wording of the DCFR implies a more objective standard than the PECL.[43]

Third, there is a non-exhaustive list of matters that may be relevant in determining the meaning of the contract. There is normally no particular hierarchy between different elements. On the other hand, the parties are free to agree on the interpretation of the contract. For example, the parties often agree on the definition of terms.

This non-exhaustive list is more detailed than the CISG list. Like the CISG list, it will be applied when seeking either the common intention of the parties or the reasonable meaning of the contract: "In interpreting the contract, regard may[44] be had, in particular, to: (a) the circumstances in which it was concluded, including the preliminary negotiations; (b) the conduct of the parties, even subsequent to the conclusion of the contract; (c) the interpretation which has already been given by the parties to terms or expressions which are the same as, or similar to, those used in the contract and the practices they have established between themselves; (e) the nature and purpose of the contract; (d) the meaning commonly given to such terms and expressions in the branch of activity concerned and the interpretation such terms or expressions may already have received; (e) the nature and purpose of the contract; (f) usages; and (g) good faith and fair dealing."[45]

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39 DCFR II.–8:101(1); PECL Article 5:101(1).

40 DCFR II.–8:101(2); PECL Article 5:101(2).

41 CISG Article 8 refers to the intent of an individual party. See DCFR II.–8:201. In the PECL, the unilateral intention of a party is mentioned in the context of the intention to be legally bound. PECL Article 2:102.

42 DCFR II.–8:101(3)(a).

43 PECL Article 5:101(3): "…according to the meaning that reasonable persons of the same kind as the parties would give to it in the same circumstances".

44 PECL Article 5:102: "… shall …"

45 DCFR II.–8:102(1).

These matters have clearly not been limited to the "four corners of the contract", and it can again be seen that the "parol evidence rule" does not apply. For example, the conduct of the parties after the closing of the contract may be used to interpret the meaning of the contract (part (b) above). In addition, there are different ways to make the parties bound by usage: the parties may be considered to have contracted with reference to usage;[46] and usage may be regarded as an implied term.[47]

Fourth, where the contract contains a gap, the gap may be closed either through interpretation or by applying the substantive provisions that complement the contract in general. The DCFR resort to completive interpretation (ergänzende Auslegung) and contain a rule on implied terms.[48]

Special interpretation rules. The special rules on interpretation relate mainly to the interpretation of individual clauses.

Special rule on merger clauses. First, there are rules on merger clauses. Although the parties may normally derogate from the main interpretation rules set out in the DCFR (party autonomy),[49] the main rule is that a merger clause does not prevent the judge or arbitrator from considering all matters in the interpretation of the contract. A merger clause will thus not prevent the parties' prior statements from being used to interpret the contract.

On the other hand, the parties may agree otherwise in an individually negotiated merger clause.[50] For example, the parties can agree that anterior negotiations may not be used even for purpose of interpretation. Such a clause is normally effective[51] and may be necessary, when the closing is preceded by long and complicated negotiations.

If the merger clause is not individually negotiated, it will only establish a rebuttable presumption.[52] Furthermore, a party may rely on the other party's later conduct even where the contract contains an individually negotiated merger clause.[53]

Special rule on amendments clauses. Second, the DCFR contains a rule on clauses according to which the contract can be modified in certain form only (i.e. amended in writing).

As said above, the main rule under the CISG is freedom of contract and freedom from formalities.[54] The parties may derogate from their previous agreement

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[46] DCFR II.–1:104; PECL Article 1:105.
[47] DCFR II.–9:101; PECL Article 6:102.
[48] DCFR II.–9:101; PECL Article 6:102.
[49] DCFR II.–1:102(2); PECL Article 1:102(2).
[50] DFCR II.–4:104; PECL Article 2:105.
[51] See nevertheless PECL Article 2:105(4) and DCFR II.–4:104(4): "A party may by its statements or conduct be precluded from asserting a merger clause to the extent that the other party has reasonably relied on such statements or conduct."
[52] DCFR II.–4:105(1); PECL Article 2:106(1).
[53] DCFR II.–4:105(2) PECL Article 2:106(2).
[54] CISG Article 29(1): "A contract may be modified or terminated by the mere agreement of the parties."

on the form of modification or termination of the agreement.[55] The DCFR contains similar provisions.[56] A clause according to which the contract can only be amended in writing only lays down a rebuttable presumption. Again, all matters may be relevant in interpreting whether or how the contract has been amended.[57]

Such an amendments clause means that the onus is on the party who nevertheless wants to rely on the modification or termination of the contract. For example, if the parties have agreed that all amendments must by signed by both parties, the lack of signature will constitute a rebuttable presumption that the parties are not in agreement.

The provisions on merger clauses and amendments clauses can be seen as examples of the protection of a party's "good faith and fair dealing" and the requirement that parties act in a reasonable way in their mutual dealings (see above).

Other special rules. Third, the DCFR provides for six other special interpretation rules: the rule on conflicting general conditions; the contra proferentem rule; the rule on giving preference to negotiated terms; the rule on interpreting the individual provisions with reference to the contract as a whole; the rule on giving preference to the interpretation that renders the terms of contract effective; and the rule on interpretation in case of linguistic discrepancies.

- The rule on conflicting general conditions: "If the parties have reached agreement except that the offer and acceptance refer to conflicting standard terms, a contract is nonetheless formed. The standard terms form part of the contract to the extent that they are common in substance."[58] "However, no contract is formed if one party: (a) has indicated in advance, explicitly, and not by way of standard terms, an intention not to be bound by a contract on the basis of [the above paragraph]; or (b) without delay, informs the other party of such an intention."[59]
- The contra proferentem rule: "Where there is doubt about the meaning of a term not individually negotiated, an interpretation of the term against the party who supplied it is to be preferred."[60]
- The rule on giving preference to negotiated terms: "Terms which have been individually negotiated take preference over those which have not."[61]

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55 CISG Article 29(2): "A contract in writing which contains a provision requiring any modification or termination by agreement to be in writing may not be otherwise modified or terminated by agreement. However, a party may be precluded by his conduct from asserting such a provision to the extent that the other party has relied on that conduct."

56 DCFR II.–4:105; PECL Articles 2:105, 2:106 and 2:107.

57 See also DCFR I.–1:103(2); PECL Article 2:107.

58 PECL Article 2:209(1).

59 DCFR II.–4:209; PECL Article 2:209(2).

60 DCFR II.–8:103(1); PECL Article 5:103.

61 DCFR II.–8:104; PECL Article 5:104.

- The rule on interpreting the individual provisions with reference to the contract as a whole: "Terms and expressions are to be interpreted in the light of the whole contract in which they appear."[62]
- The rule on giving preference to the interpretation that renders the terms of contract effective: "An interpretation which renders the terms of the contract lawful, or effective, is to be preferred to one which would not."[63]
- The rule on interpretation in case of linguistic discrepancies: "Where a contract document is in two or more language versions none of which is stated to be authoritative, there is, in case of discrepancy between the versions, a preference for the interpretation according to the version in which the contract was originally drawn up."[64]

Some of these special interpretation rules apply in particular to contracts made on standard business terms or standard forms.[65] (a) The contra proferentem rule is based on the idea that the party who has drafted the contract (or clause) unilaterally should bear the risk of any ambiguities. It covers even the use of pre-drafted clauses or standard terms prepared by a third party. (b) The preference given to negotiated clauses over clauses printed in general contract terms is based on the idea that the negotiated clauses represent the common intention of the parties. (c) As regards conflicting standard business terms, the main rule is that they form part of the contract to the extent that they are common in substance, unless a party has specifically indicated that it does not want to be bound by such a contract.

Some of the above rules are based on the fiction that both parties to the contract are rational persons who want the contract to be coherent and effective. The parties are expected to act accordingly, and their statements are interpreted accordingly. (a) The reference to the contract as a whole can mean many things: the clauses should not be read out of context; the same term should be understood to have the same meaning in different parts of the same contract (the terminology is thus presumed to be coherent); and clauses should not contradict each other (the contract terms are presumed to be coherent). These principles are also applied to contracts that consist of many contract documents (master contracts, schedules, confirmations, and so forth). (b) The principle that an interpretation that renders the terms of the contract lawful, or effective, is to be preferred means that if a clause is ambiguous and one of two possible interpretations would make the clause invalid and the other valid, the latter interpretation should prevail (favor negotii). For the same reasons, if one of two possible interpretations would lead to an absurd result the other should be taken.

Some of the special interpretation rules deal with the interpretation of international contracts. It is not unusual for international contracts to be drafted in more than one language. There can be divergences between the different linguistic versions. (a) The parties are free to state that one version is to be authoritative, in

62 DCFR II.–8:105; PECL Article 5:105.
63 DCFR II.–8:106; PECL Article 5:106.
64 DCFR II.–8:107; PECL Article 5:107.
65 DCFR II.–8:103(1) and II.–104; PECL Articles 5:103 and 5:104.

which case that version will prevail. (b) In the absence of such a clause, there is a presumption that the original version will prevail; it is nevertheless possible to eliminate these divergencies, for example, by correcting obvious errors of translation in one version. (c) The parties are free to state that the different versions shall be equally authoritative. In this case, the general rules of interpretation will apply.

5.2.4 Real Method of Interpretation

Introduction

As described above, there is a long list of general and special interpretation rules (canons of interpretation). It goes without saying that all Member States of the EU have rules on the interpretation of contracts.

Interpretation rules. In different Member States, the rules on the interpretation of contracts can be found in different sources, and they are of different levels of generality.[66]

While countries belonging to the French legal family typically have detailed statutory provisions on interpretation,[67] countries belonging to the German legal family tend to have statutory statements of general principle.[68]

Countries that belong to the Nordic legal family typically lack statutory rules on interpretation. Instead, the interpretation rules are based on case law and doctrine. The same can be said of the Netherlands.

In common law countries, the rules of interpretation are based on case law, and they are not clearly distinct from rules of evidence and rules about mistake.

Traditional method. Interpreting contracts according to the common intent of the parties is a very widely accepted principle. The judge or arbitrator is thus encouraged to start by having a look at the parties' common intent at the time the contract was made.

Like the CISG and the PECL/DCFR, the laws of the majority of Member States have adopted a combination of the subjective method, according to which the contract is interpreted according to the common intention of the parties, and the objective method, which takes an external view by reference to objective criteria such as reasonableness, good faith, and so forth.

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[66] See, for exmaple, Zweigert K, Kötz H, Einführung in die Rechtsvergleichung auf dem Gebiete des Privatrechts. Mohr (Siebeck), Tübingen (1996), 3. Auflage § 30; Kötz H, Europäisches Vertragsrecht I, Mohr (Siebeck), Tübingen (1996) § 7; Kropholler J, Internationales Einheitsrecht. Allgemeine Lehren. Mohr (Siebeck), Tübingen (1975) § 19; Scottish Law Commission, Report on Interpretation in Private Law (Scot Law Com No 160) (August 1997).

[67] For the laws of France, Belgium, and Luxembourg, see CC arts 1156–1164. For Spanish law, see CC arts 1258 and 1281–1289. For Italian law, see CC arts 1362– 1371.

[68] For German law, see § 133 BGB and § 157 BGB. See also § 242 BGB. For Austrian law, see § 914 ABGB. See also § 915 ABGB. For the law of Greece, see CC arts 173 and 200. For the law of Portugal, see CC arts 236–238. See also CISG Article 8.

The trend towards more flexible interpretation. One would expect differences between Member States' laws as to the interpretation of the parties' intent.

In common law jurisdictions, the common intent of the parties is said to be determined according to a more objective standard: what a reasonable person would have intended if he had been in the position of the actual parties to the contract at the time of contracting.

In civil law countries, the common intent of the parties is said to be understood more subjectively, as what the parties to the contract at hand really intended, but did not express clearly, when they concluded their agreement.[69]

However, there is a trend towards more flexible interpretation.

First, the older and more static rules of interpretation have generally been replaced by more dynamic rules that take into account events before and after the moment of contract formation.[70] This is necessary in particular in the context of "relational" contracts.[71]

Second, the civil law rules on the interpretation of the common intent of the parties are not as "subjective" as they might appear at first sight.

The common intent of the parties as interpreted by the court is not the same as their individual subjective intentions: the apparently "subjective" initial provisions, which set out on the basis of what *evidence* the subjective intention must be assessed, are supplemented by more "objective" provisions setting out how this evidence is to be *used*.

Therefore, it has been said that German law "tends to follow a more objective, or normative, approach; the emphasis is not so much on what a party may have meant, but on how a reasonable man would have understood his declaration. There is no room for an inquiry into the 'true intention' of the parties if the justifiable reliance of the addressee deserves protection".[72]

Third, the common law parol evidence rule no longer reflects actual business practice and case law in England.

In the past, the common intention was primarily sought in the language used by the parties. This practice was complemented by the parol evidence rule: when the wording of the contract document was clear and unambiguous, its meaning was determined from the written document alone.[73]

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69 Tetley W, Seven Rules of Interpretation (Construction) of Bills of Lading. In: Liber Amicorum Robert Wijffels. ETL, Antwerp (2001) pp 359–379.

70 Eisenberg MA, The Emergence of Dynamic Contract Law, Vol. 2, Theoretical Inquiries in Law (Online Edition): No. 1, Article 1 (2001).

71 See also Sharma KM, From "Sanctity" to "Fairness": An Uneasy Transition in the Law of Contracts? NY L School J Int Comp L 18 (1999) p 123.

72 Zimmermann R, The law of obligations: Roman foundations of the civilian tradition. Clarendon Press, Oxford (1996). See Scottish Law Commission, Report on Interpretation in Private Law (Scot Law Com No 160) (August 1997), paragraph 1.18.

73 See Lord Hoffmann in Investors Compensation Scheme v. West Bromwich Building Society [1997] UKHL 28; [1998] 1 All ER 98; [1998] 1 WLR 896: "The law excludes from the admissible background the previous negotiations of the parties and their declarations of subjective intent. They are admissible only in an action for rectification."

The parol evidence rule forces the court to first determine whether the wording of the contract document is ambiguous.[74] (a) If the wording is clear and unambiguous, the court will ascertain the intent of the parties solely from the writing as a matter of law and without reference to any other evidence (parol evidence); parol evidence is not admissible in such a case. (b) If the wording is ambiguous, the court must first turn to the extrinsic evidence offered by the parties regarding their intent in signing the contract; the contract must be construed in relation to the circumstances in which it was entered into.[75]

Nowadays, the court should interpret contracts in the light of their context. [76] The restriction on the use of background has been quietly dropped.[77] It is clear that not even the literal meaning can be ascertained without background information.[78] It is usual to rely on all of the surrounding circumstances in arbitral awards.[79] In any case, there is at most a presumption that the written documents contain all the terms of the contract. When faced with clear evidence that the parties had in fact agreed on some term which was not in the document, the courts can evade the parol evidence rule simply by saying that the contract was not wholly in writing, so that the rule does not apply.[80]

Vagueness of the subjective-objective method. The extent to which courts are bound by the interpretation rules can vary depending on the jurisdiction. While some of the interpretation rules can be regarded as mere guidelines that do not have to be followed, others may not be derogated from. Interpretation can also be regarded either as a question of fact or as a question of law.

The existence of a subjective (and objective) method of some kind in all Member States does not say much about how contracts are interpreted in real life, and it

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[74] In Higgins v Dawson, [1902] AC 1 at p 10, the House of Lords held that mere difficulty of construction is not ambiguity and that a document is only ambiguous when, after full consideration, it is determined judicially that no interpretation can be given to it.

[75] In The Diana Prosperity, Lord Wilberforce said: "No contracts are made in a vacuum: there is always a setting in which they have to be placed. The nature of what is legitimate to have regard to is usually described as 'the surrounding circumstances' but this phrase is imprecise: it can be illustrated but hardly defined. In a commercial contract it is certainly right that the Court should know the commercial purpose of the contract and this in turn presupposes knowledge of the genesis of the transaction, the background, the context, the market in which the parties are operating." Reardon Smith Line v Hansen-Tangen (The Diana Prosperity) [1976] 2 Lloyd's Rep 621 at p 624, [1976] 3 All E R 570 at p 574 (House of Lords). In addition, Lord Wilberforce said that the Court must "place itself in thought in the same factual matrix as that in which the parties were". Lloyd's Rep at p 625, All E R at p 575.

[76] Reardon Smith Line Ltd v Yngvar Hansen-Tangen [1976] 1 WLR 989, 995–996 (House of Lords).

[77] Mannai Investment Co Ltd v. Eagle Star Assurance [1997] UKHL 19; [1997] AC 749; [1997] 3 All ER 352; [1997] 2 WLR 945.

[78] Investors Compensation Scheme v West Bromwich Building Society [1997] UKHL 28; [1998] 1 All ER 98; [1998] 1 WLR 896.

[79] See Sharma KM, From "Sanctity" to "Fairness": An Uneasy Transition in the Law of Contracts? NY L School J Int Comp L 18 (1999) p 158.

[80] See Evans and Son (Portsmouth) Ltd v Andrea Merzario Ltd [1976] 1 WLR 1078 (Court of Appeal).

gives the firm little guidance about how to assess the interpretation risk and mitigate it.

Real method. In reality, the interpretation of contracts is more *objective* and less subjective than the use of this subjective-objective method would imply. The use of a subjective-objective method of some kind does not say much about the way the court interprets contracts. In addition, it is just a myth that contracts are interpreted according to the intent of the parties when the parties either do not agree on the common intent or do not communicate it to the party interpreting the contract.

In practice, interpretation of contracts is typically based on four things: the real intent of the parties, allocation of risk, hypothetical intent, and substantive rules.

Mitigation of risk. Before concluding the contract, the firm should therefore understand the real method of interpretation used by the court. The method of interpretation ex post should influence the choice and drafting of contract terms ex ante. Failure to take the real method of interpretation into account is likely to increase legal risk. If the firm takes the real method of interpretation into account, it can reduce legal risk.

The Interaction of Interpretation Rules and Substantive Rules

The person interpreting the contract applies both interpretation rules and substantive rules. It is also clear that the person interpreting the contract starts by looking at the parties' common intent at the time the contract was made. But how is the common intent determined and what role do the substantive rules play in this process?

The answer depends on many things: the interpretation of the governing law; the substantive rules of the governing law; and the legal culture of the country (in particular, the legal family to which the country belongs, and to what extent the legislator and courts want to regulate the contents of the contractual relationship).

First, all Member States have interpretation rules that answer the following question: "What did the parties really think?" When interpreting the contract, the first thing to do is to find out about the *actual intention* of the parties.

Second, the first tool is complemented by a combination of two other tools. The interpretation rules answer the following two questions. This is the first question: "If it is not clear what the parties really thought, who bears the risk?" The contract can to some extent be interpreted against the party that bears the risk for the unclarity of the actual intention of the parties. Instead of a hypothetical intention of the parties, the interpretation rules provide for the *allocation of risk*. The second question is: "What should the parties have thought"? Alternatively, one can say that the person interpreting the contract determines the *hypothetical intention* of the parties.

Third, *substantive rules* can work in different ways: (a) They can complement the contract. Dispositive rules complement the contract to the extent that the parties are not deemed to have agreed otherwise, and mandatory rules complement the contract regardless of the agreement of the parties. (b) Substantive rules can also be used as a model in the interpretation of the contract. They are very important in the interpretation of the hypothetical intention of the parties. (c) Furthermore, some substantive rules are in effect interpretation rules. This means that the borders between different kinds of rules are flexible and to some extent a matter of taste.

All of these four categories of tools are applied by the court, and they interact. The way they interact depends on the country's legal culture, interpretation rules, substantive rules, and the person interpreting the contract.

Now, let us study these four categories of tools – the real intent of the parties, allocation of risk, hypothetical intent, and substantive rules - in more detail.

The Real Intent of the Parties

It is usually said that the purpose of contract interpretation is to ascertain the real intent of both parties.[81] But the so-called real intent of the parties does not necessarily mean what the parties actually meant.[82] The so-called real intent is not "real". It is a fiction.

Fiction of real intent. During the negotiation phase, the parties' beliefs can be as diverse as their motives.

Even if the intent of the parties were expected to prevail, the intent of the parties would only be the intent of the parties as it appears to the person interpreting the contract.[83] For example, the court that interprets the contract can try to place itself in the same situation as the parties, but the court can only look for the intent of the parties in the evidence available to it, and the conclusions that the court will draw on the basis of the evidence depend on the methods applied by the court.

The contract parties cannot read each other's minds any more than the court can. For this reason, the contract is not really based on "the communion of wills" or their "common intent". Even if the contract were regarded as an expression of an opinion, it might be difficult to find any real person whose opinion it is. In complex transactions, each party can be represented by a large number of people each with different beliefs and motives. It is even more so in long-term business relationships where the people representing the parties change.

Hypothetical intent. In effect, the "real intent" rules lay down the circumstances which are to be taken into account in discovering the intent of the parties. They thus tell the court where to look for evidence for the "real" or "subjective" intent of the parties.

These "real intent" rules are complemented by rules that set out how the intent of the parties is to be interpreted on the basis of this evidence.

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81 For Swiss law, see Art. 18(1) OR.

82 See, for example, Christopher Staughton, How Do the Courts Interpret Commercial Contracts? Cambridge L J 58(2) 1999 pp 304–305.

83 See already Oliver Wendell Holmes, The Common Law (1881, Novick SM (ed), unabridged reprint, 1991) p 309: "The law has nothing to do with the actual state of the parties' minds. In contract, as elsewhere, it must go by externals, and judge parties by their conduct." Cited in Sharma KM, From "Sanctity" to "Fairness": An Uneasy Transition in the Law of Contracts? NY L School J Int Comp L 18 (1999) p 107.

In effect, these rules provide for the *hypothetical* or *fictive* intent of the parties instead of their "real" or "subjective" intent (as will be explained below).

Allocation of Risk

Although one of the purposes of contract interpretation is to ascertain the mutual intent of the parties, it is not sufficient to look for their "real intent". The search for the real intent of the parties is complemented by interpretation rules that make it possible to interpret the contract according to the hypothetical intent of the parties or, alternatively, provide for the *allocation of risk* where the real intent of the parties remains unclear. The allocation of risk will be discussed here before the hypothetical intent of the parties.

It is possible to distinguish between: (a) interpretation rules that allocate risk directly; and (b) interpretation rules that do it indirectly.

Direct allocation of risk. One of the best-known rules that directly allocate interpretation risk between contract parties is the contra proferentem rule.[84] It is widely recognised in the Member States.

According to the contra proferentem rule, ambiguous words in contracts are construed in the way least favourable to the party who drafted them or at whose instigation they were included in the contract.

The contra proferentem rule is usually applied in three cases: (a) It is applied in the area of consumer protection, not least because of the Directive on Unfair Terms in Consumer Contracts which provides that terms in consumer contracts must always be drafted in plain, intelligible language and that the seller or supplier bears the risk for failure to do so.[85] (b) In many Member States, the contra proferentem rule is applied to all pre-formulated commercial contracts and not just to consumer contracts. In Germany, the Civil Code (BGB) provides that, in case of doubt, standard business terms are interpreted against their user.[86] Furthermore, provisions in standard business terms used by a party are invalid if, contrary to the requirement of good faith, they place the other party at an unreasonable disadvantage. An unreasonable disadvantage may also result from the fact that the provision is not clear and comprehensible.[87] (c) It is also possible that the contra proferentem rule is applied to individually negotiated commercial contracts. Words will thus be construed against the party who drafted the document.

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[84] See DCFR II.–8:103(1); PECL Article 5:103.

[85] Article 5 of Directive 93/13/EEC (unfair terms in consumer contracts): "In the case of contracts where all or certain terms offered to the consumer are in writing, these terms must always be drafted in plain, intelligible language. Where there is doubt about the meaning of a term, the interpretation most favourable to the consumer shall prevail …"

[86] § 305c(2) BGB: "Zweifel bei der Auslegung Allgemeiner Geschäftsbedingungen gehen zu Lasten des Verwenders." There was an identical rule in § 5 ABGB (the Standard Contract Terms Act). The Standard Contract Terms Act (Gesetz zur Regelung des Rechts der Allgemeinen Geschäftsbedingungen) was repealed with effect of 1 January 2002 and replaced by §§ 305 et seq of the German Civil Code by virtue of the Act to Modernise the Law of Obligations (Schuldrechtsmodernisierungsgesetz).

[87] § 307(1) BGB.

For example, in England, the contra proferentem rule is applied to exemption clauses as a principle of construction. An exemption clause is construed strictly against the party at whose instigation it was included in the contract and who now seeks to rely on it.[88]

In addition to the contra proferentem rule, different Member States' laws can provide for different risk allocation rules for the interpretation of different kinds of contract terms. A typical allocation of risk rule might provide for the strict construction of a certain contract term.

For example, the Brussels I Regulation sets out how contract parties may agree that a court or the courts of a Member State are to have jurisdiction.[89] The ECJ has indicated that these requirements must be strictly construed.[90]

In England, there is a connection between some risk allocation rules and the parol evidence rule that enables the court to ascertain the (hypothetical) intent of the parties solely from the writing if the wording is clear and unambiguous. For example, an exemption clause should be "strictly" construed. But to say that a document must be "strictly" construed does not explain what it means to construe the clause "strictly". For this reason, the interpreter might fall back to the old rule about the admissibility of extrinsic evidence to construe legal documents.[91]

Indirect allocation of risk. All interpretation rules have an indirect risk-allocating effect, because the contract is more likely to be construed in favour of the party that adapts the things it says or does and its behaviour in general to the interpretation rules. The contract is more likely to be construed against the party that has not made any attempt to adapt its statements to the interpretation rules.

Some rules allocate the risk to either one of the parties. For example, interpretation rules that provide for the literal construction of the contract can have such an indirect risk-allocating effect, because each party bears the risk for the literal construction of the contract.

Hypothetical Intent of the Parties

Although the "real intent" of the parties is the starting point and the allocation of interpretation risk is very important in particular where pre-formulated contract terms are used, the largest and most important category of interpretation tools probably consists of interpretation rules that provide for the hypothetical intent of the parties.

Judges cannot read the parties' minds. In order to interpret contracts with some consistency, and to provide contracting parties with a legal framework that pro-

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88 See nevertheless Direct Travel Insurance v McGewn [2003] EWCA Civ 1606.

89 Prorogation of jurisdiction, Article 23 of Regulation 44/2001 (Brussels I).

90 Case 24/76, Estasis Salotti di Colzani Aimo e Gianmario Colzani v RÜWA Polstereimaschinen GmbH [1976] ECR 1831, and Case 25/76, Galeries Segoura SPRL v Rahim Bonakdarian [1976] ECR 1851.

91 See Lord Hoffmann in Mannai Investment Co Ltd v Eagle Star Assurance [1997] UKHL 19; [1997] AC 749; [1997] 3 All ER 352; [1997] 2 WLR 945 (House of Lords).

vides a measure of predictability, the court must bind the parties by their statements, i.e. the objective manifestations of their intent as it appears to others.

Hypothetical intent and substantive rules. Hypothetical intent rules act as a link between different kinds of statements and the substantive rules. (a) To begin with, they help to give a meaning to: the wording of the contract; the existence of different contract documents; and statements and other evidence outside the contract document. (b) In addition, they help to combine the meaning inferred from these materials with the principles and rules of substantive law.

Hypothetical intent rules could also be called rules of preference for cases of doubt.[92] Most Member States of the EU make use of rules of preference or canons of interpretation.

There is a close connection between these hypothetical intent rules and substantive provisions of law. Usually, the hypothetical intent rules (rules according to which the contract is in effect interpreted according to the hypothetical intent of the parties) are modelled on substantive law. This is hardly surprising, because laws and contracts are drafted and interpreted by people with a legal education, and these people share the same way of thinking: knowledge of substantive law is part of their mutual context.

The use of substantive law as a model. It is possible to distinguish between: (a) the use of substantive rules as a model indirectly; (b) the use of substantive rules as a model directly; and (c) not using substantive rules as a model.

To begin with, substantive rules can be used as a model *indirectly*. At a very general level, convention determines that any legally relevant material is to some extent interpreted according to the same principles. These interpretation rules belong to the mutual context of all jurists trained in the same jurisdiction. Therefore, the principles that govern legal rules and the legal system in general tend to be applied even when interpreting contracts and the statements of the parties. For example, legal rules are expected to be meaningful and coherent. The same can be said of the statements of the parties.

Substantive rules can also be used as a model *directly* in a number of ways. First, the terms and concepts used by the parties are interpreted in the light of the terms and concepts of the governing law. Second, the agreed terms of the contract may be interpreted according to the substantive provisions of the governing law (for reasons attributable to the interpreter,[93] the parties, the wording of the contract, or the provisions of the governing law). For example, if substantive law provides that a party has an obligation to act in a fair or reasonable way, it must be normal to give the obligations of the party a meaning that appears fair or reasonable. Third, if some provisions of substantive law can make the contract illegal or unenforceable, it is normal to interpret the contract to the effect that contractual obligations are binding and enforceable rather than illegal and invalid.

[92] See Scottish Law Commission, Report on Interpretation in Private Law (Scot Law Com No 160) (August 1997), paragraph 1.21.

[93] For example, the interpreter can be inclined to find such a meaning where the contents of substantive law belong to his personal context and/or the mutual context of the parties.

For example, the BGB provides that provisions in standard business terms used by a party are invalid if, contrary to the requirement of good faith, they place the other party at an unreasonable disadvantage.[94] In case of doubt, an unreasonable disadvantage is assumed if the provision cannot be reconciled with essential basic principles of the statutory rule from which it deviates (section 5.3.6).[95]

This means also that general principles such as the principle of good faith have an interpretative function. It is, in practice, impossible to separate interpretation (Auslegung) and supplementation (completive interpretation, ergänzende Auslegung) completely.

Not using substantive rules as a model. Sometimes substantive rules are not used as a model in the interpretation of the contract. This is likely to increase the interpretation risk. There are various reasons why substantive rules are not used as a model.

The reason may be the lack of statutory rules, precedents or doctrine. The lack of these legal sources can be caused by economic factors. For example, emerging markets are more likely to lack substantive rules than mature markets are, and developing countries are more likely to lack them than developed countries are. The lack of statutory rules, precedents or doctrine can also be caused by the size of the legal system. Small countries that belong to a small legal family tend to have a relatively small body of precedents and doctrine. For example, the Nordic countries often lack exact rules, because in many cases there are no statutory rules and no exact rules have been developed by the courts or doctrine due to the relatively small size of these countries and the legal family to which they belong.

Failure to use substantive rules as a model can also be caused by the (high) level of discretion available to courts. (A high level of discretion can sometimes be caused by the lack of substantive rules.) A high level of discretion can increase the risk that contracts are interpreted in an arbitrary way.

Furthermore, failure to use substantive rules as a model can be caused by the lack of respect for the rule of law. For example, corruption is likely to lead to arbitrary judgments.

Examples in Member States' laws. Member States' laws contain a large number of interpretation rules that are modelled on substantive law and provide that the contract must be interpreted according to the hypothetical intention of the parties (i.e. according to what the parties should have thought).

At a general level, both substantive law and contracts are to a large extent interpreted according to the everyday method of interpretation. Many special rules on the interpretation of contracts have been derived from the common sense rules. The rules derived from common sense rules are particularly important when the contract is interpreted according to the hypothetical intent of the parties, because the linguistic meaning and the context determine what the parties should have meant with what they said or did.

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[94] § 307(1) BGB.

[95] § 307(2)(1) BGB.

Language. Some of the hypothetical intent rules relate to language.[96]

The ordinary rules of grammar apply to the interpretation of contracts (see also the "ejusdem generis" rule below).

Words are understood in their general and popular sense unless it is obvious that this was not the intention of the parties.[97] Therefore, the parties remain bound by the appropriate objective definition of the words they use to express their intent: general words are given their commonly accepted meaning, and technical terms are given their normal technical meaning. In addition, trade usage can help to interpret the words used by the parties: the parties will be held to definitions given to words in specialised commercial and trade areas in which they deal.

Coherence. Some of the hypothetical intent rules relate to the coherence of things said or done by a party.

The statements of a party are usually interpreted as consistent with each other. The contract should be read as a whole; the entire contract should be considered in reaching a conclusion (the "whole interpretation" rule). For this reason, one part of the contract cannot be read to the exclusion of another part. If there are contradictions between different terms of the contract, specific terms are entitled to greater weight than general terms. Following this reasoning, individually negotiated terms take precedence over standard terms,[98] typed words take precedence over printed words, and written words over typed words. Handwritten or typewritten clauses take precedence over printed clauses, because, first, written clauses are posterior to printed clauses and, second, written words are regarded as the immediate language selected by the parties themselves to express their meaning. There are further examples of specific terms prevailing over general terms: large-scale details on contract drawings take precedence over smaller-scale drawings; and written specifications normally take precedence over contract drawings.

When an agreement is not clear on its face, the (hypothetical) intent of the parties is also regarded as consistent with their course of conduct. For example, the following can be used as evidence of the hypothetical intent of the parties: the "record of negotiations" between the parties prior to execution of the contract (for example, a memo clarifying a party's understanding and state of mind can often be

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[96] In the US, the plain-language laws adopted by the federal government and most states require an agreement to be written clearly, coherently, and in words of common, everyday meaning.

[97] See, for example, Lord Justice Rix in the English case of Liberty Mutual Insurance Company (UK) Ltd v HSBC Bank plc, [2002] EWCA Civ 691 at paragraph 54: "Reference has been made to modern cases on construction such as Mannai Investment … especially per Lord Steyn … Investors Compensation Scheme … especially per Lord Hoffmann … and Bank of Credit and Commerce International … especially at para 8 per Lord Bingham of Cornhill. The principles are well known. Against the background of the admissible matrix of facts known to or at least reasonably available to the parties, the meaning sought is that which the language in question would convey to the reasonable man. In that context the language used is to be given its natural and ordinary meaning, unless the reasonable man would conclude that something has gone wrong in expressing the parties' intentions."

[98] In Germany: § 305b BGB.

used as an admission if that side later expresses a different intent); and generally how the parties previously interpreted the provision up to the time of the dispute. There is usually no order of preference as regards the parties' statements and their course of conduct.[99] However, the parties' course of conduct is frequently used when one of the parties is interpreted to have waived a contractual right.

A notion closely linked to the previous course of dealing between the parties is custom and usage. Where the parties are "sophisticated" business people who have concluded previous contracts using the same terms, they are treated as being familiar with them. In consequence, courts often hold them to those terms.[100] Such "sophisticated" parties may also be deemed to be aware of contract terms because of their common use in the trade concerned. For example, the following can be used as evidence of the hypothetical intent of the parties: the "standard practice" of the industry (for example, common practices in invoicing or billing); and previous interpretation by other industry members when faced with identical contract provisions.

Effectiveness. Some of the hypothetical intent rules relate to the terms being lawful and effective.

The law may refuse to give effect to a contract on the ground of illegality, i.e. because the contract involves the commission of a legal wrong or is in some other way contrary to public policy.[101] In case of doubt, the courts may prefer an interpretation that gives an effective meaning to all terms of the contract as opposed to having a part of the contract of no effect.[102]

Reasonableness. Some of the hypothetical intent rules relate to reasonableness.

These rules can be open and vague. Rules on reasonableness can be used in three partly overlapping ways: (1) as a rule of interpretation of the law; (2) as a rule of behaviour; (3) or as a rule of interpretation of the contract.[103] When used as rules of interpretation, they provide for flexibility in the interpretation of contracts.

There are three main ways to use these rules as rules of interpretation of contracts. It is possible to distinguish between: (a) rules that relate to the interpretation process; (b) rules that relate to the contract term itself; and (c) rules that relate to the protection of reasonable expectations.

Reasonable interpretation process. Some of the hypothetical intent rules are therefore designed to make the process of interpretation reasonable. The principle

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[99] See also Section 2208(2) of the Uniform Commercial Code which provides: "The express terms of the agreement and any such course of performance, as well as any course of dealing and usage of trade, shall be construed whenever reasonable as consistent with each other; but when such construction is unreasonable, express terms shall control course of performance and course of performance shall control both course of dealing and usage of trade."

[100] See, for example, Tetley W, Seven Rules of Interpretation (Construction) of Bills of Lading. In: Liber Amicorum Robert Wijffels. ETL, Antwerp (2001) pp 359–379.

[101] See, for example, Treitel GH, The Law of Contract. Eleventh Edition. Sweet & Maxwell, London (2003) p 429.

[102] See also DCFR II.–8:106; PECL 5:106.

[103] It is possible to find these three categories also in the CISG, the PECL, the DCFR, and the UNIDROIT Principles. See section 5.2.3.

of reasonableness is thus applied to the process of interpretation rather than the contract term itself.

According to these rules, the linguistic meaning of contract terms is supplemented by how a reasonable person would have understood the terms. According to the CISG, English common law, and the PECL/DCFR, the linguistic meaning may be complemented by the requirement that the contract be interpreted in a reasonable way.

CISG Article 8(2) provides that "statements made by and other conduct of a party are to be interpreted according to the understanding that a reasonable person of the same kind as the other party would have had in the same circumstances". In English common law, the contract document is given the "meaning which the document would convey to a reasonable person having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract".[104] See also PECL Article 5:101(3) and DCFR II.–8:101(3).

Reasonable contract terms. On the other hand, some of the hypothetical intent rules relate to the contract terms being reasonable.

These rules provide that the linguistic meaning may be supplemented or replaced by a reasonable meaning. The principle of giving contract terms a reasonable meaning may have been formulated explicitly, or it may be applied in the guise of good faith or similar principles. Contracts may thus be given either a reasonable meaning or a meaning that is compatible with the principle of good faith.[105] This allows the courts to take into account the surrounding circumstances and base their decisions on the pragmatic evaluation of the context. This also contributes to the flexibility of law and the flexibility of interpretation.

It is usual to find these rules in civil law jurisdictions. (a) For example, the Swiss Civil Code (Schweizerisches Zivilgesetzbuch, ZGB) provides that if there is a gap in the statute, the judge has a duty to formulate the rule he would formulate if he were a legislator, and decide according to that rule;[106] and when something is in the discretion of the court, the judge has a duty to decide the matter according to what is reasonable.[107] The Swiss Civil Code further provides that a person has a duty to exercise his rights and fulfil his obligations according to the principle of good faith.[108] (b) In Germany, § 242 BGB lays down a flexible general principle that is used instead of a large number of detailed rules; the development of detailed rules has been left to the courts and doctrine. § 242 BGB provides that obli-

[104] See Investors Compensation Scheme v. West Bromwich Building Society [1997] UKHL 28; [1998] 1 All ER 98; [1998] 1 WLR 896 (House of Lords). See also Tetley W, Seven Rules of Interpretation (Construction) of Bills of Lading. In: Liber Amicorum Robert Wijffels. ETL, Antwerp (2001) pp 359–379. According to US law, the court is to adopt an interpretation that, under all circumstances, ascribes the most reasonable, probable, and natural conduct of the parties, bearing in mind the objects manifestly to be accomplished. Metzger v. Clifford Realty Corporation, 476 A.2d 1, 5 (Pa. Super. 1984).

[105] See especially §§ 157 and 242 BGB.

[106] Article 1(2) ZGB.

[107] Article 4(1) ZGB.

[108] Article 2(1) ZGB.

gations must be performed in accordance with good faith. Furthermore, § 241(2) BGB provides that an obligation may require each party to have regard for the other party's interests.[109] (c) French law is more restrictive than Swiss and German law. In France, judges are not supposed to create law; in exceptional cases, they are permitted to decide according to what is reasonable in the specific case.

The application of these rules is not restricted to civil law jurisdictions. Even in common law, there is a growing reliance on behaviour-linked standards like "good faith", "fair dealing" or "reasonableness".[110] This is clearly necessary in the context of relational contracts. But even in other commercial contracts, the flexibility of the interpretation of law and contracts enables the court to interpret the contract according to what it finds reasonable, or complement the contract with the duties of good faith and fair dealing.

Reasonable expectations. Some of the hypothetical intent rules relate to the protection of reasonable expectations.

First, the above rules that deal with the process of interpretation belong to this category as well (see, for example, CISG Article 8(2)). The same can be said of the rules that deal with the reasonableness of contract terms.

Second, there can also be rules that explicitly provide for the protection of reasonable or legitimate expectations. For example, CISG Article 8(1) provides that "statements made by and other conduct of a party are to be interpreted according to his intent where the other party knew or could not have been unaware what that intent was".[111]

Third, a party is generally less likely to be protected from the consequences of a matter disclosed to it before contracting. The party may be treated as being on notice of the reasonably foreseeable consequences of the matter. For example, a broadly drafted material adverse change (MAC) clause (section 5.5.5) may be interpreted so that it does not cover the consequences of a problem disclosed to the party that tries to invoke the clause.

Hypothetical Intent According to Specific Rules

There are differences as to the relative importance of the linguistically inferred meaning of the contract depending on the governing law. This will influence the role of specific hypothetical intent rules.

Weight of linguistic meaning. In common law countries, courts are more likely to interpret the contract according to its linguistic meaning and also less likely to focus on the subjective intentions of the parties compared with continental European countries.[112] For example, English courts may consider the circumstances in

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[109] § 241(2) BGB: "Das Schuldverhältnis kann nach seinem Inhalt jeden Teil zur Rücksicht auf die Rechte, Rechtsgüter und Interessen des anderen Teils verpflichten."

[110] See Berger KP, Renegotiation and Adaptation of International Investment Contracts, Vanderbilt J Transn L 36 (2003) pp 1377–1378.

[111] See also DCFR II.–8:101(2).

[112] See Lord Hoffmann in Investors Compensation Scheme v. West Bromwich Building Society [1997] UKHL 28; [1998] 1 All ER 98; [1998] 1 WLR 896.

which the contract was made and its purpose, but the courts have traditionally been more reluctant to rely on pre-contractual negotiations[113] and less willing to take account of the subsequent conduct of the parties.[114]

In civil law countries, courts have traditionally been more likely to take account of surrounding circumstances and the subjective intentions of the parties.[115]

At the same time, common law jurisdictions need, due to the smaller role played by the open or vague general principles that can be found in continental European jurisdictions, more specific hypothetical intent rules. These rules provide for a pragmatically inferred meaning that complements the linguistically inferred meaning of contract terms.

The differences can be illustrated by exemption clauses, qualified terms, "best efforts" clauses, and the "ejusdem generis" rule of contractual construction. In all these cases, the meaning conveyed by the contract terms is the hypothetical intent of the parties rather than their real intent. These clauses will be discussed in section 5.2.5 below.

Substantive Rules

Substantive rules can be divided into different categories. A substantive rule can be used: as a rule of behaviour that requires the parties to behave in a certain way; as a rule of interpretation that requires or enables the judge to interpret the law in a certain way; or as a rule of interpretation that requires or enables the judge to interpret the contract in a certain way.

The borderline between different categories of substantive rules is sometimes flexible. And as seen in the previous section, the same can be said of these rules and the hypothetical intent rules. Substantive rules are often used as a model in one way or another when interpreting the contract or the hypothetical intent of the parties (section 5.2.4).

Substantive rules as interpretation rules. In continental Europe, the general principles of contract law also function as important rules of interpretation. Usually, there are general principles on reasonableness or good faith (section 5.3.6). They require the parties to behave according to a certain standard. They are also applied when determining the contents of contracts and the law. The judge is therefore required to give both the contract and the law a meaning that promotes behaviour according to this standard.[116]

Substantive rules as de facto rules of interpretation. It is perhaps even more common to apply substantive rules as de facto rules of interpretation.

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[113] Prenn v Simmonds [1971] 1 WLR 1381 (House of Lords).

[114] James Miller & Partners v Whitworth Street Estates (Manchester) Ltd [1970] AC 583 (House of Lords).

[115] See also DCFR II.–8:101(1).

[116] See Storme ME, Good Faith and the Contents of Contracts in European Private Law, Eletronic Journal of Comparative Law, vol 7.1 (March 2003).

Judges cannot read the parties' minds, and it is difficult for judges to find out about the parties' subjective intentions. On the other hand, judges can apply and interpret legal rules, and it is relatively easy for them to do so.

For these reasons, the court will often resort to substantive law in order to supplement the linguistically inferred meaning of an obscure clause. The clause will then be given a meaning that resembles substantive law.

Direct application of substantive rules. It is also possible to apply substantive rules directly. Substantive rules will be applied as background rules where the agreement contains a gap. In the area of general contract law, the laws of continental European countries typically provide for more background rules than the laws of common law countries. In addition to gap-filling by means of dispositive rules, mandatory rules will prevail over the terms agreed by the parties.

5.2.5 Mitigation of Risk

General Remarks

The risk inherent in the interpretation of contracts cannot be eliminated. There is no exception to the main rule that all contracts must be interpreted before they can be applied. However, the firm can mitigate this risk.

Controlling outgoing information. To begin with, the firm can control outgoing information flows (generally, see Volume I; for acquisitions, see Volume III).

The contract can be interpreted on the basis of all kinds of information. Complex contracts often require the participation of a large number of people who can potentially disclose information on behalf of the firm. The firm usually discloses plenty of information in marketing materials and in other ways.

The firm should therefore influence the interpretation of the contract ex ante by limiting the amount and content of information disclosed by it or its representatives.

The firm can limit the number of information channels. The firm may make access to information technically possible only through certain channels (a certain person, website, data room, SEC disclosure, and so forth). The firm may also take internal organisational measures such as the adoption of internal guidelines that allocate the power to disclose information to certain people and prohibit the disclosure of information otherwise.

Legal relevance of outgoing information. Technical preconditions and organisational measures can be complemented by legal disclaimers. For example, the firm can state that certain information disclosed by it neither constitutes an agreement nor may be used by its recipient other than in a certain way expressly stated in the disclaimer (Volume I).

Drafting. The firm can also mitigate risk by careful drafting. In some cases the firm can pass it on to its contract party.

First, the firm should choose the governing law. The choice of the governing law determines some of the legal rules according to which the contract is interpreted and some of the things that the firm should do in order to mitigate the interpretation of contracts risk.

Second, the terms of the contract should be documented. Regardless of the choice of the governing law, the lack of proper documentation increases risk. The documentation should preferably contain a statement as to the purpose of the contract and its background. This is because contracts are usually supposed to be interpreted according to the intention of the parties, but the parties are usually firms with a constant turnover of managers, employees, and other agents. The original intent of the parties can soon become unclear and increase the interpretation risk, unless the intent is documented carefully.

Third, the firm can try to derogate from the statutory canons of interpretation to the extent that they are dispositive and not mandatory. Common clauses include clauses that increase the internal coherence of statements and clauses that lay down special interpretation rules (see below).

Fourth, the firm can adapt the contract to the statutory canons of interpretation or, to the extent that they apply, the contractual canons of interpretation. For example, in some countries ambiguities in a contract are typically construed against the drafter. This is particularly true for any general contract terms drafted and used by the firm. The firm should therefore look for ambiguities and redraft them. In addition, there are usually rules on the incorporation of standard form contracts (section 5.3.8).

Fifth, it is better to use sufficiently plain and clear language. In order to reduce risk, the firm should use language as it is usually understood in a similar context. This is because of the subjective-objective method of interpretation: the contract and statements made by a party are usually interpreted according to (A) the (subjective) intent of the parties, but if their intent cannot be determined, the contract is interpreted according to (B) the (objective) understanding that a third party would have had in the same circumstances. The application of the latter rule is likely to increase risk, unless the firm has used language as it is understood by third parties, in which event there would not be any difference between these two situations (A = B).

Sixth, it is better to agree on sufficiently detailed terms so that the parties know what to do when fulfilling their respective contractual obligations. Very open contract terms tend to leave the court plenty of discretion. Detailed regulation has, of course, a host of problems of its own, in particular inflexibility (section 5.5).[117]

Seventh, documentation governed by the laws of a certain place should preferably be drafted in local language.[118] This is usually done in domestic transactions, but it is not always done in international transactions, because English is the lingua franca of international business.

Eighth, the terms used in the contract can be adapted to the governing law. (a) The firm often faces a conflict between international standard practices and the

[117] See also Ulen TS, Information in the Market Economy – Cognitive Errors and Legal Correctives. In: Grundmann S, Kerber W, Weatherill S (eds), *op cit*, p 116.

[118] See Yescombe ER, Principles of Project Finance. Academic Press, San Diego London (2002) p 214.

laws of the country in which it wants to do business. There is a growing set of standard practices that lawyers use in dealing with the needs of firms whose operations have an international scope. These standard practices are usually based on the Anglo-American model. (b) On the other hand, the interpretation of contract terms is governed by the law applicable to the contract. Standard terms based on the Anglo-American model will not necessarily be interpreted in the same way if transplanted into a foreign legal framework.[119] (c) If the contract is governed by foreign law (the law of a civil law country), the firm can reduce this risk by using "factual" language, i.e. plain and neutral language that sets out the obligations of the parties without recourse to Anglo-American concepts that differ from those of the governing law. (d) An alternative could be to substitute foreign concepts for Anglo-American ones; on the other hand, if the language of the contract is English, the firm would again face the choice between the use of words that describe Anglo-American concepts and factual language.[120] (e) In any case, the firm should not use Anglo-American legal concepts and then choose the law of a civil law country as the governing law, or draft the contract according to the civil law model and then choose the law of a common law jurisdiction.

Ninth, the firm should address the problem of different linguistic versions of the contract. The firm should preferably choose the version that will prevail, negotiate its terms, and comply with them.

Tenth, if it is the intention of the firm to derogate from substantive legal rules, the terms of the contract should make it clear. If the statements of the parties are ambiguous or vague as to whether or how the parties have agreed to derogate from the provisions of dispositive law, there is an increased risk that dispositive law will be applied either directly (when the parties are not deemed to have regulated the matter) or indirectly (when it is used as a model for the interpretation of the hypothetical intention of the parties, section 5.2.4). It is easy for the court to resort to mandatory or dispositive rules of law to construe obscure contract terms.

Eleventh, the dispute resolution clause should follow the governing law clause. (a) Some of the legal interpretation rules that will be applied ex post depend on the place of the forum (and are governed by lex fori). (b) Furthermore, a judge is likely to use the everyday interpretation rules of the culture that the judge belongs to. (c) There is also a bias in favour of the use of the substantive and interpretation rules found in local law.[121] A court or an arbitral tribunal usually knows how to interpret its own law, but the interpretation of foreign law is another matter. The choice of a forum in a civil law jurisdiction for a contract governed by the laws of a common law jurisdiction, or vice versa, would be likely to increase the interpretation risk. Therefore, the choice of, for example, Swedish law should preferably

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[119] There are of course differences between US law and English law; standard terms based on US law are not necessarily interpreted in the same way in England.

[120] The drafters of international conventions have faced similar problems. For example, the drafters of the CISG had to consider that the text of this convention was going to be translated into other languages. Factual language was chosen, because it is easier to understand and translate.

[121] Generally, see Jänterä-Jareborg M, Svensk domstol och utländsk rätt. Skrifter från juridiska fakulteten i Uppsala 53. Iustus Förlag, Uppsala (1997).

be followed by the choice of dispute resolution in Sweden or by a Swedish arbitral tribunal.

Specific Interpretation Clauses

As discussed above, the risk inherent in the interpretation of contracts is often mitigated by using, first, contractual clauses that increase the internal coherence of contract terms and, second, clauses that lay down specific rules on interpretation.

Internal coherence of contract terms. Typical clauses that increase the internal coherence of contract terms contain, for example, (a) merger clauses, (b) amendments clauses and (c) the ranking of documents clauses.

(a) Merger clauses are also known as entire agreement clauses or integration clauses. They are often complemented by a "non-reliance statement".

The following two clauses are examples of typical merger clauses: (1) "Entire Agreement. This Agreement constitutes the entire agreement between the parties and supersedes all prior representations, agreements, statements and understandings relating to its subject matter, whether verbal or in writing." (2) "Entire Agreement. This Agreement and all other agreements, exhibits, and schedules referred to in this Agreement constitute the final, complete, and exclusive statement of the terms of the agreement between the parties pertaining to the subject matter of this Agreement and supersedes all prior and contemporaneous understandings or agreements of the parties. This Agreement may not be contradicted by evidence of any prior or contemporaneous statements or agreements. No party has been induced to enter into this Agreement by, nor is any party relying on, any representation, understanding, agreement, commitment or warranty outside those expressly set forth in this Agreement."

Merger clauses are used especially in common law countries that apply the parol evidence rule. Their purpose is to prohibit the introduction of any other evidence, oral or written, to vary or add to the terms of the contract. Merger clauses are therefore designed to be conclusive evidence that the contract documents are the final, entire, and complete agreement and that nothing else (such as a letter of intent, earlier drafts of the agreement, or oral evidence) may be introduced in court to demonstrate otherwise.

For two main reasons, merger clauses would not necessarily have the same effect in civil law jurisdictions. First, the amendment of the contract may in many countries be classified as a contractual issue governed by the law applicable to the contract, and oral amendments to written contracts may be permitted under the governing law (see above). Second, the permissibility of evidence may in many countries be classified as a matter of procedural law governed by the law of the forum (lex fori), and any evidence may be permitted regardless of the terms of the contract.

Furthermore, such continental European principles have been applied even in English case-law. If a party demonstrates that it was actually induced to enter into the bargain by a pre-contractual statement outside of the written agreement, it may have the ability to challenge the entire agreement clause and non-reliance statement.

In Thomas Witter Ltd v TBP Industries Ltd[122] and EA Grimstead & Son Ltd v McGarrigan,[123] the court held that an "entire agreement" clause alone will not exclude remedies for pre-contractual misrepresentations, and an acknowledgement of non-reliance can be challenged if in fact the buyer relied on a pre-contractual statement which induced it to enter into the contract.[124]

Even in common law jurisdictions, merger clauses would not prevent the use of everyday methods of interpretation. The court would certainly apply both linguistically decoded material and pragmatically inferred material to determine the meaning of contract documents. The merger clause would nevertheless give the court some discretion to limit the legal relevance of parts of the context.

(b) Amendments clauses have the same function as merger clauses. The effect of these clauses depends again on the governing law (see above). Compared with merger clauses, it can be easier to determine the legal relevance of amendments clauses because amendments clauses have a more limited scope and require parties to follow a formal procedure.

An amendments clause could look like this: "No change in the terms of this Agreement shall be valid unless done in writing and signed by a duly authorized representative of each party."

(c) Clauses on the ranking of documents are used in order to ensure that the specifically agreed contract terms are coherent. The parties often find them necessary when they use: general contract terms; master agreements; standard agreements; or agreements that contain schedules.

The following three clauses are examples of ranking of documents clauses: (1) "In the event of any conflict between this Agreement and any Schedule, the terms of this Agreement shall prevail." (2) "In the event of any conflict between the provisions of these General Contract Terms and the provisions of any Specific Agreement which is signed by the Firm and the Customer, the provisions of the Specific Agreement shall prevail." (3) "This English language document is a translation from the French original. In the event of any dispute as to the interpretation of any of the conditions herein, the French version shall prevail."

Canons of interpretation. Firms often use specific clauses on interpretation in order to derogate from the default canons of interpretation or, in particular in common law jurisdictions, to repeat them. These clauses may contain, for example, clauses on ambiguities, invalidity, and good faith.

In common law jurisdictions, boilerplate clauses often *repeat* the standard canons of interpretation. Boilerplate clauses can contain very technical terms.

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122 Thomas Witter Ltd v TBP Industries Ltd [1996] 2 All ER 573.

123 E A Grimstead & Son Ltd v McGarrigan [1999] EWCA Civ 3029

124 See, for example, Phillips J, Runnicles J, Schwartz J, Navigating trans-atlantic deals: warranties, disclosure and material adverse change, JFRC 15(4) (2007) pp 473–474.

For example, such an interpretation clause could begin like this: "Interpretation. In this Agreement, unless the context otherwise requires: (a) references to this Agreement shall include the Schedules; (b) references to statutes and other legislation shall include all re-enactments and amendments thereof; (c) references to the singular shall include the plural and vice versa …"

Such terms would in many jurisdictions go without saying; they would be applied by the court anyway and belong to the common mutual context of local contract parties.

Sometimes the firm wants to *derogate* from the standard canons of interpretation. The firm may find this important where the firm is the party that drafts the contract, because ambiguities in a contract are typically construed against the *drafter*.

The following clause is an example of an ambiguities clause that derogates from the normal canons of interpretation for the benefit of the party that has drafted the contract: "Ambiguities. Each party and its counsel have participated fully in the review and revision of this Agreement. Any rule of construction to the effect that ambiguities are to be resolved against the drafting party shall not apply in interpreting this Agreement. The language in this Agreement shall be interpreted as to its fair meaning and not strictly for or against any party."

It is also normal to address the problem of the *invalidity* or illegality of part of the legal framework. For example, the invalidity or illegality of part of the legal framework can lead to the expiry of the (rest of the) contract or a duty to negotiate how to amend its terms, or release, in full or in part, the firm from its obligation to perform its obligations under the contract. It may be necessary to specify the outcome of partial invalidity in the contract because it would be unusual for the governing law to regulate this question in any detailed way.[125]

For example, the following clause addresses this problem: "The invalidity of any part of this Agreement shall not affect the validity of the rest of the Agreement. In the event that any part of the Agreement is declared invalid or void, the parties shall in good faith negotiate to substitute wording to reflect as far as possible the parties' original intention."

It is perhaps not as common to use a clause according to which the contract shall be interpreted in *good faith*, or similar clauses that lay down the ethical principles of contract interpretation, because a court or arbitral tribunal that respects the rule of law (and it would not normally be meaningful to choose a forum that does not

[125] See § 139 BGB: "Teilnichtigkeit. Ist ein Teil eines Rechtsgeschäfts nichtig, so ist das ganze Rechtsgeschäft nichtig, wenn nicht anzunehmen ist, dass es auch ohne den nichtigen Teil vorgenommen sein würde." Compare this with Article 51 CISG: (1) "If the seller delivers only a part of the goods or if only a part of the goods delivered is in conformity with the contract, articles 46 to 50 apply in respect of the part which is missing or which does not conform." (2) "The buyer may declare the contract avoided in its entirety only if the failure to make delivery completely or in conformity with the contract amounts to a fundamental breach of the contract."

respect it) would be expected to follow such principles anyway. These kinds of clauses could be meaningful where the parties agree that contract terms will be interpreted by the parties themselves[126] or by a third party not subject to any prior legal framework governing the interpretation of contracts. For example, an auditor can sometimes act as a neutral third party interpreting some contractual clauses.

Choice of law. In principle, the parties are not prevented from choosing the law of one country to govern the contract and the law of another country to govern the interpretation of the contract. However, such a choice would make interpretation more difficult and increase legal risk.[127]

Particular Substantive Clauses

The interpretation of certain types of substantive clauses can depend on the governing law. This can be illustrated by exemption clauses, qualified terms, "best efforts" clauses, and the "ejusdem generis" rule of contractual construction.

Exemption clauses. Commercial contracts normally contain exemption clauses which exclude or limit the liability of a contract party.

A typical exemption clause in a software licence could look like this: "Limitation of Liability. To the extent not prohibited by law, in no event will the Company be liable for any lost revenue, profit or data, or for special, indirect, consequential, incidental or punitive damages, however caused, arising out of or related to the use of or inability to use software, even if the Company has been advised of the possibility of such damages. In no event will the Company's liability to the Customer, whether in contract, tort (including negligence), or otherwise, exceed the amount paid by the Customer for Software under this Agreement."

The main rule is that mandatory provisions of the governing law do not permit the exclusion of all damages (section 5.3.6). There are also differences relating to the interpretation of these clauses depending on the governing law.

For example, German and Nordic laws do not provide for any special rules for the interpretation of exemption clauses. The general rules of interpretation will be applied in the absence of special rules. Instead of interpretation rules, the use of exemption clauses is constrained by mandatory provisions of substantive law (section 5.3.6).

Similar constraints exist even under English common law. Any attempt to exclude or limit liability in a contract governed by English law must be reasonable if it is to be effective. In *Thomas Witter Ltd v TBP Industries Ltd*,[128] the court held that it was never reasonable to exclude liability for fraudulent misrepresentation.

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[126] This is reflected in Article 31(1) of the Vienna Convention on the Law of Treaties. An international treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context.

[127] Article 12(1) of Regulation 593/2008 (Rome I) in combination with Article 3(1). See also North PM, Fawcett JJ, Cheshire and North's Private International Law. Thirteenth Edition. Lexisnexis UK, London (2004) p 595.

[128] Thomas Witter Ltd v TBP Industries Ltd [1996] 2 All ER 573.

In addition, English common law also contains specific rules on the interpretation of exemption clauses. Exemption clauses should be construed "restrictively". This rule works in favour of the party seeking to establish liability and against the party seeking to claim the benefit of the exemption.

For example, the Court of Appeal interpreted a trustee exemption clause restrictively in *Armitage v Nurse.*[129] According to Millett LJ, the court should construe the words of the exemption clause in the light of the conduct complained of and to decide whether any potential liability has been effectively excluded by the terms of the trust. In carrying out this exercise, while the court should construe the clause restrictively, it must do so fairly, according to the natural meaning of the words used. Liability can thus be excluded only by clear, unequivocal and unambiguous terms.[130]

The use of qualified contract terms. The rights and obligations of the parties have sometimes been qualified with words like "reasonable", "approximately", or "best efforts". These qualified terms partly regulate the modalities of rights and obligations. There are differences between the Member States regarding the role of these terms.

In continental Europe, the modalities of contractual rights and obligations are often based on the general principles that complement the contract. For example, the principle of good faith is one of the basic principles of contract law. The existence of this and similar principles makes it less vital to qualify contractual rights and obligations with "reasonableness".

In common law systems, however, the modalities are less likely to be found in large codes that set out the general principles of contract law. In the absence of general principles that complement the contract, it would make more sense to qualify contract terms with words like "reasonable".

Therefore, where the creditor asks for a clause according to which the debtor shall under certain circumstances request the creditor's consent before doing a certain act, different things happen in different Member States.

In the Nordic countries, for example, the debtor would be more likely to accept the clause. There is a general belief in the Nordic countries that the court would not uphold a refusal to consent unless the refusal were reasonable under the circumstances, because the court would in any case apply the general principle of good faith and loyalty. As a result, it is less vital to qualify the clause.

In England, however, the opposite would happen. The debtor would ask himself whether such a clause would give the creditor a right to refuse to consent without reason. In order to mitigate the effects of the possible literal interpretation

[129] Armitage v Nurse, EWCA Civ 1279; [1998] Ch 241. See also The Law Commission, Trustee Exemption Clauses (A Consultation Paper) (1 May 2003), paragraph 2.42; Scottish Law Commission, Discussion Paper on Breach of Trust (Discussion Paper No 123) (September 2003), paragraph 3.16.

[130] See also The Law Commission, Trustee Exemption Clauses, paragraph 2.47.

of the clause, the debtor would insert into the contract an express clause stating that "such consent shall not be unreasonably withheld".[131]

"Best efforts" clauses.[132] There are also other ways to qualify promises in commercial agreements. For example, the parties can agree that the obligor shall use his "best efforts" or "best endeavours" to do an act (for dynamic terms in general, see section 5.5.4). All other things[133] being equal, "best efforts" clauses can be construed in different ways depending on the jurisdiction.

In the Nordic countries, the courts would interpret this expression in the light of an uncodified principle of good faith and loyalty. In practice, the courts would have plenty of discretion due to the relatively small amount of precedents. Since the courts may apply the principles of good faith and loyalty to all contract terms, there does not seem to be much difference between an obligation "to use best efforts" to do something and a clause according to which a party "shall try" to do something.

Under German law, the expression "best efforts" would be construed in the light of § 242 BGB and the principle of good faith (Treu und Glauben).[134] This general principle can be applied on a case-by-case basis in interpreting contract terms.

However, English common law does not recognise any general principle whereby parties would have to observe "good faith" or "loyalty" when negotiating contracts, concluding contracts, or performing contractual obligations. This is one of the factors that would make an English court look at the linguistic meaning of the clause very carefully. An English court might distinguish between the use of "reasonable endeavours", "best endeavours", and a promise that the result hoped for will be achieved. For example, a term requiring the party to use "best endeavours" contemplates that the result hoped for might not be achieved.[135]

There seems to be a difference between English law and US law. US courts seem to have accepted that "best efforts" really mean "reasonable efforts"; there is no clear difference between "best efforts", "reasonable best efforts", or "commercially reasonable efforts".[136]

The "ejusdem generis" rule. In common law jurisdictions, ambiguity in a contract is sometimes resolved by applying the "ejusdem generis" ("of the same genus") rule of contractual construction. The "ejusdem generis" rule is a further example of hypothetical intent rules that complement the linguistically inferred meaning of contract terms.

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131 Gorton L, "Best Efforts", JBL (2002) p 146. See, for example, Gayle C, Acquisition Finance – Syndication Best Practice, Int Comp Comm L R 13(8) (2002) p 303.

132 Gorton L, "Best Efforts", JBL (2002) pp 143–162.

133 Such as the wording of the rest of the contract, the clauses that set out the legal effects of these clauses, and the limitation of liability clauses.

134 § 242 BGB in English: "Performance in good faith. The obligor must perform in a manner consistent with good faith taking into account accepted practice."

135 See, for example, Lord Justice Laws in Marsden v Elston [2001] EWCA Civ 1746. For other cases, see Gorton L, "Best Efforts", JBL (2002) pp 153–157.

136 See Gorton L, "Best Efforts", JBL (2002) pp 157–162.

The ejusdem generis rule operates where a broad or open-ended term appears following a series of more restrictive terms in the text. Where the terms listed are similar enough to constitute a class or genus, the courts will presume, in interpreting the general words that follow, that they are intended to apply only to things of the same genus as the particular items listed. The ejusdem generis rule is a principle of construction whereby wide words associated in the text with more limited words are taken to be restricted by implication to matters of the same limited character.[137]

For example, the ejusdem generis rule was applied in the Irish High Court in *Royal Dublin Society v Revenue Commissioners*. Section 7 of the Excise Act 1835 allowed the Revenue Commissioners to grant a liquor licence to "a theatre or other place of public entertainment". Barr J found that "other place of public entertainment" should be interpreted only as referring to places of public entertainment which were similar to "theatre", i.e. to "a performance for the benefit of the public with a defined time frame and where seating is provided for patrons."[138]

The ejusdem generis rule only applies, however, where the particular words appearing before the general word belong to some identifiable genus. Where no such genus exists, the meaning of the general word is not restricted by the preceding particular words.[139] The courts will also refuse to apply ejusdem generis where the text contains general words, which are then followed by a list of particular items: in such cases the list of items is not regarded as limiting.[140]

5.3 Terms Not Binding

5.3.1 Introduction

In addition to the risk inherent in interpretation (section 5.2 above), there are other risks inherent in the statements of the parties. Normally, the firm would prefer the contract and its terms to be binding. Sometimes they are not binding.

There are many reasons for this. First, some terms may be contrary to mandatory provisions of law. Second, terms may not be binding as they have not been properly incorporated into the contract. Third, it is possible that the person representing the other party exceeded his powers (for counterparty corporate risk, see section 6.2). Fourth, the partial invalidity or unenforceability of the contract may mean that even other terms of the contract (or the contract as a whole) become invalid or unenforceable. Fifth, some terms of the contract may not be enforceable

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[137] The Law Reform Commission, Statutory Drafting and Interpretation, Consultation Paper on: Plain Language and the Law (LRC CP14–1999) [1999] IELRC 1 (1st July, 1999), paragraph 1.063.

[138] *Ibid*, paragraph 1.066.

[139] Tetley W, Seven Rules of Interpretation (Construction) of Bills of Lading. In: Liber Amicorum Robert Wijffels. ETL, Antwerp (2001) pp 359–379.

[140] See The Law Reform Commission, *op cit*, paragraph 1.068.

due to bankruptcy or insolvency laws. Sixth, it is possible that the contract is not enforceable due to matters relating to the jurisdiction of courts and restrictions on the recognition and enforcement of judgments.

For example, an OTC derivatives transaction, a master agreement, or a collateral agreement that supplements a master agreement may be unenforceable because the counterparty or the counterparty's signatory lacked the capacity or authority to enter into the contract (ultra vires).[141] In addition, documentation that contains invalid terms or fails to meet local legal standards (for example, standards set out in a statute of frauds) may be unenforceable in whole or in part. In certain jurisdictions, OTC derivatives transactions may be unenforceable because they are deemed to violate gambling laws or because they must be conducted on a recognised exchange (for example, a futures exchange).[142]

The rules that make contract terms invalid or unenforceable are sometimes based on legislative acts adopted by Community institutions. While some of these acts explicitly provide for sanctions for the infringement of rules that implement them, most do not. In any case, the EC Treaty requires some action on the part of the Member States.[143] Member States must ensure that infringements of Community law are penalised in conditions (both procedural and substantive) that are analogous to those applicable to infringements of national law of a similar nature and importance, and the penalties must be "effective, proportionate and dissuasive".[144]

5.3.2 Non-conformity with Mandatory Rules

General Remarks

Freedom of contract is nowadays limited by standardising contracting procedures (section 2.2.2), the judicial process of construction of the terms of the contract (section 5.2.4), mandatory provisions of law that regulate commercial activity, and other factors.[145]

Mandatory provisions of law. The existence of mandatory provisions of law can both reduce legal risk and increase it. Typically, the weaker party can benefit from greater judicial vigilance over repressive terms or over a repressive imbal-

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[141] In England, interest rate swaps were ultra vires local authorities following the famous decision of House of Lords in Hazell v Hammersmith and Fulham London Borough Council [1992] 2 AC 1. For Germany, see Snakes and ladders, The Economist, February 2008.

[142] BIS, OTC Derivatives: Settlement procedures and counterparty risk management (September 1998) p 14.

[143] Article 10 of the EC Treaty.

[144] Case C-167/01, Inspire Art [2003] ECR I-10155, paragraph 62; Case 68/88 Commission v Greece [1989] ECR 2965, paragraphs 23 and 24; Case C-326/88 Hansen [1990] ECR I-2911, paragraph 17; Case C-36/94 Siesse [1995] ECR I-3573, paragraph 20, and Case C-177/95 Ebony Maritime and Loten Navigation [1997] ECR I-1111, paragraph 35.

[145] See, for example, Sharma KM, From "Sanctity" to "Fairness": An Uneasy Transition in the Law of Contracts? NY L School J Int Comp L 18 (1999) p 112.

ance in bargaining power. However, the price of intervention is loss of legal certainty for a party that wants to use its own set of contract terms.[146]

Mandatory provisions can both increase costs and reduce them. They can increase transaction costs by their mere existence, because firms must gather information about them and there are costs for compliance. They do not necessarily allocate costs to the least-cost avoider in a particular case (section 2.5.5). In the best case, they allocate costs to the typical least-cost avoider. Preventing the market for lemons is one of the situations where mandatory provisions can help to reduce transaction costs by addressing information problems (Volume I).

Areas of law. Mandatory provisions can be found in many areas of law, and they are likely to influence contract terms in many ways.

They are used because of fundamental public policy objectives. In contract law, the most fundamental mandatory rules apply to fraud, unfair or unreasonable contract terms, and the incorporation of pre-formulated contract terms. Many mandatory provisions will be discussed in the context of particular contract types. For example, there are mandatory rules in the area of insolvency law (section 9.6), proprietary rights (section 11.6.3) as well as competition law (for compliance, see Volume I; for merger control, see Volume III).

Community law. There is no general harmonisation of mandatory provisions of contract law in the EU.[147]

Community institutions have adopted several legislative acts that provide for mandatory rules or require Member States to adopt them. Some provisions of Member States' laws may be necessary because of the general duty of Member States to ensure that "penalties for infringements of provisions of Community law must be effective, proportionate and dissuasive".[148]

Because of the piecemeal approach to approximation of contract law, the rules that have been the subject of approximation can be found in different sectors. First, there are a small number of rules on unfair contract terms and the protection of the weaker party. These rules apply in particular to standard terms and commercial agency. Second, EU competition law prohibits certain agreements, practices and contract terms that restrict competition. Third, provisions of EU company law influence even contracts concluded by the company.

In the absence of common rules based on Community law, the majority of mandatory provisions applicable to commercial contracts are based on Member States' national laws. For example, each Member State has its own mandatory rules and principles designed to prevent abuse and fraud.

To some extent, the DCFR can again be used as a "shortcut". For example, Chapter 7 of Book II of the DCFR sets out the grounds of invalidity.

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146 See, for example, Miller L, Penalty Clauses in England and France: A Comparative Study, ICLQ 53 (2004) pp 79–80.

147 See recitals 12–13 of Directive 93/13/EEC on unfair terms in consumer contracts.

148 Case C-387/02 Berlusconi and others [2005] ECR I-3565, paragraph 36, and case-law which has been well established since Case 68/88 Commission v Greece [1989] ECR 2965, paragraphs 23–24. See also Article 51 of Directive 2004/39/EC (MiFID) and Article 25 of Directive 2003/71 (Prospectus Directive).

Mitigation. There are two basic ways to mitigate the risk caused by the existence of mandatory rules. The firm can either avoid the jurisdiction or adapt to its mandatory rules. Mandatory rules thus require compliance in one way or another.

Mitigation of Risk Caused by the Existence of Mandatory Rules: General Remarks

Compliance is the basic method to mitigate the risk caused by mandatory provisions of law (for compliance programmes, see Volume I). The firm should basically do four seemingly simple things. First, the firm should determine the law of which country or countries can govern the matter. Second, the firm should obtain information about the mandatory rules under this law or these laws. Third, the firm should choose the governing law where possible (it is sometimes possible to circumvent mandatory rules in this way). Fourth, the firm should comply with the rules that are mandatory under all applicable laws.

On the other hand, it can be complicated to mitigate this risk, because there are different categories of mandatory rules.

Protection of different interests. Mandatory rules can protect different things: fundamental moral values; institutional structures such as competition; particular groups in the market place or against market failure; the interests of an individual party to the contract; or other interests.

The category to which the mandatory rule belongs affects the extent to which it is possible to derogate from it. For example, the firm may typically choose the law that governs contractual matters. As some mandatory rules are governed by the law applicable to the contract, these rules will normally be designated by the law chosen by the parties. But although the firm may choose the law that governs some mandatory contract law rules, it may not derogate from all mandatory contract law rules of lex fori (the law of the country where the court is situated). The reason is that some of these rules are designed to protect even other matters than the interests of contract parties (fundamental moral values, institutional structures and so forth). Sometimes mandatory rules apply to acts done in a certain place or acts that have a measurable effect in a certain place (effects doctrine, extraterritorial application).

Different sanctions for non-compliance. There are different sanctions for non-compliance depending on the case.

First, many sanctions apply to the contract. Non-compliance with a mandatory rule can mean that: the contract is binding but the agreed term is replaced by a term inserted by the mandatory rule; the contract is binding but the agreed term is not; the contract is binding but its terms are modified; or the contract is not binding.

Second, the interests protected by the rule also affect sanctions for non-compliance. For example, non-compliance with a mandatory rule that protects fundamental moral values may be more likely to make the contract non-binding as a whole, but non-compliance with a mandatory rule that protects only individual parties to the contract is less likely to have such a severe effect.

Third, non-compliance with a mandatory rule can lead to other sanctions depending on the rule. Other sanctions can range from administrative sanctions to personal sanctions such as fines managers or prison sentences for the firm's managers or organ members.

Different mandatory rules in different areas of law. The transaction is at the same time constrained by many mandatory rules found in different areas of law.

Both the interests worthy of protection and the sanctions for non-compliance vary depending on the area of law. For this reason, also the risk relating to mandatory rules will have to be mitigated in different ways depending on the area of law.

Different approaches to mandatory rules in different countries. In addition to the area of law, the scope and importance of mandatory rules also depends on the jurisdiction. Mandatory rules are a relatively powerful form of intervention in the workings of private bargaining and party autonomy. In some countries mandatory rules are used more often than in others. These differences are partly based on legal culture and different ideas about the role of the state. For example, there are fundamental differences between German law and English law in this respect (for exorbitant credit bargains, see section 5.3.6).

Different approaches to international scope. The international scope of many mandatory provisions can to some extent be avoided by choosing the governing law of the contract.

In some areas of law, the international scope of mandatory provisions is a major cause of concern. Generally, choice of law rules protect a country's fundamental policy interests. Typical examples range from the extraterritorial application of rules including the international scope of securities markets laws and competition law to the application of mandatory provisions of law or norms that belong to a country's "ordre public" regardless of the choice of governing law by the parties.[149]

The International Scope of Mandatory Rules under Community Law: General Remarks

Community law can influence the international scope of mandatory provisions in many ways. Community law can designate the applicable law or the applicable rules. Some mandatory provisions will, in practice, not act as additional constraints because of the recognition of the home Member State's mandatory provisions as equivalent to the host Member State's provisions.

Rome I Regulation. According to the Rome I Regulation, the law that governs contracts in general (for example, the law chosen by the parties) also designates the mandatory provisions applicable to the contract. There are exceptions. Some of them are based on the provisions of the Rome I Regulation.[150] Other exceptions are based on sources outside the Rome I Regulation.

Direct effect, rules designating the applicable rules. One of the peculiarities of Community law is that it creates one or more additional layers to the legal frame-

[149] Articles 3(3), 3(4), 9 and 21 of Regulation 593/2008 (Rome I).

[150] Articles 3(3), 3(4), 9 and 21 of Regulation 593/2008 (Rome I).

work that governs the contract. The additional layer can also influence the question of governing law and the scope of mandatory provisions of law. Member States' general choice of law rules may sometimes be incomplete or misleading, because sectoral legislation adopted by EU institutions can designate the applicable rules without formally affecting the question of governing law. This is likely to increase the flexibility of law and interpretation risk.

For example, the substantive rules of EU competition law apply directly to firms or "undertakings" provided that their acts have a sufficient effect on the market. Article 81 of the EC Treaty prohibits agreements and concerted practices with an anticompetitive object or effect on the market. Article 82 prohibits the abuse of a dominant position. According to Article 86, the rules on competition can also apply to public undertakings. These rules can make contract terms illegal or unenforceable in the Member States of the EU regardless of the law that otherwise governs the contract.

Furthermore, the substantive rules of Community law can prevail over provisions of Member States' national law. For example, Member States remain free to determine the law applicable to company matters since the rules relating to freedom of establishment have not led to harmonisation of the provisions of private international law in this area.[151] On the other hand, the provisions of the host Member State's laws can sometimes constitute restrictions on freedom of establishment as guaranteed by Articles 43 and 48 of the EC Treaty.[152] In effect, the provisions of the EC Treaty thus designate the applicable rules.

Such substantive rules of Community law are not limited to the EC Treaty. The Directive on electronic commerce (ECD) can be used as an example of a modern directive that can change the applicable rules without changing the applicable law. The ECD does not aim to establish additional rules on private international law. However, provisions of the applicable law designated by rules of private international law must not restrict the freedom to provide information society services as established in the ECD.[153] In effect, the ECD designates the applicable rules, although it does not designate the applicable law.

The Internal Market.[154] EU competition law, Articles 43 and 48 of the EC Treaty, and the E-commerce Directive are examples of the Internal Market influencing the scope of Member States' national mandatory rules.

The Internal Market and the *Cassis de Dijon* principle[155] can limit the international scope of mandatory provisions of law in many ways. The *Cassis de Dijon* principle means that Member States are free to regulate a matter in the absence of common rules. On the other hand, disparities between national laws may amount to obstacles to the working of the Internal Market. If they do, the provisions of the EC Treaty will prevail.[156]

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[151] Case 81/87 Daily Mail and General Trust [1988] ECR 5483.
[152] See, for example, Case C-167/01 Inspire Art [2003] ECR I-10155, paragraphs 83, 103 and 104.
[153] Article 3 of Directive 2000/31/EC (ECD). See also recital 23.
[154] Mülbert PO, Bruinier S, Die Anwendung inländischer Schutzbestimmungen am Beispiel ausländischer Kreditverträge, Wertpapier-Mitteilungen 2005/3 pp 105–115.
[155] Case 120/78, Rewe v Bundesmonopolverwaltung für Branntwein [1979] ECR p 649.
[156] Article 10 of the EC Treaty.

The ECJ has held that the application of provisions of national law may be justified on certain conditions.[157] First, the provisions of the Member State must be necessary for overriding reasons relating to public interest such as the effectiveness of fiscal supervision, the protection of public health, the fairness of commercial transactions, and the defence of the consumer. Second, the application of the national provisions of the Member State must be such as to guarantee the achievement of the intended aim and must not go beyond that which is necessary in order to achieve that objective. In other words, it must not be possible to obtain the same result by less restrictive rules. Third, the application of the national provisions of the Member States must not be discriminatory.

The international scope of mandatory provisions. The main principles regarding the international scope of mandatory provisions of law can be illustrated by two contract types: a contract that falls within the scope of the CISG; and a commercial agency contract.

Sales. In the EU, a contract for the international sale of goods is governed by the law designated by the Rome I Regulation.[158] Either the provisions of the CISG or the general rules applicable to the sale of goods will be applied as part of the substantive rules of the governing law. If the contract falls within the scope of the CISG, the provisions of the CISG should be applied to the extent that the mandatory rules applicable to the contract do not provide otherwise. First, the CISG expressly provides that "[n]othing in this Convention shall restrict the application of the rules of the law of the forum in a situation where they are mandatory irrespective of the law otherwise applicable to the contract".[159] In addition, the court should apply the mandatory rules of the law that governs the contract. The fact that certain domestic rules of contract law are mandatory in domestic contracts does not compel the court to apply such rules to a contract governed by foreign law.

Commercial agency. Commercial agency can be used to illustrate the cumulative effect of the mandatory rules of different countries (and the effect of sectoral legislation adopted by EU institutions). The Directive on commercial agents[160] requires the Member States to adopt a number of mandatory rules. The Directive further provides that the parties may not derogate from certain provisions or that agreements to derogate from certain provisions to the detriment of the commercial agent shall not be permitted. For this reason, it is prohibited under Member States' laws to circumvent such rules by choosing the law of a third country to govern the contract where the commercial agent carries out his activities in the area of the EU.[161] Therefore, the choice of the law of a foreign country can in the worst case lead to the application of both the mandatory provisions of the law of that country and the mandatory provisions of the law of the country where the commercial agent carries out his activities.

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[157] See, for example, Case 33/74, Van Binsbergen v Bedrijfsvereniging voor de Metaalnijverheid [1974] ECR p 1299; Case C-288/89, Stichting Collectieve Antennevoorziening Gouda v Commissariaat voor de Media [1991] ECR p I-4007.

[158] The Rome I Regulation applies to contracts concluded after 17 December 2009. For Denmark, see recital 46.

[159] CISG Article 7(2).

[160] Directive 86/653/EEC on the coordination of the laws of the Member States relating to self-employed commercial agents.

[161] For German law, see HGB § 92c(1). For English law, see the Commercial Agents (Council Directive) Regulations 1993, sections 1(2) and 1(3). Section 1(2).

5.3.3 Different Types of Mandatory Rules: Introduction

Mandatory provisions of law can be necessary for various public policy reasons (Volume I). For example, they can be necessary for the protection of fundamental public policy interests, third parties, or legal security.

In commercial contracts, the main rule is that each party is free to agree on terms that are contrary to its interests.[162] The enforcement of mandatory rules is usually limited to exceptional circumstances. For example, the law can require a certain form for high-risk transactions or terms or for the protection of third parties; it is also possible that the waiver of certain rights would pervert the generally acceptable purpose of the agreement.

In economics, the mere fact that a contract has been made is seen as sufficient for the conclusion that both parties have gained compared to the situation without contract. However, an implicit precondition for this conclusion is that both parties consented "voluntarily" or that the choice was "free". A common notion is that "voluntary consent" means "absence of coercion" and "absence of fraud and deception" (Hayek).[163] By giving wrong or distorted information, a potential trading partner can be seen as endangering the voluntariness of choice and consent.[164]

Rules against fraud and deception can be seen as rules that protect parties from being manipulated through intentionally wrong or distorted information and therefore help to ensure that decisions are voluntary and, particularly, help parties to make better informed choices.[165]

Mandatory provisions of substantive law. In the area of contract law, the fundamental mandatory provisions of substantive law are fraud rules, rules on unfair contract terms and rules that protect the good faith of contract parties.

Substantive rules, interpretation rules, choice of law rules. In addition to mandatory rules that belong to substantive law, there are interpretation rules sharing the same purpose. Such interpretation rules typically have a smaller impact on party autonomy compared with mandatory substantive rules. The international scope of both rules is determined by the applicable choice of law rules.

One can also note that according to English law, the parol evidence rule prevents a party from relying on extrinsic evidence only as to the contents of the contract, and not as to its validity. The parol evidence rule is inapplicable where a party seeks to avoid the contract because of illegality, fraud, duress, mistake or failure of consideration.

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162 See Coester-Waltjen D, Constitutional Aspects of Party Autonomy and Its Limits – The Perspective of Law. In: Grundmann S, Kerber W, Weatherill S (eds), *op cit*, pp 44–46.

163 Hayek FA, The Constitution of Liberty. U Chic P, Chicago (1960) pp 133–147; Kerber W, Vanberg V, Constitutional Aspects of Party Autonomy and Its Limits – The Perspective of Constitutional Economics. In: Grundmann S, Kerber W, Weatherill S (eds), *op cit*, p 63.

164 Hayek FA, The Constitution of Liberty. U Chic P, Chicago (1960) p 143.

165 See Kerber W, Vanberg V, *op cit*, p 65.

5.3.4 Fraud

Introduction

The main rule is that the contract is binding on the parties. There are mandatory exceptions to the main rule in the case of illegality, unconscionableness, fraud, duress, or mistake. Member States' laws seek to prevent or penalise fraud.[166] Legislation adopted by the institutions of the EU does not normally prevent the authorities of Member States from adopting appropriate measures for this purpose.

Community Law

Community law does not prevent Member States' authorities from adopting appropriate measures for preventing or penalising fraud. Member States are free to regulate the validity of contracts that are incompatible with public morality (contra bonos mores). Neither does Community law prevent the firm from adopting such measures.

The ECJ may apply the principle of invalidity of acts that violate public morality. Generally, the ECJ may apply, as a principle of Community law, such principles that are generally accepted by the legal systems of the Member States[167] or the legal systems of most Member States. Public morality and public policy belong to this category, and they have also been mentioned in the EC Treaty.[168]

It is a general principle of Member States' laws that a contract imposes an obligation of good faith in its performance or enforcement.[169]

These principles are complemented by the principle that Community law may not be relied on for abusive or fraudulent ends.[170] A Member State may thus take measures designed to prevent its nationals from attempting improperly to circum-

[166] See also DCFR II.–7:205. In the US, the parties are bound by the terms of their contract absent illegality, unconscionableness, fraud, duress, or mistake. Mellon Bank, N.A. v. Aetna Business Credit, 619 F.2d 1001, 1009 (3d Cir. 1980).

[167] See, for example, 80/86 Kolpinghuis [1986] ECR 3969, paragraph 13: "(the) obligation on the national court to refer to the content of the directive when interpreting the relevant rules of its national law is limited by the general principles of law which form part of Community law and in particular the principles of legal certainty and non-retroactivity".

[168] Articles 30 and 58(1) of the EC Treaty.

[169] See, for example, DCFR III.–1:103; CISG Article 7(1); UCC s 1–203; Restatement (2d) of Contracts, s 205; UNIDROIT Principles of International Commercial Contracts, Article 1.7. See also Mustill MJ (Lord Justice Mustill), The New Lex Mercatoria: The First Twenty-Five Years, Arbitration International (1988) pp 111–112; Magnus U, Allgemeine Grundsätze im UN-Kaufrecht, RabelsZ (1995) pp 478–481; Teubner G, Legal Irritants: Good Faith in British Law or How Unifying Law Ends Up in New Divergences, Modern L R 61 (1998) p 11.

[170] See Cases C-367/96, Kefalas [1998] ECR I-2843, paragraph 20; and C-373/97, Diamantis [2000] ECR I-1705, paragraph 33.

vent their national legislation or to prevent individuals from improperly or fraudulently taking advantage of provisions of Community law.[171]

On the other hand, sometimes legal acts adopted by Community institutions make allegedly illegal or fraudulent acts valid. Member States' authorities may adopt appropriate measures for preventing or penalising fraud, but they may not prevent the exercise of a right guaranteed by the provisions of the EC Treaty and secondary legislation.[172] If a Member State may in principle take account of abuse or fraudulent conduct on the part of a person in order to deny him the benefit of the provisions of Community law on which he seeks to rely, the Member State may nevertheless have to establish the existence of an abuse on a case-by-case basis and on the basis of objective evidence, and assess such conduct in the light of the objectives pursued by those provisions.[173]

Mitigation of Risk

The firm does not need to be protected against the risk that fraudulent contracts are not binding. Rather, the firm needs protection against fraud. But while the rule that fraudulent contracts are not binding protects the firm by enabling the firm to walk away from the contract, this does not prevent fraud from happening.

The firm can protect itself against fraud by using legal tools and practices designed to manage incoming information. The firm should also protect itself against fraud committed by its employees, managers and business partners. The firm can address the risk of internal fraud and fraud directed at its contract parties when organising its internal risk management and internal processes. Compliance programmes and ethical codes are often used for this purpose (Volume I).

5.3.5 Unfair Contract Terms Under Community Law

Introduction

A number of mandatory rules relate to unfair contract terms. Some of them are designed to protect the weaker party. Other mandatory rules relating to unfair contract terms have been adopted for other policy reasons such as commercial necessity. They include, in particular, rules that restrict the use of certain exclusion clauses. These types of mandatory rules can be found both in Community law and in Member States' laws.

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[171] See, for example, Case C-212/97, Centros [1999] ECR I-1459, paragraph 24.

[172] Case C-212/97, Centros [1999] ECR I-1459, paragraph 30.

[173] Case C-212/97, Centros [1999] ECR I-1459, paragraph 25; see also Case C-167/01, Inspire Art [2003] ECR I-10155.

Mitigation of Risk

The firm should comply with mandatory provisions of law. The basic legal tools and practices that can be used to mitigate the risk relating to non-compliance with unfair contract terms depend on the nature of the terms.

The main way to reduce the risk of non-compliance with these mandatory rules is to deal fairly and equitably with the other party to the contract and to take the other party's legitimate interests into account. The terms should not be too one-sided. There is a higher legal risk when the contract term is not compatible with general notions of fairness and other generally applicable societal values (for interpretation, see section 5.2.4; for compliance in general, see Volume I).

The firm should obviously gather information about the mandatory provisions. The firm can sometimes use EU directives as a "shortcut", because several EU directives reflect what is regarded as fair and equitable in the Community.

Particular ways to mitigate risk will be discussed in the context of specific mandatory provisions of law below.

Community Law

Community institutions have adopted a number of sectoral directives designed to protect the weaker party. Typically, the weaker party is protected in business-to-consumer contracts. Some directives also cover business-to-business contracts.

Such sectoral directives include, for example, the Directive on unfair terms in consumer contracts,[174] the Unfair Commercial Practices Directive,[175] the Directive on misleading advertising,[176] and the Directive on commercial agents.[177]

In the Member States, similar rules can sometimes be applied even to business-to-business contracts in general (next section).

Unfair contract terms in consumer contracts. The Directive on unfair terms in consumer contracts[178] contains several warning signs that should be observed by the firm even when drafting commercial contracts.

The Directive covers only contractual terms which have not been individually negotiated.[179]

The obvious purpose of the Directive is to eliminate unfair terms from contracts drawn up between a business undertaking and a consumer. Where a term is deemed unfair it will not be binding on the consumer.[180] A term would be considered unfair if "contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer".[181]

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[174] Directive 93/13/EEC (Directive on unfair terms in consumer contracts).
[175] Directive 2005/29/EC (Unfair Commercial Practices Directive).
[176] Directive 84/450/EEC (Directive on misleading advertising).
[177] Directive 86/653/EEC (Directive on self-employed commercial agents).
[178] Directive 93/13/EEC (Directive on unfair terms in consumer contracts).
[179] Recital 12 and Article 3(1) of Directive 93/13/EEC (unfair terms in consumer contracts).
[180] Article 6 of Directive 93/13/EEC (unfair terms in consumer contracts).
[181] Article 3(1) of Directive 93/13/EEC (unfair terms in consumer contracts).

Although the Directive does not apply to commercial contracts between firms,[182] many of its provisions resemble provisions of Member States' laws that apply to all contracts or to pre-formulated contract terms. A number of Member States have therefore chosen to extend the scope of their implementing measures also to commercial contracts. It is also worth noting that the DCFR defines "unfair" contract terms between businesses.[183]

For this reason, the firm may reduce the risk of non-compliance with mandatory rules in the EU by avoiding clauses that have been prohibited in this Directive. In the legal analysis, the firm can substitute its contract party for "the consumer", find out whether the contract contains such clauses, and, before using them, analyse whether they would be permitted under those rules of contract law that apply to commercial contracts. The firm should be particularly diligent when drafting pre-formulated contract terms.[184]

The Directive provides that "unfair terms … shall … not be binding on the consumer and that the contract shall continue to bind the parties upon those terms if it is capable of continuing in existence without the unfair terms".[185]

A list of terms that may be deemed unfair is annexed to the Directive. The list is indicative and non-exhaustive.[186] The assessment of the unfair character of contract terms requires an assessment of "good faith". This means "making an overall evaluation of the different interests involved".[187]

In addition to terms that seem to be designed for the protection of private persons, the list contains some terms that could just as well be applied to commercial contracts, provided that Member States' laws contained appropriate rules to this effect.[188] These terms include "terms which have the object or effect" of:

- "(b) inappropriately excluding or limiting the legal rights of the consumer vis-à-vis the seller or supplier or another party in the event of total or partial non-performance or inadequate performance by the seller or supplier of any of the contractual obligations, including the option of offsetting a debt owed to the seller or supplier against any claim which the consumer may have against him;"
- "(c) making an agreement binding on the consumer whereas provision of services by the seller or supplier is subject to a condition whose realization depends on his own will alone;"
- "(d) permitting the seller or supplier to retain sums paid by the consumer where the latter decides not to conclude or perform the contract, without providing for the consumer to receive compensation of an equivalent amount from the seller or supplier where the latter is the party cancelling the contract;"

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[182] Article 1 of Directive 93/13/EEC (unfair terms in consumer contracts).
[183] DCFR II.–9:405.
[184] DCFR II.–9:405 and II.–9:408.
[185] Article 6(1) of Directive 93/13/EEC (unfair terms in consumer contracts).
[186] Recital 17 and Article 3(3) of Directive 93/13/EEC (unfair terms in consumer contracts).
[187] See recital 16 of Directive 93/13/EEC (unfair terms in consumer contracts).
[188] See, for example, §§ 310(1) and 307(1) and (2) BGB. It can be noted that DCFR II.–9:410 applies to contracts between a business and a consumer.

- "(e) requiring any consumer who fails to fulfil his obligation to pay a disproportionately high sum in compensation;"
- "(f) authorizing the seller or supplier to dissolve the contract on a discretionary basis where the same facility is not granted to the consumer, or permitting the seller or supplier to retain the sums paid for services not yet supplied by him where it is the seller or supplier himself who dissolves the contract;"
- "(g) enabling the seller or supplier to terminate a contract of indeterminate duration without reasonable notice except where there are serious grounds for doing so;"[189]
- "(h) automatically extending a contract of fixed duration where the consumer does not indicate otherwise, when the deadline fixed for the consumer to express this desire not to extend the contract is unreasonably early;"
- "(i) irrevocably binding the consumer to terms with which he had no real opportunity of becoming acquainted before the conclusion of the contract;"
- "(j) enabling the seller or supplier to alter the terms of the contract unilaterally without a valid reason which is specified in the contract;"[190]
- "(k) enabling the seller or supplier to alter unilaterally without a valid reason any characteristics of the product or service to be provided;"
- "(l) providing for the price of goods to be determined at the time of delivery or allowing a seller of goods or supplier of services to increase their price without in both cases giving the consumer the corresponding right to cancel the contract if the final price is too high in relation to the price agreed when the contract was concluded;"[191]

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[189] See also Annex, 2. Scope of subparagraphs (g), (j) and (l): "(a) Subparagraph (g) is without hindrance to terms by which a supplier of financial services reserves the right to terminate unilaterally a contract of indeterminate duration without notice where there is a valid reason, provided that the supplier is required to inform the other contracting party or parties thereof immediately." "(c) Subparagraphs (g), (j) and (l) do not apply to: - transactions in transferable securities, financial instruments and other products or services where the price is linked to fluctuations in a stock exchange quotation or index or a financial market rate that the seller or supplier does not control; - contracts for the purchase or sale of foreign currency, traveller's cheques or international money orders denominated in foreign currency …"

[190] See also Annex, 2. Scope of subparagraphs (g), (j) and (l): "(b) Subparagraph (j) is without hindrance to terms under which a supplier of financial services reserves the right to alter the rate of interest payable by the consumer or due to the latter, or the amount of other charges for financial services without notice where there is a valid reason, provided that the supplier is required to inform the other contracting party or parties thereof at the earliest opportunity and that the latter are free to dissolve the contract immediately. - Subparagraph (j) is also without hindrance to terms under which a seller or supplier reserves the right to alter unilaterally the conditions of a contract of indeterminate duration, provided that he is required to inform the consumer with reasonable notice and that the consumer is free to dissolve the contract." See also letter (c).

[191] See also Annex, 2. Scope of subparagraphs (g), (j) and (l): "(d) Subparagraph (l) is without hindrance to price-indexation clauses, where lawful, provided that the method by which prices vary is explicitly described." See also letter (c).

- "(m) giving the seller or supplier the right to determine whether the goods or services supplied are in conformity with the contract, or giving him the exclusive right to interpret any term of the contract;"
- "(n) limiting the seller's or supplier's obligation to respect commitments undertaken by his agents or making his commitments subject to compliance with a particular formality;"
- "(o) obliging the consumer to fulfil all his obligations where the seller or supplier does not perform his;"
- "(p) giving the seller or supplier the possibility of transferring his rights and obligations under the contract, where this may serve to reduce the guarantees for the consumer, without the latter's agreement;"
- "(q) excluding or hindering the consumer's right to take legal action or exercise any other legal remedy, particularly by requiring the consumer to take disputes exclusively to arbitration not covered by legal provisions, unduly restricting the evidence available to him or imposing on him a burden of proof which, according to the applicable law, should lie with another party to the contract."

For example, the ECJ has held that a jurisdiction clause must be regarded as unfair within the meaning of the Directive, where it is included, without being individually negotiated, in a contract between a *consumer* and a seller or supplier and where it confers exclusive jurisdiction on a court in the territorial jurisdiction of which the seller or supplier has his principal place of business. According to the ECJ, such a clause causes, contrary to the requirement of good faith, a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer.[192] Such a clause should not be unfair in a commercial contract between *firms*.[193]

Unfair commercial practices in general. As regards unfair commercial practices in general, the two most important Community directives are the Unfair Commercial Practices Directive[194] and the Directive on misleading advertising.[195]

(a) The Unfair Commercial Practices Directive clarifies consumers' rights and facilitates cross-border trade by establishing common, EU-wide rules against aggressive or misleading business-to-consumer marketing. Companies that comply with the rules will be able to do business in all EU countries.

The Directive defines a limited range of "sharp practices" (such as pressure selling, misleading marketing and unfair advertising) which are to be prohibited EU-wide. It also lays down general principles which can be used to assess whether other types of practices should be prohibited as unfair. By defining only what should be prohibited rather than telling firms how to go about their business, the law leaves room for business to innovate in developing new, fair commercial practices.

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[192] Joined Cases C-240/98 to 244/98, Océano Grupo Editorial and Salvat Editores [2000] ECR I-4941 paragraph 24. See also Article 17 of Regulation 44/2001 (Brussels I).

[193] Article 23 of Regulation 44/2001 (Brussels I).

[194] Directive 2005/29/EC (Unfair Commercial Practices Directive).

[195] Directive 84/450/EEC (Directive on misleading advertising).

However, the Unfair Commercial Practices Directive neither covers nor affects the national laws on unfair commercial practices which harm only competitors' economic interests or which relate to business-to-business transactions. Member States will continue to be able to regulate such practices if they choose to do so.[196] Neither does the Directive address commercial communications aimed at investors.[197]

(b) There are nevertheless other commercial practices which may hurt competitors or business customers. Some of them are covered by the Directive on misleading advertising.

The purpose of the Directive on misleading advertising is "to protect consumers, persons carrying on a trade or business or practising a craft or profession and the interests of the public in general against misleading advertising and the unfair consequences thereof.[198]

"Misleading advertising" is defined as "any advertising which in any way, including its presentation, deceives or is likely to deceive the persons to whom it is addressed or whom it reaches and which, by reason of its deceptive nature, is likely to affect their economic behaviour or which, for those reasons, injures or is likely to injure a competitor".[199] Member States have an obligation to ensure that "adequate and effective means exist for the control of misleading advertising in the interests of consumers as well as competitors and the general public".[200]

Unfair commercial practices: sectoral legislation. In addition to the two Community directives on unfair commercial practices in general, there are also sectoral directives designed to prevent unfair commercial practices in particular in the area of financial services and electronic commerce. These directives can lay down general requirements to conduct business in a fair way and detailed conduct of business rules that are regarded as fair.

MiFID. For example, the MiFID[201] lays down conduct of business obligations for investment firms that provide investment services to clients: "Member States shall require that, when providing investment services and/or, where appropriate, ancillary services to clients, an investment firm act honestly, fairly and professionally in accordance with the best interests of its clients and comply, in particular, with the principles set out in [the MiFID]."[202]

Companies and issuers. Companies and issuers must comply with various disclosure obligations. The duties to disclose information to shareholders and the public have to a large extent been harmonised in the EU (see Volumes I and III).

ECD. The purpose of the Directive on electronic commerce (ECD) is to ensure "a high level of Community legal integration in order to establish a real area without internal borders for information society services"[203] and to "lay down a clear and general framework to

[196] See recital 6 of Directive 2005/29/EC.
[197] See recital 7 of Directive 2005/29/EC.
[198] Article 1 of Directive 84/450/EEC.
[199] Article 2 of Directive 84/450/EEC.
[200] Article 4(1) of Directive 84/450/EEC.
[201] Directive 2004/39/EC (MiFID).
[202] Article 19(1) of Directive 2004/39/EC (MiFID).
[203] Recital 3 of Directive 2000/31/EC (ECD).

cover certain legal aspects of electronic commerce in the internal market".[204] The ECD contains some rules on commercial communications. For example, Member States shall ensure that commercial communications which are part of, or constitute, an information society service comply at least with certain conditions[205] and that unsolicited commercial communications shall be identifiable as such.[206]

Commercial agency, distribution. The scope of the Directive on commercial agents[207] is, as its name implies, limited to commercial agency. Some of its principles form part of the principles that are applied to distribution contracts in Member States' laws. In distributorship or commercial agency contracts, the firm might therefore be able to reduce the risk relating to mandatory rules by comparing the terms of the contract even with the provisions of this Directive.

The Directive on commercial agents is based on the common principles of Member States' laws. While the parties are free to regulate their contractual relationship, the Directive lays down a number of mandatory rules or rules from which the parties may not derogate to the detriment of the commercial agent. These include, for example: the duty to act dutifully and in good faith;[208] several duties relating to termination and indemnity or compensation on the expiry of the contract;[209] and restraint of trade clauses.[210]

Protection of good faith. The existence of good faith as a generally applicable principle of Community law has been recognised in many legal instruments adopted by Community institutions.

For example, the preamble of the Directive on unfair terms in consumer contracts contains many references to the principle of good faith:[211] "Whereas the assessment, according to the general criteria chosen, of the unfair character of terms, in particular in sale or supply activities of a public nature providing collective services which take account of solidarity among users, must be supplemented by a means of making an overall evaluation of the different interests involved; whereas this constitutes the requirement of good faith; whereas, in making an assessment of good faith, particular regard shall be had to the strength of the bargaining positions of the parties, whether the consumer had an inducement to agree to the term and whether the goods or services were sold or supplied to the special order of the consumer; whereas the requirement of good faith may be satisfied by the seller or supplier where he deals fairly and equitably with the other party whose legitimate interests he has to take into account …"

In the light of Community law, the firm might therefore be able to reduce the risk of non-compliance with mandatory rules of Member States' laws by dealing "fairly and equitably" with the other party and taking the other party's "legitimate interests" into account.

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[204] Recital 7 of Directive 2000/31/EC (ECD).
[205] Article 6 of Directive 2000/31/EC (ECD).
[206] Article 7 of Directive 2000/31/EC (ECD).
[207] Directive 86/653/EEC (Directive on self-employed commercial agents).
[208] Articles 3 and 4 of Directive 86/653/EEC (self-employed commercial agents).
[209] Articles 14–18 of Directive 86/653/EEC (self-employed commercial agents).
[210] Article 20 of Directive 86/653/EEC (self-employed commercial agents).
[211] Recital 16 of Directive 93/13/EEC (self-employed commercial agents).

5.3.6 Unfair Contract Terms Under Member States' Laws

Introduction

Member States' laws contain a large amount of mandatory rules on unfair contracts and contract terms. While many of them apply especially to consumer contracts, similar rules or principles may apply to pre-formulated commercial agreements or to commercial agreements in general. There are also important mandatory rules or principles for the protection of good faith or good morals, on the validity of exemption clauses, and on the incorporation and validity of pre-formulated contract terms.

Good Morals

Contracts that infringe good morals are usually void. On the other hand, whereas some Member States prefer a higher degree of regulation of business, other Member States have opted for a more laissez-faire approach.

The effect of different approaches to the regulation of business can be illustrated by the regulation of extortionate credit bargains in Germany and England.

Germany. In Germany, a credit agreement can be held to infringe good morals and be "sittenwidrig" and void under § 138(1) BGB where the agreed interest rate exceeds the market rate by 100% or by 12 percentage points.[212]

England. In England, extortionate credit bargains have been regulated in sections 137–139 of the Consumer Credit Act 1974. A credit bargain is "extortionate" if it: "(a) requires the debtor or a relative of his to make payments (whether unconditionally, or on certain contingencies) which are grossly exorbitant, or (b) otherwise grossly contravenes ordinary principles of fair trading".[213] The statutory test of "extortionate" is a high one.[214]

Unlike German courts, English courts have only rarely found that payments are grossly exorbitant. For example, Goode has said:[215] "… it seems clear that the concepts of extortion and unconscionability are very similar. 'Extortionate', like 'harsh and unconscionable', signifies not merely that the terms of the bargain are stiff, or even unreasonable, but that they are so unfair as to be oppressive. This carries with it the notion of morally reprehensible conduct on the part of the creditor in taking grossly unfair advantage of the debtor's circumstances."

Even where payments have been held grossly exorbitant, extortionate credit bargains have not necessarily resulted in the contract being declared void and unenforceable.[216]

[212] See Mülbert PO, Bruinier S, Die Anwendung inländischer Schutzbestimmungen am Beispiel ausländischer Kreditverträge, Wertpapier-Mitteilungen 2005/3 p 105.
[213] Section 138(1) of the Consumer Credit Act 1974.
[214] Goode's Consumer Credit Law and Practice at paragraph 27.26; Nash & Ors v Paragon Finance Plc [2001] EWCA Civ 1466.
[215] At paragraph 47.26 of Goode's Consumer Credit Law and Practice.
[216] Section 139 of the Consumer Credit Act 1974.

Good Faith and the Abuse of Rights

The principle of good faith can play a different role in the laws of different Member States. The principle of good faith is a general principle of the law of obligations common to continental European legal systems. In common law countries, it does not have the status of a legal principle. On the other hand, the good faith of contract parties is protected even in common law countries.

The protection of legitimate interests. What the principle of good faith means is that a party must take into account the legitimate interests of the other party.

This has also been stated in the Directive on unfair contract terms.[217] In the CISG, good faith is mentioned as a guideline for the interpretation of the provisions of the CISG.[218]

One of the many functions of the principle of good faith and similar rules is to prevent the abuse of rights (Mißbrauch, unzulässige Rechtsausübung). It is usually a mandatory rule of contract law that a party may not without a legitimate interest act with an intent to cause the other party loss or damage; for example, the party may not exercise an option that gives a very limited benefit compared with the disadvantage to the other party. Furthermore, the party may not exercise his right in a way that manifestly exceeds the limits of its "normal" exercise.

The principle of good faith and similar rules can prevent the following acts or terms: (a) Disproportionate exercise of remedies. This group contains, for example, disproportionate penalty clauses (liquidated damages) or abusive claims for specific performance. (b) Enforcement of clauses according to which contributory negligence does not decrease the amount of compensation for loss or damage. It is often a mandatory rule of contract law that contributory negligence has such an effect. (c) Enforcement of superfluous clauses. They can also prevent a party from requiring the performance or application of a clause that has lost its justification.

Germany. In Germany, § 242 BGB provides that the obligor must perform his obligations in accordance with good faith ("Treu und Glauben"), having due regard for commercial practice. § 242 BGB lays down a general principle that creates or modifies other statutory obligations. It has enabled German courts to set aside unfair contract terms and create a number of obligations that ensure loyal behavior on the part of the parties. For example, a contract party has a duty to cooperate and to take account of the other party's interests.

Nordic countries. There are similar principles in other continental European countries. For example, in the Nordic countries, the principle of good faith applies as a general principle. It is only partly codified. Instead of a fully developed statutory rule such as the "Treu und Glauben" principle under § 242 BGB, there are different statutory rules for the phase of contracting and the phase of performance.

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[217] Recital 16 of Directive 93/13/EEC.

[218] CISG Article 7(2): "Questions concerning matters governed by this Convention which are not expressly settled in it are to be settled in conformity with the general principles on which it is based …" CISG Article 7(1): "In the interpretation of this Convention, regard is to be had to its international character and to the need to promote uniformity in its application and the observance of good faith in international trade."

The Nordic Contract Acts contain a general clause that gives the courts a possibility to adjust the effects of contracts or contract terms that are deemed too unreasonable for the other party.

England. Unlike continental European legal systems, English law does not formally recognise any general obligation to act in accordance with good faith and fair dealing. In practice, though, there are legal rules that partly share the same function.

Sector-specific rules often create obligations that in continental Europe might be regarded as examples of the application of the principle of good faith. There is a large body of case law on fiduciary duties. Some contract types (reinsurance contracts) require utmost good faith (uberrimae fidei), and good faith is required before a court will grant equitable remedies. In addition, there is the principle of estoppel (venire contra factum proprium). Estoppel means the loss of a right as a consequence of a behaviour that is deemed incompatible with its exercise.

For example, the exercise of discretion is constrained by the implied term of good faith and reasonableness.

In *Abu Dhabi National Tanker Co v Product Star Shipping Ltd (No 2)*,[219] Leggatt LJ said that where A and B contract with each other to confer a discretion on A, the discretion must be exercised honestly and in good faith, and not "arbitrarily, capriciously or unreasonably". In that case, the judge held that the owner of the vessel acted unreasonably in the sense that no owner could reasonably have exercised the discretion in the way that he did.

In *Paragon Finance v Nash and Staunton*,[220] the loan agreements contained variable interest clauses. Dyson LJ said the use of those clauses was constrained by implied terms of the contract: "I cannot accept the submission ... that the power given to the Claimant by these loan agreements to set the interest rates from time to time is completely unfettered. If that were so, it would mean that the Claimant would be completely free, in theory at least, to specify interest rates at the most exorbitant level ... In the absence of an implied term, there would be nothing to prevent the Claimant from raising the rate ... to exorbitant levels, or raising the rate to a level higher than that required of other similar borrowers for some improper purpose or capricious reason. An example of an improper purpose would be where the lender decided that the borrower was a nuisance (but had not been in breach of the terms of the agreement) and, wishing to get rid of him, raised the rate of interest to a level that it knew he could not afford to pay. An example of a capricious reason would be where the lender decided to raise the rate of interest because its manager did not like the colour of the borrower's hair."

Unilateral Definition of the Terms of the Contract

The right to define the terms of the contract unilaterally or to alter the terms of the contract unilaterally can be constrained by mandatory provisions of law that purport to make contract terms more reasonable and prohibit manifestly unreasonable contract terms.

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[219] Abu Dhabi National Tanker Co v Product Star Shipping Ltd (No 2) [1993] 1 Lloyd's Rep 397.

[220] Nash & Ors v Paragon Finance Plc [2001] EWCA Civ 1466.

For example, German law permits the unilateral determination of contract terms ("einseitige Leistungsbestimmung") by a party only provided that: the party may choose between equal alternatives (such as the specifications of nuts and bolts); and that the party exercises this right in a reasonable way ("nach billigem Ermessen"). Reasonableness means here that the balance between the respective obligations of the parties must not change.[221] The last resort is the court.[222]

Unreasonable Exemption Clauses

For policy reasons, there are mandatory rules that limit the use and validity of exemption clauses in commercial contracts between businesses. A contract party is often not allowed to limit or exclude his liability for wilful acts or gross negligence in advance. It is often necessary to distinguish between individually negotiated exemption clauses and exemption clauses in general contract terms.

Germany. The German Civil Code (BGB) provides that the obligor cannot be exempted in advance from liability for wilful acts or omissions.[223]

In addition, some exemption clauses are invalid if used as pre-formulated contract terms although they have not been prohibited as individually negotiated contract terms. For example, such invalid clauses include clauses that exclude or limit the liability for loss caused by "a grossly negligent breach of duty by the user or a deliberate or grossly negligent breach of duty by a statutory agent of the user or by a person employed by him to perform the contract".[224] Such a clause would also be regarded as a term that places the other party to the contract at an unreasonable disadvantage.[225] (The application of these rules to commercial contracts will be discussed below.)

England. Like German law, English law distinguishes between individually negotiated contract terms and standard terms of business.

The main rule is that commercial parties are free to conclude business-to-business contracts on such terms as they wish. The Unfair Contract Terms Act 1977 was nevertheless designed to deal with the problem of unfair exclusion clauses.

The 1977 Act prevents a person from excluding or restricting his liability for negligence "by reference to any contract term or to a notice", unless the term or notice "satisfies the requirement of reasonableness".[226] This rule applies both to individually negotiated and to pre-formulated contract terms.[227]

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[221] § 315 BGB, § 318 BGB, § 375 HGB.
[222] § 315(3) BGB.
[223] § 276(3) BGB: "Die Haftung wegen Vorsatzes kann dem Schuldner nicht im Voraus erlassen werden."
[224] § 309(7)(b) BGB.
[225] § 307(1) BGB.
[226] Sections 2(2), 3(2), 4(1), 6(3), 7(3), and 7(4) of the Unfair Contract Terms Act 1977.
[227] See also section 6(1) of the Unfair Contract Terms Act 1977.

The 1977 Act applies to most contract types. Unfair terms in consumer contracts are also covered by the Unfair Terms in Consumer Contracts Regulations 1999.[228]

Section 3 of the 1977 Act applies "as between contracting parties where one of them deals as consumer or on the other's written standard terms of business".[229] The 1977 Act thus makes some pre-formulated contract terms invalid. For example, a party "cannot by reference to any contract term—(a) when himself in breach of contract, exclude or restrict any liability of his in respect of the breach … except in so far as … the contract term satisfies the requirement of reasonableness".[230]

The reasonableness test differs according to whether the term is a contract term or a notice with no contractual effect: (1) Where it is a contract term, it must have been "a fair and reasonable one to be included having regard to the circumstances which were, or ought reasonably to have been, known to or in the contemplation of the parties when the contract was made".[231] (2) Where it is a notice, the question is whether "it should be fair and reasonable to allow reliance on it, having regard to all the circumstances obtaining when the liability arose or (but for the notice) would have arisen".[232]

Schedule 2 to the 1977 Act sets out "guidelines" to which regard must be had where the reasonableness test is applied to certain contracts.[233] These include the relative strengths of the parties' bargaining positions, any inducement made to the customer to agree to the term and the extent of the customer's knowledge of the term.

Where statutory rules on the validity of exemption clauses do not apply, the permissibility of exemption clauses depends on the type of the contract. For example, the English Court of Appeal held in *Armitage v Nurse*[234] that trustee exemption clauses can validly exempt trustees from liability for all breaches of trust except fraud under English law. In Scotland, it is generally believed that trustees cannot invoke an exemption clause to escape liability for gross negligence ("culpa lata").[235]

In *Armitage v Nurse*, *Millett LJ* also said of the Scottish authorities that: "none of them are authority for the proposition that it is contrary to public policy to exclude liability for gross negligence by an appropriate clause clearly worded to have that effect". Although *Armitage*

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[228] See, for example, Simmonds J, Unfair Contract Terms - The Banker's View, JIBL 14(3) (1999) pp 81–91.

[229] Section 3(1) of the Unfair Contract Terms Act 1977.

[230] Section 3(2) of the Unfair Contract Terms Act 1977.

[231] Section 11(1) of the Unfair Contract Terms Act 1977. See also section 24(1).

[232] Section 11(3) of the Unfair Contract Terms Act 1977. See also section 24(2A).

[233] Those contracts are governed by sections 6(3) and 7(3) only: see section 11(2) of the Unfair Contract Terms Act 1977.

[234] Armitage v Nurse, EWCA Civ 1279; [1998] Ch 241.

[235] Lutea Trustees Ltd v Orbis Trustees Guernsey Ltd 1998 SLT 471. Cited in The Law Commission, Trustee Exemption Clauses (A Consultation Paper) (1 May 2003), paragraph 2.54.

v Nurse gives considerable latitude to the use of trustee exemption clauses, the line is drawn at actual fraud, on the basis that to permit a trustee to act dishonestly would be to derogate from the "irreducible core of obligations" of honesty and good faith.[236]

Unfair Standard Business Terms

One of the reasons why the firm may want to use pre-formulated standard terms is to impose its terms on the other party. Sometimes these terms are one-sided. For example, the terms might permit the firm to change the terms of the contract unilaterally. They might also limit or exclude that firm's liability in cases of non-performance or impose severe penalties on the other party in case of his non-performance.

All Member States have passed legislation to control the contents of pre-formulated standard terms.[237] Some of this legislation is necessary in order to implement the provisions of the Directive on unfair terms in consumer contracts. There are also rules that apply to commercial contracts between businesses. Some of these rules are modelled on the provisions of that Directive.

It is worth noting that the DCFR contains a general clause on unfair standard terms in contracts between businesses: "A term … is unfair … only if it is a term forming part of standard terms supplied by one party and of such a nature that its use grossly deviates from good commercial practice, contrary to good faith and fair dealing."[238]

Germany. In Germany, unfair contract clauses can be declared unenforceable both in consumer contracts as well as in commercial contracts under § 242 BGB. This provision lays down the rule of "Treu und Glauben" that requires a party to take the other party's legitimate interests into account.

In addition, there is legislation about unfair standard contract terms. In 2002, the 1976 Standard Contract Terms Act (AGBG)[239] was repealed and replaced by §§ 305–319 BGB.

Like before, the control of the content of standard terms consists of three parts: a general clause (§ 307 BGB); a list of terms that may be declared void after evaluation (§ 308 BGB, the "grey list"); and a list of terms that are void with no evaluation being necessary (§ 309, the "black list").

These lists are applied even to commercial contracts between firms. Although they cannot be applied to commercial contracts directly,[240] contract terms mentioned in these two lists can be subject to evaluation under the general clause (see below): these two lists are regarded as examples of how the general clause can be applied. In effect, the courts may decide whether the contract terms make sense in

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[236] The Law Commission, Trustee Exemption Clauses (A Consultation Paper) (1 May 2003), paragraph 2.52.

[237] There is no similar legislation in Switzerland, which is not an EU Member. See, for example, Aepli V, Zur Inhaltsproblematik allgemeiner Geschäftsbedingungen, dargestellt anhand vorformulierter Klauseln von Banken, ZSR 2000 pp 85-105.

[238] DCFR II.–9:405.

[239] Gesetz zur Regelung des Rechts der Allgemeinen Geschäftsbedingungen (AGBG).

[240] § 310(1) BGB.

a business context. In practice, courts tend to apply the "grey list" and the "black list" to commercial contracts by analogy, and the application of these lists is nearly automatic in some areas.[241]

This means that the firm should not use contract terms that are not compatible with the general clause. There is, in practice, a presumption that contract terms mentioned in the two lists infringe the general clause.[242]

The wording of the general clause is as follows: "Provisions in standard business terms are invalid if, contrary to the requirement of good faith, they place the contractual partner of the user at an unreasonable disadvantage. An unreasonable disadvantage may also result from the fact that the provision is not clear and comprehensible".[243]

The general clause and the presumptions that complement it make it more difficult to derogate from dispositive law (statutory default rules): "In case of doubt, an unreasonable disadvantage is assumed if a provision 1. cannot be reconciled with essential basic principles of the statutory rule from which it deviates, or 2. restricts essential rights or duties resulting from the nature of the contract in such a manner that there is a risk that the purpose of the contract will not be achieved".[244]

The court will thus compare the legal positions of the parties under the statutory rules and the contract. The court focuses on the default solution and how it has been changed. The court then determines whether the user of the term has one-sidedly exploited control over drafting. This can be the case where the obligations under the standard terms are not reasonable in relation both to the user's own interests and the burden imposed on the other party.

The content control is limited to terms that provide for changes and additions to default law. It is not applied to core commercial terms such as the price.[245]

The general rule is complemented by several detailed rules. What makes the detailed rules even more precise is that they are complemented by thousands of judgments and numerous scholarly commentaries.

The "black list" contains thirteen categories of terms that range from some unilateral rights to change the contract terms to the exclusion of liability for gross negligence. Their headings are as follows: (1) price increases on short notice (Kurzfristige Preiserhöhungen); (2) right to refuse to perform one's own obligations; (3) prohibition of set-off (Aufrechnungsverbot); (4) putting the other party on notice (Mahnung, Fristsetzung); (5) liquidated damages (Pauschalierung von Schadensersatzansprüchen); (6) penalty clauses (Vertragsstrafe); (7) exclusion of liability for death, injury or bodily harm, or for gross negligence (Haftungsausschluss bei Verletzung von Leben, Körper, Gesundheit und bei grobem Verschul-

[241] For an English-language analysis of German law governing standardized terms, see Maxeiner JR, Standard-Terms Contracting in the Global Electronic Age: European Alternatives, Yale J Int L 28 (2003) pp 141–156.

[242] The specific rules on standard business terms do not apply in the field of company law and do apply in the area of labour law only to some extent. See § 310(4) BGB.

[243] § 307(1) BGB.

[244] § 307(2) BGB.

[245] See also Maxeiner JR, Standard-Terms Contracting in the Global Electronic Age: European Alternatives, Yale J Int L 28 (2003) p 153.

den); (8) other exclusions of liability for breach of duty (sonstige Haftungsausschlüsse bei Pflichtverletzung); (9) the term of recurring obligations (Laufzeit bei Dauerschuldverhältnissen); (10) change of contract party (Wechsel des Vertragspartners); (11) liability of an agent who executes the contract (Haftung des Abschlussvertreters); (12) burden of proof (Beweislast); and (13) the form of notices and statements (Form von Anzeigen und Erklärungen).

The "grey list" contains eight categories of terms that range from fictional statements to the right to refuse to perform under the contract. Their headings are as follows: (1) period for acceptance or performance (Annahme- und Leistungsfrist); (2) additional period for performance (Nachfrist); (3) right to walk away from a duty to perform (Rücktrittsvorbehalt); (4) right to amend the contract (Änderungsvorbehalt); (5) fictional making of statements (Fingierte Erklärungen); (6) fictional receipt of statements (Fiktion des Zugangs); (7) payments on termination of the contract (Abwicklung von Verträgen); (8) unavailability of the object of performance (Nichtverfügbarkeit der Leistung).

England. In England, the Unfair Contract Terms Act 1977 also applies to standard terms of business used in commercial contracts. This Act has already been discussed above. It deals with the problem of unfair exclusion clauses.

The Unfair Contract Terms Act 1977 is supplemented by the Unfair Terms in Consumer Contracts Regulations 1994. The 1994 Regulations apply to consumer contracts in accordance with Directive 93/13/EEC (see above).[246] The 1994 Regulations do not cover commercial contracts between corporate bodies.

5.3.7 Mitigation of Risk Caused by Mandatory Rules

There are many ways to mitigate the risk caused by the existence of mandatory provisions of contract law. They range from the choice of the governing law to compliance and the use of a salvatory clause.

Choice of law. In commercial (business-to-business) contracts, the parties may normally choose governing law.[247] The main rule is that the parties may choose even the mandatory provisions of law applicable to the contract.[248]

For example, both the Swiss Civil Code (ZGB) and the German Civil Code (BGB) provide that a person has a duty to exercise his rights and fulfil his obligations according to the principle of good faith.[249] However, as a non-Member State of the EU, Switzerland does not have specific legislation on unfair standard contract terms.[250] In order to avoid the ap-

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[246] See, for example, Simmonds J, Unfair Contract Terms - The Banker's View, JIBL 14(3) (1999) pp 81–91.

[247] Article 3(1) of Regulation 593/2008 (Rome I).

[248] Article 12(1) of Regulation 593/2008 (Rome I).

[249] Article 2(1) ZGB and § 242 BGB.

[250] For German law, see §§ 305–319 BGB. For Swiss law, see, for example, Aepli V, Zur Inhaltsproblematik allgemeiner Geschäftsbedingungen, dargestellt anhand vorformulierter Klauseln von Banken, ZSR 2000 pp 85–105.

plication of mandatory provisions of German law, the parties often choose Swiss law to govern large commercial contracts.[251]

Mitigation of the risk that mandatory rules are cumulative. In contract law, some mandatory rules may continue to apply regardless of the parties' choices. This is because there are two kinds of mandatory provisions of contract law. Some rules are mandatory in domestic transactions but not necessarily in international transactions (because of the freedom to choose the governing law). Other rules are mandatory in both types of transactions (because of limitations to the freedom to choose the governing law).

As a result, there is a risk that the mandatory rules of different jurisdictions are cumulative and result in cumulative obligations which increase costs or decrease income.

The firm can mitigate the risk of cumulative mandatory rules by decreasing the number of legal systems to which the transaction is connected and, where possible, by choosing the law of the country the mandatory rules of which would govern the transaction regardless of the choice. The problem of cumulative mandatory obligations would not arise if the transaction were only governed by the laws of one country to which the transaction has its closest connection (or a connection close enough to exclude the mandatory application of the provisions of other countries' laws). On the other hand, this is hardly ever the case in cross-border transactions.

Cumulation. When is there a risk of the cumulation of the mandatory rules of different countries? Some situations have been regulated by the Rome I Regulation. There are also situations based on other instruments of Community law.

Cumulation under the Rome I Regulation. According to the Rome I Regulation, the cumulation of mandatory rules can relate to: overriding mandatory provisions of lex fori; overriding mandatory provisions of the law of the country of performance; mandatory provisions of the law of the only country to which the contract is otherwise connected; mandatory provisions based on Community law; and the protection of consumers and employees.

There is distinction between the cumulative application of mandatory provisions of law and refusal to apply a provision of the law specified by the Rome I Regulation. The application of a provision of the law of any country specified by the Rome I Regulation may be refused only if such application is manifestly incompatible with the public policy (ordre public) of the forum.[252] The wording of the Rome I Regulation implies that this restriction does not apply to the cumulative application of mandatory provisions of law.

The Rome I Regulation does not restrict the application of the overriding mandatory provisions of the law of the forum.[253] Overriding mandatory provisions have been defined as "provisions the respect for which is regarded as crucial by a country for safeguarding its public interests, such as its political, social or eco-

[251] Eidenmüller H, Kampf um die Ware Recht, FAZ, 26 March 2009 p 8.
[252] Article 21 of Regulation 593/2008 (Rome I).
[253] Article 9(2) of Regulation 593/2008 (Rome I).

nomic organisation … irrespective of the law otherwise applicable to the contract".[254] Rules on competition, restrictive practices and consumer protection may belong to this group. The same can be said of some securities markets rules. The public policy of the forum also includes Community public policy, because Community public policy has become an integral part of the public policy of the Member States.[255]

The scope of these rules can be flexible. They are often applied when the contract has a sufficient effect on the things protected by them (for example, these rules can sometimes have extraterritorial effect in the sense that they are applied to acts done abroad where these acts have a sufficient effect inside the country).The risk that the contract falls within their scope can typically be mitigated by limiting the effect of the contract to the market of one country or the markets of some countries and by excluding its effect on the markets of other countries (this question will be discussed further below in the context of competition law). The risk that the court would apply the mandatory rules of the forum can be mitigated through a dispute resolution clause that provides for dispute resolution in a country unaffected by the contract. This would nevertheless not prevent the competent public authorities of the country affected by the contract from taking legal or administrative action against parties that breach its laws.

According to the Rome I Regulation, effect may be given to the overriding mandatory provisions of the law of the country where the obligations arising out of the contract have to be or have been performed, "in so far as those overriding mandatory provisions render the performance of the contract unlawful".[256]

Where the parties have chosen the applicable law but "all other elements relevant to the situation" are located in a country other than the country whose law has been chosen, the choice will not prejudice the application of provisions of the law of that other country which cannot be derogated from by agreement.[257]

This means that, while it may be possible to avoid the mandatory rules of country A by choosing the law of country B as the governing law and by agreeing on dispute resolution in country B or C, there remains a risk that the mandatory rules of country A will be applied regardless of the choice, if A is the country to which the contract is most closely connected.

The same rule has been extended to purely European situations: "Where all other elements relevant to the situation at the time of the choice are located in one or more Member States, the parties' choice of applicable law other than that of a Member State shall not prejudice the application of provisions of Community law, where appropriate as implemented in the Member State of the forum, which cannot be derogated from by agreement."[258]

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[254] Article 9(1) of Regulation 593/2008 (Rome I).
[255] Giuliano M, Lagarde P, Report on the Convention on the law applicable to contractual obligations, OJ C 282, 31.10.1980, pp 1–50.
[256] Article 9(3) of Regulation 593/2008 (Rome I).
[257] Article 3(3) of Regulation 593/2008 (Rome I).
[258] Article 3(4) of Regulation 593/2008 (Rome I).

In addition, there are particular choice of law rules protecting consumers[259] and employees.[260] The provisions of the law chosen by the parties and the mandatory provisions of the law which, in the absence of choice, would have been applicable can lead to cumulative protection.

Other sources of cumulation of mandatory provisions. In addition to such provisions of the Rome I Regulation, cumulation can be based on other instruments of Community law.

Some questions are not covered by the law applicable to the contract.[261] In this case, the main rule is that the parties are not free to choose the governing law (section 5.3.9).

One of the further exceptions outside the Rome I Regulation is the conflict between choice of law rules and sectoral legislation adopted by Community institutions. Sectoral legislation can sometimes designate the applicable rules without formally affecting the question of governing law (section 2.3.2).

Compliance with substantive rules. There are few mandatory rules regulating the substance of commercial contracts in general. Member States' contract laws nevertheless contain a number of rules that discourage fraud (section 5.3.4), the use of unfair contract terms (section 5.3.6), or other unwanted business practices (section 5.3.5). The firm has therefore reason to find out whether contract terms that look too one-sided or are "too good to be true" comply with the mandatory provisions of general contract law. For example, there is a relatively high risk that a contract term that enables the firm to alter the contract unilaterally is either declared void or modified if contested by the other party to the contract in the court (section 5.3.5).

There are more mandatory rules in the legislation that governs specific contracts for exchange. If specific legislation is necessary for public policy reasons, some provisions of law may be mandatory for the same public policy reasons. For example, if the terms of certain contracts influence third parties, they are often governed by mandatory rules that regulate their substance; contracts for the sale of real estate, the assignment of receivables, or the subscription or transfer of shares are examples of contract types partly governed by mandatory rules regulating the substance of contracts.

Salvatorian clause. If a contract term is invalid because of a mandatory provision of law, it will be replaced by legal background rules.[262] One of the standard ways to address this situation is to use a so-called salvatorian clause: "Should a provision of this agreement be or become invalid or unenforceable, the validity of

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[259] Article 6(2) of Regulation 593/2008 (Rome I): "… a choice may not, however, have the result of depriving the consumer of the protection afforded to him by provisions that cannot be derogated from by agreement by virtue of the law which, in the absence of choice, would have been applicable …"

[260] Article 8(1) of Regulation 593/2008 (Rome I): "… a choice of law may not, however, have the result of depriving the employee of the protection afforded to him by provisions that cannot be derogated from by agreement under the law that, in the absence of choice, would have been applicable …"

[261] Article 1(2) of Regulation 593/2008 (Rome I).

[262] § 306(2) BGB.

the rest of the agreement will not be affected. The invalid or unenforceable provision shall be replaced by a valid and enforceable rule that comes closest to the intended meaning of the invalid rule. The same rule applies to any unintended omissions in the agreement." This would not happen without a specific contract term.[263]

5.3.8 Particular Remarks on Standard Form Contracts

Introduction

Standard form contracts such as master agreements and other pre-formulated contract terms belong to the core legal tools used by firms in contractual relationships. They enable the firm to organise its operations and determine the terms of its main business transactions in advance (for core terms, see section 2.5). The use of standard form contracts is the rule and individually-negotiated contracts are the exception in business practice.[264]

Problems. In practice, standard form contracts can be one-sided. They often impose terms which are ungenerous or unfair in their application or exempt the party putting forward the document from liability. Standard form contracts can also include small-print clauses that appear on the backs of documents in minuscule type, and other surprising clauses.

For this reason, the incorporation of standard form contracts tends to be governed by mandatory provisions of law.

A further problem is "battle of the forms". The popularity of standard form contracts can mean that each party tries to impose a standard form contract on other parties. For example, the firm may offer to buy goods from a seller on a form which contains or refers to its standard conditions of trade. The seller "accepts" the offer by a confirmation on a form which contains or refers to the seller's own standard conditions of trade. These may differ materially from those of the buyer. Is there a contract? If so, whose conditions will prevail?

Governing law. The incorporation of standard form contracts and exemption clauses is usually governed by specific provisions of law. These questions are governed by the law governing the contract.

Community law. The substantive provisions on the incorporation of standard form contracts between businesses have not been approximated in the EU directly. Indirectly, however, the use of standard business terms may be affected by provisions of Community law. For example, the use of the same standard forms by many undertakings can be constrained by EU competition law. The Commission is expected to address the problem of standard terms (section 2.3.3). The incorporation of standard terms has been addressed by the DCFR.[265]

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[263] See § 139 BGB. On the other hand, see also § 140 BGB (Umdeutung). Compare DCFR II.–7:302 and II.–7:303.

[264] See, for example, Korobkin R, Bounded Rationality, Standard Form Contracts, and Unconscionability, U Ch L Rev 70 (2003) pp 1203–1204.

[265] See DCFR II.–4:409; PECL Article 2:209.

In the absence of common rules adopted by Community institutions, the incorporation of standard form contracts is governed by Member States' national laws or, in exceptional cases, by international rules (such as the provisions of the CISG) that apply to particular contract types.

The lack of harmonisation can create problems. Evidence collected by the European Commission indicates that insofar as the diversity between laws of national legal systems presents an obstacle to trade in the Internal Market, the problem consists of the inability of businesses to use their standard terms of business in cross-border trade with confidence.[266]

Unlike the substantive provisions, the choice of law provisions have been harmonised. The incorporation of standard form contracts will usually be governed by the law that would govern the contract if the contract were valid.[267]

Member States' laws. The incorporation of standard business terms depends on the governing law, and there are differences between Member States' laws. There can also be differences between consumer contracts and commercial contracts, or between commercial contracts in general and particular contracts types such as international sales of goods governed by the CISG.

The German Civil Code contains specific provisions on the incorporation of standard business terms. Many apply to consumer contracts. Some of them apply to standard business terms used in commercial contracts between businesses. These rules are mandatory (§ 306a BGB).[268]

In England, the rules on the incorporation of standard business terms are based on common law.

The CISG. The provisions of the CISG are based on common principles applied in many countries to contracts in general. They can therefore act as an introduction to national laws.

Incorporation in General

The incorporation of standard form contracts is governed by the law that would govern these terms if they were binding.[269] The firm can mitigate the risk inherent in the incorporation of standard form contracts by complying with the substantive rules of the governing law.

CISG. If the contract falls within the scope of the CISG, the incorporation of standard business terms will be governed by the general provisions of the CISG applicable to the conclusion of contracts.[270] There are no special rules for the incorporation of standard business terms. The general provisions can be found in

[266] See Collins H, The Freedom to Circulate Documents: Regulating Contracts in Europe, ELJ 10 (6) (2004) pp 787–803.
[267] Articles 10 and 11 of Regulation 593/2008 (Rome I).
[268] § 306a BGB: "The rules in this section apply even if they are circumvented by other arrangements."
[269] Article 10(1) of Regulation 593/2008 (Rome I).
[270] CISG Article 4.

Part II of the Convention.[271] These rules are fairly challenging when applied to standard business terms, and they prevail over national rules.

The requirements under the CISG are: (a) there must be a reference to the standard business terms before the conclusion of the contract; (b) they must be made available to the other party before the conclusion of the contract; and (c) the other party must have accepted the offer after reference was made to these terms and they were made available to the other party.

Mere reference to standard business terms is thus not enough. For example, if the parties agree to the terms of the contract via telephone, it is not enough for the firm just to refer to its own standard business terms. The firm should also disclose their contents to the other party.

Public disclosure of standard business terms is not enough. The firm has an active duty to hand its standard business terms over to the other party without request, and the other party has no active duty to look for these standard business terms anywhere. The standard business terms must also be made available to the other party in a form understandable to the other party. For example, there is no presumption that all companies regardless of their location would understand standard business terms drafted in English. However, the other party can be presumed to understand English where the parties have negotiated only in this language.

The provisions of the CISG are not mandatory, and the parties may agree to derogate from them.[272] In addition, usages and practices established by the parties between themselves prevail over the provisions of the CISG.[273] For example, the firm may, in the absence of a written reference to its own standard business terms in a contract with the other party, prove that these terms have regularly been incorporated into contracts between these two parties.

German law. The German Civil Code lays down a general rule on the incorporation of standard business terms in consumer contracts.[274]

Standard business terms are incorporated into the contract if, during the conclusion of the contract: (1) the user expressly draws the other party's attention to them; (2) the user gives the other party the possibility of gaining knowledge of their content; and (3) the other party agrees that they are to apply. The parties may also agree in advance that particular standard business terms will apply to a particular type of legal transaction.[275]

Now, the general rule on the incorporation of standard business terms is not directly applicable to commercial contracts between businesses.[276]

On the other hand, many rules have been developed by the courts. In commercial contracts between businesses, it is sufficient to refer to standard business

[271] Part II of the CISG is not always applicable. Upon ratifying the Convention, Denmark, Finland, Norway and Sweden declared that they would not be bound by Part II. See Article 92(1) of the CISG.

[272] CISG Article 6.

[273] CISG Article 9.

[274] § 305(2) BGB.

[275] § 305(3) BGB.

[276] § 310(1) BGB.

terms; it is not necessary to make them available to the other party before the conclusion of the contract. If the firm refers to its standard business terms before the conclusion of the contract, the other party should therefore inquire as to their contents.

In addition, some mandatory rules apply even to commercial contracts,[277] in particular: the precedence of individually negotiated terms;[278] the special incorporation rule that applies to certain contract types;[279] the special incorporation rule on surprising and ambiguous clauses (see below);[280] and the general rule that can make unreasonable terms invalid[281] (see above).

English law. There is a similar main rule on the incorporation of standard business terms under English law. In order to become binding as part of the contract, the term must be brought to the notice of the contracting party before or at the time that the contract is made. It will be sufficient if the person tendering the document has done all that might reasonably be expected to give notice of the contractual terms to the class of persons to which the other party belongs.[282] If it is not communicated until afterwards, it will be of no effect unless there is evidence that the parties have entered into a new contract on a different basis.[283]

Surprising Clauses, Small-print Clauses

Both English and German law contain special rules on the incorporation, interpretation, or enforceability of surprising clauses. Surprising clauses or clauses appearing on the backs of contracts in minuscule type can be invalid, where the court believes that they fail to give adequate notice to the other party of the provisions they contain.

German law. There is a special rule on surprising and ambiguous clauses in consumer contracts under German law:[284] "Provisions in standard business terms which in the circumstances, in particular in view of the outward appearance of the contract, are so unusual that the contractual partner of the user could not be expected to have reckoned with them, do not form part of the contract." This rule and the general rule that can make unreasonable terms invalid[285] apply even to commercial contracts.[286]

English law. There are special rules of construction and interpretation with regard to exemption clauses under English law.[287] The court applies canons of con-

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277 § 310(1) BGB.
278 § 305b BGB.
279 § 305a BGB.
280 § 305c BGB.
281 § 307(1) BGB.
282 Parker v. S.E. Ry. (1877) 2 C.P.D. 416. See Beatson J, Anson's Law of Contract, 27th Edition. OUP, Oxford (1998) p 37.
283 Beatson J, *ibid*. p 161.
284 § 305c(1) BGB.
285 § 307(1) BGB.
286 § 310(1) BGB.
287 Beatson J, *op cit*, p 125.

struction which normally work in favour of the party seeking to establish liability and against the party seeking to claim the benefit of the exemption.[288] If the particular condition relied upon by the party seeking exemption is one which is unusual in that class of contract, special measures may be required to bring it to the notice of the other party. Figuratively speaking, some clauses "would need to be printed in red ink on the face of the documents with a red hand pointing to it before the notice could be held to be sufficient".[289]

Small-print clauses in England and Germany. Small-print clauses may sometimes fail to give adequate notice to the other party.

For example, in *Crooks v. Allan*, a bill of lading case, it was held: "The clause in question comes in about the middle of thirty closely packed small type lines, without a break sufficient to attract notice. If a shipowner wishes to introduce in his bill of lading so novel a clause as one exempting him from general average contribution ... he ought not only to make it clear in words, but also to make it conspicuous by inserting it in such type and in such a part of the document as that a person of ordinary capacity and care could not fail to see it."[290]

The German Federal Supreme Court (BGH) has ruled that bill of lading clauses which can only be read with the aid of a magnifying glass do not form part of the bill of lading contract even if they are standard clauses in the trade.[291] However, courts seem reticent to strike down small-print clauses where the parties have done business previously using the same form of bill of lading.[292]

Battle-of-the-forms

The firm should never assume that its standard business terms have been properly incorporated just because it happens to send them to the other party first or last. In Europe, laws typically address the problem of conflicting standard terms (battle-of-the-forms) by encouraging the parties to agree on what terms to apply. Laws do not automatically favour either party.

On the other hand, a party that remains passive is not normally regarded as worthy of protection. If a party sends its standard terms to the other party last and the other party then fulfils its contractual obligations, the other party may be deemed to have accepted the standard business terms last sent.

There are similar rules in the US. Let us assume, first, that the firm's customer sends a purchase order that includes terms favourable to the customer and, second, that the firm ships goods to the customer in a package that includes the firm's order acknowledgment form

[288] *Ibid*, pp 165–166.

[289] J. Spurling Ltd. v Bradshaw [1956] 1 WLR 461, 466; Thornton v Shoe Lane Parking Ltd. [1971] 2 QB 163 at page 169–170 (Lord Denning); Beatson J, Anson's Law of Contract, 27th Edition. OUP, Oxford (1998) pp 163–164.

[290] Crooks v. Allan (1879) 5 Q.B. 38 at p 41. See Tetley W, Seven Rules of Interpretation (Construction) of Bills of Lading. In: Liber Amicorum Robert Wijffels. ETL, Antwerp (2001) pp 359–379.

[291] BGH, judgment of 30 May 1983 - II ZR 135/82.

[292] Tetley W, *ibid*, pp 359–379.

with terms favourable to the seller. Even in the US, shipment on the purchase order could imply acceptance of its terms.

CISG. The general provisions of the CISG distinguish between a reply that materially alters the terms of the offer on one hand,[293] and a reply that contains minor modifications on the other.[294] The use of conflicting standard business terms usually alters the terms of the offer materially.[295] If the other party's reply alters the terms of the firm's offer materially, the reply is regarded as a counter-offer. The firm can give its consent to this counter-offer expressly or, as is often the case, by its conduct.[296] The last-shot-rule will thus apply, provided that the firm accepts the other party's "last shot".[297]

German law. Under German law, the problem of battle-of-the-forms is governed by the principle also found in the CISG: If a reply to an offer purports to be an acceptance but contains additions, limitations or other modifications, the reply is regarded as a new offer (counter-offer).[298]

English law. In England, battle of the forms was discussed in *Butler Machine Tool Co. Ltd. v Ex-Cell-o Corporation (England) Ltd.*[299] A majority of the Court of Appeal adopted the "last shot" approach. The difficulty is, however, that the operation of the "last shot" approach depends upon chance and can be arbitrary. Furthermore, there is no contract, unless and until the counter-offer is accepted.[300]

DCFR/PECL. According to the DCFR, conflicting standard terms can form part of the contract "to the extent that they are common in substance", provided that: (1) the parties have reached agreement in all other respects; (2) neither party informs the other party, without delay, that it does not intend to be bound; and (3) neither party has indicated in advance (explicitly and not by way of standard terms) that it does not intend to be bound by a contract on such a basis.[301]

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[293] CISG Article 19(1).

[294] CISG Article 19(2).

[295] CISG Article 19(3).

[296] See also CISG Article 18(1), Article 18(2), and Article 29(2).

[297] There is thus a difference between the CISG and the UCC. Let us assume that the UCC apply. If a buyer sends a purchase order and the seller confirms the price and quantity terms but adds other terms not found in the offer, the confirmation may still be regarded as an acceptance of the offer. There is a binding contract, and the buyer who made the offer prevailed in the "battle of the forms". Let us assume that the CISG applies. In this case, almost any additional term in the confirmation mean that the confirmation is regarded as a counter offer. If the seller ships the goods and the buyer accepts the goods, the seller's terms will prevail.

[298] § 150(2) BGB.

[299] Butler Machine Tool v Ex-Cell–O Corporation [1979] 1 WLR 401 at 404.

[300] See Beatson J, Anson's Law of Contract, 27th Edition. OUP, Oxford (1998) pp 39–40.

[301] DCFR II.–4:209; PECL Article 2:209.

Exceptions

There can be further requirements as to form in particular areas. There are both choice of law issues and issues relating to substantive law.

The law governing incorporation of contract terms. It is usually relatively easy to comply with rules that govern the formal validity of contracts. According to the Rome I Regulation, a contract is formally valid if it satisfies the formal requirements of the law which governs it in substance or of the law of either of the countries where either of the parties or their agent is present at the time of conclusion, or of the law of the country where either of the parties had his habitual residence at that time.[302]

In practice, a party's actions may fulfil these requirements as to formal validity of contracts under the Rome I Regulation even where the party has no intention to be bound.

The Rome I Regulation therefore provides for an escape rule. A party may rely upon the law of the country in which he has his habitual residence in order to establish that he did not consent, if it appears from the circumstances that it would not be reasonable to determine the effect of his conduct in accordance with the law that would otherwise govern the contract.[303] This rule can be applied, for example, where the incorporation of standard business terms is subject to stricter requirements in that country.[304]

Special requirements as to form. There can be special requirements as to form in particular areas of law.

For example, electronic commerce can be subject to particular requirements as to form.[305] Distance sales to consumers can cause particular problems. In addition to particular requirements as to form,[306] consumers may have a mandatory right of withdrawal in distance sales.[307]

Dealings in real property or immovables must typically be in writing and executed in a prescribed manner. The law that governs the formal validity of the contract is usually the law of the country where the property is situated.[308]

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[302] Article 11(2) of Regulation 593/2008 (Rome I).

[303] Article 10(2) of Regulation 593/2008 (Rome I).

[304] For example, the flexible rules for the incorporation of standard business terms in commercial contracts under German law are complemented by Article 31(2) of the Introductory Act to the German Civil Code (EGBGB) that protects foreign contract parties.

[305] Articles 9–10 of Directive 2000/31/EC (ECD).

[306] Articles 4–5 of Directive 97/7/EC (Directive on distance sales); Articles 3–5 of Directive 2002/65/EC (Directive on the distance marketing of consumer financial services). For a comparison between Article 5(1) of Directive 97/7/EC and Article 10 of Directive 2000/31/EC (ECD), see OLG Naumburg, judgment of 13.7.2007 (10 U 14/07).

[307] Article 6 of Directive 97/7/EC (Directive on distance sales); Article 6 of Directive 2002/65/EC (Directive on the distance marketing of consumer financial services). For German law, see §§ 312c and 355 BGB; § 14 BGB-InfoV. For a comparison between Article 5(1) of Directive 97/7/EC and Article 10 of Directive 2000/31/EC (ECD), see OLG Naumburg, judgment of 13.7.2007 (10 U 14/07).

[308] Article 4(1)(c) of Regulation 593/2008 (Rome I). See also Articles 4(1)(d), 6(4)(c) and 11(5) as well as recital 27.

For example, under English law, a "deed" is necessary for certain transactions such as conveyances and other dealings in real property. A company can execute deeds through the affixing of the common seal, if a company has one. A document signed by a director and the secretary of a company or by two directors and which is expressed to be executed by the company has the same effect as a document executed under the company's common seal.[309]

Summary on the Mitigation of Risk

The most important way to mitigate the risk that a standard form contract will not be regarded as binding is compliance. Some of the rules on the incorporation of contract terms can best be described as interpretation rules (section 5.2.3). Other rules lay down requirements as to form.

Standard form contracts are usually incorporated into the contract, if: (a) they were handed over to the other party before the contract was made and not just disclosed in public (so that the terms were available to the other party at the time of contracting); (b) they were made available in a form that could be understood by the other party (in particular, in a language that the other party could be required to understand such as the language of the other party or the language of the contract); (c) there was a clear reference to the application of the standard business terms before the contract was made (the other party had been notified of the applicability of these terms); (d) the other party was specifically notified of surprising or extraordinary terms such as far-reaching exclusion or limitation of liability clauses before the contract was made; (e) the other party has, after the firm has done all these things, given its consent to the terms of the contract including the standard business terms.

If there are conflicting standard business terms (each party insists on the use of its own standard business terms), the parties should clarify which terms shall apply. In order to mitigate risk, the firm should not rely on legal background rules. Although this conflict has probably been solved under the rules of the law governing the contract, it has been solved in different ways in different jurisdictions. While some countries apply the "last-shot-rule", other countries apply the "first-shot-rule"; it is also possible that the standard business terms are not binding at all, binding to the extent that they contain the same terms, or binding to the extent that they do not contain conflicting terms.

In any case, the possibility that the incorporation of standard business terms is governed by the "last-shot-rule" puts the burden on the firm to object to additional or different terms that it has received from the other party before contracting. If the firm receives a reply to an offer which purports to be an acceptance but which contains additional or different terms, the firm should promptly notify the offeree about the discrepancy and object to it. This is a way to reduce the risk that the terms of the contract consist of the terms of the offer subject to the modifications contained in the acceptance (they could be incorporated into the contract where they do not materially alter the terms of the offer).

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[309] Section 44 of Companies Act 2006. See Griffiths A, Contracting with Companies. Hart Publishing, Oxford and Portland, Oregon (2005) pp 6–7.

It is possible that the substantive rules governing the incorporation of standard business terms are not mandatory as such in some jurisdictions. In order to mitigate the risk that the terms are not binding, however, the firm should comply with these substantive rules rather than rely on a clause in a contract derogating from them. This is because it can be easy to regard contract terms that have not been made available to the other party as unreasonable or their application as a breach of the principle of good faith or similar principles. For the same reason, such contract terms would be coupled with a high interpretation risk; the court might not uphold them (section 5.2.4).

5.3.9 Mitigation of Risk in Other Areas of Law

Introduction

As said above, mandatory provisions of contract law require compliance in one way or another (section 5.3.7). There are mandatory provisions even in many other areas of law (section 5.3.3). In many investment transactions, the firm will have to comply with mandatory provisions that belong to company law, insolvency law, the law of property, and competition law. Compliance can require different things depending on the area of law. This can be illustrated by company law, insolvency law, property law, and competition law. Their mandatory provisions will often influence the validity or enforceability of contracts.

Mitigation of Risk in Company Law

In company law, the firm may not choose the governing law as such. The Rome I Regulation does not apply to matters that belong to company law.[310] Depending on the context, different things can be classified as company law matters or matters of contract law.[311] However, there are at least four particular things that the firm can do for the purpose of mitigating the risk that a contract is not binding or not enforceable on grounds of breach of company law rules.

First, one of the effects of incorporation and the separate legal personality of a limited-liability company is asset partitioning, allocation of risk (Volume I), and the ring-fencing of assets and debts (section 11.6.3). The firm can change this by changing the company structure or by contracting.

Second, the firm may sometimes choose to deal with a company incorporated under the laws of country A instead of country B, or form a new company under the laws of country A instead of country B, or change its company form. Adaptation to mandatory provisions of company law enables the firm to choose the gov-

[310] Article 1(2)(f) of Regulation 593/2008 (Rome I).

[311] For example, the articles of association of a company can be regarded as "contract" where the articles contain a dispute resolution clause and the question is about the international jurisdiction of courts. See Case C-214/89 Powell Duffryn v Petereit [1992] ECR I-1745, paragraphs 15–17. See also Østergaard K, Fusionsdirektivets internationale process- og privatretlige implikationer I EU, NTS 2006:4 pp 46–60.

erning law. Company law matters will generally (in jurisdictions that apply the incorporation theory) or at least to a large extent (in jurisdictions that apply the company seat theory) be governed by the law of the country in which the company has been formed (section 6.2.2; for incorporation, see Volume I).

The law governing company law matters is important, because the existence of the company, the capacity of the company to enter into contracts, the power and authority of its representatives to bind the company, the limited liability of its shareholders, and many questions relating to the internal decision-making of the company or its capital are governed by this law (for counterparty corporate risk, see section 6.2). The company law of country A may be more favourable than the company law of country B in the circumstances.

Third, the firm may ensure that the company's effective management is located in the country in which the company has been formed.

This can be important when doing business in countries that apply the company seat theory (real seat doctrine, Sitztheorie).[312] The recognition of companies can be governed by different principles in different jurisdictions, and sometimes the company is not recognised unless its effective management – company seat – is in the country under the laws of which it has been formed. In any case, the firm should be particularly careful where the effective management of the company is not in the country of incorporation.

It is worth noting that this risk has been reduced in the EU. A company incorporated in one Member State and having its effective management somewhere in the EU will be recognised in the other Member States under the EC Treaty and the case-law of the ECJ. The ECJ has held that a necessary precondition for the exercise of the freedom of establishment is the recognition of those companies by any Member State in which they wish to establish themselves.[313] These principles are applied both in the firm's country of origin and the host country.[314] This forced countries like Germany and Austria to abandon the seat theory.

Fourth, the law governing company law matters may provide that acts done by the company through a certain person or persons are binding on the company; in such a case, the firm should deal with another company through these persons. This question will be discussed in the context of representation in more detail (section 6.2.3).

Fifth, the firm should ensure that it has taken adequate corporate action to make its contracts binding. This question will also be discussed below.

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312 For the benefits of the real seat doctrine, see Schmidt K, Sitzverlegungsrichtlinie, Freizügigkeit und Gesellschaftsrechtspraxis, ZGR 1999 pp 23–24; Roth WH, From Centros to Ueberseering: Free Movement of Companies, Private International Law, and Community Law, ICLQ 52 (2003) pp 181–182.

313 Case C-208/00, Überseering BV v Nordic Construction Company Baumanagement GmbH (NCC) [2002] ECR I-9919, paragraph 59.

314 Case C-9/02, Hughes de Lasteyrie du Saillant [2004] ECR I-2409, paragraph 42.

Mitigation of Risk in Insolvency Law

The rules dealing with insolvency, bankruptcy, and similar events are mandatory. There are nevertheless various kinds of insolvency-related rules. The firm must basically comply with all applicable insolvency laws, but non-compliance can mean different things in different contexts.

Effect of non-compliance. Some sanctions may typically be applied to the debtor. Non-compliance may in this case result in penal sanctions or civil liability, and these sanctions may be applied at the level of the debtor's owners, the debtor, the debtor's statutory bodies (such as its board or auditors), or the debtor's management, as the case may be.

Some sanctions may typically be applied to the creditor. Non-compliance may in this case result in: penal sanctions; civil liability or a duty to make payments; contractual terms being void; the exhaustion of previously valid claims; or claims becoming unenforceable.

On the other hand, the effect of insolvency laws can be to make otherwise binding contractual terms unenforceable (see section 9.6.3).

Mitigation of risk. There are two basic ways to mitigate the risk that contract terms are not binding or enforceable due to mandatory provisions of insolvency law.

The first is not to deal with a company in the first place when the company is insolvent or when there is reason to suspect that the company may become insolvent during the term of the contract. This is because insolvency laws are typically applied to acts done during a certain short period of time before the commencement of formal insolvency proceedings (for private equity and refinancing, see Volume III).

The second is to avoid terms that make the obligations of the debtor due and payable as a result of the commencement of formal insolvency proceedings or the debtor becoming insolvent in the legal sense (acceleration, section 6.3.3). Insolvency laws often restrict the validity or enforceability of such terms (for example, this has made it necessary to adopt specific rules for netting, section 9.6.5). The risk of non-compliance is generally lower where the acceleration is triggered by events prior to the debtor becoming insolvent and the acceleration will not make the debtor insolvent.

However, even terms that would be unenforceable or non-binding against an insolvent debtor are often necessary to mitigate credit risk (section 11.6.2). It is worth noting that terms that cannot be enforced against the debtor due to mandatory insolvency laws might be binding and enforceable against other creditors or co-debtors depending on the governing law.

Mitigation of Risk in the Law of Property

The law of property affects the effectiveness of security or proprietary rights and the finality of funds transfers. There is a difference between contract law and the law of property. Matters that belong to the law of property are to a very large extent governed by mandatory laws, and the parties are not free to choose the governing law as such.

Mandatory provisions of law. While contract law is based on the principle of party autonomy, it is also a general principle of law that the parties to the contract are not free to create binding rights or obligations for third parties. As a rule, a contract is binding on its parties but not on outsiders, and a contract does not pass on benefits to a third party. In common law countries, this principle is called privity of contract.

In civil law countries, a distinction is also made between the law of obligations (Schuldrecht) and the law of property (Sachenrecht). While the former deals with the relationship between contract parties, the latter deals with rights to movable or immovable property, or rather, the relationship between persons who might claim rights to the same property. These legal rules are usually mandatory, and there is an exhaustive list of types of possessory or proprietory rights (numerus clausus principle); the firm should adapt the transaction to these rules in order to achieve the desired outcome.

In civil law countries, third parties are often protected by the requirement that the assignment of security or proprietary rights is not enforceable against third parties – and sometimes not binding between the contract parties - unless certain publicity requirements are met. Depending on the type of property, this requirement may include: the physical transfer of possession; the separation of the property from other property; the making of a notification of the transfer; or the filing of information with a public register.

Compliance. The firm should therefore adapt the transaction to mandatory rules in order to achieve the desired outcome. Before complying with the mandatory provisions of law, the firm should identify the governing law.

Governing law. Matters that belong to the law of property are often governed by the law of the country where the assets are situated (the law of the *situs*, lex situs). There are some differences depending on the nature of the assets (immovable or movable property; tangible property or intangible property; receivables or securities) and the exact nature of the question (the obligation to transfer property; the transfer of property; the effect of the transfer on third parties).

This means that the law governing part of the transaction can change depending on where the property is situated and where different acts are done.

Mitigation of risk. The firm has few legal options when trying to reduce the risk relating to the law of property.

The firm should first make sure that the contract terms are binding and enforceable in contract law. The next step is compliance with the mandatory provisions of property law.

In principle, the firm can choose a country with rules acceptable to the firm and ensure that the assets will be located in this country according to the rules that would be applied by the forum. The firm should comply with the law of this country (lex situs) if it wants the security or proprietary rights to be effective and the funds transfers final. It would normally be necessary to find out about any possible publicity requirements and comply with them.

In practice, however, the physical transfer of assets to a country with rules acceptable to the firm is seldom a real option because proprietary rights issues arise wherever the firm does business and the firm usually prefers to do business in many countries.

Sometimes it is nevertheless a real option. For example, central counterparties are usually located in jurisdictions with a legal framework that supports the finality of settlement.[315] Furthermore, funds are deposited in financial institutions that are perceived as safe in this respect.

Mitigation of Risk in Competition Law

The main rule is that competition law is mandatory, meaning that the firm must adapt its contract terms. The firm can reduce the risk of non-compliance by: limiting the effect of the contract only to certain countries; avoiding contract terms most likely to breach competition laws; and/or obtaining the competent competition authorities' consent (for competition law compliance, see Volume I; for merger control, see Volume III).

Mandatory provisions. Certain types of contracts or contract terms are prohibited almost without exception. Such contracts include, for example: the fixing of prices; the partitioning of market segments; and the sharing of markets.

According to the EC Treaty, any agreements or decisions prohibited pursuant to Article 81 are void. Regulation 1/2003[316] provides that companies may be fined up to 10% of their total annual turnover for breach of Articles 81 or 82 of the EC Treaty.[317]

Some Member States have also adopted criminal sanctions. For example, conspiring to rig markets is punishable by prison in Germany, France, Ireland and Britain as well as Japan, Canada and the US.[318]

Avoidance. The international scope of domestic competition law rules may make it necessary to limit the effect of the contract only to certain countries. According to the "effects doctrine", domestic competition laws are applicable to foreign firms when their behaviour or transactions produce an "effect" within the domestic territory. According to this doctrine, the "nationality" of firms is irrelevant for the purposes of antitrust enforcement.

The international scope of EU competition law is based on this doctrine. In *Gencor*, the Court of First Instance stated that the application of the Merger Regulation to a merger between companies located outside EU territory "is justified

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[315] See BIS, Committee on Payment and Settlement Systems, Recommendations for Central Counterparties, CPSS Publications No 64 (November 2004), paragraphs 4.1.7 and 4.1.8.

[316] Regulation 1/2003 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty.

[317] See also Guidelines on the method of setting fines imposed pursuant to Article 23(2)(a) of Regulation No 1/2003. Official Journal C 210, 1.09.2006 pp 2–5.

[318] Well-dressed thieves. Why the threat of prison is necessary to deter cartels, The Economist, February 2008.

under public international law when it is foreseeable that a proposed concentration will have an immediate and substantial effect in the Community".[319]

Prior consent. The firm might also be able to obtain the prior consent of competition authorities. In the US, the firm can ask for a consent degree. In the EU, the Commission can adopt commitment decisions under Regulation 1/2003.

Where there is a risk that an agreement or practice could be prohibited, undertakings can offer the Commission commitments such as to meet its concerns. The Commission can then adopt decisions which make those commitments binding on the undertakings concerned. In a commitment decision, the Commission states that there are no longer grounds for action by the Commission. However, the Commission does not say whether or not there has been or still is an infringement.[320]

Commitment decisions are legally enforceable. All national courts and authorities have a duty to enforce them when necessary.[321] They may not decide that conduct clearly permitted by the commitment is contrary to EU competition law.[322]

However, national courts and authorities may decide that conduct clearly permitted by the commitment is contrary to national competition law.[323]

The Commission is likely to use commitments in cases in which it is not clear that a fine would be justified, the facts or the legal rules are unclear, and the case would involve a lot of work for the competition authority. They are also likely to be used in cases in which an effective remedy would be complicated to work out and difficult to impose.[324]

Where the public interest of the Community so requires, the Commission can also adopt a decision of a declaratory nature finding that the prohibition in Article 81 or Article 82 of the Treaty does not apply, with a view to clarifying the law and ensuring its consistent application throughout the Community.[325]

The Commission has similar powers in merger control. According to the EC Merger Regulation, the Commission may declare concentrations compatible with the common market.[326]

Leniency (whistle-blowing). In December 2006, the Commission adopted a revised Leniency Notice.[327] The purpose of the revised Leniency Notice is to reward companies that report cartels by giving full immunity or a reduction in fines to the first company to confess to the Commission their existence.

Choice. The choice between different ways to tackle competition law problems requires careful analysis. For example, the firm may employ specialist lawyers to

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[319] Case T-102/96, Gencor Ltd v Commission [1999] ECR II-0753 at paragraphs 89–92.
[320] Recital 13 and Article 9 of Regulation 1/2003.
[321] Article 10 of the EC Treaty.
[322] Article 3(2) of Regulation 1/2003.
[323] Article 3(3) of Regulation 1/2003.
[324] Temple Lang J, Some unanswered questions in the decentralisation of European Community competition law. Portuguese Competition Authority Seminar - Lisbon, October 23, 2006, paragraph 3.5.
[325] Recital 14 and Article 10 of Regulation 1/2003.
[326] Article 6 of Regulation 139/2004 (the EC Merger Regulation).
[327] Commission Notice on Immunity from fines and reduction of fines in cartel cases, OJ 2006/C 298/11 pp 17–22 .

recommend whether to ask for leniency, or whether to offer a commitment rather than arguing that no infringement has been committed. If the firm offers a commitment, the firm should negotiate acceptable terms carefully.[328]

5.4 Binding Terms Not Enforceable

5.4.1 Introduction

Legally binding contract terms are not always legally enforceable. This is normally caused by the insolvency of the other party (section 9.6.3) or the lack of legal remedies. The lack of legal remedies is sometimes caused by the regulation of the recognition of judgments or the availability of specific performance.

5.4.2 Recognition and Enforcement of Judgments

The risk relating to the recognition of foreign judgments and arbitral awards has already been discussed above (section 4.4.4). This risk can effectively be managed by the dispute resolution clause.

The "Brussels I" Regulation provides for the mutual recognition of judicial decisions in civil matters throughout the EU.

The firm can therefore mitigate the risk relating to the recognition of judgments by: (1) agreeing that a court or courts of a Member State have jurisdiction to settle any disputes which have arisen or may arise in connection with a particular legal relationship; (2) ensuring that this agreement (prorogation agreement) satisfies certain requirements as to form;[329] and (3) bringing proceedings before this court or one of these courts.

Alternatively, the firm can benefit from the New York Convention on the Recognition and Enforcement of Foreign Arbitral. The New York Convention also lays down requirements as to the form of the arbitration clause.[330]

5.4.3 Availability of Specific Performance

The right to claim specific performance depends on the obligation. In principle, there is a difference between monetary obligations and non-monetary obligations

[328] Temple Lang J, Some unanswered questions in the decentralisation of European Community competition law. Portuguese Competition Authority Seminar - Lisbon, October 23, 2006, paragraph 8.1; Temple Lang J, Commitment Decisions under Regulation 1/2003: Legal Aspects of a New Kind of Competition Decision, ECLR 24 (2003) pp 347–356.

[329] Article 23 of Regulation 44/2001 (Brussels I).

[330] Article II of the New York Convention.

on one hand,[331] and between continental European legal systems and common law legal systems on the other.

Monetary obligations. In continental Europe, the main rule is that a creditor may require the performance of a contractual obligation to pay money. In common law countries, there is a similar rule. An action for an agreed sum of money is also generally available under common law.

Non-monetary obligations. As regards non-monetary obligations, the right of the creditor to required performance can be subject to limitations.

In continental Europe, the main rule is that the aggrieved party may claim performance of the contract and obtain a judgment ordering the obligor to fulfil it.

In common law countries, the main rule is that the specific performance of non-monetary obligations is a discretionary remedy based on equity, and it is only granted if compensation for damages would be inadequate.

At first sight, it would seem that the right to claim specific performance is much wider in civil law countries.[332] In practice, however, the differences are less striking.

First, the right to claim specific performance is subject to limitations even in civil law countries due to the general principle of good faith. The aggrieved party may therefore pursue an action for specific performance only if the party has a particular interest in performance that cannot be adequately satisfied by compensation.

Second, there are common limitations to the right to claim specific performance in common law countries and continental European countries: (a) Specific performance is not normally available where the performance of the obligation has become impossible or unlawful or specific performance is deemed unreasonable. (b) In addition, it might not be available where the obligation is of a personal character. For example, the obligation might be an obligation to provide services or carry out work of a personal character, or the obligation could depend on a personal relationship. Such obligations might be found, for example, in commercial agency contracts, sole distributorship contracts or partnership contracts.[333]

Mitigation of risk. The risk relating to the availability of specific performance can be mitigated but not excluded. Because of restrictions on the availability of specific performance in common law jurisdictions, it is more usual to address this risk in Anglo-American contract practice. The unavailability of specific performance is normally compensated by contractual terms that make it easier for the aggrieved party to claim compensation. Both the obligations of the other party and the sanctions for their breach might thus be set out in detail in the contract.

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[331] See also DCFR III.–3:301 and III.–3:302.

[332] This helps to explain why Article 28 of the CISG preserves the discretion exercised by common law courts: “If, in accordance with the provisions of this Convention, one party is entitled to require performance of any obligation by the other party, the court is not bound to enter a judgment for specific performance unless the court would do so under its own law in respect to similar contracts of sale not governed by this Convention.”

[333] See also DCFR III.–3:302; PECL Article 9:102(2).

5.5 Binding Terms Too Rigid

5.5.1 Introduction

The firm cannot assess cash flow and risk under a contract unless it defines the parties' rights and obligations. The firm can reduce uncertainty by careful drafting (section 2.5). For example, the firm can fix the price and other core commercial terms once and for all. However, the firm may find the terms of the contract too rigid after changes in the availability of useful information, the bargaining power of the parties, or other circumstances.

Circumstances. Circumstances can change and have an adverse effect on the economic equilibrium of the contract. In the worst case, the contract may give the other party an incentive to behave opportunistically, or the other party may be entitled to windfall gains at the expense of the firm.

This risk is particularly high in two types of contracts. "Relational contracts" require closer cooperation between the parties compared with traditional contracts for exchange. Relational contracts can require flexibility and open terms. The risk is also particularly high in long-term contracts.[334]

Information. The reliability of information can change over time. There is a connection between the risk that the contractual framework is too rigid and the reliability of information.

The reliability of information is not static. Information about things that have happened in the past tends to be more reliable than information about things that might or might not happen in the future.

At the time of contracting, the firm needs information about things that influence cash flow and risk. The firm needs reliable information about past things and useful information about things that will happen in the future.

The firm may nevertheless conclude the contract and agree to its terms although it does not have such information. The firm may also have sufficient information at the time of contracting but become better informed during the term of the contract.

As information is revealed and becomes more accurate during the contract period, there can be a conflict between the terms that the firm has agreed to and the terms that the firm should have agreed to if the firm had had the information that it has at a certain point of time after contracting.

Bargaining power. The bargaining power of the firm can change over time. If it changes to the benefit of the firm, the firm might find the original terms too rigid. Rigid terms can prevent the firm from renegotiating them. They can also restrict opportunistic behaviour by the firm.

Contractual framework. It is also possible that the contractual framework is too large and detailed. It can be difficult to comply with all terms because of their sheer number; the contractual framework can also become internally incoherent the more complex it is.

[334] See Berger KP, Renegotiation and Adaptation of International Investment Contracts, Vanderbilt J Transn L 36 (2003) pp 1348–1349.

Contributory legal risks. The firm might find the contractual framework too rigid even for other reasons. Generally, too rigid contract terms can increase contributory legal risks (legal risks that increase other risks). For example, the commercial risks relating to the investment project are likely to be higher if the legal framework does not address the possibility that the surrounding circumstances will change for the worse.

5.5.2 Community Law

Community law does not address the risk of a change in circumstances in commercial contracts. Community institutions have not adopted any legal instruments that would make rigid commercial contracts more flexible and dynamic. In contrast, the principle of the protection of legitimate expectations is one of the fundamental principles of the Community.[335]

On the other hand, Community law can be the cause of changes in the legal framework of the project (section 4.4.2), and there can be competition law constraints on the use of various contract terms.[336]

Competition law. For example, EU competition law can influence the duration of long-term contracts. Although long-term contracts are not as such illegal under EU competition law, some long-term contracts restrict competition and are prohibited.

In October 2007, the Commission increased competition in the Belgian gas market. *Distrigas*, the largest gas supplier and importer in Belgium, made several commitments and promised to reduce the volumes of gas sold in Belgium that are tied to it under long-term contracts.[337] In the context of the *Distrigas* case, the Commission explained that the Commission focuses on five elements when assessing the likely positive and negative effects on competition in individual cases: (i) the market position of the supplier; (ii) the share of the customer's demand tied under the contract; (iii) the duration of the contracts; (iv) the overall share of the market covered by contracts containing such ties; and (v) efficiencies. In the *Distrigas* case, the Commission considered that no competition concerns would arise if the contracts that lasted for more than a year would cover less than 20% of the market.[338] – The Distrigas case was preceded by the decision of the Bundeskartellamt against *E.On Ruhrgas* in January 2006.

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[335] See, for example, Case C-17/03 VEMW [2005] ECR I-4983, paragraph 73.

[336] Articles 81 and 82 of the EC Treaty.

[337] The commitments are summarised in the notice published in the Official Journal on 5 April 2007 (OJ C77). Distrigas agreed to ensure that on average 70% of the gas that it had contracted to supply to customers covered by the commitments will return to the market every year. Under the commitments, Distrigas also agreed not to conclude new gas supply contracts with gas resellers for a duration of over two years. The maximum duration of new contracts with other large gas customers (industrial consumers and electricity generators) was five years."

[338] Commission of the European Communities, Antitrust: Commission increases competition in the Belgian gas market – frequently asked questions, MEMO/07/407, 11 October 2007.

There are even other competition law constraints depending on the category of agreements. For example, the block exemption regulation for technology transfer agreements contains a list of hardcore restrictions of competition. When a technology transfer agreement contains a hardcore restriction of competition, the agreement as a whole falls outside the scope of the block exemption.[339]

5.5.3 Member States' Laws

The main rule under Member States' contract laws is that contract parties must keep their bargain (the principle of the sanctity of contract). Change of circumstances during the term of the contract is not regarded as a sufficient ground to free a party from its obligation to fulfil its contractual obligations.[340] Neither will contracts have to be modified when circumstances change.

The firm should therefore use specific contract terms in order to address the risk of change in circumstances.

On the other hand, in some cases the legal background rules do derogate from the main rule that contract parties must keep their bargain.

Termination at will. Generally, a long-term contract will not binding forever although it is in force for an indefinite period of time. If it is not in force for an agreed contract period, it can be terminated.

Unforeseeable events. In addition, the occurrence of certain unforeseeable events may give the adversely affected party a chance to escape from its contractual obligations, unless the parties have agreed otherwise. In addition to being unforeseeable at the time of contracting, it is normally required that these events must severely prevent the performance of the party's contractual obligations or erode its expected benefits from the contract.

Different legal doctrines. While the existence of these factors may give a party a chance to escape from its contractual obligations in most jurisdictions, there are differences depending on the governing law. Member States' laws are not identical.

First, different legal concepts and doctrines are used in different Member States, and similar concepts such as unforeseeability and serious effect can be understood differently depending on the governing law.

Second, changed circumstances can be addressed by various categories of legal background rules. (a) For example, the relevance of these circumstances and their influence on the contractual relationship depend on the applicable interpretation rules (section 5.2.4). (b) In addition, there are substantive rules that purport to make contracts reasonable (section 5.2.4). (c) In most jurisdictions, it would also be possible to escape from contractual obligations if they have been affected by

[339] See Article 4 of Regulation 772/2004 (TTBER); Commission Notice, Guidelines on the application of Article 81 of the EC Treaty to technology transfer agreements, OJ C 101, 27.04.2004 p 2–42, paragraph 77.

[340] There is in other words no general clausula rebus sic stantibus rule in Member States' contract laws.

unforeseeable circumstances that severely prevent performance or erode the benefits expected from the contract.

Third, different forms of unforeseeability and serious effect may be required depending on the governing law. While a narrow range of excuses is accepted in some jurisdictions, other jurisdictions may be more generous.

In any case, these legal rules and doctrines tend to be applied restrictively in all Member States. The main rule is that parties to a contract must keep their bargain.

Rebus sic stantibus. The principle that contract parties must keep their bargain could in principle be modified by the maxim rebus sic stantibus. The maxim rebus sic stantibus means that the contract remains binding provided that things remain the same as they were at the time of conclusion of the contract. Therefore, it could sometimes give a total or partial relief to a party in case of changed circumstances.

For example, this general principle of law has been recognized and codified in international law. Article 62 of the 1969 Vienna Convention on the Law of Treaties provides that "[a] fundamental change of circumstances which has occurred with regard to those existing at the time of the conclusion of a treaty, and which was not foreseen by the parties, may not be invoked as a ground for terminating or withdrawing from the treaty unless: (a) the existence of those circumstances constituted an essential basis of the consent of the parties to be bound by the treaty; and (b) the effect of the change is radically to transform the extent of the obligations still to be performed under the treaty."

However, the maxim rebus sic stantibus is not normally a sufficient ground for relief in contract law. Instead of this general principle, Member States' laws have adopted more specific legal rules and doctrines such as impediment beyond control, frustration, force majeure, imprévision and Störung der Geschäftsgrundlage.

Termination for an important reason. Under German law, a party may terminate a long-term contract for an important reason.[341] An important reason exists, where the party cannot reasonably be expected to continue the contractual relationship.

Impossibility v hardship. Usually, however, Member States' laws distinguish between events that make performance impossible or quasi-impossible (vis major) and events that make the contract more onerous for one of the parties (hardship).

In cases of vis major, the obligor's non-performance is excused. The contract is terminated, because there is no room for any modification of its terms. One of the examples of the application of this principle can be found in the provisions of the CISG (see below).

In cases of hardship, the main rule is that the parties must keep their bargain. For example, mere economic hardship does not affect international sales under the CISG. The best known exceptions to this main rule include Störung der

[341] Kündigung aus wichtigem Grund, § 314 BGB. For loan agreements, see also § 490(3) BGB.

Geschäftsgrundlage under German law[342] (see below) and the doctrine of imprévision under French administrative law (see below).[343]

Impediment beyond control. The principle that performance can be excused due to impossibility or quasi-impossibility has been applied, for example, in the CISG. The term used in CISG Article 79 is impediment beyond control. The DCFR contains a similar rule on the debtor's excuse due to an impediment.[344]

The CISG provides that "[a] party is not liable for a failure to perform any of his obligations if he proves that the failure was due to an impediment beyond his control and that he could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome it or its consequences."[345]

The scope of this impediment beyond control rule is narrower than the scope of a force majeure clause (see below). The lack of a force majeure clause is therefore not cured by applying CISG Article 79 as a background rule.

The three most important factors that make the relief granted by the impediment beyond control rule narrower include: the fact that acts done by other parties are to some extent attributable to the party itself and therefore not beyond its control;[346] the duty to give notice to the other party;[347] and the fact that the impediment beyond control rule does not prevent either party from exercising any right other than to claim damages.[348]

Frustration. Under English law, the starting point is that a party is not excused from performing his contract merely on the ground that performance turns out to be unexpectedly burdensome or difficult. In principle, a contract may nevertheless be discharged under the doctrine of frustration.

This doctrine can be applied if after the formation of the contract events occur that make its performance impossible or illegal, and in certain analogous situations.[349]

In practice, English courts have been generally reluctant to find that a particular contract has been frustrated. English courts lack a general power to adapt contract terms to changed circumstances or to substitute new terms more suitable for the changed situation.

Force majeure. Under French law, the doctrine of force majeure means that the obligor can be freed from its contractual obligations only in the case of absolute impossibility in the execution of these obligations.

The doctrine of force majeure has imposed three strict basic conditions for excusing the obligor. (a) The performance of contractual obligations can be excused

[342] § 313 BGB.
[343] See also UCC section 2–615 on impracticability. This rule can relieve the seller in cases of severe hardship.
[344] DCFR III.–3:104; PECL Article 8:108.
[345] CISG Article 79(1).
[346] CISG Articles 79(1) and 79(2).
[347] CISG Article 79(4).
[348] CISG Article 79(5).
[349] See Treitel GH, The Law of Contract, Eleventh Edition (2003) p 866.

under the doctrine of force majeure only in cases of impossibility, unless there is a contractual clause to the contrary. Mere hardship is not enough. (b) In addition, the occurrence of a force majeure event must have been unforeseeable. (c) The third condition is that the event must have been unavoidable in the sense that the party invoking force majeure would not have been able to prevent it.

Imprévision. Under French law, the main rule is thus that no relief is granted under the doctrine of force majeure for changed circumstances that make the performance of the contract more onerous but not impossible.

In principle, relief could sometimes be granted under the doctrine of unforeseen events (théorie de l'imprévision). However, this doctrine is only applied to contracts concluded with public entities. It has been applied by French administrative courts.

The doctrine of force majeure can sometimes share the same function as the doctrine of imprévision (and the German rule that addresses Störung der Geschäftsgrundlage, see below). French courts have some flexibility when applying the doctrine of force majeure, and it is applied in light of the good faith and equity requirements set out in Article 1134 of the Code Civil.

Störung der Geschäftsgrundlage. Under German law, a contract can be adjusted or terminated because of "interference with the basis of the contract" (Störung der Geschäftsgrundlage, § 313 BGB). Inserted by the Schuldrechtsmodernisierungsgesetz of 2001, this provision of the BGB codifies the previous theory of Wegfall der Geschäftsgrundlage that was originally based on § 242 BGB (Treu und Glauben). The rule on Störung der Geschäftsgrundlage can even be applied in some cases of hardship.[350] Compared with the doctrines of frustration and force majeure, it has a wider scope and is more generous.

Good faith. Especially in continental Europe, the flexible principle of good faith may be used to address the problem of changed circumstances (section 5.2.4).[351] The principle of good faith can basically be used in three ways: as a rule of interpretation of law; as a rule of behaviour; and as a rule of interpretation of contract.

As said above, the German theory of Wegfall der Geschäftsgrundlage was originally based on the good faith principle set out in § 242 BGB. The good faith principle set out in Article 2 of the Swiss Civil Code (Schweizerisches Zivilgesetzbuch, ZGB) enables parties to terminate long-term contracts due to changed circumstances in the same way as the French principle of force majeure.

[350] A similar rule can be found in US law. See Section 2–615 of the UCC and Section 268 (2) of the Restatement (Second) of Contracts. Relief can be granted under these provisions in the event of commercial impracticability (rather then impossibility under the older common law rule). Excuse or partial relief is awarded if the occurrence of a certain contingency has made the performance of a commercial contract unnecessarily burdensome, unprofitable or unfair to one of its parties.

[351] Generally on this principle Teubner G, Legal Irritants: Good Faith in British Law or How Unifying Law Ends Up in New Divergences, Modern L R 61 (1998) pp 11–32.

Interpretation of contract terms. In addition to the substantive provisions of contract law, rules on the interpretation of contracts can be used to address the problem of changed circumstances. As said above, the latter are influenced by the former: the contens of the substantive provisions of law can influence the interpretation of contracts (section 5.2.4). When the contract contains terms which address the problem of changed circumstances the governing law of the contract can influence their interpretation directly (interpretation rules) and indirectly (provisions of substantive laws as a model).

Material adverse change (MAC) clauses can, in practice, be interpreted differently depending on the governing law and the forum. For example, a German court would be likely to interpret an MAC clause governed by German law more broadly (against the background of the doctrines of Störung der Geschäftsgrundlage and Treu und Glauben) compared with an English court that interprets an MAC clause governed by English law (against the background of the doctrine of frustration) or a French court that interprets an MAC clause governed by French law (against the background of the doctrine of force majeure).

Hardship. If the firm needs to mitigate the risk of a material adverse change in circumstances during the term of the contract and finds a hardship term necessary,[352] the firm should make sure that there is a specific hardship clause in the contract.

The firm should not rely on legal background rules, because the modification of contractual obligations is not normally possible without a specific contract term. Such default rules are rare, because economic hardship does not normally constitute a relief from contractual obligations.[353] The main rule is that courts adhere to the "all or nothing" principle: contractual obligations either stand unamended or disappear altogether.

In exceptional cases, the modification of contractual obligations would be possible in some jurisdictions without the support of an express contract term.[354] For example, § 242 BGB (Treu und Glauben), § 313 BGB (Störung der Geschäftsgrundlage), § 36 of the Swedish Contract Act and similar provisions of other Nordic contract laws enable the courts to set unreasonable contract terms aside or modify them.[355]

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[352] A typical hardship term contains the following elements: (a) Performance need only be excessively onerous, not impossible. (b) The contract is not automatically terminated, but may be modified. (c) Where the parties do not reach agreement within a reasonable time, the court (or the arbitrator) may either terminate the contract at a time and on terms determined by the court, or adapt the contract so as to distribute between the parties in a just and equitable manner the losses and gains resulting from the change of circumstances. See Lando p 369.

[353] See Article 6.2.1 of the UNIDROIT Principles. The mere fact that a contract becomes more onerous for one of the parties should not relieve that party from its obligations. See also DCFR III.–1:110(1) and PECL Article 6:111(1).

[354] Compare Article 6.2.2 of the UNIDROIT Principles. Relief should be available in case of "hardship".

[355] See also Article 6.2.3 of the UNIDROIT Principles. If hardship is available as a relief, the disadvantaged party is entitled to request re-negotiations. If the re-negotiations fail, the contract may either be terminated or adapted so as to restore its equilibrium.

A similar rule can be applied in exceptional cases even according to the DCFR.[356]

Renegotiation. If the parties have not included special mechanisms for dealing with a change in the commercial equilibrium in their contract, a renegotiation or adjustment of the contract to changed circumstances can be considered only where other contractual terms or the applicable law provide an appropriate starting point.[357]

There are differences relating to the effect of renegotiation clauses depending on the governing law. Is there a duty to negotiate[358] or a duty to agree? (a) German law provides for an obligation to reach agreement if the adjustment criteria and the objectives of adjustment have been defined with sufficient clarity.[359] (b) Internationally, however, renegotiation clauses only lay down an obligation to make the best possible effort to reach an agreement. They do not require the parties to actually reach agreement. Their effect is thus similar to that of a "best efforts" clause (section 5.2.5).[360]

The procedural aspects of renegotiation obligations are important, because renegotiation clauses are often complemented by a special review procedure and an arbitration clause. The procedural aspects of renegotiation obligations are governed by lex fori. Typically, arbitration proceedings are also governed by the rules of arbitration chosen by the parties.

5.5.4 Mitigation of Risk

There should be enough built-in flexibility in the contract. Especially relational contracts will not work unless the contract terms leave the parties some discretion. In complex contracts, the parties cannot regulate everything in advance. A party does not know everything that will happen during the term of the contract. Even if the party had knowledge of a certain matter, it might not necessarily understand how to regulate it in an optimal way, or the other party might not accept the optimal term. Legal background rules that govern the contract can rarely solve this problem.

The firm can mitigate the risk that contract terms are too rigid in six typical ways: (1) the firm can use short-term contracts; (2) the firm can have a right to determine the contract terms unilaterally; (3) certain acts can require unilateral consent by the firm (covenants); (4) the firm can use a combination of increased flexibility, terms that make the contract more dynamic, and special review clauses; (5) the contract terms can be determined unilaterally by a third party; and (6) the firm can have an exit right.

[356] DCFR III.–1:110. Compare PECL Article 6:111.

[357] Berger KP, Renegotiation and Adaptation of International Investment Contracts, Vanderbilt J Transn L 36 (2003) p 1350.

[358] Compare PECL Article 6:111(2): "…the parties are bound to enter into negotiations ..."

[359] Berger KP, *op cit*, p 1367.

[360] *Ibid*, p 1367.

Short-term contracts. The use of short-term contracts can increase flexibility. For example, a long-term purchase agreement is more likely to become too rigid compared with purchase agreements negotiated separately for each purchase, and a short-term loan typically gives rise to a lower commercial and credit risk compared with a long-term loan (section 11.3).

In exceptional cases, the use of short-term contracts can be constrained by public policy objectives that protect weaker parties. For example, Member States must take measures to prevent abuse arising from the use of successive fixed-term employment contracts or relationships.[361]

Unilateral determination of terms by the firm. The second way to mitigate this risk is to agree that the firm may determine the contents of certain contract terms.

Before using such contract terms, the firm should make sure that they are binding under the governing law. The use of such terms is often constrained by mandatory rules that purport to make contract terms more reasonable and prohibit manifestly unreasonable contract terms. These mandatory rules may be interpretation rules (section 5.2.4) or substantive rules (section 5.2.6).

For example, German law permits the unilateral determination of contract terms by the firm only provided that the firm may choose between equal alternatives (such as the specifications of nuts and bolts) and that the firm exercises this right in a reasonable way (nach billigem Ermessen) meaning that the balance between the respective obligations of the parties will not be changed.[362] The court is the last resort.[363] An electricity utility that supplies electricity under long-term contracts must observe certain restrictions if it wants to increase the price. Price increases are constrained in two ways. First, the customer can invoke the defence that the price increase is unreasonable.[364] This defence is not available where the contract terms lay down objective criteria according to which the price is increased. In that case, the customer may invoke the second defence. The second defence is that the interests of the customer are unfairly prejudiced by the standard contract terms of the electricity company.[365] The defences have often been applied against electricity companies.[366]

Sometimes it can nevertheless be feasible to use unilateral determination clauses. For example, an electric utility that considers the construction of a power plant that relies on coal for fuel would require assurance of the availability of coal. As the demand for power will be uncertain over the life of the agreement, the utility would also prefer to be able to determine the quantity of coal it will take. Typically, this would take the form of a "requirements contract". A requirements contract provides for filling the buyer's actual purchase requirements for supplies or services during a specified contract period, with deliveries or performance to be

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[361] Directive 1999/70/EC concerning the framework agreement on fixed-term work concluded by ETUC, UNICE and CEEP. See, for example, Teilzeit- und Befristungsgesetz (TzBfG).

[362] § 315 BGB, § 318 BGB, § 375 HGB.

[363] § 315(3) BGB.

[364] § 315(3) BGB.

[365] § 307 BGB.

[366] See Heller HF, Strompreiserhöhungen. Den Schwarzen Peter hat der Stromkunde. FAZ, 27 November 2007.

scheduled by placing orders with the seller. Since the coal supplier is affected by the exercise of that discretion, the contract would usually contain a mechanism to mitigate the coal supplier's risk. This could be a take-or-pay clause. This requires that the utility pay for a minimum amount of coal even if it does not take it all. The contract may state the maximum limit of the seller's obligation to deliver and the buyer's obligation to order. The contract may also specify maximum or minimum quantities that the buyer may order under each individual order and the maximum that it may order during a specified period of time.

Unilateral consent by the firm. Alternatively, the parties may agree that some acts are subject to the firm's consent. For example, negative covenants used in many commercial loan agreements often provide that certain acts require the lender's consent.

Sometimes these rights have been qualified by stating when the consent may be withheld or that the consent may not be withheld unreasonably. Legal background rules often contain a mandatory rule to this effect. (a) A contract governed by English law contains an implied term about the use of discretion. Where A and B contract with each other to confer a discretion on A, the discretion must be exercised honestly and in good faith, and not "arbitrarily, capriciously or unreasonably".[367] The duty not to exercise discretion unreasonably means that approval cannot be withheld arbitrarily or in circumstances so extreme that no reasonable party in the same position could possibly withhold approval.[368] (b) Under German law, contract terms that restrict the autonomy of one contract party in an excessive way can be contrary to "good morals" (sittenwidrig) and illegal under § 318 BGB. Where the contract is governed by German law, parties take this into account when designing negative covenants.[369]

Flexible terms. Contracts are frequently quite specific when it comes to the definition of the core commercial terms of the transaction and the parties' main contractual duties. But it may be difficult to find an expression which is sufficiently specific and at the same time not too narrow.[370] For this reason, the specific terms of the contract will often be complemented by "open" contract terms that can be interpreted in a flexible way. Elements that provide for flexibility will often be complemented by elements that set out how that flexibility will be used (elements that make the contract more dynamic).

Elements that provide for flexibility. Instead of entrusting the determination of contract terms to one of the parties, the parties may resort to open terms in order to allow for adjustments to future contingencies. Open terms will often be qualified with words like "reasonable", "best efforts", "fairness" or "good faith".

Such terms can often be found in long-term relational contracts. As trust and cooperation are vital in order to make these contracts work, the use of open terms

[367] Leggatt LJ in Abu Dhabi National Tanker Co v Product Star Shipping Ltd (No 2) [1993] 1 Lloyd's Rep 397.
[368] Mance LJ in Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd [2001] All ER (D) 33.
[369] See Mülbert PO, Bruinier S, Die Anwendung inländischer Schutzbestimmungen am Beispiel ausländischer Kreditverträge, Wertpapier-Mitteilungen 2005/3 pp 110–111.
[370] Gorton L, "Best Efforts", JBL (2002) p 145.

usually reflects sound commercial practice. On the other hand, the prospect of vengeful retaliation is likely to open up opportunities for amicable co-operation even without open terms, if it is vital for each party to show some flexibility regardless of the wording of the contract (for counterparty commercial risk, see section 6.3.3).[371]

Open terms are not limited to long-term relational contracts. In practically all contracts that require the disclosure of financial information, one can find words such as "true and fair view" or "presents fairly". One of the reasons is the legal requirement to prepare accounts which give a true and fair view of the business in accordance with accounting standards. Ultimately, it is for the court to define the exact meaning of these concepts.

Terms can be even more flexible when they require both parties' consent. However, this alternative requires a great deal of trust between the parties.

Elements that make terms more dynamic. If the open contract terms leave both parties plenty of discretion, it can be necessary for the firm to regulate how this discretion may be used. By using additional contract terms, the firm can change a flexible contract that can be interpreted in many ways (with a high interpretation risk) into a more dynamic contract that is more likely to be interpreted according to the interests of the firm (with a lower interpretation risk).

There are two basic types of clauses designed to make the contract relationship more dynamic. First, the firm can use very general clauses such as clauses that provide for a duty to act "in good faith" or "in a reasonable way". Second, it is possible to draft terms that set out how this discretion may be used. For example, renegotiation clauses and open price adjustment clauses (used instead of automatic price adjustment clauses such as index clauses) belong to this category. It is not unusual to combine these two approaches.

This is done, for example, in the following clause: "If the trigger event happens, the Firm shall consult with the Counterparty whether in the light of all relevant circumstances, and taking into account all payments made, any alterations in the terms of the agreements between the Counterparty and the Firm would be equitable to the parties."[372]

Whereas the duty to consult provides for flexibility in the above clause, the latter part of the clause tells the parties how that flexibility must be used and makes the clause more dynamic.

Renegotiation clauses in particular. Renegotiation clauses are a particular form of open clauses. The reason for using renegotiation clauses can be that neither force majeure clauses nor the hardship concept (see section 5.5.5) offer adequate protection against an adverse change in the circumstances assumed at the initial negotiation and conclusion of the contract.[373]

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[371] See Sharma KM, From "Sanctity" to "Fairness": An Uneasy Transition in the Law of Contracts? NY L School J Int Comp L 18 (1999) pp 165–166.

[372] See Berger KP, Renegotiation and Adaptation of International Investment Contracts, Vanderbilt J Transn L 36 (2003) pp 1358.

[373] *Ibid*, pp 1357–1358.

Renegotiation clauses should not be too open in style. For example, the other party would not have any duty to renegotiate under the following term: “The parties may from time to time by agreement in writing add to, substitute for, cancel or vary all or any of the provisions of this Agreement.[374]

On the other hand, renegotiation clauses should be open to an appropriate degree in order to make the contractual framework flexible and dynamic. Renegotiation clauses are often general enough to accommodate even such hardships where supervening circumstances of any kind have rendered contractual performance not only excessively burdensome but also commercially less attractive.

The key issues that affect risk are usually: (1) the definition of events triggering the duty to renegotiate (trigger events); (2) the exact content of the contractual obligations, in particular whether there is (a) an obligation to negotiate or (b) an obligation to reach a result or a particular result; (3) the legal consequences of failure to fulfil the contractual obligation to negotiate; and (4) the enforceability of the obligation to negotiate, in particular the authority of the court or arbitration tribunal to adapt the contract to the changed circumstances in lieu of the parties.[375]

How well the renegotiation clause will work depends therefore partly on how clearly the trigger events have been defined. The trigger event can be determined in different ways depending, for example, on the duration and complexity of the contract. (a) Some clauses (general review clauses) set out very general conditions. For example, renegotiation under a clause used by the petroleum industry in Ghana could be triggered by “such changes in the financial and economic circumstances relating to the petroleum industry, operating conditions in Ghana and marketing conditions generally as to materially affect the fundamental economic and financial basis of this Agreement”.[376] (b) Other clauses (special risk clauses) trigger the procedure upon the occurrence of one or more events defined more precisely in the clause, such as tax increases, price changes for raw materials, or the materialising of a certain risk.[377]

General review clauses and special risk clauses influence risk in different ways. There is a trade-off between: (a) the advantage of being protected against events that are complex, unforeseen, or influenced by volatile economic determinants; and (b) difficulties in formulating a general renegotiation clause that defines specifically when a change of circumstances and its impact is serious enough to trigger a renegotiation. In addition, there is a trade-off between: (a) the advantage of determining more precisely the beginning of the adaptation procedure; and (b) the disadvantage of having addressed only a specific, more or less strictly limited, type of risk.[378]

Remedies. Contract terms that tell a party how to exercise its discretion are usually complemented by clauses that set out what happens if the party fails to do so. In practice, the functioning of open terms would be too unreliable without ade-

[374] See *ibid*, p 1359.
[375] *Ibid*, p 1361.
[376] *Ibid*, pp 1362–1363.
[377] *Ibid*, pp 1362–1363.
[378] *Ibid*, pp 1362–1363.

quate sanctions such as dispute resolution clauses, termination clauses, penalty clauses, or clauses on liquidated damages.

Typically, the right to terminate the contract or damages for the breach of contractual obligations are not regarded as sufficient remedies, if the contract is flexible and dynamic. This is especially true in tailor-made long term investment projects that are specific to the particular counterparty, because these investments might not be easily transferable and might yield profit only after a long period of time. Part of the investment might be lost if the project were terminated.

Dispute resolution. For these reasons, contract terms that make the contract flexible and dynamic are typically complemented by a dispute resolution clause.[379]

A sample term that makes the contract more dynamic (A) and a simple dispute resolution clause (B) could be combined like this: (A) "If any future law, decree or regulation affects Contractor's financial position, both Parties shall enter into negotiations, in good faith, in order to reach an equitable solution that maintains the economic equilibrium of this Agreement." (B) "Failing to reach agreement on such equitable solution, the matter may be referred by either Party to arbitration."

In some cases, the contract expressly provides that the parties also have the right to call on the arbitral tribunal designated in the contract to decide on the adjustment of the contract on behalf of the parties if negotiations on adaptation foreseen in the contract have failed.[380] Such a clause is called a special review clause. The contract may also contain other kinds of special review clauses.

Special review clauses. Usually, open clauses that make the contractual relationship more flexible and dynamic are complemented by a special review clause.

This is because of the nature of these open clauses. First, it can be difficult for the parties to reach agreement on how to amend the agreement or adapt it to changed circumstances. Second, it is not normally in the firm's long-term interests to terminate the contract or to commence arbitration proceedings for alleged breach of contract by the other party. It is economically more sensible in complex investment projects to adjust parties' obligations than to terminate their business relationship altogether.

For these reasons, a special review clause will define a particular event that will trigger review by an independent party. A special review clause requires that the parties make clear that they wish to transfer to an independent consultant or arbitral tribunal competence that goes beyond normal dispute resolution. The presence of a normal arbitration agreement in the contract will not suffice for this purpose. Instead, an express allocation of the competence to adapt the contract is required.[381]

For example, a simple special review clause could look like this: "Y and X shall mutually agree to nominate an independent consultant and refer the dispute to the independent consultant for a decision on the disputed points. The decision of the independent consultant shall be without prejudice to the rights of either party to submit the dispute to arbitration."

[379] See *ibid*, pp 1368–1378.
[380] *Ibid*, p 1370.
[381] *Ibid*, pp 1378–1380.

Determination by a third party. The parties may agree that some contract terms are determined by a third party. Such clauses are common in particular where technical expertise is necessary. For example, the valuation of the target company may be determined by an outside expert such as an investment bank or auditor.

Where the parties have agreed that certain contract terms may be determined by a third party, the parties are basically bound by the decision of the third party. There are exceptions to this main rule. Member States' laws typically provide that the court may set the decision aside if the decision is manifestly unreasonable. Member States laws provide for limits within which reasonable persons must act. German contract law provides that a third party determining the content of the contract must act in a reasonable way (nach billigem Ermessen);[382] in a case of dispute, the court is the last resort.[383]

The firm typically wants to mitigate the agency problem (section 6.3.3) caused by the discretion granted to the third party. For example, the use of the discretion may be constrained ex ante by contract terms that set out how it may be used (in good faith, the use of a certain valuation method, and so forth) and the limits within which decisions taken by the third party must fit (for example, valuation of the firm, the value of the firm not exceeding x euro). The use of the discretion may be constrained ex post by contract terms that provide for special review or dispute resolution and a possibility to have the decision taken by the third party set aside (see above).

Exit rights. Exit rights belong to the core terms of a long-term contract (generally, see Volume III).

There are different kinds of exit rights. They can be triggered by different events. Depending on the contract type, standard exit rights may consist of: the right to assign the contract (section 11.4); the right to terminate the contract (section 6.3.3); and the right to walk away or let the contract expire without assigning or terminating it in the legal sense.

There are different forms of termination rights. The firm may have a right to terminate the contract: after the expiry of a notice period or with immediate effect; for cause or without cause; and without charge or against a fee.

In addition, there are ways to exit the contract without having a prior right to do so. A contract may be modified or terminated by the agreement of the parties.[384] Alternatively, the firm may prefer to breach the contract and reimburse the other party for damage.[385]

The firm should not rely on legal background rules. A party usually has a right to terminate a contract with immediate effect in the event of a material breach of contract by the other party, but not just by reason of the contract becoming commercially less attractive (section 5.5.3 above). Under German law, a long-term contract can be terminated for an important reason. Generally, a long-term con-

[382] § 317 BGB.
[383] § 319 BGB.
[384] CISG Article 29(1).
[385] CISG Articles 74–77.

tract which is in force for an indefinite period of time will not be binding forever but can be terminated.

Exit rights can be restricted in particular areas like in labour law. For example, discrimination on the basis of age and race is prohibited,[386] and employees are protected when an undertaking is transferred.[387]

5.5.5 Particular Remarks on Material Adverse Change

Introduction

The firm might find a long-term contract too rigid after a material adverse change in circumstances. The change may be unanticipated or anticipated, and it may either be beyond the control of the parties or caused by the voluntary actions of the parties.

Typical unanticipated events that have not been caused by the voluntary actions of the parties include, for example, natural disasters (floods, earthquakes), various forms of social unrest (wars, revolutions, political insurrection), and large accidents (fire).

Typical anticipated events that may be beyond the control of the parties include, for example, changes in market prices (this is what the parties can expect to happen), changes in laws (it is normal that laws are amended), and the withholding of administrative consents (administrative consents are often required, and they are sometimes withheld).

Typical anticipated events that are not beyond the control of the counterparty include, for example, major business decisions such as takeovers.

All such events may occur before the closing of the contract (section 5.6.2) or after closing.

The firm should mitigate this risk by careful drafting. The main rule is that laws will not grant relief just because the contract has become unprofitable. The firm cannot take the risk that unexpected difficulties in reaching its objectives would be solved by the application of legal background rules under the governing law.

Mitigation of the Risk of a Material Adverse Change

It is normal to make provision for changed circumstances in the contract. The risk of a material adverse change can be addressed in many ways. First, the firm can use a termination clause. Second, the firm can protect itself by an early warning

386 Article 3(1)(c) of Directive 2000/78/EC; Case C-303/06 Coleman, paragraphs 3 and 37. Directive 2000/43/EC; Case C-54/07 Centrum voor gelijkheid van kansen en voor racismebestrijding v Firma Feryn NV, paragraph 24. Vom Stein J, Bei Kündigungen darf das Alter weiterhin eine Rolle Spielen, FAZ, 17 September 2008 p 23 (discussing das Allgemeine Gleichbehandlungsgesetz, AGG).

387 Article 1 of Directive 2001/23/EC. Case C-458/05 Jouini et al [2007] ECR I-7301, paragraphs 23–27 and 31–32. For the lack of rules on financial compensation, see Case C-396/07 Mirja Juuri v Fazer Amica Oy, paragraph 35.

system combined with exit rights (covenants). Third, the contract can also contain particular material adverse change clauses, force majeure clauses, and hardship clauses. Fourth, the contract can provide for an escape by setting out the only sanctions for the firm's breach of contract. Fifth, the risk of material adverse change can partly be addressed by the obligations of the other party.

Open rather than specific clauses. Clauses that address material adverse change can be either general in nature and formulated in an open way, or specific and deal with specific events.

Typical "open" clauses that protect the firm in uncertain economic environments include particular material adverse change clauses, force majeure clauses, and hardship clauses.

These "open" clauses typically contain a reference to a number of specific events. A broad or open-ended term can be combined with a series of more restrictive terms in the text; these clauses often contain [a] an open description of events combined with [b] several examples of the events covered by it. The combination of [a] and [b] could look like this: [a] "conditions beyond the party's control …" [b] "… such as, but not limited to, war, strikes, fires, floods, acts of God, governmental restrictions, power failures, or damage or destruction of any network facilities or servers".

In order to mitigate interpretation risk, it is often better to specifically set forth some of the most important specific events rather than just rely on an open term. On the other hand, restrictive terms combined with an open term can also influence the interpretation of the clause and make the clause narrower (for the "ejusdem generis" rule, see section 5.2.5). For this reason, it is normal to add the phrase "such as, but not limited to" between the open term and the more restrictive terms.

Specific rather than open clauses. In addition to "open" clauses such as particular material adverse change clauses, force majeure clauses and hardship clauses, the firm may use clauses that are more specific.

These clauses may alter the obligations of the parties if a specific event occurs. For example, a struggling football club playing in the English Premier League would make sure that there are clauses inserted in players' and the manager's contracts that will trigger cuts in pay in the event of relegation.

Specific clauses may also exclude the obligations of the firm or provide other relief if a specific event occurs. For example, the contract of a football star with his club may contain various get-out clauses depending on the team's performance.

Covenants. A contractual early warning system typically consists of covenants.[388] Such covenants are typically used in combination with termination clauses. The most common forms of covenants include: affirmative covenants;[389]

[388] See, for example, Diem A, Akquisitionsfinanzierungen. C.H. Beck, München (2005) § 23.

[389] Affirmative covenants can include, for example, the requirement to comply with laws or to maintain insurance coverage. In a loan agreement, one of the most typical affirmative covenants is the pari passu clause: "All the obligations and liabilities of the borrower under this contract rank, and will rank, either pari passu in right of payment with or senior to all other unsubordinated indebtedness of the borrower."

negative covenants;[390] financial covenants; and reporting requirements (information undertakings).

The purpose of a covenant package is to set the business parameters within which the other party can operate efficiently but which the other party may not exceed. These covenants can be complemented by reporting requirements that enable the firm to monitor the other party. Reporting requirements can provide a timely warning of any adverse change in counterparty commercial risk. In a loan transaction, they can provide information about any potential downgrade in the creditworthiness of the borrower. A further purpose to use covenants in a commercial loan transaction is to earn agreed waiver fees every time a covenant is breached.[391]

The use of covenants depends on the nature of the transaction. For example, a high-yield investor would expect to see a very defined and established set of covenants in any documentation relating to a high-yield deal.

A typical high-yield covenant package would include covenants restricting the following: indebtedness (including preferred stock); liens; restricted payments (dividends and so forth); payment restrictions affecting subsidiaries; sale and leaseback transactions; asset dispositions; ownership of subsidiaries; transactions with affiliates; and mergers and consolidations. In addition, the covenants would also include a change of control provision and a clause requiring the provision of certain financial information to noteholders.

Sanctions for breach of contract. One of the ways to address the problem of material adverse change is to regulate the only sanctions for the firm's breach of contract in advance. These clauses typically exclude specific forms of liability or limit the liability of the firm generally.

Exemption or relief clauses or caps can be found in most international commercial contracts, because they belong to the fundamental ways of determining the maximum extent of the firm's obligations in advance (section 2.5.2). For example, it would be normal for the firm to [a] exclude its own liability for indirect or consequential loss or damage and to [b] limit its overall liability for loss or damage to a certain amount of money. Such a clause could look like this: [a] "Limitation of Liability. Under no circumstances shall the Firm be liable to the other Party or any other person for any indirect, special, incidental or consequential loss or damage." [b] "Further, in no event shall the Firm's liability under any provision of this agreement exceed the license fee paid to the other Party."

One of the specific clauses that can be used to mitigate the risk of changed circumstances in financial transactions and buy-outs is simply the right to walk away against the payment of a (usually large) break-up fee.

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[390] In a loan agreement, a typical negative covenant could be the negative pledge: "The borrower covenants that it shall not directly or indirectly create, incur, assume or permit to exist any lien on or with respect to any property or assets of the borrower."

[391] Switching off the lites, The Economist, October 2007: "Whereas covenants exist mainly to keep companies on the straight and narrow, they also earn banks a handsome fee each time they are breached. That is an incentive to be tough."

A termination fee and a contractual exclusion of other remedies were used in the United Rentals case. On 22 July 2007, Cerberus Capital Management agreed to acquire United Rentals for $34.50 per share in cash. On 14 November 2007, Cerberus informed United Rentals that it was not prepared to proceed with the purchase on the terms set forth in the Merger Agreement. Cerberus specifically confirmed that there had not been a material adverse change at United Rentals. However, the global financial crisis of 2007 had made it difficult for private equity funds to raise low cost finance. This forced Cerberus to pull its offer. United Rentals sued Cerberus and tried to force the takeover. However, it lost. According to the contract, Cerberus had a right to pull out of the deal at any time if it paid a fee of $100 million. – In contrast, Kohlberg Kravis Roberts & Co. (KKR) and Goldman Sachs Group's private equity unit backed out of their buyout of Harman International Industries citing “a material adverse change in Harman’s business”.[392]

Material adverse change clauses. Now, what do material adverse change clauses, force majeure clauses and hardship clauses mean?

Material adverse change (MAC) clauses are most commonly used in “relational” or long-term contracts (such as project finance contracts or credit agreements) or, before closing, in any major contracts (section 5.6). MAC clauses are used to circumvent many of the constraints of frustration, force majeure and unpredictability clauses. MAC clauses are typically more flexible than force majeure clauses.[393]

An MAC clause refers fundamentally to the occurrence of an event that may lead to a significant negative change in return or risk. These events may often relate to disruptions in the markets, government or administrative actions, or the assets or profitability of the counterparty.

The choice of these MAC events partly depends on the remedies available to the firm upon the occurrence of an MAC event, and vice versa. The choice of MAC events and the remedies attached to the MAC clause also depend on whether the MAC clause can be invoked not only by the firm but also by its counterparty.

Typical MAC clauses may take the form of: (a) a condition to the completion of the contract (section 5.6.2); (b) a promise that no MAC has occurred since a certain date; or (c) a promise that no MAC will occur during the term of the contract (for credit enhancements, see section 11.6.2). Typical MAC clauses that relate to the time after the completion of the contract can thus be found in a representation or warranty by the counterparty as to the absence of any material adverse change and as an event of default triggered by a material adverse change.

The occurrence of an MAC can be determined in a number of ways. However, the parties often choose one of three alternatives: (1) the firm may be given some discretion to determine whether an MAC has occurred; (2) the MAC is triggered by the occurrence of certain objectively identifiable facts; or (3) the MAC is triggered by the occurrence of these objectively identifiable facts provided that this

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[392] See, for example, Schäfer D, Streit um abgesagte Übernahme. Der Höllenhund Cerberus mag nicht mehr fressen, FAZ, 23 November 2007 p 19.

[393] Julien F, Lamontagne-Defriez JM, Material Adverse Change and Syndicated Bank Financing: Part 1, JIBLR 19(5) (2004) p 172.

adverse change in the circumstances is likely to prevent the counterparty from fulfilling its obligations.[394]

For example, the first alternative was used in the English case of *BNP Paribas SA v Yukos Oil Company*.[395] Events that had a "Material Adverse Effect" had been defined in a loan agreement between a syndicate of 13 banks and Yukos as events that had "in the opinion of an Instructing Group [representing the Banks] a Material Adverse Effect on: (a) The business, condition or production or export capacity of the Group taken as a whole; (b) The ability of … the Borrower [and several other connected parties] to perform its obligations under any of the Finance Documents; or (c) The legality, validity or enforceability of any of the Finance Documents or the rights or remedies of any of the Finance Parties under any of the Finance Documents".

A number of circumstances constituted an Event of Default upon the declaration of which the whole of the amount outstanding under the Loan Agreement would become repayable. These circumstances included, for example, the following: "If any event or circumstance occurred which (in the reasonable opinion of an Instructing Group) had or might reasonably be expected to have a Material Adverse Effect ..."

In July 2004, the Facility Agent representing the banks declared an Event of Default in the following terms: "We write to you in our capacity as Facility Agent under the above loan agreement … The Lenders have determined, by unanimous vote, that an Event of Default has occurred under Clause 19.27 (Material Adverse Change) of the Loan Agreement. We hereby give you notice, at the instruction of an Instructing Group, that an Event of Default has occurred under Clause 19.27 (Material Adverse Change) of the Loan Agreement …"

MAC clauses need to be complemented by a term that lays down the remedies available to the firm should such an event occur: (a) If the MAC clause is a condition to the completion of the contract, the clause is normally complemented by a term that gives the firm the right to walk away from the contract (section 5.6.2). (b, c) If the counterparty promises that no MAC has occurred after a certain date, or that no MAC will occur during the life of the contract, it is normal to choose one of three possible remedies: (I) The parties may agree that an MAC amounts to an event of default; it is then necessary to agree on the remedies available to the firm in an event of default. (II) The parties may also agree that the firm may terminate the contract. The MAC clause can thus provide for an exit mechanism. (III) Alternatively, the firm may reserve an option to adjust the contract (section 5.5.4 above).

These clauses should be drafted carefully because an "open" MAC clause may not always provide the protection the firm is seeking. (a) It is usually easier to combine an "open" MAC - a very generally drafted MAC - with a term that pro-

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394 See also *ibid*, p 172: "An MAC clause can take three principal forms: • one which allows lenders to determine, in a more or less subjective and discretionary way, whether a significant adverse change has occurred; • that of the single-shot, which is triggered at the moment of the occurrence of a significant adverse change in the financial or operating situation of a borrower; • that of the dual test, which is satisfied only (a) at the point when a material adverse change occurs and (b) if that change is likely to prevent the contracting party from fulfilling its obligations."

395 BNP Paribas SA & Ors v Yukos Oil Company [2005] EWHC 1321 (Ch).

vides for renegotiation than an automatic right to terminate the contract, because the flexibility of such a term might encourage the other party to sue the firm for breach of contract should the firm terminate the contract on this ground. (b) On the other hand, where the firm wants to protect itself against a specific event, the firm should insert this event and the remedies for its occurrence as a separate term rather than seeking to rely on a general MAC clause. If possible, the MAC should be defined with simple objectively identifiable facts. (c) It may also be necessary to complement a general MAC clause with a term that gives the firm the right to terminate the contract upon the occurrence of certain specific events. The lack of such a term may increase the risk that the counterparty may sue the firm for breach of contract should the firm terminate the contract instead of renegotiating its terms under the MAC clause.

There is even more reason to be careful when drafting an MAC clause if not only the firm but even its counterparty may rely on it.

Material adverse effect clauses. In principle, there could be a distinction between material adverse change (MAC) clauses and material adverse effect (MAE) clauses. An MAC clause might refer to events which, if they occur, prevent a party from getting the benefit of the bargain, while the MAE could describe the negative consequences of such events. Generally, such a distinction does not seem to bring any clear legal benefits.[396]

Force majeure clauses. Other general or "open" clauses that address the risk that there will be a material adverse change in circumstances include force majeure clauses. Force majeure clauses can routinely be found in most major commercial contracts.

The purpose of the force majeure clause is to deal with the risk that the firm may find itself in the position of having to default because of events beyond its reasonable control. Force majeure clauses serve primarily as precautions against the risks posed by economic, political or social events unforeseeable at the time of contracting, though without the aim of ensuring or re-establishing the commercial equilibrium of the contract.[397]

Force majeure clauses are normally designed in the interests of the performing party. They excuse the party from liability if some unforeseen event beyond the control of that party prevents it from performing its obligations under the contract.

Force majeure clauses do not usually cover the obligation just to pay money. First, the obligation to pay money would seldom be impeded by the occurrence of force majeure events. Second, unlike MAC clauses, force majeure clauses do not regulate the firm's frustrated objectives. It is thus normal to exclude the obligation to pay money, for example, in the following way: "Neither party shall be liable for any failure or delay in performance under this Agreement (other than for delay in the payment of money due and payable hereunder) …"

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[396] Julien F, Lamontagne-Defriez JM, Material Adverse Change and Syndicated Bank Financing: Part 1, JIBLR 19(5) (2004) p 174.

[397] See Berger KP, Renegotiation and Adaptation of International Investment Contracts, Vanderbilt J Transn L 36 (2003) pp 1351–1352.

Force majeure clauses typically contain a long list of circumstances that prevent or hinder performance. There are pre-formulated clauses that can be used as a model. For example, the International Chamber of Commerce (ICC) has designed the ICC Force Majeure Clause 2003 to facilitate the drafting process for businesses. These ICC model clauses set out: (a) a list of force majeure events; (b) the consequence of force majeure; (c) when force majeure can lead to termination of the contract; and (d) when the party must give notice of the force majeure event.

Like specific MAC events, specific force majeure events are complemented by a general force majeure formula, such as "circumstances beyond control". While the purpose of the general formula is to catch circumstances that fall outside the listed events, the purpose of the list of specific force majeure events is to provide predictability.

In business practice, some specific force majeure events may be included in order to exclude the liability of one of the parties for failure to fulfil its contractual obligations. Not all events listed in force majeure clauses are really "circumstances beyond the party's control". The two most typical examples of force majeure events that are not really "circumstances beyond control" might be: the failure of the party's own contractors (general contractors, suppliers, subcontractors, carriers, or other contract parties) to fulfil their obligations; and the party's labour unrest. The firm should make sure that its counterparty does not limit its liability for breach of contract by inserting these kinds of events into the force majeure clause.

The most common consequence of the occurrence of a force majeure event is that the obligations of the party affected by it are suspended for the duration of the force majeure situation.[398]

For example, the following clause would be typical in this respect: "The obligations of each of the Parties hereunder, other than the obligation to make payments of money, shall be suspended during a period of Force Majeure and the term of the relevant period or phase of this Agreement shall be extended for a time equivalent to the period of Force Majeure situation. In the event of Force Majeure the Party affected thereby shall give notice thereof to the other Party as soon as reasonably practical stating the starting date and the extent of such suspension of obligations and the cause thereof. A Party whose obligations have been suspended as aforesaid shall resume the performance of such obligations as soon as reasonably practical after the removal of the Force Majeure and shall notify the other Party accordingly."[399]

The party affected by the force majeure event usually has a duty to notify the other party of the force majeure event and its effect on that party's ability to perform. The party affected by the force majeure event must normally do this "as soon as reasonably practical"; the force majeure clause would not protect the party affected by the force majeure event sufficiently if this party could invoke the force

[398] Compare this with Article 79(5) of the CISG.
[399] See Berger KP, *op cit*, pp 1350–1351.

majeure clause only after notifying the other party in advance (the party may be unable to notify due to the force majeure event).[400]

It is not the purpose of force majeure clauses to re-establish the commercial equilibrium of the contract. However, force majeure clauses can also contain an obligation on the parties to negotiate and to search for ways to overcome the situation resulting from intervention by "acts of god".[401] Therefore, the parties sometimes agree that the parties will renegotiate the contract or that the contract can be adjusted following the occurrence of a force majeure event. In such a case, the force majeure clause should be complemented by the usual terms regulating renegotiation or adjustment (section 5.5.4).

The parties may also agree that the other party may terminate the contract after the expiry of a certain period of time. In these cases, the force majeure clause provides for an extension of the contractual performance period and the cancellation of the contract as a measure of last resort.

Hardship clauses. Whereas it is not the purpose of force majeure clauses to re-establish the commercial equilibrium of the contract, hardship clauses aim at maintaining it. Unlike force majeure clauses, hardship clauses typically provide that the parties have a duty to renegotiate the contract if the continued performance of one party's contractual duties has become excessively onerous due to an unforeseen event beyond the control of that party. Hardship clauses are thus a special form of renegotiation or adjustment clauses: making contractual obligations more flexible in light of alterations to the commercial equilibrium (section 5.5.4).

The parties are free to agree on the contents of the hardship clause according to their particular circumstances, and there are different kinds of hardship clauses. Some hardship clauses provide for a duty to renegotiate or adjust the contract to the new circumstances. Other clauses provide that the contract terms will be automatically changed (for example, indexation clauses or price revision clauses). There are also clauses according to which the contract will be terminated.

It is possible to use pre-formulated hardship clauses as a model. The best-known model is probably the ICC Hardship Clause 2003. In addition, the UNIDROIT Principles of International Commercial Contracts define both hardship and its effects. The UNIDROIT Principles are regarded as the codification of international commercial practice.

The UNIDROIT Principles define hardship as follows (Article 6.2.2): "There is hardship where the occurrence of events fundamentally alters the equilibrium of the contract either because the cost of a party's performance has increased or because the value of the performance a party receives has diminished, and (a) the events occur or become known to the disadvantaged party after the conclusion of the contract; (b) the events could not reasonably have been taken into account by the disadvantaged party at the time of the conclusion of the contract; (c) the events are beyond the control of the disadvantaged party; and (d) the risk of the events was not assumed by the disadvantaged party."

The UNIDROIT Principles also define the effects of hardship (Article 6.2.3): "(1) In case of hardship the disadvantaged party is entitled to request renegotiations. The request

[400] Compare this with Article 79(4) of the CISG.

[401] See Berger KP, *op cit*, p 1352.

shall be made without undue delay and shall indicate the grounds on which it is based. (2) The request for renegotiation does not in itself entitle the disadvantaged party to withhold performance. (3) Upon failure to reach agreement within a reasonable time either party may resort to the court. (4) If the court finds hardship it may, if reasonable, (a) terminate the contract at a date and on terms to be fixed; or (b) adapt the contract with a view to restoring its equilibrium."

5.6 Contract Terms Become Binding

5.6.1 Introduction

Parties to a contract must keep their bargain. There are circumstances in which the firm would rather not or not yet be bound by the terms of the contract. The firm can prefer an option to walk away from an unfavourable contract before its terms become binding and enforceable. Sometimes the firm prefers obligations which are enforceable against it.

Stages. For example, in contracts concerning large sums of money, negotiations between the parties are frequently performed in stages (section 7.1; for acquisitions, see Volume III; for information management generally, see Volume I). This enables the firm to walk away before the contract becomes binding. Furthermore, sometimes the terms of the contract are amended or renegotiated later, because it might not be feasible to agree on everything in advance.

Even where the contract would not become binding and enforceable as such, a party could owe pre-contractual negotiation duties to the other party. The main rule is that a party is free to negotiate and is not liable for failing to reach an agreement, but a party who has conducted or discontinued negotiations contrary to good faith can be liable for loss sustained by the other party under the law that would have governed the contract.[402] In particular, a party acts contrary to good faith if it enters into or continues negotiations with no real intention of reaching an agreement.

Offer and acceptance model. At a general level, one of the factors increasing legal risk in this context is that it is not clear when a party's statements and/or actions trigger contractual liability.

The traditional *offer and acceptance* model does not reflect legal reality in complex business deals.

Both the CISG[403] and the DCFR/PECL recognise the traditional offer and acceptance model of contracting. The DCFR and the PECL also contain a provision on contracts not concluded through the traditional offer and acceptance model.[404]

402 Article 10 of Regulation 593/2008 (Rome I); DCFR II.–3:301.
403 CISG Article 14(1).
404 DCFR II.–4:211; PECL Article 2:211.

It is well-known that the *process* by which complex business deals are arranged differs markedly from that presumed by the offer and acceptance paradigm.[405]

In addition, the *interpretation* of contracts is flexible (section 5.2.4). The statements and actual behaviour of the parties can trigger contractual obligations when they seem to signal that the parties have begun to act according to the terms of their mutual understanding.

Mitigation of risk. There are contractual ways to mitigate the risk that the firm's actions trigger a binding and enforceable contract. The most important of them include the separation of signing and closing as well as the use of letters of intent, commitment letters, and letters of comfort. In addition, the firm should control by whom and how it is represented in its dealings with other parties (Volume I).

For the term "subject to contract", see the section on commitment letters below.

5.6.2 Mitigation of Risk

Closing

In commercial contracts, one of the most common ways to ensure a binding and enforceable contract will be created only in certain circumstances is to use a procedure that consists of signing, closing, and conditions to closing. The absence of a material adverse change in circumstances, events of default and other unwanted events can be made conditions to closing.

Closing. The use of closing means the parties agree on all or most terms of the contract in advance but make the formal acceptance of the transaction subject to certain conditions that must be present or events that must occur before the contract becomes binding. In this way, the firm can separate the date of the execution of the contract (after the parties have agreed on the terms of the contract, "signing") from the date of the contract becoming binding ("closing"). For example, the date of the execution of the contract may be months prior to closing, if regulatory approvals such as the consent of competition authorities are required for the transaction.

One-sided option or two-sided option. The firm would normally prefer a one-sided option to walk away from the contract. If the conditions are not fulfilled, the firm would then be able to walk away from the contract or choose to go on with the transaction. A one-sided option can also give the firm a chance to require changes to the contract.

A two-sided option, or an automatic mechanism making the agreed terms null and void and of no effect, would increase the risk that the contract terms will *not* be binding and enforceable. Such clauses would make it difficult for the firm to go on with the transaction without the consent of the other party when a non-vital condition is not met.

[405] See, for example, Johnston JS, Communication and Courtship: Cheap Talk Economics and the Law of Contract Formation, Virg L R 85 (1999) pp 466–467.

Conditions to closing. The conditions to closing typically contain conditions of a general nature and specific events. The general conditions usually include (a) the absence of a material adverse change and (b) the absence of events of default. The specific events depend on the nature of the contract and the circumstances. In any case, some of these specific events relate to (c) information.

Absence of material adverse change. Material adverse change (MAC) clauses are a usual means of mitigating the risks presented by adverse business or economic developments that occur between signing and closing. They are most commonly used in acquisitions and large financing transactions.

Absence of events of default. Other normal conditions to closing include the absence of events of default. The firm typically wants to specify conditions that must be present or events that must occur before it is obligated to consummate the deal. The other party typically makes representations and warranties as of the date that the contract is executed. As this date may be months prior to closing, the firm will typically require that the statements made by the other party are still true at the time of closing.

Information. Some typical conditions to closing relate to information (sections 6.3.3 and 7.1). The choice between different conditions depends on the nature of the transaction. In many large investment transactions, it is normal to require a due diligence investigation with an acceptable outcome and a legal opinion with an acceptable result (see Volume III).

For example, such a clause could look like this: "Completion of this agreement is conditional on the Firm completing due diligence investigation of the Counterparty and that investigation not revealing any fact or matter that would have a Material Adverse Effect as determined in this agreement."

Material adverse effect. Usually, it is not in the interests of the firm's potential contract party to give the firm completely free hands to walk away from the contract in the very likely event that some things are not 100% right at the time of closing. For this reason, some conditions to closing tend to be qualified. For example, the parties can define material adverse effect.

In an acquisition contract, it could be defined as: "any event, condition or change which materially and adversely affects or could reasonably be expected to materially and adversely affect the assets, liabilities, financial results of operations, financial conditions, business or prospects of the target company".

Specific conditions. In addition to conditions that are general in nature, the conditions to closing can be transaction-specific. For example, if the firm is relying on external finance, the conditions to closing should match the finance terms, because the firm will need to walk away from the contract if it turns out that sufficient funding is not available. If the contractual framework consists of many contract documents, it is normal to require that all other contracts are binding and enforceable according to their terms. In acquisitions, it may be necessary for the parties to obtain regulatory or shareholder approval for the deal.

Walk-away clauses, reverse-breakup fee. The contract can also contain an express walk-away clause. Private equity firms often require the inclusion of a "reverse-breakup fee" clause in the business acquisition contract. Without a breakup mechanism, a private equity firm would typically be bound to buy the company it has agreed to acquire or risk being sued. The reverse-breakup fee clause enables the private equity firm to walk away at any time and for any reason provided that it pays a fee. A typical fee could amount to 3%–5% of the total value of the deal.

A low reverse-breakup fee typically protects the buyer or the party that can be regarded as the principal investor. A low reverse-breakup fee can be turned by the investor into a bargaining tool.

Letter of Intent

Letters of intent are sometimes applied before signing and closing. Letters of intent are typically used in complex negotiations such as negotiations over the sale of a business, the extension of commercial loans, or executive employment contracts.

The purpose of letters of intent – or documents called "memorandum of agreement" or "heads of agreement" – may vary depending on the context. A party may want to: make the other party more committed to the negotiations; prevent the other party from negotiating with competing parties; ensure that its managers comply with their duties of care before giving the other party access to confidential information in the form of due diligence inspections or otherwise; reach a de facto agreement on the fundamental terms of the contract; or reach an agreement that can be enforced by the court as the final contract of the parties should the other party refuse to sign the final version of the contract document.

As the context and purpose of letters of intent may vary, so do their contents. (a) For example, some letters of intent may explicitly spell out to what extent the parties will be bound by what they have already agreed, and to what extent the parties need to carry on negotiations in order to reach the final contract. (b) If the purpose of the letter of intent is to create a sense of moral obligation during the lengthy process of negotiating a full agreement and to provide a framework and context for further negotiations and due diligence, the letter of intent may set forth the proposed structure of the deal, the price or how it is to be determined, the form of consideration, and other key terms, and specifically state that it does not create binding obligations.[406] (c) Many letters of intent specifically state that they do not create binding obligations.

For the purpose of such a "Texaco clause" in the US, see Volume III. Prior to the *Texaco* decision, it was difficult for merger and acquisition lawyers to persuade clients to propose that a disclaimer clause be included in the letter of intent. Clients were concerned that the

[406] Bainbridge SM, Mergers and Acquisitions. Foundation Press, New York (2003) pp 174–175.

proposal to include such a clause would signal that the client was pessimistic about the chances that the deal would actually go through.[407]

In any case, letters of intent are not normally drafted merely as written proposals. They can look a lot like normal and complete contracts. A key legal issue in using a letter of intent is therefore whether it will be deemed a binding contract that can be enforced by the court. If the letter of intent in effect creates a binding final contract, reneging on the deal may expose the reneging party to liability for breach of contract.[408]

In the US case of *United Acquisition Corp. v Banque Paribas*, the court adopted a four-factor test for determining whether a letter of intent is binding: (1) Does the document contain an express statement of intent to be bound only by a written agreement? (2) Has one party partially performed and has the other party accepted that performance? (3) Are there issues remaining to be negotiated? (4) Does the agreement involve complex issues in which definitive written contracts are the norm?[409]

The breakdown of negotiations can even in other cases lead to a liability to compensate the other party for loss or damage.

In *England*, this question is governed by the principles of negligent misrepresentations. The leading case is that of *Hedley Byrne v Heller* (Volume I). In *Esso Petroleum v Mardon*,[410] the Court of Appeal applied liability for misrepresentation in the area of contract law. According to this decision, the special relationship-type of situation required for negligent misrepresentation may also be found in a contractual relationship and liability for breach of warranty does not preclude negligent misrepresentation. In *Box v Midland Bank Ltd*,[411] the plaintiff sued the defendant bank for recovery of damages for financial losses he had incurred relying on predictions by an agent of the bank about the outcome of the plaintiff's application to a regional office for a loan. The loan was not granted.

In *Germany*, the Federal Supreme Court (BGH) has applied the doctrine of culpa in contrahendo and awarded the aggrieved party damages in cases of breakdown of negotiations. There are two main alternatives. A party's behaviour during the negotiation process before the break-off may trigger a breach of duty, or the break-off itself may be regarded as a breach of duty.

For those reasons, the firm should spell out to what extent it will be bound. In order to mitigate the risk that the contract becomes binding and enforceable anyway, it should be stated in the letter of intent that the parties will not be bound until there is a final written contract signed by the parties' authorised representatives. If

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[407] Johnston JS, Communication and Courtship: Cheap Talk Economics and the Law of Contract Formation, Virg L R 85 (1999) pp 459–460.

[408] Bainbridge SM, *op cit*, pp 174–175: "If the target sought to renege so as to merge with a competing bidder, a binding letter of intent will also expose the competing bidder to liability for tortious interference with contract."

[409] United Acquisition Corp. v. Banque Paribas, 631 F. Supp. 797 (S.D.N.Y. 1985); Bainbridge SM, *op cit*, pp 174–175.

[410] Esso Petroleum Co Ltd v Mardon [1976] 2 All ER 5; [1976] QB 801.

[411] Box v Midland Bank Ltd [1979] 2 Lloyds Law Reports 391 (AB).

the firm wants to make the other party committed to the negotiations, the letter of intent should provide for a duty of loyalty. General duties of loyalty can be complemented by more specific duties such as a duty to abstain from such measures which may defeat the stated objective of the parties to reach final agreement and a duty not to negotiate the same bargain with a third party.[412]

It is possible that the letter of intent will not lead to a binding and enforceable agreement. The firm can therefore need an obligation of the other party to keep any information received during the negotiations secret and to abstain from using it for any other purpose.

Commitment Letter

Commitment letters are used between a bank and a prospective borrower. They are typically requested by the prospective borrower who wants to: (a) secure funding for a transaction; and (b) signal to third parties that it not only has secured the funding - the availability of funding being a standard condition precedent to closing in many transactions - but is a reliable contract party in general. In other words, the prospective borrower wants to use a bank as a source of funding and as a screening and signalling agent.

Bank's interests. For two reasons, the bank may be unwilling to undertake a binding obligation to lend at this stage. The first is that the bank does not yet know the terms of the transaction for which it is asked to provide funding. The second is capital requirements. According to Basel II, the committed amount increases the bank's credit exposure.[413]

Contents. A commitment letter sets out the nature of the contemplated loan, and some or all of the terms to which it will be subject. There are as many types of commitment letter as there are prospective loans. In general, the legal character of commitment letters depends on their individual nature.

Whether a commitment letter is binding is a matter of interpretation (section 5.2.4). Typically, a commitment letter "subject to contract" will be regarded as not being binding. The phrase "subject to documentation" does not have the same conclusive quality. The phrase "documentation satisfactory to the bank" means a subjective test; it is for the bank to determine whether the final documentation is satisfactory. A commitment letter may also contain so few of the core commercial terms which would be expected in the formal documentation that it cannot be said that the parties intended to be bound.[414]

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[412] Ramberg J, International Commercial Contracts, ICC, Kluwer Law International, Norstedts Juridik, Stockholm (1997) p 29. The other party might do so in bad faith, for example, by insisting upon onerous terms or diminishing the value of performance under the contemplated contract.

[413] See, for example, paragraphs 83 and 310 of the Basel II Accord. See also BIS, Basel Committee on Banking Supervision, Proposed enhancements to the Basel II framework. Consultative Document (January 2009) pp 5–6.

[414] Cranston R, Principles of Banking Law. Second Edition. OUP, Oxford (2002) pp 301–303.

Fees. The bank gives a commitment letter for a fee and may require the prospective borrower to reimburse it for its expenses. The fees may be characterized as fees payable for considering whether to grant the proposed loan and do not depend on whether the commitment letter creates a legal obligation to lend or not.[415]

Letter of Comfort

Letters of comfort are off-balance sheet guarantees generally not regulated by law. A letter of comfort can be given by a party who only intends to be morally but not legally bound. It is an instrument that is used to facilitate an action or transaction but is constructed with the intention of not giving rise to a legal obligation. The interpretation of a letter of comfort depends to a large extent on its exact wording. Legal background rules typically say little about the contents of comfort letters. Whether a comfort letter creates a legal obligation to pay or just a moral obligation that cannot be enforced by the court depends on its wording.

Parent companies. Some letters of comfort may be regarded as statements which are morally binding only. For example, a parent company can be asked to guarantee a loan taken out by a subsidiary company. However, a guarantee would appear on the balance sheet of the parent company. Instead of a binding guarantee, the parent company may issue a letter of comfort that contains a non-binding the statement.

A non-binding statement can look like this: "It is our policy to ensure that the subsidiary is at all times in a position to meet its liabilities to you under the loan agreement. We will not reduce our financial interests in the subsidiary until the loan has been repaid."

A letter of comfort may lead to an actual liability under some circumstances. The court may find that the party receiving the letter of comfort was entitled to rely upon its contents in the light of its exact wording and the circumstances.

For example, the parent is more likely to be held liable if it issues a letter of comfort with the following content: "We are aware of the subsidiary company's obligations to you under the loan agreement. We will take all appropriate means to ensure that the subsidiary is able to meet its obligations to you."

In any case, the parent is not automatically liable for the obligations of the subsidiary although it has issued a letter of comfort. In *Kleinwort Benson Limited v Malaysia Mining Corporation Berhad*,[416] a parent company was not responsible for the liabilities of a subsidiary even though it had written a "letter of comfort" indicating that it was its policy to support the subsidiary. In *Re Augustus Barnett & Son Ltd*,[417] the parent company was not liable, although it had repeatedly issued

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415 *Ibid*.

416 Kleinwort Benson Limited v Malaysia Mining Corporation Berhad [1989] 1 WLR 379; see Modern Company Law: Completing the Structure, paragraph 10.6.

417 Re Augustus Barnett & Son Ltd [1986] BCLC 170; see Dine J, The Governance of Corporate Groups. Cam U P, Cambridge (2000) pp 44–45.

statements that it would continue to support the subsidiary, it had failed to do so, and the subsidiary had gone into liquidation.

Sometimes the moral obligation will, in practice, force the party who signed the letter of comfort to act accordingly.

Other uses. Letters of comfort can be used in many contexts and not only by parent companies. For example, a SME may have received a contract from a large company but needs loan financing in order to invest in new equipment to carry out the contract. The large company can agree to issue a letter of comfort stating that the SME has received a contract to produce products which the large company will buy for a certain price and describe which new equipment for what amount of money is needed to carry out the contract. The most important part in the letter of comfort is the company's statement it will honour the contract and thus pay the confirmed price for the products delivered by the SME as long as the SME delivers the products with the quality described in the contract.

6 Management of Counterparty Risk

6.1 Introduction

Counterparty risk is normally understood as the risk that the other party fails to fulfil its contractual obligations. Managing the firm's exposure to counterparty risk means managing the principal-agency relationship with the firm as principal and its contract party as agent.

Forms of counterparty risk. It is possible to distinguish three basic forms of counterparty risk on the basis of how they are mitigated. According to the definitions used here, the basic forms of counterparty risk are counterparty *corporate* risk, counterparty *commercial* risk, and counterparty *credit* risk. Different forms of counterparty risk will typically be mitigated in different ways.

General counterparty risk. General counterparty risk means the risk that the other party to the contract for any reason fails to fulfil its contract obligations. This can also be caused by legal reasons.

Counterparty corporate risk. Counterparty corporate risk is caused by the fact that the other party is a legal entity. For example, questions of the existence of the counterparty, its capacity to enter into the contract, and the power of its representatives to bind it belong to counterparty corporate risk.

Counterparty commercial risk. Counterparty commercial risk is the risk that the other party fails to fulfil its obligations for commercial or operational reasons. Questions of the commercial ability or willingness of the counterparty to fulfil its contractual obligations belong to counterparty commercial risk.

Counterparty credit risk. The firm is exposed to credit risk if the firm has advanced value in exchange for a promise to pay at a later date. Counterparty credit risk is the risk that the debtor will, for whatever reasons, not fulfil its payment obligations when due. Counterparty credit risk is a combination of counterparty corporate risk, counterparty commercial risk, and other risks that may influence the fulfilment of payment obligations. It will be discussed in the context of payment claims (Chapter 10; for debt contracts, see Volume III).

Effect of legal aspects. Legal aspects influence counterparty risk in two ways. Some counterparty risks can be regarded as transaction-specific legal risks (counterparty corporate risk). Other counterparty risks are affected by contributory legal risks (counterparty commercial risk, counterparty credit risk).

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6.2 Counterparty Corporate Risk

6.2.1 Introduction

Counterparty corporate risk is caused by five core problems: (a) Does the other party *exist* as a legal entity? (b) Does it have legal *capacity* to enter into the agreement and perform its obligations under the agreement? (c) Do the people who act on the other party's behalf have legal *power to bind* it?[1] (d) Has the other party taken all necessary (internal) *corporate action* for it to be bound by the agreement? (e) What company is the right *contract party* or responsible for the performance of the contract party's obligations where the other party in reality consists of many companies that form a company group or otherwise form one business undertaking?[2] The firm should know these things about its counterparty, but the firm should ask itself the same questions.[3]

These questions arise from the basic legal characteristics of the business corporation and are therefore governed by corporate laws. In order to provide legal security and reduce information costs both for third parties and for corporate agents (i.e. people who act on behalf of or in the name of a legal entity), corporate laws typically limit freedom of choice. In particular, there can be overriding rules of attribution of the exchange of information and acts to a legal entity (Volume I).[4]

6.2.2 Community Law and Member States' Laws

Introduction

Community law and Member States' laws influence counterparty corporate risk in many ways. Community law and Member States' laws have addressed questions such as the existence, recognition, capacity, and representation of companies as well as the law governing these issues.

The Right Contract Party

The quality of the firm's contract party is a question of counterparty commercial risk (section 6.3). The identity of contract parties is a question of counterparty corporate risk. The identity of contract parties can be unclear in two ways. The

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1 Griffiths A, Contracting with Companies. Hart Publishing, Oxford and Portland, Oregon (2005) pp 16–17.

2 See also *ibid*, p 16.

3 See, for example, *ibid*, p 21. "... the constitution of a company may impose limits on the contractual power of a company's board that even its own directors fail to notice and, in any event, the action necessary to override certain limits can be far from clear."

4 See Hansmann H, Kraakman R, What is Corporate Law? In Kraakman R, Davies PL, Hansmann H, Hertig G, Hopt KJ, Kanda H, Rock EB (eds), The Anatomy of Corporate Law. OUP, Oxford (2004) p 1; Griffiths A, *op cit*, p 21.

firm can be mistaken about the identity of its true contract party.[5] The firm can also be mistaken about its own role. It can be that the firm is a contract party although it did not intend to become one.

Identity of the other party. The identity of the other party can be a particular problem when dealing with company groups.

Sometimes the firm may confuse the identity of connected companies. For example, two or more subsidiaries can have common shareholders and board members, and the parent and its subsidiary can have common board members.[6] Although companies are connected, they are legally separate. In company law, each company is a separate corporate entity distinct from its shareholders.[7] This means that a subsidiary will not be identified with its parent company. Where the firm contracts with a subsidiary, it cannot expect the parent to fulfil the contractual obligations.

The parent is not automatically liable for the obligations of its subsidiary. However, the parent may have undertaken such an obligation. The existence of such an obligation is sometimes a matter of interpretation of contract.

Normally, the firm should not assume that a subsidiary acts as an agent of the parent. For example, in the English case of *Kodak Ltd v Clark* it was held that a 98% controlling interest in a company does not in itself give rise to an agency relationship.[8]

The firm should not assume that a division of the parent cannot be a separate legal entity. The firm be mistaken to believe that it contracts with the parent while it in fact contracts with a separate legal entity.

In the English case of *Porteus v Element Books*,[9] a "new age" publishing company had acquired a subsidiary and a third party had agreed to provide his services to the subsidiary. The financial status of the subsidiary deteriorated. The third party later sued the parent company for breach of contract claiming to have believed that the subsidiary was merely a division of the parent company. The Court of Appeal rejected his claim, holding that the subsidiary was the only party to his contract.[10]

The firm itself as contract party. The situation is more problematic for the firm if the firm itself is regarded as the true contract party although it did not expect to be one. For example, the firm may have intended one of its subsidiaries or network companies to be the contract party in order to reduce its own risk exposure.

The firm may itself be regarded as the true contract party where agents of the firm have purported to act in the name of another company but their actions are attributed to the firm instead. The firm can reduce this risk by ensuring that different

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5 See Griffiths A, *op cit*, pp 128–129.

6 See *ibid*, p 129.

7 For English law, see Salomon v A Salomon & Co Limited [1897] AC 22 (House of Lords).

8 Kodak Ltd v Clark [1905] 1 KB 505; see also Dine J, The Governance of Corporate Groups. Cam U P, Cambridge (2000) p 45.

9 [1996] CLY 1029 (Court of Appeal), see Griffiths A, *op cit*, p 130.

10 See Griffiths A, *op cit*, p 130.

companies belonging to its group or network are not represented by the same people. For example, the firm can avoid dual board memberships in group companies and adopt internal guidelines that provide for the separation of the representation of different group companies.

Existence of the Contract Party

A business entity can be party to a contract only provided that it has separate legal personality. A company has separate legal personality. However, for that to occur, the law must recognise the company in question as in existence at the relevant time. The existence of a company is partly a matter of legal formality. It must have been duly incorporated and admitted onto the register of companies, but not dissolved and removed from the register. In addition, the existence of a company depends on whether it is recognised as a company according to the choice of law rules of the country in which it was registered and the choice of law rules of other countries.

Recognition of companies and governing law. Community law influences the recognition of companies founded in the Member States of the EU and the law that governs the company (for incorporation, see Volume I).

A company formed in a Member State will normally be governed by the company law of that state and recognised in the other Member States (Article 43 of the EC Treaty), provided that the company also has its registered office, central administration or principal place of business in the same or another Member State (Article 48 of the EC Treaty). It is therefore possible to choose the law that governs the company by registering the company in the preferred jurisdiction.[11]

The judgments of the ECJ in *Centros*[12] and *Überseering*[13] have effectively abolished the real seat doctrine applied in Germany, France and most continental Member States, or limited its scope. In *Überseering*, the ECJ held that a "necessary precondition for the exercise of the freedom of establishment [by companies] is the recognition of those companies by any Member State in which they wish to establish themselves“.[14] In *Inspire Art*, the ECJ in effect confirmed that "company-law rules" are designated by the law of the Member State where the company is registered.[15]

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11 For registration, see Article 3(1) of Directive 68/151/EEC (First Company Law Directive). For the freedom to choose the governing law, see Volume I.

12 C-212/97 Centros [1999] ECR I-1459.

13 C-208/00 Überseering [2002] ECR I-9919.

14 Paragraph 59. Further Leible S, Hoffmann J, „Überseering“ und das deutsche Gesellschaftskollisionsrecht, ZIP 2003 pp 926 and 929 after footnote 42; Timmermans CWA, Company Law as Ius Commune? First Walter van Gerven Lecture, Leuven Centre for a Common Law of Europe (2002) p 13; Zimmer D, Ein Internationales Gesellschaftsrecht für Europa, RabelsZ 67 (2003) p 310; Roth WH, From Centros to Ueberseering: Free Movement of Companies, Private International Law, and Community Law, ICLQ 52 (2003) pp 206–207.

15 C-167/01 Inspire Art [2003] ECR I-10155, paragraph 97.

These general principles apply to all company forms. In addition, there are particular rules for companies incorporated as an SE. An SE (Societas Europaea, European Company) is governed by the SE Regulation. An SE founded in a Member State must be recognised as a public limited-liability company in all Member States. An SE is governed by the law of the Member State in which it has its registered office.[16] The SE will be complemented by the SPE in the future. The SPE (European Private Company) will be a European company form for SMEs.

Information about incorporation. EU company law makes it easier to find information about the existence of limited-liability companies and their nullity (non-existence).

The First Company Law Directive requires the compulsory disclosure of basic information about companies. The First Directive applies to all (private and public) companies with limited liability. The means of disclosure are threefold: first, the opening of a file on every company in an official register; second, publication in a national official gazette;[17] and third, an indication, on all business documents, of the legal form and registered place of business of the company and the register in which the file on the company is kept, together with the number of the company in that register.[18] The First Directive also lays down when documents and particulars may be relied on by the company against third parties or by third parties.[19]

Register of companies. The First Company Law Directive requires compulsory disclosure of basic information about each company.[20]

There must be "a central register, commercial register or companies register" in each Member State and a file must be opened for each of the companies registered in the Member State in question. The minimum information to be disclosed about each company has been listed in the Directive.[21] The Directive requires disclosure by publication in the national gazette appointed for that purpose. All documents and particulars which must be disclosed must be kept in the file or entered in the register. Outsiders must be able to obtain a copy of the whole or any part of those documents or particulars at a price not exceeding the administrative cost thereof.

In addition, the First Company Law Directive requires Member States to prescribe that letters and order forms shall state: (a) the register and the number of the company in that register; and (b) the legal form of the company, the location of its seat and, where appropriate, the fact that the company is being wound up.

Validity of obligations. The First Directive contains a set of rules on the validity of obligations entered into by a company.

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16 Article 3(1) of Regulation 2157/2001 (SE Regulation).
17 Article 3 of Directive 68/151/EEC (First Company Law Directive).
18 Article 4 of Directive 68/151/EEC (First Company Law Directive).
19 Article 3 of Directive 68/151/EEC (First Company Law Directive).
20 Articles 2 and 3 of Directive 68/151/EEC (First Company Law Directive).
21 Article 2 of Directive 68/151/EEC (First Company Law Directive).

The main rule is that transactions entered into by the organs of the company are binding on it, "unless such acts exceed the powers that the law confers or allows to be conferred on those organs".[22] This question will be discussed in below.

Pre-incorporation contracts. The starting point is that a company is incapable of being party to a contract made at a time when it did not exist and cannot therefore be bound by or enforce any such contract in its own right.[23] The question of pre-incorporation contracts has been addressed by the First Company Law Directive.

Where an act is done in the name of the company before the company has acquired legal personality, the persons who act in the name of the company are jointly and severally liable for the act, unless the parties agree otherwise or the company assumes the obligations arising from the act.[24] A company should therefore be able to take over pre-incorporation contracts made on its behalf once it has been formed.[25]

Nullity of companies. The First Directive contains a set of rules on the nullity of companies. The main rule is that nullity must not be automatic. It must require a decision by the court.[26] There is an exhaustive list of circumstances in which nullity may be ordered.[27]

Capacity

The lack of legal capacity belongs to the classic examples of legal risk in financial markets. The landmark decision internationally is the decision of the House of Lords in *Hazell v London Borough of Hammersmith and Fulham*.[28]

In the early 1980s, local authorities began to enter into interest rate swap transactions in the UK. It was assumed that such transactions were within their powers and binding. However, in *Hazell v London Borough of Hammersmith and Fulham*, the House of Lords held that such transactions were ultra vires the local authorities who had entered into them and therefore void. This caused concern among financial institutions, and especially foreign banks, which had entered into such transactions with local authorities in good faith, with no idea that a rule as technical as the ultra vires doctrine might undermine what they saw as a perfectly legitimate commercial transaction. Plenty of litigation followed.[29]

Powers of the company v powers of its representatives. To begin with, one should distinguish between (a) the power (capacity or power of any kind) of the company to enter into binding agreements and (b) the power (authority or power

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22 Article 9(1) of Directive 68/151/EEC (First Company Law Directive).

23 See Griffiths A, Contracting with Companies. Hart Publishing, Oxford and Portland, Oregon (2005) p 133.

24 Article 7 of Directive 68/151/EEC (First Company Law Directive).

25 See also Griffiths A, *op cit,* p 139.

26 Article 11(1) of Directive 68/151/EEC (First Company Law Directive).

27 Article 11(2) of Directive 68/151/EEC (First Company Law Directive).

28 Hazell v London Borough of Hammersmith and Fulham [1992] 2 AC 1

29 See Lord Goff of Chieveley in Westdeutsche Landesbank Girozentrale v Islington LBC [1996] UKHL 12, [1996] 5 Bank LR 341, [1996] 2 All ER 961, [1996] 2 WLR 802.

of any kind[30]) of its representatives to bind the company (in the following, capacity of the other party refers to the former).

Different national doctrines. In company law, Member States have adopted different doctrines as regards the capacity of companies and how companies become bound by contracts. In legal literature, it is often distinguished between the organic theory (Organtheorie) and the agency theory (mandate theory, Mandatstheorie).[31]

This distinction is based on the competing 19th century theories of German jurists Otto von Gierke and Friedrich Karl von Savigny.

German law has adopted von Gierke's organic theory. According to German law, a company has capacity to do any act whatsoever. Acts done by its organs are regarded as acts done by the company itself. Both an AG and a GmbH have "organs" that represent the company. An AG is generally represented by its management board (Vorstand),[32] and a GmbH by its managing directors (Geschäftsführer).[33]

Unlike German law, English law did not adopt the organic theory. English law has traditionally applied the mandate theory and the doctrine of ultra vires. According to this doctrine, the powers of the company (capacity) are restricted to matters covered by its stated objects. Any act outside those objects is a nullity, having no effect whatsoever. Even if an act is within the capacity of the company, it may be outside the powers of the individuals who were involved in the transaction. On the other hand, persons outside the company are entitled to assume that internal procedures have been complied with (the rule in Turquand's case).[34] This was the traditional position of English law. The law was substantially changed following the Companies Act 1989.[35]

Internal Corporate Action

Whether the counterparty has taken adequate internal corporate action to authorise the transaction depends on the regulation of corporate governance matters.

In the absence of harmonisation, the main rule is the internal distribution of power in a company is determined by the law governing company law matters (for corporate governance, see Volume I).

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30 For the terminology, see, for example, DCFR II.–6:102.

31 Schwarz GC, Europäisches Gesellschaftsrecht (2000) pp 216–217. See already Lietzmann H, Die Vertretungsmacht gegenüber Dritten im Schnittpunkt der geplanten europäischen Aktiengesellschaft, Die Aktiengesellschaft (1961) pp 125–129; Wyatt D, The First Directive and Company Law, LQR 94 (1978) p 183; Prentice DD, Section 9 of the European Communities Act, LQR 89 (1978) p 529; Werlauff E, EC Company Law (1993) p 266 and EU Company Law. Second Edition. DJØF Publishing, Copenhagen (2003) p 411; Edwards V, Ultra Vires and Directors' Authority – An EC Perspective, Comp Lawyer 18(7) (1995) pp 202–203; Edwards V, EC Company Law (1999) p 35; Habersack M, Europäisches Gesellschaftsrecht (1999) p 48. See also Fischer-Zernin C, Der Rechtsangleichungserfolg der Ersten gesellschaftlichen Richtlinie der EWG (1986).

32 §§ 78(1) and 82(1) AktG; Hüffer U, Aktiengesetz (2002) § 78 Rn 5 and § 82 Rn 3.

33 § 35(1) GmbHG; Lutter M, Hommelhoff P, GmbH-Gesetz (2000) § 35 Rn 3.

34 Royal British Bank v Turquand (1856) 6 E & B 327 (Exchequer Chamber). See even Davies PL, Gower and Davies' Principles of Modern Company Law, Seventh Edition. Sweet & Maxwell, London (2003) pp 157–158.

35 See especially section 35 of the Companies Act 1985.

Shareholders in general meeting typically decide on amendments to the company's statutes, articles of association, or other constitutional documents.

The European legal capital regime is an exception to the rule that Community law does not influence the internal distribution of power in a company (for the legal capital regime, see Volume III). The European legal capital regime means that the general meeting will decide on many questions relating to shares and share capital. The general meeting will typically have a veto right.[36] The legal capital regime applies at least to public limited-liability companies under the Second Company Law Directive. It may apply even to other limited-liability companies under the national provisions of Member States' company laws. This is often the case, because the legal capital regime is characteristic of continental European company laws.

During a public takeover bid, actions which may result in the frustration of the bid may not be taken without the prior authorisation of the general meeting. This rule is based on the Directive on takeover bids and implementing legislation.[37]

Whether the general meeting decides on other significant corporate actions depends on the governing law.[38] The governing law will influence the structure of the statutory board and internal decisions on the distribution of power. This can be illustrated by the regulation of listed companies in Germany and England.

Germany. Under German law, many corporate bodies can participate in the internal decision-making of a public limited-liability company (AG). It is characteristic of German law that the internal distribution of power is relatively standardised and predictable as far as important decisions are concerned.

The management board (Vorstand) has large management powers. The main rule is that the management board can initiate all kinds of transactions and decide on all management matters.[39]

Many important corporate decisions require the consent of the supervisory board (Aufsichtsrat). The main powers of the supervisory board relate to monitoring.[40] The main rule is that the supervisory board does not have management powers. Management matters must not be delegated to the supervisory board.[41] The supervisory board can nevertheless have a

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[36] According to Directive 77/91/EEC (Second Company Law Directive), the general meeting decides on: winding up (Article 17); acquisition of own shares (Article 19); increase in capital (Article 25); restriction or withdrawal of right of pre-emption (Article 29); reduction in the subscribed capital (Article 30); redemption of the subscribed capital (Article 35); and reduction of subscribed capital by compulsory withdrawal of shares (Article 36). Similar rules on the veto rights of the general meeting can also be found in: Directive 78/855/EEC (Third Company Law Directive); Directive 2005/56/EC (Directive on cross-border mergers); Regulation 2157/2001 (SE Regulation); Directive 82/891/EEC (Sixth Company Law Directive); Directive 2004/25/EC (Directive on takeover bids).

[37] Article 9 of Directive 2004/25/EC (Directive on takeover bids).

[38] See also Kraakman R, Davies PL, Hansmann H, Hertig G, Hopt KJ, Kanda H, Rock EB (eds), The Anatomy of Corporate Law. OUP, Oxford (2004) p 131.

[39] § 76(1) AktG.

[40] § 111(1) AktG.

[41] § 111(4) AktG.

veto right. Although it may lack a right to initiate management decisions, it can have a right to decide on certain management matters.[42]

According to the Aktiengesetz, the general meeting has a veto right regarding many matters relating to share capital or structural change (for the legal capital regime, see Volume III). The provisions of the Aktiengesetz are complemented by the Holzmüller doctrine. The Holzmüller doctrine means that fundamental matters (Grundlagenentscheidungen) are decided on by the general meeting. Because of qualitative and quantitative criteria, the Holzmüller doctrine is applied only rarely. In the Holzmüller case, assets were transferred to a subsidiary (qualitative criteria). In later cases, this doctrine has been applied to the transfer of at least 80% of the company's assets (quantitative criteria).

England. In England, the internal distribution of power in a public limited company (plc) depends to a large extent on the internal choices of the company. It has not been standardised by mandatory provisions of law.

The board of directors has large management powers under the articles of association. According to model articles of association, the board of directors may exercise all the powers of the company.

However, the board of directors can delegate powers to an executive director or to sub-board executives. As such powers are not regulated by company law, they must be determined on a case-by-case basis.

Like in Germany, shareholders in general meeting decide on matters relating to share capital and structural change under the European legal capital regime. The legal capital regime is not part of traditional English company law.

In addition, the Listing Rules provide that shareholder approval must be obtained for decisions which are likely to have a major impact on the company's business. If a transaction is regarded as a "Class 1 transaction", the Listing Rules provide that "an explanatory circular must be despatched to the company's shareholders and the company must obtain the prior approval of its shareholders in general meeting, and any transaction must be conditional upon such approval being obtained". Prior approval means here a veto right. A transaction is regarded as a "Class 1 transaction" where a "percentage ratio" is 25% or more.

Employee participation. Employees have certain participation and information rights according to the provisions of Community law (for acquisitions, see Volume III). Typically, their rights act as constraints on governance. They do not influence the validity of the company's internal decision-making under company law. In very exceptional cases, the rights of employees may have such an effect. For example, the German Aktiengesetz contains many references to co-determination laws.

Internal corporate action and the power to represent the other party. Internal corporate action (the representation of the company internally) must be distinguished from the representation of the company in its dealings with third parties (the representation of the company externally).[43] To what extent internal corporate action can influence the power of company representatives to bind it depends on the governing law and the bodies that acted on the company's behalf (see below). There is a distinction between "organs" and other representatives (agents).

Where the third party deals with the company through its "*organs*", the transaction is as a rule binding whether or not the company has taken care of its internal

[42] § 111(4) AktG.
[43] See also DCFR II.–6:102.

corporate action in a proper way, if the "organ" acts within the powers that the law confers or permits to be conferred on it (Article 9 of the First Company Law Directive).

Where the third party deals with the company through its *other* representatives, problems with the internal decision-making of the company can play a bigger role (see below).

Power to Represent the Other Party

If a legal entity has legal capacity, it can in principle be bound. Whether it will be bound, depends on whether the people who purported to represent it had power to do so. This question has partly been addressed by the First Company Law Directive.

The purpose of Article 9 of the First Company Law Directive is to make contracts concluded on behalf of limited-liability companies binding. However, Article 9 applies to acts done by the statutory "organs" of the company. It applies only to a limited extent to dealings with the company through its other representatives.

Dealing with the company through its statutory "organs". It is safer for the firm to deal with a limited-liability company incorporated in a Member State through its statutory "organs" authorised by company law to represent it.

The first sentence of Article 9(1) provides that "acts done by the organs of the company shall be binding upon it even if those acts are not within the objects of the company, unless such acts exceed the powers that the law confers or allows to be conferred on those organs."

"Organs of the company" mean only persons who are, pursuant to law, authorised to represent the company in its dealings with third parties. Their identity must be disclosed to the public.[44] The First Directive does not require the disclosure of their general powers. It is sufficient to disclose "whether the persons authorised to represent the company may do so alone or must act jointly."[45]

According to the wording of the second sentence of Article 9(1), Member States may "provide that the company shall not be bound where such acts are outside the objects of the company, if it proves that the third party knew that the act was outside those objects or could not in view of the circumstances have been unaware of it", but "disclosure of the statutes shall not of itself be sufficient proof thereof". Accoding to Article 9(2), "[t]he limits on the powers of the organs of the company, arising under the statutes or from a decision of the competent organs, may never be relied on as against third parties, even if they have been disclosed".

In principle, third parties need not be concerned about the terms or scope of a board's or other organ's actual authority if they can rely on overriding rules of attribution that remove or reduce the resulting risk of invalidity.[46]

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44 In accordance with Article 2(1)(d)(i) of Directive 68/151/EEC (First Company Law Directive). Likewise Edwards V, EC Company Law (1999) p 43.

45 Article 2(1)(d) of Directive 68/151/EEC (First Company Law Directive).

46 Griffiths A, Contracting with Companies. Hart Publishing, Oxford and Portland, Oregon (2005) p 161.

In practice, however, the First Directive has not eliminated all differences between Member States' laws. The remaining differences are quite large (they will be discussed in the context on mandatory rules of attribution below).

Dealing with the company through its other representatives. It is less safe for the firm to deal with a limited-liability company incorporated in a Member State through its other representatives.

In most cases, however, companies are not represented by their "organs". A company is normally represented by one or more managers, officers or employees at a relatively low level of corporate hierarchy. The firm will probably not deal with a limited-liability company through the other company's board or other statutory organs unless the other company is very small or the transaction is very important.

As a rule, the validity of acts done by such other agents remains outside the scope of Article 9 and is covered by national agency laws. Whether the act is binding on the other party to the contract depends on whether the agent had actual authority (for example, a written power of attorney) or apparent authority to act on its behalf (a position that is typically combined with a certain authority to take actions that bind the principal).

The need to obtain information. The limited level of harmonisation means that the firm faces a risk of invalidity even where the other party is represented by its board of directors. This can increase the firm's costs of contracting with other companies.[47]

Mandatory Rules of Attribution

The existence of mandatory rules of attribution means that some acts will be attributed to the company by reason of law. Apart from Article 9 of the First Directive, the mandatory rules of attribution have not been subject to harmonisation in the EU.

Wording of Article 9. The first sentence of Article 9(1) provides that "acts done by the organs of the company shall be binding upon it even if those acts are not within the objects of the company, unless such acts exceed the powers that the law confers or allows to be conferred on those organs." According to the wording of the second sentence of Article 9(1), Member States may nevertheless "provide that the company shall not be bound where such acts are outside the objects of the company, if it proves that the third party knew that the act was outside those objects or could not in view of the circumstances have been unaware of it", but "disclosure of the statutes shall not of itself be sufficient proof thereof". Article 9(2) sets out that "[t]he limits on the powers of the organs of the company, arising under the statutes or from a decision of the competent organs, may never be relied on as against third parties, even if they have been disclosed".

Problems relating to interpretation. Article 9 of the First Directive leaves plenty of room for interpretation. It can be difficult to interpret the provisions of

[47] See also *ibid*, pp 21 and 162.

Member States' laws that fall within the scope of Article 9, because Article 9 should be interpreted first.[48]

First, it is clear that not all contracts concluded by the organs of the company can be binding. Contracts are generally governed by contract law, the law of agency and other areas of law depending on the circumstances. Some of these provisions govern the formation of contracts, and some of them deal with factors tending to defeat contractual liability. What is the scope of Article 9?

Second, the concepts used in the First Directive often seem to be used in national legal orders as well. But the provisions of the Directive must be given a Community meaning. What is meant by the "organs of the company" under the First Directive? How does one define the "powers" of those organs? How do you interpret the "powers that the law confers" on those organs? How do you define the "powers that the law allows to be conferred"? Who is a "third party"? What is meant by "the objects of the company"?

Third, company outsiders or insiders may have actual knowledge of limitations on the authority of company representatives. If all contracts concluded by "organs" were binding, outsiders and unethical insiders would be able to abuse this rule to the detriment of the company. What role does knowledge - actual knowledge or constructive notice - play under Article 9?

Fourth, Article 9 refers to acts done by the "organs of the company". But most acts attributable to the company are done by executives and shop-floor employees. To what extent can Article 9 be applied when a person deals with the company through such representatives?

Fifth, substantive Community law can sometimes designate the applicable rules without affecting the governing law as such. Does Article 9 affect the governing law or designate the applicable rules?

Remaining differences between national company laws. The First Directive has not eliminated all differences between Member States' laws in spite of the general objective that contracts entered into by a company should be binding when it has been represented by its organs. For many reasons, the remaining differences are surprisingly large. The First Directive thus does not abolish the need to find out about the contents of Member States' laws.

First, it is clear from the judgment of the ECJ in *Rabobank*[49] that a foreigner still has to find out who is regarded as an "organ" and what "powers" national law "confers or allows to be conferred" on these "organs", and a foreigner is expected to find out whether knowledge of the "objects of the company" will, according to national law, affect the validity of the transaction or not.[50] It is clear that the First Directive does not give managers "full powers" to enter into contracts with third parties.

Second, the role of "organs" and therefore also the relevance of Article 9 depend on the Member State. In Germany, "organs" (for example, the management board of an AG as a whole and each board member) actually represent companies in a relatively large number of

[48] Case C-106/89 Marleasing v Comercial Internacional de Alimentación [1990] ECR I-4135, paragraph 8.

[49] Case C-104/96 Coöperatieve Rabobank "Vecht en Plassengebied" BA v Erik Aarnoud Minderhoud [1997] ECR I-7211.

[50] See especially paragraphs 22–24.

cases. In England, the role of "organs" is, in practice, relatively limited. The board of directors as a whole is regarded as an "organ", but the CEO is regarded as a mere agent.

Third, the powers that the law confers on those organs vary. For example, the powers of the Vorstand of a German AG to bind the company in dealings with third parties are basically unlimited (they are "unbeschränkt") and it is said that such powers cannot be restricted (they are "unbeschränkbar").[51] The same can be said of the powers of the Geschäftsführer of a GmbH.[52] In England, the powers of the organs of the company are to a large extent based on the company's articles of association and may thus vary depending on the company.

Limited scope. The limited scope of Article 9 means that the firm can seldom rely on the mandatory rules of attribution based on Article 9 when dealing with a limited-liability company in Europe.

Article 9 does not prevent Member States from protecting companies against abuse and *fraud*. Member States are free to regulate the validity of contracts that violate public morality (and are contra bonos mores).[53] The public morality exception is based on the EC Treaty and the case-law of the ECJ. In the light if *Kefalas*, Community law does not preclude a national court from examining whether a third party is seeking to derive, to the detriment of the company, an improper advantage, manifestly contrary to the objective of Article 9.[54] This probably means that the First Directive does not limit the scope of provisions like § 138 BGB (sittenwidrige Rechtsgeschäfte) although this provision can affect the validity of acts done on the company's behalf.[55]

Article 9 covers the *form* of the decision-making *process*. A third party who deals with a company through its "organs" may thus assume two things: (1) that the acts of these "organs" bind the company (main rule); and (2) that the company has taken care of its internal decision-making in a formally correct way.[56]

Article 9 does *not* cover *other aspects* of the company's decision-making process. Apart from the form of the decision-making process, the decision-making of the company should not fall within the scope of Article 9. The effects of misrepresentation, duress, undue influence, mistake and the like should therefore not be covered by the First Directive. Neither does the First Directive cover the question whether the conduct of company representatives amounts to offer or acceptance or

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51 §§ 78(1) and 82(1) AktG; Hüffer U, Aktiengesetz (2002) § 78 Rn 5 and § 82 Rn 3.

52 § 35(1) GmbHG; Lutter M, Hommelhoff P, GmbH-Gesetz (2000) § 35 Rn 3.

53 Thorbek J, Aktieselskabsorganernes Kompetence i EF (1973) p 393; Edwards V, EC Company Law (1999) pp 39–40.

54 Case C-367/96 Kefalas [1998] ECR I-2843, paragraph 28.

55 For § 138 BGB, see, for example, Larenz K, Allgemeiner Teil des deutschen bürgerlichen Rechts, C.H. Beck, München (1989) pp 440–447.

56 This result is supported by the purpose of the First Directive. According to the fifth recital in the preamble, the protection of third parties must be ensured by "provisions which restrict to the greatest possible extent the grounds on which obligations entered into in the name of the company are not valid". It is also supported by Article 9(2). Article 9(2) is based on the assumption that even other company bodies can take part in the decision-making process. See even Meilicke W, Selbstkontrahieren nach europäischem Gemeinschaftsrecht, RIW (1996) p 717.

whether acts done by company representatives are otherwise sufficient for the conclusion of a contract. These questions are governed by the governing law of the contract.

As a rule, Article 9 does *not* cover the *substance* of the decision. There are many reasons for this. Legal questions and legal rules are arranged under different categories in national legal systems (company law, contract law, tort, and so on). The classification of the issue in national legal systems is irrelevant when determining whether a Member State complies with the First Directive. One cannot assume that the First Directive would cover all rules that limit the substance of decisions made by companies. For example, it should be clear that it is not the purpose of the First Directive to harmonise national provisions on the validity and enforceability of contract terms;[57] there cannot be any across the board harmonisation of contract law, because the EU does not possess general regulatory power in this area.[58] Since the classification of the issue in national legal systems is irrelevant and the First Directive can hardly cover all rules that limit the substance of decisions made by companies, the First Directive should not be applicable to any such rules.[59] For example, the ECJ held in *Rabobank* that Article 9 is not intended to coordinate rules that govern self-dealing by company insiders.[60]

There is one exception to the rule that the First Directive does not cover the substance of decisions. Member States may provide that the company shall not be bound by acts outside the *objects* of the company "if it proves that the third party knew that the act was outside those objects or could not in view of the circumstances have been unaware of it; disclosure of the statutes shall not of itself be sufficient proof thereof".

Organs. Article 9(1) of the First Directive protects third parties only to the extent that acts have been done by the "organs of the company". Member States are free to choose the level of protection granted to parties dealing with the company through other representatives than company "organs".

The First Directive takes a formalistic view to the attribution of acts to the company. Although there is no definition of the term "organs of the company" in the Directive, it is clear from the wording of Article 9(1) that this concept must refer to persons: (a) who are, pursuant to law, authorised to represent the company in its dealings with third parties; (b) whose acts can therefore bind the company; and (c) who have represented the company with regard to the third party in question. This term can mean a corporate body, a person, or a group of people.

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57 For a contrary view, see, for example, Jacobsen B, The Relationship between Article 9 of the 1st Company Law Directive and the Grounds for Annulment under General Contract Law. In: Neville M, Engsig Sørensen K (eds), The Regulation of Companies. A tribute to Paul Krüger Andersen. Thomson, Copenhagen (2003) p 291.

58 Case C-376/98 Germany v Parliament and Council [2000] ECR 2000 p I-2247 ("tobacco").

59 Recital 5.

60 Paragraph 22. See even Meilicke W, Selbstkontrahieren nach europäischem Gemeinschaftsrecht, RIW (1996) p 715.

Such a narrow interpretation is supported by the scheme of the First Directive, the purpose of Section II of the First Directive, and the judgments of the ECJ in *Friedrich Haaga GmbH*[61] and *Ubbink Isolatie.*[62]

First, the term "organs of the company" must mean only persons who are, *pursuant to law, authorised to represent* the company in its dealings with third parties. This term has also been mentioned in Article 8, Article 9(2) and Article 9(3) of the First Directive. It can be interpreted in the light of these provisions and Article 7[63] of the First Directive.

Second, the identity of these persons must have been *disclosed to the public* in accordance with Article 2(1)(d)(i).[64] The First Directive does not require the disclosure of their general powers. It is sufficient to disclose "whether the persons authorised to represent the company may do so alone or must act jointly."[65] The First Directive nevertheless requires the disclosure of their identity. Article 9 does not protect third parties to the extent that they rely on the powers of persons whose identity has not been disclosed to the public. In *Ubbink Isolatie*, the ECJ said that "disclosure is intended to permit third parties to ascertain ... particulars of the persons who are authorized to bind the company"[66] and that the "purpose of the directive is not therefore to permit third parties to rely on appearances created by the company's organs or representatives if those appearances do not conform to the information contained in the public register".[67] Article 9 lays down minimum requirements and does not prohibit national rules that protect third parties where they have been dealing with the company through a person whose identity was not properly disclosed to the public although it should have been.

The third requirement is that this person or these persons should have *represented* the company in its dealings with the third party in question. When interpreting the term "organs of the company", one should avoid the result that restrictions on the authority of many different company bodies[68] can be taken into account cumulatively to the detriment of third parties (fifth recital). Since someone must have represented the company with regard to the third party anyway, this term must mean persons: who are, pursuant to law, authorised to represent the company in its dealings with third parties generally; whose identity has been formally disclosed to the public; and who have represented the company with regard to the third party in question. – In principle, it could be argued that the concept organs of the company refers not only to persons who may represent the company in its dealings with

61 Case 32/74 Friedrich Haaga GmbH [1974] ECR 1201.

62 Case 136/87 Ubbink Isolatie v Dak- en Wandtechniek [1988] ECR 4665.

63 See also Schwarz, Europäisches Gesellschaftsrecht (2000) pp 213 and 214: "Dem Schutzzweck der Richtlinienvorschrift entsprechend ist der Handelndenbegriff weit auszulegen. Handelnder kann jeder sein, der im Namen der Gründungsgesellschaft auftritt ..." "Der Handelnde muß dem Geschäftspartner deutlich machen, daß er nicht im eigenen Namen, sondern im Namen der Gründungsgesellschaft auftritt."

64 Likewise Edwards V, EC Company Law (1999) p 43.

65 Article 2(1)(d).

66 Paragraph 12. See also Friedrich Haaga GmbH, paragraph 6.

67 Paragraph 13. See also Edwards, EC Company Law (1999) p 41.

68 For example, bodies responsible for representing the company with regard to third parties and bodies responsible for the internal decision-making of the company.

third parties but even to persons who may take care of the company's internal administration, management, supervision or control.[69]

Third party. The term "third parties" should probably be interpreted widely. In *Friedrich Haaga GmbH*, the ECJ indicated that the First Directive protects "any person wishing to establish and develop trading relations with companies" because these persons "cannot be expected to have a full knowledge of the legislations or current commercial practices of other member states".[70] In *Verband deutscher Daihatsu-Händler eV v Daihatsu Deutschland GmbH*, the ECJ interpreted Article 6 of the First Directive widely; protection under Article 6 was not limited merely to creditors of the company.[71]

Organ member as a third party? Although the concept "third parties" should be interpreted widely, it does not cover the "organs of the company". The wording of Article 9 distinguishes between these two concepts. However, this does not mean that members of corporate bodies who deal with the company would never be protected under Article 9.

Members of corporate bodies can deal with the company either in this capacity or in another capacity. In the latter case, there is less reason not to apply Article 9 and more reason to protect them by applying it.[72]

In the former case, however, the people who deal with the company are not as worthy of protection as most company outsiders. In the light of *Verband deutscher Daihatsu-Händler eV v Daihatsu Deutschland GmbH*,[73] one could say that the provisions of the First Directive on the representation of the company are primarily designed to protect third parties who generally do not know or cannot obtain sufficient knowledge thereof; members of the company's statutory bodies who deal with the company in this capacity hardly belong to this category. Unlike most

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[69] Such a wide interpretation of this concept could be supported by Articles 2(1) and 9(2) of the First Directive, Article 2(d) of the Second Directive, Article 2 of the now dropped Fifth Directive as well as Article 38 of the SE Regulation.

[70] Case 32/74 Friedrich Haaga GmbH [1974] ECR 1201, paragraph 6.

[71] Case C-97/96 Verband deutscher Daihatsu-Händler eV v Daihatsu Deutschland GmbH [1997] ECR I-6843, paragraphs 20 and 22.

[72] According to the fifth recital, the protection of third parties must be ensured by "provisions which restrict to the greatest possible extent the grounds on which obligations entered into in the name of the company are not valid". Treating organ members as third parties restricts those grounds more than the opposite view. The opposite view could be supported by the fourth recital and the judgment of the ECJ in Verband deutscher Daihatsu-Händler eV v Daihatsu Deutschland GmbH. A person who is a member of one of the company's statutory bodies is hardly less likely to know or be able to obtain sufficient knowledge of the representation of the company although he only deals with the company in his personal capacity.

[73] Case C-97/96 Verband deutscher Daihatsu-Händler eV v Daihatsu Deutschland GmbH [1997] ECR I-6843, paragraphs 20 and 22. When interpreting Article 6 of the First Directive, the ECJ said that "the fourth recital in the preamble shows that disclosure of annual accounts is primarily designed to provide information for third parties who do not know or cannot obtain sufficient knowledge of the company's accounting and financial situation".

company insiders and outsiders, they can be expected to have knowledge of the rules that govern the company.[74]

However, this question can probably be solved in the same way as the problem of self-dealing by company representatives. Organ members and members of the company's statutory bodies will be protected as third parties, but the Member States are free to limit the "powers" of company organs; this is the way to ensure that sufficient legal constraints are in place.

Article 9 does not provide explicitly that a company can invoke self-dealing by company representatives as a defence or that contracts concluded in this way are void.[75] In *Rabobank*, the ECJ held that "the rules governing the enforceability as against third parties of acts done by members of company organs in circumstances where there is a conflict of interests with the company fall outside the normative framework of the First Directive and are matters for the national legislature".[76]

Shareholder as a third party? It is not clear whether shareholders can be regarded as "third parties" protected by Article 9 of the First Directive.

In the light of Article 12 of the First Directive, it could be argued that shareholders are not regarded as third parties and will not benefit from Article 9.[77]

However, there are arguments that support the opposite view. The internal market for financial services cannot function effectively unless investors in what circumstances contracts concluded with companies are binding. For example, an investor can hardly benefit from the approximation of standards on disclosure if it turns out that there is no binding investment contract in the first place, and a person subscribing for shares in a company does not benefit much from the disclosure of the terms of the share issue if these terms are not binding.

The case of a shareholder or a future shareholder such as subscriber of shares dealing with the company is special. First, EU company law protects to some extent other shareholders who are not party to the transaction.[78] Second, the protec-

[74] Compare Case 32/74 Friedrich Haaga GmbH [1974] ECR 1201, paragraph 6.

[75] See also Meilicke W, Selbstkontrahieren nach europäischem Gemeinschaftsrecht, RIW (1996) p 715.

[76] Case C-104/96 Coöperatieve Rabobank "Vecht en Plassengebied" BA v Erik Aarnoud Minderhoud [1997] ECR I-7211, paragraph 28. See also Meilicke W, Selbstkontrahieren nach europäischem Gemeinschaftsrecht, RIW (1996) p 713.

[77] Article 12 distinguishes between third parties and members of the company. Article 12(1) sets out that the "question whether a decision of nullity pronounced by a court of law may be relied on as against third parties shall be governed by Article 3". According to Article 12(4), the "laws of each Member State may make provision for the consequences of nullity as between members of the company". The scheme of the First Directive would thus support this view. Article 12 is mirrored by the sixth recital of the Directive. See even Farrar, Powles, The effect of section 9 of the European Communities Act 1972 on English company law, Modern L R 36 (1973) p 271; Meilicke W, Selbstkontrahieren nach europäischem Gemeinschaftsrecht, RIW (1996) p 715.

[78] See, for example, recitals 2 and 5 of Directive 77/91/EEC (Second Company Law Directive); as well as recitals 1, 2 and 9 and Article 3(1)(a) of Directive 2004/25/EC (Directive on takeover bids).

tion of a shareholder dealing with the company and the protection of other shareholders can be mutually exclusive. For example, one of the stated objectives of the Second Directive is that "Member States' laws relating to the increase or reduction of capital ensure that the principles of equal treatment of shareholders in the same position … are observed and harmonized".[79] The beneficial treatment of one shareholder can be contrary to the interests of other shareholders. Third, EU company law provides that many transactions relating to shares and share capital require the consent of shareholders in general meeting (Volume III).[80]

It is therefore necessary to ask whose interests shall prevail. One solution could be to distinguish between shareholders acting in the capacity of shareholders and shareholders acting in another capacity, and to use the principles applicable to self-dealing as a model.

In the light of the purpose of the First Directive, it is probably clear that a shareholder can benefit from Article 9 when he does not act in the capacity of a shareholder or a future shareholder.

Sometimes shareholders do act in the capacity of shareholders or future shareholders. It would again be possible to apply the principles laid down by the ECJ in *Rabobank*. If shareholders are protected by Article 9, Member States can protect the interests of the company, other shareholders and other stakeholders by limiting the "powers" of company organs.

However, there is a limitation. The interpretation of Article 9 should not frustrate the application of other parts of EU company law. For example, the provisions of EU company law that ensure the equal treatment of shareholders could be frustrated if any shareholder dealing with the company always were entitled to rely on Article 9. The same can be said of the requirement that certain transactions must be decided on by shareholders in general meeting.

This problem can be illustrated by the British case of *EIC Services Ltd v Phipps*.[81] A large number of bonus shares were allotted to shareholders whose shares were not paid up, and the issue of the bonus shares was not authorised by an ordinary resolution of shareholders in general meeting, as it should have been. Were shareholders protected as "third parties"? In *Smith v Henniker-Major & Co*,[82] Robert Walker LJ had earlier pointed out that it was not entirely clear what was meant by "third parties" in Article 9 of the First Directive. In *EIC Services Ltd v Phipps*, however, Peter Gibson LJ said that "it is tolerably clear from the Directive itself that third parties do not include members of the company". Peter Gibson referred to the "sixth preamble". He said: "In the context of a company, the term 'third parties' naturally refers to persons other than the company and its members."

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[79] Recital 5 of Directive 77/91/EEC (Second Company Law Directive).

[80] See, for example, Articles 11(1), 19(1), 25, 29(4), 30, 31, 35, 36(1), 37(1) and 38 of the Second Directive; Articles 6, 7(1), 16 and 22(1) of Directive 78/855/EEC (Third Company Law Directive); and Article 9(2) of Directive 2004/25/EC (Directive on takeover bids).

[81] EIC Services Ltd and others v Phipps and others [2004] EWCA Civ 1069.

[82] Smith v Henniker-Major & Co [2002] EWCA Civ 762.

The Law Governing the Representation of Companies and Agency

In practice, it can be difficult to determine the law that governs the representation of a company. The representation of a company can simultaneously be connected to the laws of many countries. In addition, the legal questions relating to the representation of a company can belong to contract law or company law or be classified as questions of agency. For this reason, different legal instruments adopted by Community institutions or used by Member States can influence different aspects of representation.

For the sake of clarity, the person purporting to represent the company will here be called the agent, the company that the agent purports to represent will be called the principal, and the party that purports to deal with the principal through the agent will be called the third party.

Three legal relationships. Three legal relationships arise from a contract concluded by an agent: the first between the principal and the agent, the second between the agent and the third party, and the third between the principal and the third party. Counterparty corporate risk relates to the third relationship.

"Company law questions" under Community law. In some cases, Community law designates the governing law. Where the principal is a company incorporated under the laws of another Member State and benefits from the freedom of establishment under the EC Treaty, questions that can be classified as company law questions under Community law will be governed by the law of the state of incorporation in the light of judgment of the ECJ in *Inspire Art.*[83]

This choice of law rule will apply at least where the third party deals with a company through its "organs". The question whether an "organ" is able to bind the principal to the third party is a question that clearly can be classified as a company law issue under Community law.[84]

Company law questions under Member States' laws. In some cases, the question will be classified as a company law question under lex fori. The national choice of law rules of a Member State may thus provide that the question is governed by the law governing the company.

A precondition is that the principal is recognised as a legal entity under lex fori. In principle, a Member State may have a duty to recognise a company incorporated in another Member State even where the representation of that company would not, under Community law, have to be classified as a company law question governed by the company law of the other Member State.

Agency law questions under Member States' laws. In most cases, the third party will deal with the principal through representatives at a relatively low level of corporate hierarchy, and the question of representation will be classified as one of agency rather than company law.

[83] C-167/01 Inspire Art [2003] ECR I-10155.

[84] Article 9 of Directive 68/151/EEC (First Company Law Directive).

Although the relationship between the principal and the third party is a contractual one, the question whether an agent is able to bind the principal is not governed by the Rome I Regulation.[85]

The reasons for the exclusion of this question from the 1980 Rome Convention were the diversity of the national conflict rules when the Convention was negotiated and the existence of the Hague Convention of 14 March 1978 on the law applicable to agency (which only three Member States have signed and/or ratified).

The Commision had originally proposed new rules for agency.[86] In the absence of an express choice in writing, one of three connecting factors would have determined the governing law. However, the proposed rules were regarded as a threat to legal certainty and were not adopted.

Special Rules on Dealing with Government Entities

There is a large body of special rules on dealing with government entities. These rules can apply to capacity, internal decision-making, representation, the conclusion of contracts, the choice of contract parties, the use of contract terms, the enforcement of obligations, and other things.

Capacity. If the other party is a government entity, a local municipality or any other public entity, its capacity can be determined by special rules, as was the case in *Hazell v London Borough of Hammersmith and Fulham.*[87]

Decision-making and representation. The internal decision-making of government entities and their representation in their dealings with outsiders are often subject to mandatory requirements as to form.

State aids. Furthermore, the conclusion of contracts may generally be limited by rules that govern public procurement and state aids.

Article 87(1) of the EC Treaty *prohibits* certain state aids: "Save as otherwise provided in this Treaty, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market."

State aids must be *notified* to the Commission in advance under Article 88 of the EC Treaty.

Generally, Community law does *not* prohibit the granting of all state aid. For example, aid may be given to the extent that it neither distorts nor threatens to distort competition. According to Commission guidelines,[88] the main rule is that state

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85 Article 1(2)(g) of Regulation 593/2008 (Rome I).

86 Proposal for a Regulation of the European Parliament and the Council on the law applicable to contractual obligations (Rome I), COM/2005/0650 final. See Article 7 of the draft Regulation.

87 Hazell v London Borough of Hammersmith and Fulham [1992] 2 AC 1

88 Community Guidelines on State aid for rescuing and restructuring firms in difficulty, OJ No 244, 1.10.2004 pp 2–17.

aid is prohibited but state aid may exceptionally be given to "firms in difficulty" according to the "one time, last time". A distinction is made between "rescue aid" and "restructuring aid". Rescue aid is exceptional and it must not be authorised for more than six months. Restructuring aid may be granted only once and the conditions for granting such aid must include: the formulation and implementation of a restructuring plan; measures to mitigate the adverse effects on competitors; the imposition by the Commission of specific conditions and obligations; and certain other things.

The prohibition on state aids can be illustrated with by cases[89] like the case of Bankkgesellschaft Berlin AG. As a result of high-risk real estate transactions, Bankgesellschaft Berlin AG went into serious difficulties. To prevent the German banking supervisory authority (BaFin) from closing the bank or taking other existence-threatening action, the majority shareholder Land Berlin injected fresh capital and provided risk guarantees in 2001. Germany notified these measures as restructuring aid to the Commission on 28 January 2002.[90] In exchange for obtaining the Commission's approval under the state aid rules, Germany and the Land Berlin submitted a variety of divestiture commitments. This included the undertakings to divest Berliner Bank, one of BGB's two retail brands, to hive-off the real estate services subsidiaries which were the main cause for the crisis and, finally, to sell Bankgesellschaft Berlin by the end of 2007.

Public procurement. Public procurement is subject to Community and international rules. The opening up of public produrement improves the working of the Internal Market. Public sector procurement must follow transparent open procedures ensuring fair conditions of competition for suppliers.[91]

The enforcement of obligations, state immunity. There can be restrictions on the enforcement of obligations against a contract party which is a government entity. According to a traditional rule, a sovereign foreign state (or a foreign sovereign) is immune from the jurisdiction of the court, unless the foreign sovereign state submits to its jurisdiction. There is thus a distinction between sovereign acts (*acta iure imperii*, no jurisdiction) and commercial or private-law acts (*acta iure gestionis*, jurisdiction).[92]

The member states of the Council of Europe have adopted the European Convention on State Immunity (1972). The main rule under the Convention is that a Contracting State is entitled to immunity from the jurisdiction of the courts of an-

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89 See Rossi P, Sansonetti V, Survey of State Aid in the Lending Sector: A Comprehensive Review of Main State Aid Cases, EBLR 2007 pp 1353–1394

90 Article 88 of the EC Treaty. See also Community Guidelines on State aid for rescuing and restructuring firms in difficulty, OJ No 244, 1.10.2004 p 2.

91 See, for example, Case C-280/00 Altmark Trans and Regierungspräsidium Magdeburg [2003] ECR I-7747.

92 For the common law rule, see North P, Fawcett JJ, Cheshire and North's Private International Law, Thirteenth Edition. Reed Elsevier (UK) Ltd, UK (1999, reprinted 2004) p 388. For Swiss law, see BGE 104 Ia 371, BGE 106 Ia 150, and Gutzwiller PC, Die Vollstreckung gegenüber ausländischen staatlichen Körperschaften, insbesondere in die "Währungsreserven" einer Zentralbank, ZSR Recht 2002 pp 121-136.

other Contracting State.[93] However, there are exceptions.[94] In particular, a Contracting State "cannot claim immunity from the jurisdiction of a court of another Contracting State if it has undertaken to submit to the jurisdiction of that court either: 1. by international agreement; 2. by an express term contained in a contract in writing; or 3. by an express consent given after a dispute between the parties has arisen."[95]

6.2.3 Mitigation of Counterparty Corporate Risk

General Remarks

Counterparty corporate risk can be mitigated by using a combination of traditional legal tools. As will be discussed in this section, the firm can: manage information; ensure compliance; rely on mandatory rules of attribution (such as rules based on Article 9 of the First Directive); and verify that it has the right contract party.

In a compliance culture, acceptance is a popular strategy to manage counterparty corporate risk. It can be too expensive to gather information about the counterparty corporate risk of individual contract parties in minor transactions and mass transactions. The general level of counterparty corporate risk is reduced if virtually all counterparties try to comply with the legal requirements.

Verifying the Identity of the Contract Party

The firm can mitigate risk by ensuring that it has the right contract party. The identity of the contract party is sometimes unclear.

Caution when dealing with companies in the process of incorporation. Many transactions are, in practice, done on behalf of companies in the process of incorporation. Pre-incorporation contracts cause particular legal risks.

If the firm is prepared to accept the risks inherent in pre-incorporation contracts, the firm should ensure that the contract is conditional on the company assuming the obligations once it has been formed and that the company actually takes over the pre-incorporation contract made on its behalf.[96]

Choice of contract party, company groups. The contract should be attributed to the right contract party. It goes without saying that a mistake in the identity of the contract party increases counterparty risk. It can be particularly easy to confuse the identity of companies that belong to the same group. In practice, a person who acts on behalf of one group company can sometimes act on behalf of other group companies as well.[97]

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93 Article 15 of the European Convention on State Immunity (1972).
94 Articles 1 to 14 of the European Convention on State Immunity (1972).
95 Article 2 of the European Convention on State Immunity (1972).
96 Article 7 of Directive 68/151/EEC (First Company Law Directive). See also Griffiths A, Contracting with Companies. Hart Publishing, Oxford and Portland, Oregon (2005) p 139.
97 See Griffiths A, *ibid*, pp 128–129.

When dealing with a company group, the choice of contract party can depend on many things (for acquisitions, see Volume III). For example, the firm may have particular objectives relating to the alignment of interests and structural subordination.

Structural subordination typically arises where the main assets of a group are owned by one or more subsidiaries, but the borrower is the parent company.[98] Structural subordination can be avoided where the borrower is the entity that owns the assets (for subordination, see Volume III).

On the other hand, the firm can align the interests of those in control of the assets with the interests of the firm by ensuring that the party in control will be the firm's contract party. For example, the parent company can be a safer contract party than any of its subsidiaries, because the parent can decide on asset transfers and distributions inside the group, and the controlling shareholder can be a safer contract party compared with the company controlled by the controlling shareholder.

The firm can at the same time mitigate structural subordination and align the interests of the party in control of the assets with the interests of the firm. The entity that owns the assets and the party that controls the entity can be made jointly responsible for the fulfilment of contractual obligations to the firm. For example, the owner of a small business often has to undertake the same obligations as his company.

Comfort letters. On the other hand, the parent or the controlling shareholder may not be prepared to assume any binding responsibility for the fulfilment of the contract. A letter of comfort can be used to create at least a moral obligation (section 5.6.2). A typical situation is where a bank is seeking a guarantee from a parent company to support a loan made to a subsidiary company. The bank asks for a guarantee but the parent company refuses to give one. The bank may be content to be given a letter of comfort instead.

Management of Information

Counterparty corporate risk is mitigated by using several traditional legal tools that address the question of information.

Verification. The firm can verify information about its potential contract party.

A basic requirement is that the other party must have been duly incorporated and admitted onto the register of companies, but not dissolved and removed from the register. The firm can therefore check the register of companies itself, or ask an intermediary to do it.

The firm can also prefer to do business with counterparties whose existence has been verified by someone else. For example, the counterparties could be members of a professional organisation or companies that have obtained a government permit to carry on business.

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[98] Fuller G, Corporate Borrowing. Third Edition. Jordans, Bristol (2006), paragraph 8.3.

Financial institutions have a know your customer duty under the MiFID. This makes customer due diligence to some extent compulsory for banks.[99]

Screening. The firm can use various kinds of screening devices ranging from such professional organisations to legal opinions and contract terms.

Legal opinions. Obtaining an acceptable legal opinion belongs to the most common forms of screening. An acceptable legal opinion contains a statement on the components of counterparty corporate risk.

International legal opinions tend to be given in a relatively standardised form. For example, where the borrower is a Danish company, a (fictive) legal opinion given to international banks in a loan transaction may contain the following statements about counterparty corporate risk:

Table 6.1 Legal Opinion, Counterparty Corporate Risk, Loan Transaction

"a) Status: The Borrower is a company duly incorporated for an unlimited duration and is validly existing under the laws of Denmark, with power and authority to own its assets and conduct its business as presently being conducted and no administrator, receiver or trustee of the Borrower, its business or assets, has been appointed. b) Powers and Authority: The Borrower has the corporate power to enter into and perform the Loan Agreement and to borrow thereunder and has taken all necessary corporate action to authorise the borrowing of loans upon the terms and conditions of the Loan Agreement and to authorise the execution, delivery and performance of the Loan Agreement in accordance with its terms. c) Execution: Ms A.B., Mr C.D. and Mr E.F. have the right, power and authority to execute the Loan Agreement on behalf of the Borrower. d) Enforceability: The Loan Agreement as executed and delivered constitutes a legal, valid and binding obligation of the Borrower enforceable with its terms, except as the enforceability of the Loan Agreement against the Borrower may be limited as applicable bankruptcy, insolvency, reorganisation, moratorium or similar laws affecting the enforcement of creditors' rights generally."

Representations. The firm can also use contract terms as a screening device. Representations clauses and standard legal opinions typically address the same aspects of counterparty corporate risk. For example, a loan agreement between a syndicate of international banks and a Finnish borrower may contain the following representations:

[99] Article 19 of Directive 39/2004/EC (MiFID). See also Basel Committee on Banking Supervision, General Guide to Account Opening and Customer Identification, February 2003 (attachment to Basel Committee publication Customer Due Diligence for Banks, October 2001).

Table 6.2 Representations, Counterparty Corporate Risk, Loan Transaction

"The Borrower hereby represents and warrants to each of the Banks that: (i) it is a company duly incorporated under the laws of Finland, which possesses the capacity to sue and be sued in its own name and which has the power to carry on its business and to own its property and other assets; (ii) its has power to execute, deliver and perform its obligations under each of the Contract Documents to which it is a party and all necessary corporate, shareholder and other action has been taken to authorise the execution, delivery, performance and creation of the same; (iii) its obligations under each of the Contract Documents to which it is a party, and which it has executed, constitute its legal, valid and binding obligations enforceable in accordance with their terms, are in full force and effect in accordance with such terms; (iv) it has not taken any action nor have steps been taken or legal proceedings been started or threatened against it for winding-up, dissolution or re-organisation, the enforcement of any encumbrance over any of its assets of for the appointment of a receiver, administrative receiver, or administrator, trustee or similar officer of it or of any or all of its assets or revenues."

Conditions precedent to closing. It is a common condition precedent to closing the representations of the other party are true not only at the time of signing but also at the time of closing.

Standard form contracts, standard business terms. The firm can signal its requirements to potential contract parties and their representatives by always doing business under its own standard business terms and by making its standard business terms available in advance.

Compliance

The second strategy to mitigate counterparty corporate risk is to ensure compliance. There are many ways to try to ensure that the other party actually complies with legal requirements. Ensuring compliance can be complemented by reliance on the mandatory rules of attribution. The firm can ensure that it deals with another company through its "organs" under Article 9 of the First Directive.

Appropriate corporate action, actual authority. The core question of compliance is whether the contract party has taken appropriate corporate action to authorise the transaction and whether its representatives have actual authority to execute the contract.

For example, the firm could ensure that the contract is approved on behalf of the other party to the contract by its board. As said above, most transactions can be decided on by the board (section 6.2.2).

In addition, the firm can ensure that the contract is executed by people who, according to the register, are empowered to represent the contract party.[100]

Dealing with the company through its statutory "organs". When dealing with a company incorporated in a Member State of the EU, the firm can decrease coun-

[100] See Griffiths A, Contracting with Companies. Hart Publishing, Oxford and Portland, Oregon (2005) p 18.

terparty corporate risk by dealing with the company through one of its statutory "organs" empowered to represent it in dealings with third parties.

It is relatively easy for the firm to identify these organ members, because a company must disclose their identity and this information must appear in a public register.[101]

The First Company Law Directive requires the disclosure of the "appointment, termination of office and particulars of the persons who either as a body constituted pursuant to law or as members of any such body ... are authorised to represent the company in dealings with third parties and in legal proceedings".[102]

The firm should observe limitations to the power of the other party's organs to act on the other party's behalf. In the light of the First Directive, the firm should make sure that the act is within the powers that the company law that governs the counterparty "confers" on that organ or "allows to be conferred" on it.[103] The firm should also ensure whether the persons authorised to represent the other party may do so alone or must act jointly. Even that information must appear in a public register.[104]

The disclosure rule and the rule of attribution under the First Directive are designed to reduce the firm's information costs.[105] However, statutory limitations to the power to represent a company will not appear in the public register. This can increase costs.

Dealing with the company through persons that it has held out to represent it and observing limitations to their authority. In most cases, the firm does not deal with other companies through their statutory "organs" (such as the statutory board of directors) but through their other representatives. If the firm cannot deal with the other company through its "organs", the firm can deal with the other company through persons that the other party has held out as its agents, and by observing limitations to their authority to represent the other party.

According to Member States' national agency laws, the other party may be bound by the contract if it has held the person representing it out as its agent. In other words, "the principal's authorisation may be express or implied".[106] (a) As said above, a company must hold out its "organs" as its agents, because the First Directive requires the disclosure of the "persons who ... are authorised to represent the company in dealings with third parties and in legal proceedings".[107] (b) The First Directive only refers to the statutory organs of a limited-liability company. The other party can hold a person out as its agent even in other ways.

101 Article 3 of Directive 68/151/EEC (First Company Law Directive).
102 Article 2(1)(d)(i) of Directive 68/151/EEC (First Company Law Directive).
103 Article 9(1) of Directive 68/151/EEC (First Company Law Directive).
104 Article 2(1)(d) of Directive 68/151/EEC (First Company Law Directive).
105 See Griffiths A, *op cit*, pp 20–21.
106 DCFR II.–6:103(2).
107 Article 2(1)(d)(i) of Directive 68/151/EEC (First Company Law Directive).

For example, the Bank of Finland, the Finnish central bank, has held several persons out as its agents on its website by making the following statements: “Officials authorised to sign for the Bank of Finland, 15 February 2008. All documents that are binding on the Bank of Finland must be signed by two Bank of Finland officials, one of whom must be an official on the list below. Authorization to sign is either based directly on the official’s position or on a Bank of Finland decision.” The list contains the name, position, and department or unit of each official mentioned on it.

The firm should pay attention to limitations to the other party’s agents’ authority. According to Member States’ laws, the other party is not bound by the contract where the firm knew or should have known that the person who acted in its name exceeded his authority.[108]

Caution when the transaction exceeds the party’s objects. The firm should also pay attention to the other company’s field of activity (objects) stated in its articles of association. Counterparty corporate risk (and the risk that the contract is not enforceable) is increased where the contract falls outside the other party’s objects (and is, to use an old common law expression, ultra vires).

For example, Article 9 of the First Company Law Directive states that: “Member States may provide that the company shall not be bound where [acts done by organs] are outside the objects of the company, if it proves that the third party knew that the act was outside those objects or could not in view of the circumstances have been unaware of it; disclosure of the statutes shall not of itself be sufficient proof thereof.”

Caution when the transaction is very large, speculative or unusual for the other party. Generally, when the transaction is very large, speculative or unusual for the other party, there is a higher risk that the transaction: exceeds the capacity of the other party; exceeds the powers that the law confers on the statutory “organ” that represents the other party; exceeds the normal (apparent or ostensible) powers of the other party’s other representatives; exceeds the powers that have been conferred on the other party’s other representatives in fact; and must be decided on internally by another corporate body of the other party. The risk is higher in cross-border transactions, because there is no across the board harmonisation of the international decision-making of companies, and the representation of companies

[108] Griffiths A, *op cit*, p 12: “The relevant law has in many places failed to attach much weight to the fact that a corporate agent does not have a real and tangible principal that can act as a reference point for third parties. In reality, there are significant differences between a third party dealing with a corporate agent and a third party dealing with an agent acting for a human principal. These differences are likely to affect the third party’s perception of the agent and should be taken into account in determining the burden that the law places on a third party who wishes to ensure the validity of a contract. Thus, third parties dealing with many kinds of corporate agent (especially those with an apparently senior position within a company’s management hierarchy) are likely to view the agent as the external face of the company and as a key source of information about its affairs. They are unlikely therefore to have a clear awareness of a separate principal who can act as a superior reference point and a superior source of information in the same way as they would when dealing with an agent acting for a natural person.”

has been subject to very little harmonisation (apart from Article 9 of the First Directive).

Where the transaction is very large for the other party, the firm can typically mitigate the risk relating to the internal decision-making of the company by requiring a decision by the other party's board authorising the transaction. In the Member States of the EU, many transactions relating to legal capital and shares will have to be authorised by the general meeting under the legal capital regime, and the amendment of the constitutional documents of the company must be decided on by the general meeting.

Caution when there is a conflict of interests between the other party and its representatives. One of the most common examples of transactions that are unusual for the other party is that the other party's representatives have a personal interest in the contract.[109] For example, self-dealing by "organ" members is often constrained by mandatory provisions of law limiting their "powers".[110]

Caution when the other party is not a normal business enterprise. The firm should generally be aware of the existence of special legal and administrative rules that govern the activities of parties that are not normal business enterprises (see below).

6.3 Counterparty Commercial Risk

6.3.1 Introduction

Counterparty commercial risk relates to the commercial ability or willingness of the other party to the transaction to fulfil its contractual obligations. Generally, the management of counterparty commercial risk is about behaviour modification. The firm tries to increase the likelihood that the other party will do what the firm wants it to do.

Counterparty commercial risk is generally influenced by the legal framework. There are both contributory legal risks and legal ways to mitigate counterparty commercial risk.

For example, the firm can be exposed to a moral hazard. The other party can have incentives to do things that are contrary to the interests of the firm. Moral hazard can be managed by reducing these incentives and putting in place incentives to further the firm's interests. This can be done by using legal tools designed to manage agency relationships in general.

It is not normally sufficient to tell the counterparty what it must do (rules and standards). The firm should also align the parties' interests (incentives and sanctions) and improve the flow of information (transparency).

[109] See *ibid*, p 19.

[110] See Case C-104/96 Coöperatieve Rabobank "Vecht en Plassengebied" BA v Erik Aarnoud Minderhoud [1997] ECR I-7211.

The firm is exposed to a higher counterparty commercial risk where contracts, property rights and other interests associated with the project are not supported and enforced by the legal framework. Counterparty commercial risk is therefore particularly high in a jurisdiction that does not enforce the rule of law.

6.3.2 Community Law and Member States' Laws

While Community law influences the management of counterparty corporate risk, it leaves the management of counterparty commercial risk practically unaffected. Legal background rules that influence counterparty commercial risk are to a large extent provisions of contract law, and there is no across the board harmonisation of contract law in the EU. There is thus a difference between counterparty commercial risk (no harmonisation at EU level) and counterparty corporate risk (harmonisation of certain company law rules). Some general remarks can nevertheless be made.

Sanctions. Legal background rules create incentives to fulfil contractual obligations in particular by providing for sanctions for breach of contract. There are differences depending on the governing law of the contract and the country where the sanctions are enforced.

The default sanctions are less effective in a country that fails to enforce the rule of law. There can even be differences between countries that do enforce the rule of law. For example, whereas some countries have activist judges, in other countries judges are less eager to intervene in the commercial relationship between the parties. Activist judges tend to accept a lower burden of proof when applying sanctions for breach of contract. Passive judges tend to require a higher burden of proof before applying sanctions for alleged breach of contract.

The firm may therefore have to mitigate counterparty commercial risk in different ways depending on the governing law and the country where the contract is likely to be enforced. In a country with passive judges, the firm should use less open terms and leave the court less discretion. In a country that does not enforce the rule of law, the firm should design an incentive system which does not require the co-operation of the court.

Substantive provisions of law. There are substantive provisions of law governing sanctions for breach of contract in general, specific performance, damages, set-off, reasonableness, penalty clauses, and other matters. They will be discussed in the following section in the context of the management of counterparty commercial risk.

6.3.3 Management of Counterparty Commercial Risk

General Remarks

As discussed in Volume I, Chapter 6, there are several basic legal strategies to address agency problems: behaviour modification; choice of the scope of agency;

alignment of interests; monitoring and transparency; choice of agents; rules and standards; initiation and ratification; and trusteeship and rewards.[111] The firm can mitigate its exposure to counterparty commercial risk by employing these strategies.

On the other hand, informed contract parties will choose from the same pool of risk management strategies (see below). Each contract party can try to manage its own exposure to counterparty commercial risk. Differences in the legal skills or bargaining power of the parties can influence the agreed terms and the strategies that will prevail.

Furthermore, the strategies used by the firm's contract party will influence the firm's exposure to counterparty commercial risk. For example, the contract party may have some discretion to exit the contractual relationship. Counterparty commercial risk is obviously increased, if the contract party has unlimited discretion. It is reduced, if the use of exit rights is subject to effective constraints.

This can be illustrated by early repayment (prepayment). A borrower may have a right to repay the loan before the due date and to terminate the loan agreement in some jurisdictions.[112] However, the borrower may have the right to prepay the loan only on condition that it pays a prepayment fee[113] or reimburses the lender for loss.[114]

Behaviour Modification

At a very general level, the management of counterparty commercial risk requires managing the behaviour of the other party. The other party should be made to cooperate.

Role of culture. The choice of the behaviour-modification method can depend on the parties attitudes and beliefs and cultural factors in general. The other party's attitudes and beliefs should influence the choice of the method. Furthermore, the overall bias of a contract culture towards emphasis on compliance or deterrence can be a key feature of the behaviour-modification style that the firm will use.[115] One can distinguish between compliance, opportunistic, and confrontational cultures.

Compliance culture. Within a compliance culture, the existence of contractual obligations can be expected to discourage infringements. For example, small developed countries can be more likely to have a compliance culture because of

[111] Compare Kraakman R, Davies PL, Hansmann H, Hertig G, Hopt KJ, Kanda H, Rock EB (eds), The Anatomy of Corporate Law. OUP, Oxford (2004) pp 22–23.

[112] See § 271 BGB. Diem A, Akquisitionsfinanzierungen. C.H. Beck, München (2005) § 24 number 5.

[113] There is, as a rule, no prepayment fee under German law. See Diem A, *op cit*, § 25 numbers 2 and 35.

[114] § 490(2) BGB (Vorfälligkeitsentschädigung). § 489(4) BGB prohibits the duty to reimburse the lender for damage (Vorfälligkeitsentschädigung) in some cases (ordentliches Kündigungsrecht).

[115] Generally, see Hood C, Rothstein H, Baldwin R, The Government of Risk. OUP, Oxford (2001) p 27.

stronger social control (many people know you or someone who knows you); in such countries, breach of contract can be expected to trigger less severe agreed sanctions, because other sanctions (such as getting a bad reputation) will often be expected to work as a sufficient deterrent. On the other hand, outsiders might not benefit from mutual social control in close-knit societies. Furthermore, a party may have incentives to breach contractual obligations owed to outsiders in a close-knit society. For this reason, it would be necessary for outsiders to agree on sufficient contractual sanctions in detail even in a compliance culture.

Opportunistic culture. Within an opportunistic culture, contractual obligations will work better if accompanied by a substantial investment in detection and the application of sanctions for breach of contract. Detailed disclosure duties and detailed sanctions for non-compliance are the norm. For example, large countries like Germany and the US tend to have an opportunistic culture (most people are strangers).

Confrontational culture. Within a confrontational (defiance) culture, it is the norm that contractual obligations will be breached if the party can benefit from it. Contract parties typically try to obtain a position of strength and force the other party to behave in a certain way. For example, communist countries or countries that belonged to the former Soviet Union are more likely to have a defiance culture.[116]

Corruption. High-corruption countries are less likely to have a compliance culture. The Transparency International corruption index therefore shows in which countries counterparty commercial risk is particularly high.

Setting the Terms of Entry

Before choosing the counterparty, the firm would like to know whether the counterparty is reliable. Information about reliability is often difficult to obtain or not verifiable. However, the firm can mitigate counterparty commercial risk in advance by determining the terms of entry. The purpose of the entry strategy is to screen out unwanted counterparties in advance.

First, the firm may use processes that establish, in advance, the overall parameters of counterparty relationships: the approval of counterparties and the core terms of the contractual framework.

Second, the firm may use preformulated contract terms designed for its preferred target group. This can help the firm to avoid counterparties who do not belong to its preferred target group and for whom the legal documentation has not been designed. For example, the firm can use standard form contracts and standard legal practices to document transactions. This can help the firm to identify parties that are not familiar with such standards. Boilerplate language in standard legal

[116] *Ibid*.

agreements can increase transaction costs for customers who have not already applied them (for legal platforms, see section 2.2.2).[117]

Third, the firm may require some form of disclosure to obtain an adequate supply of information regarding the other party. The separation of signing and closing, conditions precedent to closing, due diligence and legal opinions, as well as representations and warranties belong to traditional legal tools that enable the firm to obtain more information about its counterparty.

Verification of Previously Unverifiable Information

Many popular legal tools and practices have been designed to manage agency relationships by helping the firm to verify information that could not have been verified prior to the conclusion of the contract. Typically, they give the firm an early exit option or make the obligations of the firm conditional upon the other party fulfilling its obligations in general, achieving an agreed result, or complying with an agreed minimum standard. This can be illustrated by the following three situations.

Employees. It is difficult to know whether a new employee will live up to expectations. Instead of offering immediate full-time and long-term employment, the firm can agree on a probationary arrangement as a test period on the assumption that the firm is free to end the employee's contract for any reason during the probationary period.

New suppliers. It is just as difficult to know whether a new supplier will live up to expectations. Instead of agreeing on large and long-term purchases, the firm can buy smaller amounts and test the supplier's ability.

Sale and installation. Commercial contracts which involve the production and installation or building of investment goods such as factories, production equipment or computer systems give rise to increased risk because of the project's size and complexity. The contractor may have promised not only to sell and install certain investment goods which have the agreed specifications but also that the goods achieve a certain agreed technical result in the context of the buyer's existing industrial infrastructure. As the contractor does not necessarily have sufficient information about the context, it can be difficult to know in advance whether the contractor will be able to fulfil its promise. For those reasons, the contract often provides for: an installation period; a testing period; forms of acceptance and delivery; a payment schedule; and liquidated damages.

According to the terms of such a contract, the contractor typically agrees to furnish the agreed technical equipment, software, and other investment goods. These goods must meet the agreed specifications. The contractor also agrees to install them, and the parties have agreed that the installed system must fulfil certain performance specifications in the context. The buyer has agreed to prepare the site.

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[117] See also Gilo D, Porat A, The Hidden Roles of Boilerplate in Standard Form Contracts: Strategic Imposition of Transaction Costs, Segmentation of Consumers and Anticompetitive Effects, Mich L R 104 (2006).

There is a performance period as well as agreed installation and delivery dates.

Upon completion of installation, a period of acceptance testing will commence. Acceptance testing is intended to ensure that the system operates substantially in accordance with the agreed technical specifications and meets a satisfactory level of performance reliability.

Upon successful completion of the acceptance tests, the buyer will notify the contractor of acceptance of the system and pay the purchase price or one of the agreed instalments.

If the effective delivery date is later than the agreed delivery and acceptance date, the contractor typically pays liquidated damages.

Setting the terms of exit

The firm can mitigate counterparty commercial risk by setting out the terms of exit in advance. The exit strategy can allow the firm to walk away if it turns out that the other party cannot or will not fulfil its obligations.

Broadly speaking, there are three kinds of exit rights.[118] (1) The first is the right to withdraw the value of one's investment (or pay the outstanding amount) (withdrawal right). For example, a loan agreement can provide that the creditor may call on a loan (acceleration). Acceleration or withdrawal clauses are typical clauses in international commercial contracts (see below). (2) The second exit right type is the right to transfer claims or the contract as a whole. For example, the terms of the contract can provide that a shareholder has the right to sell the shares that it has bought, or award to a creditor the right to transfer the loan to a third party. (3) The third exit right is the right simply to terminate the relationship (right to walk away). For example, the parties may have agreed that termination of the agreement releases both parties from their obligations under it.

Exit rights are complemented by the modalities of exit. (a) In a contractual relationship, one of the basic questions is whether the contract will remain binding between the parties or whether the contractual relationship will be terminated and cease to be binding. For example, the firm may be able to transfer all its rights under a contract (but remain responsible for the fulfilment of its obligations under the contract) or transfer the whole contract (and cease to be a contract party). (b) There may be other modalities of exit such as requirements as to form (ranging from express termination of the contract to automatic expiry of the contract on the occurrence of a certain event, and from immediate termination to termination after the expiry of a certain period of time). (c) In addition, the legal framework may provide for payments that must be made between the parties (for example, reimbursement for damage or a termination fee).

[118] Two (withdrawal right and right of transfer) according to Kraakman R, Davies PL, Hansmann H, Hertig G, Hopt KJ, Kanda H, Rock EB (eds), *op cit*, pp 24–25.

Alignment of Interests

At a very general level, the firm can mitigate counterparty commercial risk by aligning the interests of the counterparty with its own interests. This can be done in many ways (see Volume I).

The firm can help its counterparty to comply with contractual obligations by ensuring that the obligations are expressed in clear terms in writing (section 5.2.5).

These clear terms can be complemented by terms providing for rewards for compliance. For example, the firm can align interests by promising to make payments to the other party only after the other party has fulfilled its contractual obligations.

In addition, sanctions for non-compliance should make it clear that non-compliance will increase the other party's costs. Sanctions for non-compliance play an important role in the management of counterparty commercial risk (for sanctions, see below). Especially in long-term contractual relationships, a party should ensure that non-compliance will not go unpunished.

Robert Axelrod suggests that there are three necessary conditions for people to cooperate with each other:[119] (1) a likelihood of meeting in the future (the knowledge of future meetings changes behaviour, but people will act selfishly if there is no future to the relationship); (2) an ability to identify each other (if people cannot identify who they are dealing with, they cannot hold that person accountable); and (3) a record of past behaviour (having a positive record of behaviour leads to cooperation). Axelrod came to this conclusion after applying game theory to a game that is repeated. The game was thus a modification of the prisoners dilemma.

According to Axelrod, when the game is repeated the most successful strategy has three elements: (1) players should start out by co-operating; (2) they should deter betrayals by punishing the transgressor in the next round; and (3) they should start co-operating with treacherous players again after meting out the appropriate punishment. The result of this strategy can be sustained co-operation rather than a cycle of recrimination.

Prevention of Moral Hazard, Prevention of Hold-up

Regardless of legal culture (see above), the firm can reduce counterparty commercial risk by avoiding contract terms that create moral hazard situations. For example, the firm can try to avoid the hold-up problem (section 2.5.5) by making sure that it is not dependent on one supplier or one customer. The firm can also try to reverse the hold-up problem by increasing the dependency of this supplier or customer on the firm.

In the case of Lord of the Rings, the movie studio did both. All three movies in the Lord of the Rings series were made before the first was released. The studio wanted to avoid a situation in which Elijah Wood, who played central character Frodo Baggins, could negoti-

[119] Axelrod R, The Evolution of Cooperation. Basic Books, New York (1984); and Axelrod R, Hamilton WD, The Evolution of Cooperation, Science, 27 March 1981, Vol 211, no 4489, pp 1390–1396.

ate a new and more expensive contract on the strength of the success of the first film before completing the final part of the trilogy, Return of the King.[120]

The risk of hold-up can sometimes be avoided by vertical integration. Vertical integration can be achieved, for example, by merging the businesses of the involved parties. The Fisher-GM case is the canonic (but misleading) example of vertical integration designed to mitigate the hold-up problem in the presence of asset specificity.[121]

Vertical integration can be illustrated by the case of distribution networks. A manufacturer that starts doing business in a foreign market can first turn to a local sole distributor that already has access to potential customers. If the sole distributor is successful, the manufacturer can become too dependent on it. The manufacturer will therefore try to acquire the distributor, or terminate the sole distributorship and establish a subsidiary instead. As this is a standard situation in commercial agency and distributorship contracts, it is addressed by agency laws[122] and standard sole distributorship contracts.[123]

Monitoring and Transparency

Transparency is one of the core ways to manage agency relationships, and disclosure obligations and other information obligations belong to the most important ways to manage counterparty commercial risk. The management of information between contract parties will be discussed in Chapter 7. Covenants will be discussed in section 11.6.2.

Selection and Removal

The right to select or remove the people or other parties responsible for the execution of the contractual obligations of the counterparty can be used in some circumstances.

Selection and removal rights are typically connected with capital investment in the other party to the contract. For example, private equity or venture capital firms may require a right to select and remove board members and senior executives.[124]

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[120] Gilson R, Goldberg V, Klausner M, Raff D, Building foundations for a durable deal, Financial Times, Mastering Transactions, October 12, 2006.

[121] For a critical view see Coase R, The Conduct of Economics: The Example of Fisher Body and General Motors, J Econ Man Strat 15 (2006) pp 255–278.

[122] Directive 86/653/EEC (self-employed commercial agents). See Chapter IV of the Commercial Agency Directive on termination of the agency contract and Article 17 on indemnity or compensation payable on termination.

[123] See, for example, the ICC Model Distributorship Contract.

[124] Burrough B, Helyar J, Barbarians at the Gate. The Fall of RJR Nabisco (1990): “But while the CEO remains nominal head, and often retains operating autonomy, there is no mistaking who calls the shots: firms such as Kohlberg Kravis and Forstmann Little control every board, approve every budget, and retain the power to remove senior executives at their whim.”

If they can appoint their agents ex ante, they can screen for loyalty. If they can remove their agents ex post, they can punish disloyalty.[125]

Ratification, Covenants

In principle, the use of selection and removal rights is not limited to capital investment. The ratification strategy can expand the firm's rights to intervene in the counterparty's management in all kinds of investment contracts.

Ratification terms can be used instead of selection and removal rights to act as a constraint on the exercise of other party's selection and removal rights. Such ratification terms are typical in investment projects the completion of which is to a high degree dependent on the personal involvement of certain people employed by the counterparty or the participation of certain subcontractors.[126] For example, if it is important who will actually perform the other party's obligations, the identity of that person or those persons can be agreed on in advance and the firm may make any changes subject to its prior written approval.

In contracts where the change of ownership and control of the firm's counterparty would influence the firm's risk exposure, the firm typically requires a covenant according to which the ownership and control of the other party must not change or that changes of ownership and control require the firm's prior written consent (change of control clause). Where the firm's contract party is owned and controlled by a certain person, whose personal involvement is essential for the project, the change of ownership or control can be made subject to the consent of the firm, and the firm may also require that person to undertake a personal obligation to participate in the project.

Large financial contracts often contain covenants or terms according to which large and fundamental corporate decisions (such as mergers and charter amendments) require the prior written consent of the investors.[127] As a reaction to the judgment in the US case of *Metropolitan Life Insurance v RJR Nabisco*,[128] bond purchasers began to demand covenants in the form of put option and repurchase provisions to protect themselves in the case of takeovers.[129]

Rules and Standards

The most basic legal strategy to address agency problems nevertheless is to tell the agent what to do. This can be done in advance by using either rules or standards. For example, the firm can use detailed contract terms (rules) combined with open clauses such as the duty to act in "good faith" (standards).

[125] See Kraakman R, Davies PL, Hansmann H, Hertig G, Hopt KJ, Kanda H, Rock EB (eds), *op cit*, pp 27–28.
[126] See *ibid*, p 26.
[127] *Ibid*.
[128] Metropolitan Life Insurance Co. v. RJR Nabisco, Inc. 716 F. Supp. 1504.
[129] See Bratton WW, Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process, EBOLR 7 (2006) pp 39–87.

In order to mitigate counterparty commercial risk, the firm should ensure that the other party knows what is expected from it and that the other party will not accidentally breach its obligations. The firm should therefore use clear contract terms that lay down with sufficient precision the core duties of its counterparty (a rule-based strategy).

However, it is in many cases neither possible nor cost-effective to regulate everything in advance. For example, the contract should not be made too rigid. It is normal to complement the rule-based strategy and core contract terms by relatively open terms (a standard-based strategy). For example, these open terms can include catch-all terms such as the duty to act in "good faith".

The role of such agreed standards depends on the governing law. In civil law countries, legal background rules typically provide for standards. The standards will also influence the interpretation of the agreed terms (section 5.2.4). In common law countries, the absence of implied legal standards has traditionally been complemented by the parol evidence rule (section 5.2.4). For these reasons, it is typically more important to agree on standards in common law jurisdictions.

This can be illustrated by the US case of *Metropolitan Life Insurance v RJR Nabisco*[130] in which the court in effect said that there is no good faith duty in bond contracts between highly sophisticated parties. According to the court, it can be presumed that such contracts are complete, because highly sophisticated parties are fully capable of negotiationg protection. Therefore, absent an explicit contract term, there should be no legal constraints on borrower opportunism and no good faith (or fiduciary) duties run from the borrower to the bondholders, unless the opportunistic conduct violates an explicit clause of the contract.[131]

Trusteeship

The "hard" method of using rules and standards can, at least within a compliance culture, be complemented by the trusteeship strategy. The trusteeship strategy is "softer".[132]

The trusteeship seeks to eliminate conflicts of interest in advance to ensure that bad behaviour by the counterparty will not be rewarded. For example, the investment contract may provide that certain things may not be done by the counterparty without a favourable opinion given by an independent party (a bank, an auditor, a lawyer). The terms of the contract may also lay down procedures for disclosure and management of information and for internal controls.

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[130] Metropolitan Life Insurance Co. v. RJR Nabisco, Inc. 716 F. Supp. 1504.

[131] See Bratton WW, Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process, EBOLR 7 (2006) pp 39–87.

[132] See Kraakman R, Davies PL, Hansmann H, Hertig G, Hopt KJ, Kanda H, Rock EB (eds), The Anatomy of Corporate Law. OUP, Oxford (2004) pp 26–27. For "high-powered incentives" and "low-powered incentives", see Williamson OE, The economic institutions of capitalism. The Free Press, New York (1985); Holmström B, Milgrom P, The Firm as an Incentive System, Am Econ R 84 (1994) p 972.

Rewards, Incentives

The reward strategy can reward the other party for successfully advancing the interests of the firm. There are monetary rewards and non-monetary rewards.

Monetary rewards. There are two principal reward mechanisms. The first is a sharing rule that motivates loyalty by tying the counterparty's monetary returns directly to those of the firm. The second reward mechanism is the pay-for-performance regime, in which the counterparty, although not sharing in the firm's returns, is nonetheless paid for successfully advancing the firm's interests.

Effect of risk. Different forms of payment obligations are combined with different levels of risk (see Chapter 10). If given the choice, the counterparty can be biased to favour action which leads to rewards which are more predictable.

This can be illustrated by the hedge-fund industry. A portfolio of small, young funds with prior good performance tends to outperform a portfolio of large, mature funds with prior poor performance.[133] However, young, small funds prefer not to stay small. This is because of their fee structure. An annual fee (for example, 2% of capital managed) is fixed. A performance fee (for example, 20% of profits) is based on performance. For a small hedge fund, the annual fee may not be enough to cover the costs. Because the annual fee is predictable but the performance fee is not, fund managers can prefer to start up more funds and increase the amount of assets under management.[134]

Non-monetary rewards. There are even other rewards. For example, the trusteeship strategy is based on the assumption that "in the absence of strongly focused – or 'high-powered' – monetary incentives to behave opportunistically, agents will respond to the 'low-powered' incentives of conscience, pride, and reputation".[135]

Long-term incentives, staggered payments. Long-term incentives and staggered payments can sometimes be used to manage information problems.

Generally, where information about the other party's performance becomes available during the course of the contract after the fact, the firm can mitigate counterparty commercial risk by making payments after the other party's performance has been verified.

This can be a solution to hold-up problems (section 2.5.5). The firm can structure its payments to coincide with the counterparty's investments.

Long-term incentives and staggered payments can also be used when dealing with suppliers of credence goods (generally, see Volume I). Suppliers of credence goods not only provide a service but also tell the customer what service the customer needs. Where the firm is a buyer of credence goods, the firm can mitigate counterparty commercial risk by ensuring that the counterparty has the same one-off incentives to fulfil its obligations and better long-term incentives depending on the quality of its work.

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[133] Boyson NM, Hedge Fund Performance Persistence: A New Approach, Financial Analysts Journal 64(6) (2008) pp 27–44.

[134] Buttonwood, Locked away, The Economist, December 2008.

[135] See Kraakman R, Davies PL, Hansmann H, Hertig G, Hopt KJ, Kanda H, Rock EB (eds), The Anatomy of Corporate Law. OUP, Oxford (2004) pp 26–27.

The Use of Sanctions: General Remarks

Non-compliance should not go unpunished (see alignment of interests above). For any type of conduct that the firm wishes to discourage, rational choice theory advises the firm to set the penalty for the undesirable conduct such that the counterparty will calculate that the expected costs of the conduct exceed the expected benefits to it.

The use of contract terms that lay down sanctions for failure to perform contractual obligations belongs to the basic ways to mitigate counterparty commercial risk. Their purpose is to increase the cost for non-compliance and act as a deterrent. The choice of sanctions depends on many things: the relative bargaining power of the parties; the importance of the obligation to each party; societal culture; legal culture; and other things. The use of sanctions can be part of a rule-based strategy (where both the contractual obligations and the sanctions are clear) or a standard-based strategy (where either the obligations or the sanctions or both will be determined after the fact).

Level of trust. In practice, firms often execute contracts without consideration of the legal principles involved. This may be done, for example, to avoid inconvenience or to cut costs in the short term, or because of the level of trust between the contracting parties.

The level of trust varies depending on the circumstances. The firm should regulate sanctions for breach of contract in advance, if the counterparty would not face sufficiently serious adverse consequences for non-compliance otherwise. For example, a small firm with little bargaining power should not assume that a large counterparty will always honour its contractual obligations to firms in that position.

On the other hand, sometimes the contractual sanctions for breach of contract are not vital. Failure to perform would sometimes have adverse consequences on the other party's reputation and future trading relations.[136] For example, if a small firm is dependent on a large customer, it will have to keep its large customer happy. In some business areas, trust is particularly important. A famous example of the importance of trust is the development of financial markets in the UK in the 20th century. Parties relied more on informal relations of trust than on formal systems of regulation.[137]

Sometimes the other party really has no other option than to comply with its contractual obligations. For example, the prospect of vengeful retaliation prevented the United States and the Soviet Union from starting a thermonuclear war.

Contractual sanctions: adverse consequenses to the counterparty. The firm may therefore have reason to assume that the other party will do its best to fulfil its contractual obligations where it is absolutely vital for the other party to do so.

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[136] See Sharma KM, From "Sanctity" to "Fairness": An Uneasy Transition in the Law of Contracts? NY L School J Int Comp L 18 (1999) pp 118–119.

[137] See Franks JR, Mayer C, Rossi S, Ownership: Evolution and Regulation (March 25, 2005). ECGI - Finance Working Paper No. 09/2003; EFA 2004 Maastricht Meetings Paper No. 3205; AFA 2003 Washington, DC Meetings.

Due to the self-interest of the other party, the firm might not need to rely on specific contract terms that lay down extensive sanctions for non-compliance.

In such a case, the firm tends to rely more on informal and extra-legal sanctions. They may be based on the counterparty's moral beliefs (sensitivity of commercial righteousness, the preservation of private friendships and relationships) or commercial self-interest (the preservation of a reputation, the effect of this reputation on other potential business partners, the effect of disputes or litigation on future dealings between the parties).[138] Serious commercial enterprises in developed countries are generally concerned with preserving rather than with discontinuing their contractual commitments.[139]

On the other hand, it may be necessary to agree on complementary contractual sanctions. They may be necessary in particular to clarify the effect of non-compliance on the contractual obligations of the parties. They will set out the process of dispute resolution, the liability for costs, the adjustment of price and other payment obligations, the future obligations of the parties, and so forth.

For example, in long-term relational contracts (such as long-term leases, construction and civil-engineering contracts, joint-venture agreements, license and know-how agreements) the parties are often better off adjusting their mutual obligations in the event that one of the parties fails to fulfil some of its obligations than terminating the contractual relationship. Complementary contractual sanctions can help to facilitate this process and to reimburse the other party for any inconvenience caused by the breach.

Contractual sanctions: no adverse consequences for the counterparty. If failure by the counterparty to perform its contractual obligations would not have serious adverse consequences for the counterparty, it can be necessary for the firm to agree on an effective package of sanctions for non-compliance. The threat of the enforcement of sanctions can give the counterparty an incentive to fulfil its obligations.

Contractual sanctions: adverse consequences for the firm. In addition, the firm may need to agree on sanctions for non-compliance if non-compliance by the counterparty would have serious consequences for the firm. If non-compliance by the counterparty had serious consequences for the firm, there would also be a higher risk that the counterparty would breach its obligations or threaten the firm with non-compliance in order to press for changes to the contract (hold-up, section 2.5.5).

For example, the risk of serious consequences is likely to be higher in long-term contracts where the firm will incur significant costs upfront and recover them over the duration of the contract; the firm depends on the contract actually being carried out for the length of time and on the basis of the framework initially nego-

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[138] See Burrough B, Helyar J, Barbarians at the Gate. The Fall of RJR Nabisco (1990): "'The fact that it's a small fraternity is good for discipline,' Flom says. 'I see this in small-town legal bars. You fight harder because, it's like, who's going to win the chess game? It keeps you honest because everybody knows each other. Everybody knows what everybody's doing. There are no secrets.'"

[139] See Sharma KM, From "Sanctity" to "Fairness": An Uneasy Transition in the Law of Contracts? NY L School J Int Comp L 18 (1999) pp 160–161.

tiated with the counterparty. The contractual sanctions for non-compliance would then have to be serious enough in order to counterbalance the potential harm that the firm might sustain and to prevent the counterparty from getting the upper hand in the contractual relationship.[140]

Sanctions and the overconfidence bias. The overconfidence bias can have an influence on the effectiveness of contractual sanctions as a deterrence. According to the rational choice theory, the firm should ensure that the expected costs of non-compliance exceed the expected benefits. Where the counterparty exhibits overconfidence, however, the firm will have to set the penalties higher than it would set them in the absence of overconfidence.[141]

Dispute resolution and the self-serving bias. According to behavioural economics, the self-serving bias can influence the effectiveness of dispute resolution as a system that contributes to compliance. Evidence of the self-serving bias provides support for legal structures that require litigating parties to view the fact of a dispute through the eyes of their opponents. These might include, for example, the use of mandatory settlement conferences, court-ordered mediation, or non-binding arbitration. According to rational choice theory, mandated interaction would merely increase transaction costs for no useful purpose.[142]

Sanctions: Some Legal Background Rules

Sanctions for breach of contract are governed by the law that governs the contract.[143] There are differences depending on the governing law.

Specific performance. Generally, there are limitations on the availability of specific performance, but differences exist as to the extent of these limitations.

In civil law countries, the main rule is that specific performance is available generally, subject to narrow exceptions. Parties are expected to keep their bargain. If the obligor does not perform, the law will instead employ various legal means to compel him to do so. It is only where these fail, or where such means are not available, that the question of substitutionary relief in the form of damages arises.

In common law countries, specific performance is an exceptional remedy. The duty to keep a contract means a prediction that you must pay damages if you fail to do so.[144]

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[140] See Berger KP, Renegotiation and Adaptation of International Investment Contracts: The Role of Contract Drafters and Arbitrators, Vanderbilt J Transn L 36 (2003) pp 1348–1349.

[141] See Ulen TS, Information in the Market Economy – Cognitive Errors and Legal Correctives. In: Grundmann S, Kerber W, Weatherill S (eds), *op cit*, p 118.

[142] *Ibid*, p 121.

[143] Article 12(1) of Regulation 593/2008 (Rome I): "The law applicable to a contract by virtue of this Regulation shall govern in particular: … (c) within the limits of the powers conferred on the court by its procedural law, the consequences of a total or partial breach of obligations, including the assessment of damages in so far as it is governed by rules of law …"

[144] See Miller L, Penalty Clauses in England and France: A Comparative Study, ICLQ 53 (2004) pp 96–99.

According to the CISG, the aggrieved party has a broad right to contractual performance: "The buyer may require performance by the seller of his obligations unless the buyer has resorted to a remedy which is inconsistent with this requirement."[145] Such inconsistent remedies include: (1) avoidance of the contract;[146] (2) price reduction; [147] and (3) a claim for damages based on the market-contract price differential. [148]

However, the court is not required to grant specific performance of a foreign contract under the CISG unless it would require specific performance of a similar domestic contract.[149] This limitation was the result of a compromise between civil law countries and common law countries.

Damages. Damages are the most common sanction for breach of contract. For example, the CISG provides: "Damages for breach of contract by one party consist of a sum equal to the loss, including loss of profit, suffered by the other party as a consequence of the breach. Such damages may not exceed the loss which the party in breach foresaw or ought to have foreseen at the time of the conclusion of the contract, in the light of the facts and matters of which he then knew or ought to have known, as a possible consequence of the breach of contract."[150]

Price reduction. Reduction of the price is a related remedy. Typically, damages are not available under legal background rules to the extent that the loss has been offset by a price reduction.[151]

Unreasonable sanctions. Depending on the governing law, some agreed sanctions may be void or unenforceable or can be modified by the court. This applies to sanctions that are regarded as unreasonable or the exercise of which would be a violation of the duty to act in good faith. Unfair contract terms have already been discussed above (sections 5.3.5 and 5.3.6).

Penalty clauses. Penalty clauses can raise questions of fairness and reasonableness. These clauses are treated differently in civil law and common law jurisdictions.[152]

In civil law countries, the main rule is that they are binding and enforceable unless they are unreasonable.

In France, the main rule is that a clause pénale[153] is binding. The clause is deemed to fix in advance the amount of damages upon the occurrence of de-

[145] CISG Article 46(1).
[146] CISG Articles 26, 49, and 81.
[147] CISG Article 50.
[148] CISG Article 74.
[149] CISG Article 28: "If, in accordance with the provisions of this Convention, one party is entitled to require performance of any obligation by the other party, a court is not bound to enter a judgement for specific performance unless the court would do so under its own law in respect of similar contracts of sale not governed by this Convention."
[150] CISG Article 74.
[151] CISG Article 50.
[152] Miller L, Penalty Clauses in England and France: A Comparative Study, ICLQ 53 (2004) pp 79–106. See also Scottish Law Commission, Penalty Clauses [1999] SLC 171 (Report) (May 1999).
[153] Article 1226 Code civil.

fault.[154] Originally, the main rule was that the court must respect freedom of contract and may not modify a clause pénale.[155] Nowadays, the court may decrease the sum where it is manifestly excessive or derisory. The parties are not permitted to waive this mandatory rule.[156]

In Germany, the use of penalty clauses is constrained by rules that limit the use of unreasonable contract terms in general (section 5.3.6). For example, there are particular restrictions on the contents of standard form contracts.[157]

This can be contrasted with English law. In England, a distinction is made between liquidated damages (a payment clause) and penalty clauses according to the principles set out in *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd*.[158]

A payment clause represents a genuine pre-estimate of damages. It does not matter whether actual (or recoverable) loss amounts to more or less than the sum stipulated. A payment clause is enforceable when it functions as a liquidated damages clause.

However, a payment clause is unenforceable to the extent that it is held as a penalty clause.[159] It has been said that "the main purpose of the law relating to penalty clauses is to prevent a plaintiff recovering a sum of money in respect of a breach of contract committed by a defendant which bears little or no relationship to the loss actually suffered by the plaintiff as a result of the breach by the defen-

154 Article 1229 al.1 Code civil.

155 Article 1152 Code civil.

156 Article 1152 al. 2 Code civil. See also Article 1231 Code civil. In principle, the court may even increase the sum.

157 § 309 BGB: "Auch soweit eine Abweichung von den gesetzlichen Vorschriften zulässig ist, ist in Allgemeinen Geschäftsbedingungen unwirksam … 5. die Vereinbarung eines pauschalierten Anspruchs des Verwenders auf Schadensersatz oder Ersatz einer Wertminderung, wenn a) die Pauschale den in den geregelten Fällen nach dem gewöhnlichen Lauf der Dinge zu erwartenden Schaden oder die gewöhnlich eintretende Wertminderung übersteigt oder b) dem anderen Vertragsteil nicht ausdrücklich der Nachweis gestattet wird, ein Schaden oder eine Wertminderung sei überhaupt nicht entstanden oder wesentlich niedriger als die Pauschale; 6. eine Bestimmung, durch die dem Verwender für den Fall der Nichtabnahme oder verspäteten Abnahme der Leistung, des Zahlungsverzugs oder für den Fall, dass der andere Vertragsteil sich vom Vertrag löst, Zahlung einer Vertragsstrafe versprochen wird; …"

158 Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd [1915] AC 79, at 87.

159 Jobson v Johnson [1989] 1 WLR 1026. Miller L, Penalty Clauses in England and France: A Comparative Study, ICLQ 53 (2004) p 80: "This prohibition of the penalty clause accords with the English conception of damages. Since the purpose of an award of damages is to compensate the claimant, it follows that it would be illegitimate to allow a clause in a contract that stipulated for a sum which is in excess of the actual loss of the obligee."

dant."[160] In essence, the court will modify penalty clauses rather than wholly disregard them.[161]

Set-off. Set-off and netting can be used for the purpose of mitigating counterparty credit risk. They as well as other credit enhancements will be discussed in section 11.6.

Termination. Termination clauses belong to the core terms of long-term contracts. Termination is also a way to mitigate counterparty commercial risk.

The main rule is that parties to a contract must keep their bargain even if there has been a change in the circumstances. There are exceptions to this main rule. (1) The contract can be declared null and void in the case of fraud (section 5.3.4). (2) Some exceptions apply generally in the case a change in the circumstances (section 5.5.3). (3) Long-term contracts concluded for an indefinite duration can be terminated. (4) As regards the management of counterparty commercial risk, the most important exception is nevertheless the right of the aggrieved party to terminate the contract where the other party fails to fulfil its obligations. The right to terminate the contract is not unlimited.

For example, the CISG provides that the buyer may declare the contract avoided in three cases: (1) if the seller is guilty of a fundamental breach of contract;[162] (2) in case of non-delivery, if the buyer has fixed an additional period of time of reasonable length for performance by the seller of his obligations (Nachfrist),[163] and the seller still does not deliver the goods or declares that he will not deliver within that period;[164] and (3) on grounds of the seller's anticipated fundamental breach of contract.[165]

The CISG also provides that the buyer loses the right to declare the contract avoided on grounds of breach of contract unless he does so within a reasonable period of time. First, the buyer must have given the seller notice of breach of contract within a reasonable time.[166] Second, the buyer must have declared the contract avoided within a reasonable time.[167]

In the case of an anticipated breach, the party intending to declare the contract avoided must give reasonable notice to the other party in order to permit him to provide adequate assurance of his performance.[168]

Similar principles can be found in other areas of contract law. For example, German law provides that: (a) a loan agreement can be declared void in the case of fraud;[169] (b) a loan agreement can be terminated due to a material adverse change

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160 Lord Roskill in Export Credits Guarantee Department v Universal Oil Products [1983] 2 Lloyd's Rep 152, at 155.
161 See Miller L, Penalty Clauses in England and France: A Comparative Study, ICLQ 53 (2004) pp 84–85.
162 CISG Article 49(1).
163 See § 308 Nr. 2 BGB, 676b(3) BGB,
164 CISG Article 49(1).
165 CISG Articles 72(1) and 73.
166 CISG Article 39(1).
167 CISG Article 49(2).
168 CISG Article 72(2). See also CISG Article 72(3).
169 See § 119 BGB (Irrtum) and 123 BGB (Täuschung).

in circumstances (Störung der Geschäftsgrundlage);[170] (c) a loan agreement concluded for an indefinite duration can be terminated by notice;[171] (d) a loan agreement can generally be terminated for an important reason (aus wichtigem Grund);[172] and (e) a loan agreement can be terminated in certain cases of anticipated default.[173] In Germany, termination is constrained by the general duty to observe good faith (Treu und Glauben, § 242 BGB). For example, a bank may not terminate a loan agreement at an unusual time when it is impossible for the borrower to refinance the loan (Kündigung zur Unzeit),[174] or when it would only cause the borrower harm.[175]

Sanctions, Remedies and Events of Default

The firm will take the legal background rules into account when designing a sanction package.

The firm should ensure that the contractual obligations and sanctions for their breach form a meaningful whole. Sanctions are always connected to the occurrence of certain events. For example, if failure to comply with a certain contractual obligation is not regarded as an event that triggers contractual sanctions, compliance is left to the discretion of the other party. This would create a moral hazard. The firm should therefore ensure that each obligation is complemented by adequate sanctions.

Sanctions and remedies. There are contractual sanctions that do not have to be regarded as remedies for breach of contract. For example, many de facto sanctions such as turning to the contract party's competitors belong to this category.

On the other hand, many contractual sanctions can be regarded as remedies for breach of contract.

Default. A usual technique is to give the aggrieved party certain rights upon the occurrence of a "default" and to define these events.

Usually, the occurrence of an event of default does not require any action by the aggrieved party. According to the laws of some countries, however, a contract party will not be in default unless the aggrieved party has notified it of the failure to comply with contractual obligations. Provisions of German law can require no-

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[170] § 314 BGB in combination with § 490(3) BGB.

[171] See, for example, Diem A, Akquisitionsfinanzierungen. C.H. Beck, München (2005) § 23 number 2.

[172] § 314 BGB in combination with § 490(3) BGB.

[173] § 490(1) BGB: "Wenn in den Vermögensverhältnissen des Darlehensnehmers oder in der Werthaltigkeit einer für das Darlehen gestellten Sicherheit eine wesentliche Verschlechterung eintritt oder einzutreten droht, durch die die Rückerstattung des Darlehens, auch unter Verwertung der Sicherheit, gefährdet wird, kann der Darlehensgeber den Darlehensvertrag vor Auszahlung des Darlehens im Zweifel stets, nach Auszahlung nur in der Regel fristlos kündigen."

[174] See, for example, Diem A, *op cit*, § 23 number 24. For the application of the same principle, see § 627(2) BGB, § 671 (2) BGB, § 675(1) BGB, § 723(2) BGB.

[175] See Diem A, *op cit*, § 23 number 27.

tification (Mahnung).[176] If the firm is both the obligee and the party with the stronger bargaining position, the firm tends to agree otherwise and ensure that such dispositive provisions will not be applied.[177]

Cross-default. A cross-default clause goes even further. A cross-default clause is a provision under which default on one obligation under one contract triggers default on many other obligations under one or more other contracts. It is usually applied in international loan agreements and can, in practice, mean that breach of any one of the borrower's many debt obligations triggers default on all other debt obligations. The existence of a cross-default clause makes it very important for the party to comply with its obligations (see below and Volume III).

Obligations. When drafting the obligations of the other contract party, the firm should check their effect on the availability of remedies. Legal background rules may give the firm a right to certain remedies where the other party fails to do certain things. If the agreed obligations of the other party differ from the obligations based on the governing law, the availability of remedies can be less clear. In order to mitigate interpretation risk, the firm should therefore regulate its remedies expressly.[178]

Particular Remedies in the Case of Default

Typical remedies available to the firm depend on the nature of the contract and the particular circumstances of the parties. For example, there is plenty of variation between a Eurocurrency loan agreement and an agreement that belongs to another contract type, but there is variation even between remedies available to lenders under two Eurocurrency loan agreements (section 9.5.2). Usually, a mix of remedies is used. The governing law may provide for a mix of remedies depending on the contract type.[179]

Discretion to use remedies. To begin with, the firm should pay attention to the level of discretion available to it. In some cases, a party may be deemed to have waived a particular remedy if it has not exercised it. Furthermore, some remedies such as damages and specific performance may be mutually exclusive in the cir-

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[176] § 286 BGB. See also § 309 Nr. 4 and § 307 BGB

[177] See, for example, Diem A, *op cit*, § 18 number 5.

[178] *Ibid*, § 22 number 35: "Financial Covenants haben den Vorteil, dass klar bestimmt ist, wann ein Recht zur Nachbesicherung oder ein Kündigungsrecht gegeben ist. Andererereseits bedeutet das aber auch, dass die Financial Covenants den allgemeiner formulierten Rechten der Bank zur Nachbesicherung (z.B. Nr. 13 Abs. 2 AGB-Banken) und zur Kündigung aus wichtigem Grund (§ 490 Abs. 1 BGB, Nr. 19 Abs. 3 AGB-Banken) als speziellere Regelung vorgehen können. Wenn also ein bestimmter Sachverhalt von einem financial Covenant erfasst wird, dessen Voraussetzungen aber nicht vollständig erfüllt sind, besteht die Gefahr, dass der Anspruch der Bank auf Nachbesicherigung und ihr Kündigungsrecht aufgrund anderer allgemeinerer Rechtsgrundlagen ausgeschlossen sein könnte. Dies kann aber durch eine klarstellende Vertragsbestimmung verhindert werden, wonach die Geltung der AGB durch den Kreditvertrag nicht berührt werden soll."

[179] See, for example, CISG Article 45.

cumstances. Where the firm is the party most likely to exercise the agreed remedies, the firm should ensure that it will always have discretion to do so. The firm might address this problem by using a no-waiver clause.

This is a no-waiver clause: "No failure to exercise, nor any delay in exercising, on the part of the Firm any right or remedy hereunder shall operate as a waiver thereof, nor shall any single or partial exercise of any right or remedy prevent any further or other exercise thereof or the exercise of any other right or remedy."

Cumulative or non-cumulative rights. The above no-waiver clause is complemented by the rights cumulative clause. When drafting the contract, the firm should decide whether the explicit remedies set out in the contract are complemented by legal background rules (rights cumulative), or whether the application of the agreed contract terms will exclude the application of the legal background rules (rights non-cumulative). This choice depends on whether the firm is more likely to be the aggrieved party or the party that will fail to fulfil its obligations (section 2.4.3).

The following clause is an example of cumulative sanctions: "All remedies of any party under this Agreement, whether provided herein or conferred by statute, civil law, common law, custom or trade usage, are cumulative and not alternative and may be enforced successively or concurrently."

The following clause is an example of non-cumulative sanctions: "The remedies set out in this Agreement shall be the only remedies available to the parties for breach of contract."

According to the Rome I Regulation, remedies available to a contract party in the case of default are governed by the law that governs the contract. Some sanctions may nevertheless be regarded as procedural or administrative according to lex fori and governed by lex fori. It is possible that such sanctions are cumulative regardless of the terms of the contract.

Typical clauses. The parties normally agree on certain basic remedies. They include: interest for late payment; waiver; grace period; suspension of the performance of obligations; damages; termination at will; and termination for cause.

Interest for late payment. Late payment can trigger an obligation to pay default interest under legal background rules (section 9.5.1) or specific contract terms. The firm should check whether the legal framework enables the firm to claim reimbursement for loss in addition to interest for late payment.[180]

Waiver. The aggrieved party can agree to waive remedies after the fact, in which case the breach will not result in serious consequences for the party in breach. A waiver can be complemented by waiver fees (for covenant waivers in debt contracts, see section 5.5.5 and Volume III).[181]

Grace period. Sometimes non-compliance by the other party would not really have any adverse consequences for the firm. This can be reflected in the contract.

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[180] Under § 288(4) BGB, the right to claim interest for late payment does not exclude the existence of a claim for damages.

[181] Compare CISG Article 45(3): "No period of grace may be granted to the seller by a court or arbitral tribunal when the buyer resorts to a remedy for breach of contract."

The other party may be given a right to remedy its breach of contract during a short period of time (grace period). It is normal to combine a grade period mechanism with a notification or “Nachfrist” mechanism.[182]

For example, the following default clause contains a grace period mechanism complemented by a notification mechanism: “Defaults: ... (i) the Defaulting Party shall default in any payment to the Non-Defaulting Party with respect to any sum when due pursuant to the Agreement and such failure shall continue for two (2) Business Days after written notice of non-payment has been given by the Non-Defaulting Party to the Defaulting Party ...”

Suspension of performance of obligations. The parties may agree that a party may suspend the performance of his obligations if it becomes apparent that the other party will not perform a substantial part of his own obligations. This remedy is usual where the parties have agreed on repeated deliveries over a period of time.[183]

Damages. According to legal background rules, the payment of damages either complements other remedies or limits their scope. For example, the CISG expressly provides that “the buyer is not deprived of any right he may have to claim damages by exercising his right to other remedies”.[184] The agreed damages clause usually consists of many elements.

First, the contract usually contains a clause according to which the party in breach must hold the aggrieved party harmless against any loss or damage caused by the breach.[185]

The following clause is an example of such a clause: “Indemnification by the Contractor. The Contractor shall indemnify and hold ABCD harmless against any loss, damage, cost, expense or liability arising out of any breach of a representation, warranty, or covenant by the Contractor under this Agreement or from any misrepresentation in or omission from any certificate, instrument, or paper delivered by the Contractor to ABCD pursuant to this Agreement.”

Second, a contract party typically tries to exclude its liability for indirect or consequential loss or damage.[186]

This is the purpose of the following clause: “In no case shall we be responsible for any indirect, special, incidental, consequential, or similar loss or damage to you.”

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[182] CISG Article 47(1): “The buyer may fix an additional period of time of reasonable length for performance by the seller of his obligations.” CISG Article 47(2): “Unless the buyer has received notice from the seller that he will not perform within the period so fixed, the buyer may not, during that period, resort to any remedy for breach of contract. However, the buyer is not deprived thereby of any right he may have to claim damages for delay in performance.”

[183] See CISG Articles 71–73.

[184] CISG Article 45(2).

[185] For the amount of damages for breach of contract, see CISG Article 74. For the duty to take measures to mitigate the loss, see CISG Article 77.

[186] Compare CISG Article 74.

Third, the laws of many countries make it more difficult to limit a party's liability for damage caused wilfully or through gross negligence.[187] Such clauses are either unenforceable when they are regarded as unreasonable,[188] or void.[189].

This is why the following limitation of liability clause does not exclude all liability: "Neither party shall be liable for any consequential or indirect loss or damage caused to the other party unless such loss or damage is caused wilfully or through gross negligence."

Fourth, the party who is more likely to be liable for damage will prefer a cap.[190]

For example, the vendor of a computer software program might use the following clause in its standard business terms: "The maximum liability of the supplier shall be limited to refund to the customer of the price paid by the customer for the program." On the other hand, an Operation and Maintenance Agreement could contain the following clause: "The aggregate liability of Operator, including its subcontractors, agents and employees, under this Agreement for the period from the Plant Acceptance Date until the end of the first Operating Year shall not exceed five million euros."

Fifth, these duties can be complemented by a clause on liquidated damages. A penalty clause (clause pénale) is a functional equivalent to a clause on liquidated damages. A clause on liquidated damages operates to secure two objectives: it gives an incentive to fulfil contractual obligations, and acts as an agreed pre-estimate of damages for breach of a contractual obligation. The benefit of a liquidated damages clause is that the amount payable to the aggrieved party is clear and the extent of actual damage will be less important.

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[187] See, for example, Treitel GH, International Encyclopedia of Comparative Law, Volume VII, Contracts in General, Chapter 16, Remedies for Breach of Contract pp 57–59; Limpens J, Kruithof RM, Meinertzhagen-Limpens AL, International Encyclopedia of Comparative Law, Volume XI, Torts, Chapter 2, Liability for One's Own Act pp 127, 130–134; Rodiére R, International Encyclopedia of Comparative Law, Volume XII, Law of Transport, Chapter 1, Introduction to Transport Law and Combined Transports pp 29–30; Grönfors K, Sjölagens bestämmelser om passagerarbefordran (1987) p 130; Wetterstein P, "Wilful misconduct" och redarens globalbegränsningsrätt. In: Festskrift till Kurt Grönfors (1991) p 442.

[188] For example, § 2–302 of the Uniform Commercial Code (the US) and section 2(2) of the Unfair Contract Terms Act 1977 (the UK).

[189] For example, § 309 BGB (Germany): "Auch soweit eine Abweichung von den gesetzlichen Vorschriften zulässig ist, ist in Allgemeinen Geschäftsbedingungen unwirksam … 7. ... b) ein Ausschluss oder eine Begrenzung der Haftung für sonstige Schäden, die auf einer grob fahrlässigen Pflichtverletzung des Verwenders oder auf einer vorsätzlichen oder grob fahrlässigen Pflichtverletzung eines gesetzlichen Vertreters oder Erfüllungsgehilfen des Verwenders beruhen …"

[190] Compare CISG Article 74: "... Such damages may not exceed the loss which the party in breach foresaw or ought to have foreseen at the time of the conclusion of the contract, in the light of the facts and matters of which he then knew or ought to have known, as a possible consequence of the breach of contract."

In large sales contracts, construction contracts, and installation contracts, liquidated damages are often triggered by delays in the following way: "If the delivery, due to no fault of the buyer, is delayed, the buyer shall be entitled to liquidated damages for delay of 0.5% of the agreed purchase price for the delayed part per each commencing week."

Mandatory laws often prohibit liquidated damages that are exorbitant.

For example, an English law student was hit with £64 in overdraft charges for going 5p overdrawn. He took the bank to court for illegal profiteering and won.[191] The student relied on the Unfair Terms in Consumer Contracts Regulations of 1999, which state that charges must reflect real costs and not be used as an excuse for imposing a penalty. This opened the floodgates, because other banks had been using similar practices.

Sixth, where the contract provides for liquidated damages, the party more likely to pay them typically prefers liquidated damages and other damages that are not cumulative. The party more likely to become the aggrieved party typically prefers them to be cumulative.[192]

For example, the following clause favours the party in breach at the expense of the aggrieved party: "Liquidated damages paid by the Vendor shall be deducted from the amount of damages payable by the Vendor."

Seventh, the same can be said of interest for late payment. The party more likely to pay them typically prefers remedies not to be cumulative. The aggrieved party prefers remedies that are cumulative.[193]

Termination. The events that can trigger termination vary depending on the contract. In a Eurocurrency loan agreement, the following events of default could give the lender the right to terminate the loan agreement: (a) contracts not binding; payment default; breach of financial covenants; misrepresentation; cross-default; (b) the commencement of insolvency proceedings; liquidation of the borrower; execution against the borrower's assets; litigation against the borrower; (c) material adverse change; change of the field of the borrower's business; and change of control.[194]

Termination - forfeiture. The right to suspend the performance of ones own obligations can be complemented by a forfeiture clause. According to a forfeiture clause, money paid by a party in advance of performance will not be recoverable

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[191] Office of Fair Trading v Abbey National plc & others [2008] EWHC 875 (Comm), [2008] 2 All ER (Comm) 625.

[192] CISG Article 45(2): "The buyer is not deprived of any right he may have to claim damages by exercising his right to other remedies."

[193] § 288(4) and § 280(1) and (2) BGB in combination with § 286 BGB provide for cumulative remedies under German law. See, for example, Diem A, Akquisitionsfinanzierungen. C.H. Beck, München (2005) pp 72–73 and 77–78.

[194] Diem A, *op cit*, pp 110–112: "Verletzung einer Zahlungspflicht, Nichterfüllung einer Auflage, Vertragsverletzung; Unrichtigkeit einer Zusicherung; Cross Default; Insolvenz u.ä.; Auflösung; Zwangsvollstreckung; wirksame Verträge; Änderung der Geschäftstätigkeit; Rechsstreite; Kontrollverlust; wesentliche nachteilige Veränderung."

in the event that the contract is terminated because of breach of contract by that party (section 11.3).

Termination - after grace period. If there is a grace period and the other party fails to cure the breach during the grace period, the aggrieved party can have a right to terminate the contract.

Such a clause could look like this: "The provisions of Clause XYZ notwithstanding, this Agreement may be terminated with immediate effect by a Party with respect to the defaulting Party, upon the occurrence of one or more of the following events: (i) A Party commits a breach of any of the provisions of this Agreement and fails to remedy such breach within thirty (30) days after receipt of written notification of such breach given by the other Party ..."[195]

Termination - substantial breach or material adverse change. A substantial breach of contract typically gives the aggrieved party a right to terminate the contract.[196] It is normal to define at least the most fundamental breaches of contract that can lead to termination.

In addition, the parties may agree that certain material adverse changes in circumstances will give the firm a right to terminate the contract. These changes typically include the other party's insolvency and/or change of ownership. They should at least give the firm a right to suspend the performance of its obligations.[197]

The following clause contains all of those elements: "Earlier termination. 1. Each party may terminate this Contract with immediate effect, by notice given in writing, in case of a substantial breach by the other party of the obligations arising out of this Contract, or in case of exceptional circumstances justifying the earlier termination. 2. The parties hereby agree that the violation of the provisions under Clause XYZ of the present contract is to be considered as a substantial breach of this Contract. 3. Furthermore, the parties agree that the following situations shall be considered as exceptional circumstances that justify the earlier termination by the other party: bankruptcy, moratorium, receivership, liquidation or any kind of composition between the debtor and the creditors, or any circumstances that are likely to affect substantially one party's ability to carry out his obligations under this contract."

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[195] CISG Article 49(1): "The buyer may declare the contract avoided: (a) if the failure by the seller to perform any of his obligations under the contract or this Convention amounts to a fundamental breach of contract; or (b) in case of non-delivery, if the seller does not deliver the goods within the additional period of time fixed by the buyer in accordance with paragraph (1) of article 47 or declares that he will not deliver within the period so fixed."

[196] CISG Article 49(1): "The buyer may declare the contract avoided: (a) if the failure by the seller to perform any of his obligations under the contract or this Convention amounts to a fundamental breach of contract ..."

[197] CISG Article 71(1): "A party may suspend the performance of his obligations if, after the conclusion of the contract, it becomes apparent that the other party will not perform a substantial part of his obligations as a result of: (a) a serious deficiency in his ability to perform or in his creditworthiness; or (b) his conduct in preparing to perform or in performing the contract."

Change of ownership gives the other party a right to terminate the contract in the following clause: “Termination. This Agreement may be terminated by a party ('terminating party') with respect to another party ('terminated party'): ... (iii) immediately upon written notice if the terminated party is taken over by or merges with a third party ...”

Termination – important reason. The firm should find out whether a party has a right to terminate the contract for an important reason[198] or due to changed circumstances under legal background rules (section 5.5.3). The firm should also ensure that there is an escape clause that enables it to exit the contractual relationship if necessary (sections 5.5.4 and 5.5.5).

Acceleration. An acceleration clause means that payments become due. They are typically used in loan agreements.

A typical acceleration clause looks like this: “At any time when any Default remains unremedied the Bank may: (i) require the Borrower immediately to repay the Loan together with accrued interest thereon and immediately to pay all other sums payable under this Agreement, whereupon the same shall become immediately due and payable ...”

A cross-default clause typically leads to acceleration. For example, Cirio, an Italian processor of food, failed in 2002 to repay investors who expected €150 million when their bonds matured. This caused Cirio further financial problems, because default on any bond repayment could have triggered a cross-default and immediate demands for repayment of all other bonds issued by the company. That could have forced Cirio to find a total of €1.1 billion in cash for its bondholders.[199]

The following clause is an example of a cross-default clause in a loan agreement: “Default: ... The Borrower or any Subsidiary (i) fails to pay any of its Indebtedness as and when that Indebtedness becomes payable or (ii) fails to perform or observe any covenant or agreement to be performed or observed by it contained in another agreement or in any instrument evidencing any of its Indebtedness and, as a result of such failure, any other party to that agreement or instrument is entitled to exercise, and has not irrevocably waived, the right to accelerate the maturity of any amount owing thereunder.”

Set-off. Acceleration can be complemented by a set-off clause.

The list of remedies can contain, for example, the following clause: “Party A may set off against any amounts owing to Party B any and all amounts due and payable to Party A as damages or liquidated damages or otherwise.”

[198] Kündigung aus wichtigem Grund, § 314 BGB.
[199] Cirio folks, The Economist, November 2002.

7 Management of Information

7.1 Introduction

Legal background rules regulate information in various ways. For example, it has been said that "the bulk of contract-related secondary EC legislation is about finding intelligent information mechanisms and thus to extend the area of party autonomy".[1]

The management of information is one of the general legal objectives of the firm, and contracts belong to the generic ways to manage the firm's legal objectives. Information-related aspects can influence contract terms, and information about contract terms can influence the behaviour of contract parties (see Volume I).

Pre-contract stage. Information management plays an important role during the pre-contract (negotiation) stage.

First, there is the question of risk and certainty. The availability of useful information increases certainty and reduces risk.

Second, there is the question of cost. The firm will have to decide how much to invest in information gathering. The firm can also assess whether the other party has an incentive to invest in information gathering. The existence of such incentives is in the interests of both parties.

For instance, producers will invest in improving the quality of their products only if consumers have sufficient incentives to acquire information about the product's quality before buying it, and can thus be expected to pay a higher price for better quality. If consumers do no research before buying a product, an adverse selection process leading to a market for lemons is expected and the benefits from efficient investment in quality will be lost.[2]

The cost of the gathering, analysis, and disclosure of information is also one of the reasons why signing and closing have often been separated in contract practice (see section 5.6 and Volume III).

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1 Grundmann S, Kerber W, Weatherill S, Party Autonomy and the Role of Information in the Internal Market – an Overview. In Grundmann S, Kerber W, Weatherill S (eds), Party Autonomy and the Role of Information in the Internal Market. Walter de Gruyter, Berlin New York (2001) p 20.

2 Grosskopf O, Medina B, A Revised Economic Theory of Disclosure Duties and Break-up Fees in Contract Law, Stanf J L Bus Fin 13 (2007) p 154; Akerlof GA, The Market for Lemons: Quality Uncertainty and the Market Mechanism, Quarterly J Econ 84 (1970) pp 488–500.

P. Mäntysaari, *The Law of Corporate Finance: General Principles and EU Law*,
DOI 10.1007/ 978-3-642-03055-0_7,

There are direct costs of analysing the legal framework and drafting the contract terms. Such direct transaction costs can make a party use its own preformulated contracts terms, and they can give the other party an incentive to accept their use (section 2.2.2).

Third, there is the question of how to verify unverifiable information. For example, draft contract terms and preformulated contracts can be used as a screening mechanism. The firm will obviously prefer to do business with parties who are prepared to accept its standard terms.

Fourth, if the firm wants to use its own terms, it will have to make the other party accept them. It is normal to employ draft contract terms and standard form contracts as an anchoring mechanism. Because of the anchoring bias (see Volume I), the draft terms can influence estimations and valuations. The firm can benefit if the parties negotiate on the basis of the firm's own draft terms. The cost of drafting and legal work can give the other party a further incentive to use the firm's estimations and valuations as a basis for negotiations.

Substance of contract. When the parties finally reach agreement, the parties manage information by regulating the substance of the contract, i.e. their core rights and obligations.

It is not possible to separate the regulation of information from the regulation of the core obligations of the parties.

Furthermore, the disclosure of information can influence substantive rights and obligations. First, it can influence the interpretation of the contract (section 5.2). Second, a party can try to qualify its warranties by all information disclosed to the other party (see below; for acquisitions, see Volume III).

There are nevertheless particular clauses designed to regulate information issues. Some of these provisions can be regarded as core obligations. Others influence core obligations without changing their wording as such.

Information management after the conclusion of the contract. Information must be managed even after the conclusion of the contract. First, a party may have to ensure that the other party complies with its obligations. Second, the parties may have agreed on information duties (information covenants, notices). The management of counterparty commercial risk and counterparty credit risk typically require information management (for credit management, see Volume III).

7.2 Information Duties

Generally, the parties can have various contractual duties relating to information. There are three categories of information duties: information duties which regulate the substance (or core commercial duties under the contract); information duties which are secondary duties (complementing the core duties); and separate information duties.[3]

[3] Compare Craswell R, Taking Information Seriously: Misrepresentation and Nondisclosure in Contract Law and Elsewhere, Virg L R 92 (2006) p 567.

Many information duties exist for policy reasons. For example, it is one of the basic rules of contract law that the legitimate expectations of a contract party should be protected where the other party had notice of those expectations. In particular, they should always be protected where the other party knew that it would not fulfil those expectations.

Information rules v rules on substance. In most contracts, the core duties can also be regarded as information warranties, or they are influenced by information duties. Information duties cannot be evaluated independently of the substance of the contract (for information as a commodity, see Volume I).

First, some duties relating to information or disclosure duties can better be regarded as warranties or obligations concerning the substance of the contract. For example, the CISG contains many such provisions:

- Article 35(1): "The seller must deliver goods which are of the quantity, quality and description required by the contract and which are contained or packaged in the manner required by the contract."
- Article 35(2): "Except where the parties have agreed otherwise, the goods do not conform with the contract unless they: ... (b) are fit for any particular purpose expressly or impliedly made known to the seller at the time of the conclusion of the contract, except where the circumstances show that the buyer did not rely, or that it was unreasonable for him to rely, on the seller's skill and judgement; (c) possess the qualities of goods which the seller has held out to the buyer as a sample or model; ..."

Second, if a party knew about a fact at the time of contracting, the party may not invoke that fact as breach of contract. The CISG can again be used as an example:

- Article 35(3): "The seller is not liable … for any lack of conformity of the goods if at the time of the conclusion of the contract the buyer knew or could not have been unaware of such lack of conformity."
- Article 38(1) in combination with Article 39(1): "The buyer must examine the goods, or cause them to be examined, within as short a period as is practicable in the circumstances." "The buyer loses the right to rely on a lack of conformity of the goods if he does not give notice to the seller specifying the nature of the lack of conformity within a reasonable time after he has discovered it or ought to have discovered it."
- Article 42(2): "The obligation of the seller [under Article 42(1)] does not extend to cases where: (a) at the time of the conclusion of the contract the buyer knew or could not have been unaware of the right or claim ..."

Third, duties relating to information can be used as a statute of limitation. Typically, a party must give timely notice to the other party if it wants to invoke breach of contract. This technique has also been used in the CISG:

- Article 38(1): "The buyer must examine the goods, or cause them to be examined, within as short a period as is practicable in the circumstances."
- Article 39(1): "The buyer loses the right to rely on a lack of conformity of the goods if he does not give notice to the seller specifying the nature of the lack of conformity within a reasonable time after he has discovered it or ought to have discovered it."

Fourth, the fraud rule can be an information rule and, indirectly, a rule on the substance of the contract. The CISG contains examples of such rules:

- Article 40: "The seller is not entitled to rely on the provisions of articles 38 and 39 if the lack of conformity relates to facts of which he knew or could not have been unaware and which he did not disclose to the buyer."
- Article 43(2): "The seller is not entitled to rely on the provisions of the preceding paragraph [Article 43(1)] if he knew of the right or claim of the third party and the nature of it."

Fifth, the information possessed by the parties will influence the interpretation of their mutual obligations (section 5.2), and disclosure rules will also work as interpretation rules in disguise.

For example, the prevailing legal doctrine in the US is that, short of fraud, a buyer is not liable for non-disclosure of material facts that were legally available to both parties.[4] In Europe, a party's actual or constructive knowledge of a certain fact and a general fairness standard would influence the interpretation of contractual obligations. A party will often be deemed to have an obligation to disclose some of such facts according to the applicable fairness standard.

Information duties as secondary duties. Information duties that complement the substance or core duties under the contract can consist of reporting duties or duties to provide information during the term of the contract. For example, a syndicated loan agreement typically provides for many information undertakings (covenants) that complement the borrower's payment obligations.[5] Unlike the breach of a core obligation (such as payment default), non-compliance with a mere information covenant is not normally regarded as a serious breach of contract under the terms of a loan agreement.

Separate information duties. There are information duties that are separate from the core duties under the contract and are not secondary duties that complement

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4 Restatement (Second) of Contracts, §161, cmt. a. (1981). See Grosskopf O, Medina B, A Revised Economic Theory of Disclosure Duties and Break-up Fees in Contract Law, Stanf J L Bus Fin 13 (2007) pp 160–161.

5 The standard terms adopted by the Loan Market Association (LMA) provide for information undertakings with the following headings: "Audited accounts", "Half year accounts", "Compliance certificate", "Accounting principles", "Shareholder information", "Litigation", "Other information", "Default notification", and "No default certificate".

them. For example, the firm may ask a law firm for a legal opinion, or a rating agency for a credit rating report.

7.3 Substance

7.3.1 Core Obligations

Some information provisions are core obligations. Such provisions contain in particular conditions precedent to closing as well as representations and warranties. In addition, the parties can agree on non-disclosure obligations.

Conditions precedent to closing. The separation of signing and closing is a means to mitigate the problem of information asymmetries when the contract is being made (generally, see Volume I). Typically, the contract does not have to become binding, unless the firm is satisfied that conditions precedent to closing are met. Conditions precedent address many information issues.

Conditions precedent to closing tend to contain similar elements regardless of the contract type. For example, business acquisition contracts (Volume III) practically always contain the following two conditions precedent to closing: (a) the representations and warranties of the parties must be true and correct at the time of closing; and (b) the pre-closing covenants have been performed or fulfilled prior to closing.

Typically, these core conditions precedent are complemented by more specific conditions such as the following: (c) receipt of the necessary third party consents; (d) receipt of the necessary governmental approvals; (e) receipt of acceptable legal opinions and other closing documents; (f) receipt of certain financial statements or the achievement of certain financial milestones; (g) receipt of employment or non-competition agreements from key employees; (h) satisfactory completion of buyer due diligence; (i) availability of funding; and (j) absence of material adverse change.

Representations and warranties. A contract party typically represents and warrants that statements contained in representations and warranties are true and correct as of a certain date, typically both on the signing date and on the closing date.

In the UK, a party resists giving representations in addition to warranties and it is common practice to delete the word "representation" from the written agreement to mitigate the risk that a statement will also be treated as a representation for purposes of bringing a tortious claim for damages or seeking rescission ab initio under the Misrepresentation Act 1967. In addition, a party will seek to exclude tortious remedies and rescission by express provision to that effect.[6]

Representations. In the representations, a contract party normally states that the contract is or will become binding. The party states: that it has capacity to con-

6 Phillips J, Runnicles J, Schwartz J, Navigating trans-atlantic deals: warranties, disclosure and material adverse change, JFRC 15(4) (2007) p 473.

clude binding contracts in general; that its representatives have power to conclude binding contracts on its behalf; and that the contract is binding (for counterparty corporate risk, see section 6.2). Representations tend to be more or less similar regardless of the transaction,. Furthermore, the representations and a standardised legal opinion typically address the same aspects of counterparty corporate risk.

Warranties. Warranties are declarations that relate to the substance of the contract. Their contents always depend on the type of transaction (for business acquisition contracts, see Volume III).

The Acquis Principles (section 2.3.3) consist of recommendations for the drafting, transposition and interpretation of Community law.[7] They also contain plenty of pre-contractual information warranties which in effect act as warranties as to the substance of a party's performance. They include the following:[8] (1) A duty to act in accordance with good faith[9] and a duty to negotiate in good faith.[10] (2) A duty to provide clear and precise information expressed in plain and intelligible language.[11] (3) A duty to give such information as the other party can reasonably expect, taking into account normal standards of quality and performance.[12] (4) A duty to act with the special skill and care that may reasonably be expected to be used with regard, in particular, to the legitimate expectations of consumers.[13] – Similar information warranties can be found in Chapter 3 of Book II of the DCFR.

Non-disclosure obligations. Non-disclosure and/or non-compete obligations are often core obligations, because some types of contracts would not be possible without them. For example, vertical distribution agreements,[14] technology licencing agreements,[15] and research and development agreements[16] often contain such clauses.

7.3.2 Provisions that Influence Core Obligations

In addition to information provisions that are core obligations, the contract can contain various kinds of knowledge clauses. Their main purpose is to influence a party's core obligations indirectly. The most common forms of knowledge clauses are: actual knowledge clauses; "to the knowledge of clauses"; investigation claus-

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7 Article 1:101 of the Acquis Principles.
8 Article 2:207 of the Acquis Principles.
9 Article 2:101 of the Acquis Principles.
10 Article 2:103 of the Acquis Principles.
11 Article 2:206 of the Acquis Principles.
12 Article 2:201 of the Acquis Principles.
13 Article 2:102 of the Acquis Principles.
14 Regulation 2790/1999 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices.
15 Regulation 772/2004 on the application of Article 81(3) of the Treaty to categories of technology transfer agreements.
16 Regulation 2659/2000 on the application of Article 81(3) of the Treaty to categories of research and development agreements.

es; knowledge and experience clauses; attribution of knowledge clauses; and notices clauses.

Disclosure clauses. First, the mere disclosure of information can influence substantive rights and obligations. It can change the interpretation of the contract (section 5.2.5). In addition, a party giving warranties typically seeks to qualify all warranties by all information disclosed to the other party (for due diligence, see Volume III). The contract can therefore set out what information is deemed to have been disclosed to the other party; these provisions can contain references to warranties.

There can be a general contract term to this effect. The contract can also contain a term according to which disclosure against one representation and warranty would be disclosure against all representations and warranties. Alternatively, disclosures can contain specific cross-references to warranties.

According to English law, a disclosure must be "fair". In a sales contract, a seller is normally required to disclose "facts and circumstances sufficient in detail to identify the nature and scope of the matter disclosed and to enable the purchaser to form a view whether to exercise any of the rights conferred on him by the contract".[17] Merely making known the means of knowledge or reference to a source of information that may enable the buyer to work out certain facts and conclusions may not in itself be sufficient. Because of the requirement of "fair disclosure", the seller will attempt to include provisions which seek to imply that the buyer accepts the content of the disclosure as constituting fair disclosure.[18]

Full disclosure clauses. Some clauses require "full disclosure". In practice, "full disclosure" is hardly ever possible. Even for the simplest of contracts, there is generally far more information than it would ever be possible to communicate.[19] The typical reason why the firm might want the other party to undertake an obligation to make full disclosure is to dilute the firm's own obligations or provide an escape - where the other party has not made "full" disclosure, the firm might have a right not to fulfil its own obligations.

Actual knowledge clauses. Second, sometimes the parties state that a party has actual knowledge of a certain fact.

The purpose of such clauses can be to influence the core obligations of the "obligor" or "debtor" indirectly, i.e. without changing the wording of the core obligations as such. As said above, the core obligations of the parties depend on their knowledge of certain facts. If the "obligee" or "creditor" to whom the obligation is owed knew of the existence of a fact, the existence of that fact will, under legal background rules, not as such constitute breach of contract by the "obligor" or "debtor". If the parties state in the contract that a party knows of the existence of a certain fact, the parties in effect mean that the existence of that fact does not constitute breach of contract by other party.

17 Edward Prentice v. Scottish Power [1997] 2 BCLC 264.

18 See Phillips J, Runnicles J, Schwartz J, Navigating trans-atlantic deals: warranties, disclosure and material adverse change, JFRC 15(4) (2007) pp 476–477.

19 Craswell R, Taking Information Seriously: Misrepresentation and Nondisclosure in Contract Law and Elsewhere, Virg L R 92 (2006) p 575.

In practice, the parties may agree that facts are disclosed in a "disclosure schedule" annexed to the contract. Disclosure before the conclusion of the contract will in effect exclude breach of contract as far the existence of the disclosed facts is concerned.

For the "obligor" or "debtor" whose core obligations are influenced by a knowledge clause, a knowledge clause is not as effective as a clear exclusion or limitation of liability clause. Depending on the jurisdiction, the clause only creates a rebuttable presumption about what the other party knew.

For the "obligee" or "creditor" to whom the obligation is owed, a knowledge clause can be a means to make the "obligor" or "debtor" accept responsibility for the obligation by qualifying it with the "obligee's" or "creditor's" knowledge in a limited number of cases.

"To the knowledge of" clauses. Third, core obligations are often qualified by expressions "to the knowledge of", "to the best knowledge of", "to the knowledge of and after making reasonable inquiry", and similar expressions.

Investigation clauses. Fourth, one of the parties may acknowledge that it has had access to information.

For example, a business acquisition contract may contain the following clause: "Investigation. The Buyer acknowledges that it has had an opportunity to discuss the business, affairs and current prospects of the Company with the Company's CEO. The Buyer further acknowledges having had access to information about the Company that it has requested or considers necessary for purposes of purchasing the Company's shares."

The purpose of such an investigation clause is again to influence the core obligations of the "obligor" or "debtor" without changing the wording of the core obligations as such. As said above, the CISG provides that the seller is not liable for any lack of conformity of the goods if at the time of the conclusion of the contract the buyer knew or could not have been unaware of the lack of conformity.[20] In addition, the CISG requires the buyer to examine the goods, or cause them to be examined, within as short a period as is practicable in the circumstances.[21] The "investigation" clause above can create a defence that the "obligee" or "creditor" knew or should have known about the existence of a certain fact.

However, for the "obligor" or "debtor", a knowledge clause is not as effective as a clear exclusion or limitation of liability clause or a knowledge clause. Depending on the jurisdiction, the investigation clause does not even create a presumption about what the other party knew. It forces the "obligor" or "debtor" to prove that the "obligee" or "creditor" knew or should have known about the existence of the fact.

For the "obligee" or "creditor" to whom the obligation is owed, an investigation clause can be a way to make the "obligor" or "debtor" accept responsibility for the obligation by qualifying it.

Knowledge and experience clauses. Fifth, the contract terms may set out the knowledge and experience of a party.

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20 CISG Article 35(3).

21 CISG Article 38(1).

For example, a financial investor may, in an agreement for the purchase of shares in a company, state as follows: "The Investor has such knowledge and experience in financial and business matters that it is capable of evaluating the merits and risks of its investment in the Company's shares."

(a) The purpose of such a knowledge and experience clause can be to influence the disclosure duties of a party without changing the wording of those disclosure obligations as such.

Where the stated level of a party's knowledge and experience of the matter is high, it is typically easier for the other party to fulfil its disclosure duties. One of the two extremes is that the party is presumed to be able to assess both the case-specific usefulness of information and its subjective usefulness (for the categories of usefulness, see Volume I).

Where the stated level of a party's knowledge and experience is low, the other party typically needs to disclose more information or more useful information in order to fulfil its disclosure duties. The other of the two extremes is that the party cannot be expected to assess the usefulness of information at all.

(b) In principle, the firm can increase the usefulness of information that must be disclosed by the other party by stating in the contract that the firm has little knowledge and experience of the matter. The firm can decrease the usefulness of information that must be disclosed by the other party by stating that the firm has a high level of knowledge and experience of the matter.

The other side of the coin is that the firm can influence the scope and content of its own disclosure obligations in the same way.

(c) Knowledge and experience clauses may also be taken into account when assessing the duty of care of the parties. Knowledge and experience clauses can create a presumption about the required minimum level of care.

Attribution of knowledge clauses. Sixth, the firm may use attribution of knowledge clauses.

The following four separate clauses are examples of attribution of knowledge clauses: First clause. "The term 'knowledge', when used in relation to a Party, means the knowledge of such Party's officers and directors." Second clause. "'Knowledge' with respect to any Party, means the actual knowledge of the senior executive officers of the Party, after reasonable inquiry." Third clause. "Where any statement is to the effect that the Firm is not aware of any matter or circumstance, or is a statement qualified by the expression 'so far as the Firm is aware' or 'to the Firm's best knowledge' or any similar expression, that statement shall refer to the knowledge of the officers of the Firm principally responsible for the management and conduct of the Business, including their actual knowledge and their knowledge obtainable in a reasonable investigation of the applicable matter." Fourth clause. "1.6 Knowledge. Where any representation or warranty … is expressly qualified by reference to the knowledge of a Party, it shall be deemed to refer to the actual knowledge (without further enquiry) of those Persons listed in Section 1.6 of the ERF Disclosure Schedule in the case of WS Holdings …"[22]

[22] Article 1.6 of a share purchase agreement for the purchase of the whole of the issued share capital of ERF (Holdings) Plc. See Man Nutzfahrzeuge AG and another v Freightliner Ltd and another [2007] EWCA Civ 910.

The purpose of attribution of knowledge clauses is to manage the attribution of information to the company and to establish communication (Volume I). They can be necessary due to the fact that the firm has an organisation. A person who belongs to the firm's organisation can never know for sure what other people that belong to the same organisation know. Typically, the firm may want to reduce risk by keeping the group of people whose knowledge is attributed to the firm small. The other side of the coin is that the firm may want to increase the other party's risk by increasing the number of people whose knowledge is attributed to the other party.

A particular form of attribution of knowledge clauses is a clause according to which certain information should *not* be attributed to a party. For policy reasons (like prevention of fraudulent acts and circumvention of mandatory provisions of law), such clauses should not be upheld.

This also seems to be the case under English law. In *Eurocopy plc v Teesdale and others*,[23] an agreement for the sale of shares contained the following clause: "The Warranties are given subject to matters set out in the Disclosure Letter … but no other information of which the Purchaser has knowledge (actual constructive or imputed) shall preclude any claim made by the Purchaser for breach of any of the Warranties or reduce any amount recoverable." The defendants argued as a defence that the plaintiff had actual knowledge of the matters of which it complained. The Court of Appeal declined to strike out that defence. The court's decision suggests that a buyer may not be able to rely on such a clause where it has actual knowledge of certain facts not disclosed in the Disclosure Letter. In *Infiniteland Ltd and another v Artisan Contracting Ltd and another*,[24] the acquisition agreement included a knowledge-saving provision to the effect that a claim for breach of warranty would not be affected by any of the buyer's due diligence investigations of the target, except to the extent that such investigations gave the buyer actual knowledge of the relevant facts or circumstances giving rise to the breach. The court found that the actual knowledge of the buyer would defeat any claim for breach of warranty but constructive knowledge would not prevent the buyer from relying on the knowledge-saving clause in the agreement.[25]

Notices clauses. Seventh, notices clauses can be found in practically all major contracts. They are used in order to manage communication. Unlike attribution of knowledge clauses, they create a formal procedure for information exchange and a rebuttable presumption that no exchange of information has taken place unless the formal procedure has been followed.[26]

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[23] Eurocopy plc v Teesdale and others [1992] BCLC 1067. See also Infiniteland Ltd and another v Artisan Contracting Ltd and another [2005] EWCA Civ 758, [2006] 1 BCLC 632.

[24] Infiniteland Ltd and another v Artisan Contracting Ltd and another [2005] EWCA Civ 758, [2006] 1 BCLC 632.

[25] Phillips J, Runnicles J, Schwartz J, Navigating trans-atlantic deals: warranties, disclosure and material adverse change, JFRC 15(4) (2007) pp 477–478.

[26] See, for example, Diem A, Akquisitionsfinanzierungen. C.H. Beck, München (2005) § 27; § 130 HGB; § 308 Nr. 6 BGB.

7.3.3 Secondary Duties

Many information provisions create secondary duties that complement core obligations under the contract. Some of the secondary duties relate mainly to the substance of the contract. Other secondary duties relate mainly to the modalities of disclosure or communication.

Substance. The duties that relate to substance can often be found under the heading Covenants (section 11.6.2). There are different kinds of covenants. The standard covenants include: affirmative covenants; negative covenants; financial covenants; and reporting requirements.

Reporting requirements. In long-term contracts, reporting requirements can be used to increase transparency and the likelihood that the other party will fulfil its obligations. For example, the firm can use a covenant package designed to set the business parameters within which the other party still can operate efficiently but which the other party may not exceed (such as financial covenants). Such covenants can be complemented by reporting requirements which make it easier for the firm to monitor the other party. Reporting requirements can provide a timely warning of any adverse change in counterparty commercial risk. In a loan transaction, they can provide information about any potential downgrade in the creditworthiness of the borrower.

Modalities. Even after deciding which attributes should be the subject of disclosure, many other decisions must be made concerning the exact form in which that information is presented.[27]

7.4 Separate Information Duties

In addition to information duties that regulate the substance of the contract or complement them as secondary duties, there are also separate contractual information duties. Separate information duties are typically information duties owed by the firm's external advisers and external information intermediaries to the firm. The outcome of their fact-finding exercise is often a condition precedent to closing or a condition that must be fulfilled before a party has a legal obligation to make payments.

Information intermediaries in general. The role of information intermediaries and the nature of their duties have been discussed generally in Volume I.

Legal opinions. Legal opinions can be used in many contexts (Volume I). In a loan transaction, legal opinions typically confirm that all the documents associated with the loan are legally valid and enforceable. In a loan transaction, the opinion is normally requested by the bank's lawyer, provided by another lawyer (typically a lawyer qualified in the jurisdiction whose laws the lawyer opines on) and ad-

[27] Craswell R, Taking Information Seriously: Misrepresentation and Nondisclosure in Contract Law and Elsewhere, Virg L R 92 (2006) p 581.

dressed to the bank.[28] The opinion can sometimes be provided by a company's inside counsel.[29]

Due diligence. There are various forms of due diligence. For example, a takeover can be preceded by commercial due diligence, financial due diligence, legal due diligence, environmental due diligence, and insurance due diligence. The firm can carry out a due diligence inspection itself or ask one or more external advisers to take care of the necessary inspections. Due diligence will be discussed in the context of takeovers (Volume III).

[28] See, for example, Adams D, Banking and Capital Markets; Gruson M, The Remedies Opinion in International Transactions, The International Lawyer 27(4) (1993) pp 911–939; Kuster M, Die Legal Opinion in Internationalen Kreditgeschäft, SZW/RSDA 6/98 pp 274–284.

[29] See Gruson M, Liability of Inside Counsel for Legal Opinions, JIBLR 19(4) (2004) pp 143–145.

8 Payment Obligations: Introduction

8.1 Traditional Payment Obligations

The purpose of the following chapters is to discuss the particular legal nature of payment obligations and the management of credit risk. The existence of various kinds of payment claims is characteristic of corporate finance. Payment claims give rise to a credit risk.

Most contracts create or can create payment obligations (monetary obligations). Where money is legal tender, it serves as the means of fulfilling many obligations. These obligations can be contracted voluntarily. They can also be imposed compulsorily. In the context of almost any claim, the court may ultimately force the defendant to discharge its obligations by means of a monetary payment.[1] This is the case in particular in jurisdictions where specific performance is not freely available as a remedy for breach of contract (common law); specific performance is generally available in civil law countries.[2]

A monetary obligation has been described as "an obligation (a) whose subject matter is the payment of money (whether fixed at the outset or subsequently ascertained prior to the date on which performance is due), (b) which cannot become impossible to perform, (c) which is capable of bearing interest, and (d) to which the principle of nominalism is capable of application."[3]

Voluntary payment obligations are often based on financial arrangements between two or more parties. There is plenty of variation. Financial arrangements are based on three key foundations: the intertemporal transfer of value through time (like in a loan), the ability to contract on future outcomes (contingent claims; a contingent claim means that one side pays the other depending on the outcome of an event), and the transferability of claims.[4]

Traditional legal rules on payment obligations have been designed for the most well-known form of payment obligations, i.e. payment obligations where the

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1 Proctor C, Mann on the Legal Aspect of Money, Sixth Edition. OUP, Oxford (2005) paragraph 3.01.
2 See §§ 280–283 BGB.
3 Proctor C, *op cit*, paragraph 3.08.
4 Goetzmann WN, Rouwenhorst KG, Financial Innovations in History. In: Goetzmann WN, Rouwenhorst KG (eds), Origins of Value: The Financial Innovations that Created Modern Capital Markets. OUP, Oxford (2005) p 4.

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debtor must pay a fixed sum of money.[5] This obligation may, for example, be based on a loan contract. A loan is the simplest financial arrangement (an intertemporal value transfer). Traditionally, legal default rules have addressed questions like currency and interest rate as well as the time, place, and other modalities of payment.

8.2 Other Forms of Payment Obligations

On the other hand, there are other forms of payment obligations. The three key forms of financial arrangements (intertemporal value transfer, the ability to contract on future outcomes, and the transferability of claims) have enabled firms to develop a vast number of financial products.[6]

The form of the payment obligation influences the applicable legal rules and the mitigation of risk, in particular the mitigation of legal risk and counterparty credit risk.

In the following, traditional legal questions common to all payment obligations will be discussed first (Chapter 9). These questions will be followed by a taxonomy of payment obligations (Chapter 10) and the normal ways to mitigate counterparty credit risk (Chapter 11).

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[5] Proctor C, Mann on the Legal Aspect of Money, Sixth Edition. OUP, Oxford (2005) paragraph 3.03.

[6] Goetzmann WN, Rouwenhorst KG, *op cit*, p 4.

9 Payment Obligations: Traditional Legal Questions

9.1 Introduction

Payment obligations raise the same legal issues as contracts in general. Some questions are characteristic of payment obligations. Traditional legal questions relate to currency as well as the time, place and other modalities of payment. These questions have already been discussed in legal literature in detail.[1] It suffices to focus on the main points.

9.2 Money, Currency, Governing Law

Monetary obligations are obligations to pay money. What is regarded as money in law depends on the legal context.

State. Generally, money is issued under the central authority of a State. Money can be regarded as "chattels (a) which are issued under the authority of the law in force within the State of issue; (b) which under the terms of that law, are denominated by reference to a unit of account; and (c) which, under the terms of that law, are to serve as the universal means of exchange in the State of issue."[2]

In some legal contexts, money can be issued by private parties instead of any State. For example, Directive 2000/46/EC,[3] which approximates Member States' laws relating to the business of electronic money institutions, regards "electronic money" as "an electronic surrogate for coins and banknotes, which is stored on an electronic device such as a chip card or computer memory and which is generally intended for the purpose of effecting electronic payments of limited amounts".[4]

The Payment Services Directive (PSD)[5] foresees the development of non-bank "payment institutions" which need an authorisation to act as a payment institution but no banking licence. Payment institutions are not allowed to issue money or

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[1] See Proctor C, Mann on the Legal Aspect of Money, Sixth Edition. OUP, Oxford (2005).

[2] See *ibid*, paragraphs 1.15 and 1.16.

[3] Directive 2000/46/EC on the taking up, pursuit of and prudential supervision of the business of electronic money institutions.

[4] Recital 3 and Article 1(3)(b) of Directive 2000/46/EC.

[5] Directive 2007/64/EC (PSD).

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electronic money. However, they can operate "payment systems", i.e. funds transfer systems with formal and standardised arrangements and common rules for the processing, clearing and/or settlement of payment transactions.

For example, the PSD can facilitate the establishment of businesses that operate like M-PESA, a Kenyan mobile-payment scheme run by two telecoms firms. M-PESA allows customers to transfer money using a mobile phone. The use of M-PESA does not require any bank account or bankcard.[6]

In addition to electronic money, there are other units of account that can serve as a means of exchange but not as the universal means of exchange.

There are alternative currencies like "stamp scrip".[7] Such alternative currencies can be spent, but not hoarded. A report commissioned by the Bundesbank identified at least 16 regional currencies in Germany.[8] Frequent-flyer miles and similar schemes have long been a form of functional equivalence to "money", used as a means of exchange and a store of value. Calculations by The Economist in January 2005 suggested that the total stock of unredeemed frequent-flyer miles was worth more than all the US dollar bills in circulation.[9]

Currency. Payment obligations are denominated in a currency. A State can have its own currency. In the EU, 16 Member States have so far adopted a single currency, the euro.[10]

Community institutions have adopted legislation for the introduction of the euro. Regulation 1103/97[11] provides that: the Council adopts irrevocably fixed conversion rates;[12] the conversion rates are adopted with six significant figures and used for conversions either way between the euro unit and the national currency units;[13] and that the introduction of the euro "shall not have the effect of altering any term of a legal instrument or of discharging or excusing performance under any legal instrument, nor give a party the right unilaterally to alter or terminate such an instrument", unless the parties have agreed otherwise.[14]

Money of account, money of payment. There is a distinction between the money of account and the money of payment. The money of account is the currency in

6 For non-bank payment systems, see Dial M for money, The Economist, June 2007.
7 Fisher I, Stamp Scrip. Adelphi Company, New York (1933).
8 Rösl G, Regional currencies in Germany - local competition for the Euro? Deutsche Bundesbank, Discussion Papers Series 1: Economic Studies, No 43/2006. See also The money go-around, The Economist, January 2009.
9 In terminal decline? The Economist, January 2005; Funny money, The Economist, December 2005.
10 Article 106 of the EC Treaty. In 1999: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain. In 2001: Greece. In 2007: Slovenia. In 2008: Cyprus and Malta. In 2009: Slovakia.
11 Regulation 1103/97 on certain provisions relating to the introduction of the euro.
12 Article 1 of Regulation 1103/97.
13 Article 4 of Regulation 1103/97.
14 Article 3 of Regulation 1103/97.

which the obligation is expressed and the measure of the obligation. The money of payment is the currency in which the obligation is required to be discharged.[15]

Governing law. The currency and other aspects of the obligation depend on the governing law. From the perspective of a firm located in its home country, different systems of law may govern different aspects of the contract or its performance where: the contract is a cross-border contract involving one or more *overseas parties*; the contract is governed by a *foreign system of law*; or the contract involves a *foreign currency*.[16]

In the EU, the law applicable to the contract and the manner of performance are determined by the Rome I Regulation. The interpretation of the money of account is governed by the law that governs the contract as a whole.[17] The money of account may sometimes differ from the money of payment. [18] The introduction of the euro has reduced legal problems relating to currency in the euro area.

9.3 Principle of Nominalism

Monetary obligations are governed by the principle of nominalism. The principle of nominalism is derived from considerations of the stability of currency and also the promotion of good faith and legal certainty.

The principle of nominalism means that inflation and currency depreciation are considered to be irrelevant. As a matter of principle, only the nominal value of the currency is due and payment of the depreciated money releases the debt. The principle of nominalism governs all kinds of contracts. For example, the loss of value of a currency after a delayed payment is not recognised as a compensable loss under the CISG.[19]

The risk of inflation and currency depreciation has been addressed by legal default rules that provide for interest (see below). These problems can also be mitigated by the use of index clauses and contract clauses that address the risk of changed circumstances (section 5.5.5). The use of index clauses may be limited in some countries in order to maintain currency stability and to reduce inflation. For example, the use of index clauses has been limited under German law.[20]

Typically, the principle of nominalism does not apply to obligations to pay the actual value of money or assets. There is thus a difference between nominal value debts (Geldsummenschuld) and actual value debts (Geldwertschuld).

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[15] Proctor C, Mann on the Legal Aspect of Money, Sixth Edition. OUP, Oxford (2005) paragraphs 5.01, 5.02, 5.06 and 5.09.

[16] *Ibid*, paragraph 3.10.

[17] Article 12(1)(a) of Regulation 593/2008 (Rome I).

[18] Article 12(2) of Regulation 593/2008 (Rome I).

[19] See, for example, Landgericht Heidelberg 27 January 1981 (O 116/81), translated by Jarno Vanto and Ruth M Janal.

[20] § 2(1) PreisAngG (Preisangaben- und Preisklauselgesetz).

9.4 Money as Money or a Commodity

Foreign money may function either as money (a medium of exchange) or as a commodity (an object of exchange), depending on the circumstances. The nature of money has an effect on how the payment obligation may be discharged. Sometimes the contract requires the physical delivery of money as a commodity.[21] In foreign exchange contracts, however, there is not a physical delivery in this sense, but rather the contract is performed by arranging a credit to a bank account. The important distinction is therefore not that of the characterisation of money as money or as a commodity, but the distinction between money of account and money of payment.

9.5 Interest

9.5.1 Introduction

A monetary obligation is capable of bearing interest. Interest is a payment by a borrower to a lender for the use of money. Not all payment obligations bear interest. For example, trade debts paid on or before the due date are normally interest-free. Interest rates can be fixed or floating. In the euro area, the most important reference rates are determined by the ECB. Obligations to pay interest are constrained by mandatory laws. The most extreme example can be found in Islamic banking, because the Koran prohibits the making of money from money (section 12.3).

9.5.2 Fixed Rates, Floating Rates, the Eurosystem

Interest may be calculated in various ways.[22] The interest rate can be: a fixed rate (interest is specified to be a fixed percentage of the principal amount for the duration of the loan); a floating rate (interest is fixed by reference to specified market rates and changes either when the reference rate changes or at the end of a specified interest period); linked to some other rate or index; stepped (meaning that it changes at pre-arranged intervals); replaced with a discount or premium (like in zero bonds); or a rate that can be adjusted.

Floating rates. There are various types of floating rates. For example, interest can be calculated by reference to: the lending bank's base rate on lending in its own currency (base rate); the lending bank's USD prime rate (prime rate); inter-bank market bid rates (the rate which a bank is prepared to pay a depositor want-

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[21] In Germany, under § 243 BGB (Gattungsschuld such as Krugerrand gold coins) or § 433 BGB (Stückschuld such as certain antique coins).

[22] For an introduction, see, for example, Paul C, Montagu G, Banking and Capital Markets Companion. Third Edition. Cavendish Publishing, Great Britain (2003).

ing to deposit funds as opposed to the rate a borrower must pay to borrow from the bank); interbank market offered rate (the rate banks offer funds to other banks); or published US Treasury bill rates (US Treasury bill rate).

In Eurocurrency lending (international lending), a bank is presumed to fund its loan by taking short-term deposits in the interbank market that precisely match the interest periods under the loan (matched funding). In Europe, floating rates that banks pay for their funding are normally based on LIBOR or EURIBOR.[23]

LIBOR, which stands for London Interbank Offered Rate, is the interest rate paid on interbank deposits in the Eurocurrency markets (international money markets). LIBOR is normally chosen for loans denominated in other Eurocurrencies than the euro (USD-LIBOR, GBP-LIBOR, CHF-LIBOR). Because Eurocurrency deposits priced at LIBOR are almost continually traded in highly liquid markets, LIBOR is commonly used as a benchmark for short-term interest rates in setting loan and deposit rates and as the floating rate on an interest rate swap.

EURIBOR, the Euro Interbank Offered Rate, is the rate at which euro interbank term deposits within the euro zone are offered by one prime bank to another prime bank. It is also chosen for loans denominated in the euro.

The floating rate consists of the chosen benchmark reference rate and a margin (also known as spread).

Interest rate linked to some other rate or index. The parties may sometimes agree to link the interest rate to another rate or index. For example, the interest rate could be linked to: the profit level of the debtor company itself; the rate of interest being paid on another debt; or an index. The use of index clauses can be constrained by mandatory provisions of law (for the principle of nominalism, see section 9.3).

Stepped interest rates. A stepped interest rate will change at pre-arranged intervals. The original interest rate can be fixed or floating. Stepped interest rates can be used in many ways. For example, the parties might agree that the borrower will not pay any interest initially and that the interest rate will rise to 4% in the second year and 8% in the third.

In US subprime mortgage lending, it was customary to give two or three years of low "teaser" rates, which then switched to much higher tariffs. After the initial low-interest period, the number of defaults increased, as borrowers were not able to meet higher interest payments. This contributed to the subprime mortgage crisis in 2007.[24]

Borrowing at a discount or premium. Interest payments are sometimes replaced by a discount or premium. (a) When a discount is used, the lender pays to the borrower less than the face value of the claim, but the borrower will repay the face value of the claim. (b) Alternatively, the borrower could negotiate to pay a reward on redemption (a premium).

In both cases, the size of the discount or premium is based on the agreed interest rate or, if no interest is payable on the lender's claim, on the interest that the

[23] See, for example, Diem A, Akquisitionsfinanzierungen. C.H. Beck, München (2005) § 12 numbers 12–14.

[24] See Houses built on sand, The Economist, September 2007.

lender might have received otherwise. In addition, the size of the discount or premium will reflect credit risk.

Zero bonds. Borrowing at a discount or premium can be illustrated by zero-coupon bonds. Interest on a zero-coupon bond is not paid until the bond matures. Zero-coupon bonds are issued at a discount below their face value, and are redeemed at their face value upon maturity. The interest rate is calculated on the basis of the difference between the purchase price and the face value, for which reason the face value, in practice, contains compound interest (section 9.5.3 below).

Adjustment. The parties may agree that a fixed or floating rate can be adjusted (generally, see Volume III). The bank may also be given a unilateral right to increase a fixed interest rate.

For example, German law provides that a clause (Zinsanpassungsklausel) contained in the general contract terms (allgemeine Geschäftsbedingungen) of a bank is valid, provided that the interest rate is adjusted for a reason (sachlicher Grund) and that it is not unreasonable for borrowers (§ 307 BGB). It is not unreasonable for borrowers, if they can understand under what circumstances and to what extent interest rates can rise. A change in the bank's refinancing costs is regarded as an acceptable reason for a bank to increase its interest rates, but a negative change in the credit rating of the borrower is not regarded as one.[25]

The Eurosystem. In the euro area, the ECB and the Eurosystem are the source of the most important reference rates. The Eurosystem is responsible for the implementation of the single monetary policy for the euro area. The Eurosystem is composed of the national central banks in the euro area and the European Central Bank (ECB) in Frankfurt am Main. The main monetary instruments are the key interest rates set by the Governing Council of the ECB.

The tasks of the Eurosystem are laid down in the EC Treaty.[26] They are specified in the Statute of the European System of Central Banks (ESCB) and of the European Central Bank (ECB).[27] The Statute is a protocol attached to the Treaty. The Treaty text refers to the ESCB rather than to the Eurosystem. It was drawn up on the premise that eventually all EU Member States will adopt the euro. Until then, the Eurosystem will carry out the tasks.

The Eurosystem has at its disposal a set of monetary policy instruments. The Eurosystem conducts open market operations, offers standing facilities and requires credit institutions to hold minimum reserves on accounts with the Eurosystem.[28]

Open market operations play an important role in the monetary of policy of the Eurosystem for the purposes of steering interest rates, managing the liquidity

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[25] See Diem A, *op cit*, § 12 numbers 27–35.

[26] Article 105(1) of the EC Treaty.

[27] Protocol on the Statute of the European System of Central Banks and of the European Central Bank annexed to the Treaty establishing the European Community, Official Journal C 191 of 29.07.1992.

[28] See ECB, The implementation of monetary policy in the euro area (September 2006); Guideline of the European Central Bank of 31 August 2000 on monetary policy instruments and procedures of the Eurosystem (ECB/2000/7) (as amended).

situation in the market and signalling the stance of monetary policy. For example, the main refinancing operations are regular liquidity-providing reverse transactions with a weekly frequency and a maturity of normally one week. The main refinancing operations provide the bulk of refinancing to the financial sector. The ECB publishes a minimum bid rate on the margin refinancing operations.[29]

Standing facilities are aimed at providing and absorbing overnight liquidity, signalling the general stance of market policy and bounding overnight market interest rates. Two standing facilities are available to eligible counterparties. (1) Counterparties can use the *marginal lending* facility to obtain overnight liquidity from national central banks. The interest rate on the marginal lending facility normally provides a ceiling for the overnight market interest rate.[30] (2) Counterparties can use the *deposit* facility to make overnight deposits with national central banks. The interest rate on the deposit facility normally provides a floor for the overnight market interest rate.[31]

9.5.3 Contract v Mandatory Law

The main rule is that the debt bears interest if the parties have agreed so. In addition to interest, the parties may have agreed on the payment of fees and an indemnity for costs and expenses.[32] The duty to pay interest may also be based on the provisions of the governing law.[33] In loan agreements, the duty to pay interest belongs to the core obligations of the debtor. The parties are free to agree on the interest rate and how the interest is calculated.

For example, there is no general right to interest at common law. German law provides that where the debtor has a right to interest by virtue of law or an agreement by the parties, the annual interest rate is 5% in business-to-business contracts[34] and 4% in other contracts,[35] unless the parties have agreed otherwise.

The scope of the main rule is limited by various mandatory provisions of law ranging from restrictions on the use of compound interest to provisions protecting goods morals.

Compound interest. The payment of compound interest is prohibited in many continental European countries. Under German law,[36] prior agreements on the

[29] At its meeting of 15 January 2009, the Governing Council of the ECB decided to decrease the interest rate on the main refinancing operations of the Eurosystem by 50 basis points to 2.00%, starting from the operation to be settled on 21 January 2009.

[30] At the same meeting, the Governing Council of the ECB decided to set the interest rate on the marginal lending facility at 3.00%.

[31] At the same meeting, the interest rate on the deposit facility was set at 1.00%.

[32] Cranston R, Principles of Banking Law. Second Edition. OUP, Oxford (2002) p 310.

[33] § 488(1) BGB; §§ 353 and 354(2) HGB.

[34] § 352(1) HGB.

[35] § 246(2) BGB.

[36] Generally, see Diem A, Akquisitionsfinanzierungen. C.H. Beck, München (2005) § 18 numbers 22–40.

payment of compound interest (Zinseszins) are void;[37] banks may nevertheless agree to pay compound interest to their customers.[38] English law has no objection to compounding.[39]

The prohibition of compound interest typically applies to payments that can be regarded as payment of interest.[40] Some payments can be regarded as payment of interest although they are not labelled as such.

Many firms have a practice of rendering statements of account to their customers at regular intervals, and of charging interest on the balance shown in these statements once it has been outstanding for, for example, 30 days. As this interest will itself appear in the following statement of account, the effect is that the interest is compound.[41] Such practices are possible both in England and in Germany.[42]

In practice, the discounting of claims requires compounding. However, discounted claims such as zero-coupon bonds issued by banks are not illegal in the Member States.[43]

In mezzanine financing, the parties may agree on a rolled-up margin meaning that part of the interest payments will be added to the capital amount ("rolled up") rather than paid to the lender in cash. If the borrower has an option to issue such payment-in-kind (PIK) notes rather than an obligation to do so, the transaction will not be regarded as the payment of prohibited compound interest. If the borrower has agreed to issue payment-in-kind notes without any option to pay interest in cash, the transaction may be regarded as the payment of prohibited compound interest in some countries.[44]

Variation clauses. Variation clauses may be distinguished from floating interest rate clauses. A variation clause means that the creditor may change the method of calculating the interest rate.

Non-financial firms ordinarily understand what floating interest rates mean. However, they might not expect a change in the method of calculating interest rates which results in a rate being substantially greater than under the previous method of calculation. For this reason, there is a risk that such clauses either are not incorporated into the contract, unless the contract party's attention was drawn to the clause at the time of contracting (section 5.3.8), or are construed against the creditor (sections 5.2.4 and 5.3.6).

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37 § 248(1) BGB.

38 § 248(2) BGB.

39 National Bank of Greece SA v Pinios Shipping Co. (No. 1) [1990] 1 AC 637 (House of Lords).

40 §§ 248 and 289 BGB.

41 The Law Commission, Compound Interest (Consultation Paper) [2002] EWLC 167(1) (31 July 2002) paragraph 2.12.

42 § 355 HGB, § 248(2) BGB.

43 See Bezzenberger T, Das Verbot des Zinseszinses, Wertpapier-Mitteilungen 32/2002 pp 1622–1623. For German law, see the first sentence of § 248(2) BGB.

44 Diem A, *op cit*, § 38 C.

For example, such a variation clause could be treated as unusually wide or onerous under English law.[45] In Germany, it could be declared unenforceable or void under § 242 BGB (Treu und Glauben) or § 308 BGB (right to amend standard contract terms).

Fees. Fees can have the same function as interest. In the EU, this has been recognised in the context of retail financial services[46] and also in Member States' consumer protection laws.[47] Fees can sometimes be treated in the same way as interest.

For example, the 2008 Consumer Credit Directive provides that, for the purposes of that Directive, "total cost of the credit to the consumer" means "all the costs, including interest, commissions, taxes and any other kind of fees which the consumer is required to pay in connection with the credit agreement and which are known to the creditor" (except for notarial costs) and even some costs in respect of "ancillary services relating to the credit agreement".[48] "Annual percentage rate of charge" means "the total cost of the credit to the consumer, expressed as an annual percentage of the total amount of credit".[49]

Maximum interest rate, good morals. There may be a statutory cap on the interest rate. The cap may be based on an explicit provision of law. Alternatively, very high interest rates may be contrary to good morals. There are differences between Member States. Typically, consumer credit is subject to stricter rules.

In Germany, the agreed interest rate is contrary to good morals (sittenwidrig)[50] and illegal where it exceeds the market rate by 100% or 12 percentage points.[51] This is an example of the application of two things: the general principle that the price of a good must not exceed its market value by 100% or more, and § 138 BGB which prohibits contracts that are contrary to good morals. § 138 BGB has a wide scope.

In England, section 138 of the Consumer Credit Act has a narrow scope. The Consumer Credit Act 1974 applies to agreements between traders and individuals, sole traders, partnerships and unincorporated associations, but not to agreements made between traders and corporate bodies such as limited companies. The 1974 Act covers most forms of lending, but only up to £25,000. The Act lays down rules covering, for example, extortionate credit bargains. According to section 138 of the 1974 Act, a credit bargain is extortionate if it requires the debtor to make payments which are "grossly exorbitant". In practice, there are

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45 See Cranston R, Principles of Banking Law. Second Edition. OUP, Oxford (2002) p 146.

46 Article 19 (conduct of business obligations when providing investment services to clients) of the MiFID (Directive 2004/39/EC); Article 3 (information to the consumer prior to the conclusion of the distance contract) of Directive 2002/65/EC; Article 36(1) (information for policy holders) and Annex III(A) of Directive 2002/83/EC; Article 12 (information provided by an insurance intermediary) of Directive 2002/92/EC.

47 For example, § 492 BGB.

48 Article 3(g) of Directive 2008/48/EC, previously Article 1(2)(d) of Directive 87/102/EEC.

49 Article 3(i) of Directive 2008/48/EC, previously Article 1(2)(e) of Directive 87/102/EEC.

50 § 138(1) BGB.

51 See, for example, Mülbert PO, Bruinier S, Die Anwendung inländischer Schutzbestimmungen am Beispiel ausländischer Kreditverträge, WM 2005/3 p 105.

unlikely to be many situations in which a complaint that the interest rate is "grossly exorbitant" so as to render the transaction "extortionate", would succeed.[52]

In Switzerland, Article 9(2)(b) of the Consumer Credit Act and its implementing ordinance provide that the annual interest rate (including commissions and other costs) for consumer credits may not exceed 15%. In addition, statutory law and generally accepted principles of usury make interest rates unenforceable in Switzerland to the extent that they exceed 18% per annum.

Particular remarks: interest for late payment. Interest for late payment belongs to the most important legal tools used by creditors. It can create an incentive not to pay late, and failure to pay regardless of a high interest rate for late payment can signal serious financial problems.

In the EU, the provisions on interest for late payment have been influenced by two objectives. (1) Small businesses should be protected against more powerful firms. Member States' laws on interest for late payment have been approximated by the provisions of the Directive on combating late payment in commercial transactions.[53] The purpose of this legislation is to implement a culture of prompt payment and to protect in particular small businesses against more powerful firms. (2) On the other hand, the charging of interest for late payment and the interest rate on late payments should be reasonable. The charging of interest and its rate are therefore constrained by mandatory provisions of law.

The Directive on combating late payment in commercial transactions lays down minimum requirements. The Directive applies to all payments made as remuneration for commercial transactions.[54] Member States may maintain or bring into force provisions which are more favourable to the creditor.[55]

The Directive does not apply to all debts. (a) It does not apply to consumer debts. According to the Directive, a business undertaking or a public authority is obliged to pay interest for late payment.[56] (b) Member States may exclude some debts when transposing the Directive: debts that are subject to insolvency proceedings instituted against the debtor; contracts that have been concluded prior to 8 August 2002; and claims for interest of less than €5.[57]

When the Directive applies, it regulates the core terms of interest on late payment. (a) The Directive provides for a statutory interest rate for late payment. Unless the parties have agreed otherwise, the penalty interest rate is the European Central Bank's main refinancing rate (the reference rate) plus 7 percentage points (the margin). For a Member State which is not participating in the third stage of economic and monetary union and has not joined the euro area, the reference rate is the equivalent rate set by its national central bank.[58] (b) Interest for late payment becomes payable from the day following the date or the end of the period for

52 Nash & Ors v Paragon Finance Plc [2001] EWCA Civ 1466.
53 Directive 2000/35/EC (Late Payment Directive).
54 Article 1 of Directive 2000/35/EC (Late Payment Directive).
55 Article 6(2) of Directive 2000/35/EC (Late Payment Directive).
56 Article 2 of Directive 2000/35/EC (Late Payment Directive).
57 Article 6(3) of Directive 2000/35/EC (Late Payment Directive).
58 Article 3(1)(d) of Directive 2000/35/EC (Late Payment Directive).

payment fixed in the contract.[59] If the date or period for payment have not been fixed in the contract, statutory interest becomes payable 30 days after the date of receipt of the invoice or the date of receipt of the goods or services.[60] (c) No reminder will be necessary.[61] Late payment constitutes in itself a breach of contract and will be automatically sanctioned. This can be contrasted with the traditional provisions of some Member States' laws which require the sending of a reminder.[62] (d) The creditor is also entitled to claim full compensation for all relevant recovery costs.[63]

The Directive on combating late payment in commercial transactions does not prevent contract parties from agreeing on interest for late payment. This is nevertheless subject to mandatory constraints. (a) For example, the parties may agree that interest will become payable in a period longer than 30 days or that the interest rate is below the statutory rate. The parties may also agree on more stringent terms. (c) Such contract terms are constrained by Member States' national laws and the Directive. According to the Directive, Member States shall provide that such an agreement "either shall not be enforceable or shall give rise to a claim for damages if, when all circumstances of the case, including good commercial practice and the nature of the product, are considered, it is grossly unfair to the creditor". One of the things that must be taken into account is whether the debtor had any objective reason to derogate from the provisions of the Directive.[64]

The Directive does not force the firm to actually exercise the right to claim interest. In practice, doing so might sometimes harm existing business relationships. However, mandatory provisions of law can make it easier for small businesses to state in the contract that they are entitled to interest for late payment and reimbursement of costs, and to refuse contract clauses limiting such rights.

Interest on late payment under Member States' laws. Generally, civil law systems and international restatements such as the UNIDROIT Principles do not find penalty clauses objectionable, although they may provide for a power of reduction where the amount payable is disproportionately high.[65]

German law provides for a statutory default interest rate for late payments. For consumer credits, this statutory default interest rate is five percentage points over the statutory base rate.[66] For commercial payment obligations, it is eight percentage points over the statutory base rate.[67] The parties may agree on a higher interest

[59] Article 3(1)(a) of Directive 2000/35/EC (Late Payment Directive).
[60] Article 3(1)(b) of Directive 2000/35/EC (Late Payment Directive).
[61] Article 3(1)(b) of Directive 2000/35/EC (Late Payment Directive).
[62] See, for example, Rüetschi D, Zahlbar „30 Tage netto". Beginn der Verzinsungspflicht im Vertragsrecht unter besonderer Berücksichtigung von Rechnungen zahlbar „30 Tage netto". SJZ 99 (2003) pp 341–349.
[63] Article 3(1)(e) of Directive 2000/35/EC (Late Payment Directive).
[64] Article 3(3) of Directive 2000/35/EC (Late Payment Directive).
[65] Cranston R, Principles of Banking Law. Second Edition. OUP, Oxford (2002) pp 310–311.
[66] § 288(1) BGB.
[67] § 288(2) BGB, Article 6(2) of Directive 2000/35 EC.

rate.[68] According to legal default rules, the creditor is entitled to the reimbursement of loss or damage that exceeds the statutory default interest rate.[69]

This can be contrasted with common law. English law has traditionally prohibited penalty clauses (section 6.3.3) but not default interest as such. Default interest clauses have been treated as penalties when the higher default interest rate is payable for both the interest period and the period of default from the due date. There is no objection if the default rate is modest and is confined simply to the period from the due date.[70] Legislation implementing the Directive has made late payment penalties easier to apply.

In England, the EU late payment legislation has been implemented by the Late Payment of Commercial Debts (Interest) Act 1998 and the Late Payment of Commercial Debts Regulations 2002. (a) Businesses may agree on remedies for late payment (contractual interest). If they do not, the statutory remedies will apply. The creditor is entitled to interest under the 1998 Act and compensation under the 2002 Regulations. The late payment interest rate is eight percentage points plus the reference rate. The creditor is entitled to compensation (a fixed charge of £40, £70 or £100) to be paid to the creditor depending on the size of the unpaid debt (under £1,000, under £10,000, and higher). (b) Contractual remedies for late payment are subject to constraints. Contractual remedies are void unless they are "substantial". Remedies are substantial if they cover the debtor for losses incurred due to late payment or act as a deterrent, and it is reasonable to let the contractual compensation replace the provisions of the Late Payment of Commercial Debts (Interest) Act 1998.

9.6 The Performance of Monetary Obligations

9.6.1 Introduction

The debtor can discharge monetary obligations in many ways. The main ways to discharge a monetary obligation are: payment (with or without conversion); set-off; and netting.

The law that governs the question how monetary obligations should be discharged is the law applicable to the contract.[71] In the EU, the law applicable to the contract is complemented by the rule that "[i]n relation to the manner of performance and the steps to be taken in the event of defective performance regard, shall be had to the law of the country in which performance takes place".[72]

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[68] § 288(3) BGB.
[69] § 288(4) BGB.
[70] See Cranston R, *op cit*, pp 310–311.
[71] Article 12(1)(b) of Regulation 593/2008 (Rome I).
[72] Article 12(2) of Regulation 593/2008 (Rome I).

9.6.2 Payment

Payment is the standard way to perform monetary obligations. Commercial payments are usually made into a bank account, as notes and coins have been replaced by information. There are several basic legal questions relating to payments. There are rules on the place and time of payment. A distinction is made between the money of account and the money of payment. The right of conversion is important when the monetary obligation is denominated in a foreign currency. There are varying degrees of payment finality; payments can be unconditional or conditional, and irrevocable or revocable.

Money of account and money of payment. There is a distinction between the money of account and the money of payment. The money of account is the currency in which an obligation is measured. It tells the debtor how much he has to pay. The money of payment is the currency in which the obligation is to be discharged. It tells the debtor by which means he has to pay.[73]

The money of account and the money of payment are questions of interpretation and governed by the law applicable to the contract.[74] Depending on the jurisdiction, the court may presume that local currency is the money of account. In Germany, the choice of a foreign currency will not be enforced unless it is express, if the contract is governed by German law.[75] It follows from the Rome I Regulation that the currencies in which the payment obligation can be discharged also depend on the place of payment.[76] In practice, the debtor may have a right of conversion (see below).

Place of payment and international jurisdiction. The place of payment is legally important because it can influence the mode of payment, the money of payment (in particular, the right of conversion), and the international jurisdiction of courts. The Brussels I Regulation provides that "a person domiciled in a Member State may, in another Member State, be sued ... in matters relating to a contract, in the courts for the place of performance of the obligation in question".[77]

Place of payment. Unless the parties have agreed otherwise, the place of payment is determined by the governing law of the contract. Cross-border contracts are often silent on the question of the due place of payment.

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73 Lord Denning MR in Woodhouse AC Israel Cocoa Ltd v Nigerian Produce Marketing Co Ltd [1971] 2 QB 23, 54. Proctor C, Mann on the Legal Aspect of Money, Sixth Edition. OUP, Oxford (2005) paragraph 7.54.

74 Article 12 of Regulation 593/2008 (Rome I).

75 § 244 BGB.

76 Article 12(2) of Regulation 593/2008 (Rome I).

77 Article 5(1)(a) of Regulation 44/2001 (Brussels I). See also C-288/92 Custom Made Commercial Limited v Stawa Metallbau [1994] ECR I-2913, paragraph 23: "The Court has ruled that the obligation cannot be interpreted as referring to any obligation whatsoever arising under the contract in question, but is rather that which corresponds to the contractual right on which the plaintiff's action is based (see Case 14/76 De Bloos v Bouyer [1976] ECR 1497, paragraphs 10 and 13)."

The normal English rule applied in sale of goods cases is that, in the absence of contrary implication, the debtor must seek out his *creditor*.[78] German law distinguishes between the performance of payment obligations (the seat of the *creditor*)[79] and the performance of obligations in general (the seat of the *debtor*).[80]

Payment in cash or payment to the account of the creditor. In financial contracts, the parties ordinarily agree that payments will be made through the banking system.[81] Payment to the account of the creditor is the most common form of payment in commercial contracts.[82]

In the absence of a contract, legal rules may provide that payment must be made in cash.[83] In such a case, payment to the account of the creditor with a particular bank may not discharge the obligation in the absence of the creditor's consent.[84]

Time of payment. Payment must be made by the due date.[85] Generally, payment must have reached the payee by the pay date. Commercial contracts often provide that payment is to be made by having immediately available (or "same day") funds in a specified account in a specified bank on a specified day.

The definition of the time of payment raises several questions. (a) At what point of time should the payment be made? The parties can agree on the due date in various ways, or it can be determined on the basis of the governing law (section 9.2). (b) At what point of time has the payment been made? Unless the parties have agreed otherwise, the answer to this question can again be found in the governing law of the contract.

According to German law, the payment has reached the payee when the payee's bank account has been *credited* with the payment. There is a presumption that the account has been credited where the payee can freely dispose of the funds.[86]

According to English law, however, the key point is the unconditional *decision* of the payer's bank to credit. It is a well-established common law rule that, so long as payment arrives before midnight in the relevant time zone on the pay date, that is sufficient in the ab-

[78] See Credit Agricole Indosuez v Chailease Finance Corporation [2000] EWCA Civ 19.

[79] § 270 BGB.

[80] § 269 BGB.

[81] For payments made through the banking system generally, see Cranston R, Principles of Banking Law. Second Edition. OUP, Oxford (2002) pp 238–245.

[82] For parties to payment transfers and contractual relationships between them, see, for example, Cranston R, *op cit*, pp 235–238; Kittner M, Schuldrecht. Rechtliche Grundlagen - Wirtschaftliche Zusammenhänge. 2. Auflage. Verlag Franz Vahlen, München (2002) pp 90–91, paragraphs 257–261.

[83] § 929 BGB.

[84] Proctor C, Mann on the Legal Aspect of Money, Sixth Edition. OUP, Oxford (2005) paragraph 7.12.

[85] See, for example, § 271 BGB. § 271(1) BGB: "Ist eine Zeit für die Leistung weder bestimmt noch aus den Umständen zu entnehmen, so kann der Gläubiger die Leistung sofort verlangen, der Schuldner sie sofort bewirken." § 271(2) BGB: "Ist eine Zeit bestimmt, so ist im Zweifel anzunehmen, dass der Gläubiger die Leistung nicht vor dieser Zeit verlangen, der Schuldner aber sie vorher bewirken kann."

[86] § 362 BGB, §§ 676a-676h BGB.

sence of an express provision to the contrary.[87] The law treats the payee as having been paid, even if it cannot draw on the funds that day - this derives from the midnight rule.[88] The precise point of the decision to credit will depend on the evidence of practices within the particular bank.[89]

Payment of interest or capital. It is a general principle of Member States' contract laws that if the debtor pays part of the debt owed, the part-payment will first go to reduce the amount of costs owed, then the amount interest owed and finally the amount of capital owed.[90]

The right of conversion. Depending on the governing law, legal background rules may provide for a general right of conversion where the payment obligation is denominated in foreign currency.[91] The right of conversion means that the debtor may elect to pay in the currency of the place of payment instead of the money of account.[92]

Legal background rules may also provide for the exchange rate. Depending on the governing law, the exchange rate could be: the exchange rate which prevailed at the maturity date, or that which prevails at the date of payment,[93] or one of these two rates of exchange selected by the creditor.[94] The creditor should ensure that the creditor may select either the exchange rate which prevailed at the maturity date or that which prevails at the date of payment, if payment is made after the maturity date.

Payment services. The Payment Services Directive (PSD) establishes the legal framework necessary for the creation of an integrated payments market (the Single Euro Payments Area, SEPA). The PSD enables payments to be made more

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87 Cranston R, *op cit*, p 239: "Where banks are involved, the midnight rule is based on the consideration that, since banks close their business at different times, to use close-of-business as the crucial point would be too uncertain a test, given the drastic consequences which may follow late payment."

88 *Ibid*, pp 239–240.

89 See *ibid*, p 240. The test is an objective one: Were the payee to contact its bank, at what point would it have been told that it had made an unconditional decision to credit? This could be termed "the hypothetical positive response test". In Mardorf Peach & Co. Ltd v Attica Sea Carriers Corporation of Liberia [1977] AC 850, however, the House of Lords held that a credit transfer had not been effected when funds, although available, were subject to an interest liability; the account of the payee was credited with the amount on 22 January and the payee had immediate use of the money, but if the payee had withdrawn the sum, it would have incurred a liability to its bank to pay interest until 26 January.

90 § 367 BGB.

91 Article 12(2) of Regulation 593/2008 (Rome I): "In relation to the manner of performance and the steps to be taken in the event of defective performance, regard shall be had to the law of the country in which performance takes place."

92 § 244(1) BGB; Proctor C, Mann on the Legal Aspect of Money, Sixth Edition. OUP, Oxford (2005) paragraphs 7.30–7.33.

93 § 244(2) BGB: "Die Umrechnung erfolgt nach dem Kurswert, der zur Zeit der Zahlung für den Zahlungsort maßgebend ist."

94 See Proctor C, *op cit*, paragraph 7.33.

quickly and easily throughout the EU. For example, it is possible to use direct debits across borders in the euro area (Volume III).

9.6.3 Finality, Conditionality, Revocability, Recourse

There are various degrees of payment finality. The payment may be unconditional or subject to certain conditions. The payment may also be an irrevocable payment that will not have to be repaid, or revocable.

The payment may be unconditional but either revocable or irrevocable under legal background rules. Revocation (or countermand) involves the obligation of a bank to comply with its customer's instructions (or mandate) to cancel a payment instruction. In addition to legal background rules, revocation may be governed by the terms agreed by the bank and its customer (the payer), and/or the the terms agreed by the payer and the payee.[95] There is thus a distinction between the contractual relationship between the payer and the bank (or central counterparty) on one hand, and between the payer and the payee on the other.

The payment may be conditional but irrevocable. For example, the payer and the payee may have agreed that the payment is made for a particular purpose and that the use of moneys in any other way will amount to default or breach of contract and trigger the obligation to return the moneys to the payer. The payment may also be conditional on a certain event occurring, such as a refinancing agreement being reached. For security reasons, a bank may sometimes prefer to agree with a borrower that moneys lent should not become the general property of the borrower, but should be kept separate and applied exclusively for a particular purpose.[96] In common law countries, the payment may have to be returned on the basis that the moneys are held in trust for the payer or someone else as beneficiary.[97]

In some cases the payment is not final because of the payer's right of recourse. The payer may have a right of recourse, for example, where it makes a payment by mistake.[98] Mistakes are not unusual: according to a study, documents presented under letters of credit comply in only 27% of cases.[99]

Finality in payment and settlement systems. The irrevocability of payments is particularly important in payment and payment settlement systems.

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95 Cranston R, *op cit*, pp 242–243.

96 See *ibid*, pp 241–242.

97 In English law, a trust may arise from different sources: a "Quistclose trust" (Barclays Bank v Quistclose Ltd [1970] AC 567; Twinsectra Ltd v Yardley [2002] 2 AC 164); a constructive trust arising out of the unconscionability of retaining moneys; and the express declaration of trust, or an implied declaration arising out of the related facts. See, for example, Farepak Foods and Gifts Ltd & Ors v Revenue and Customs & Anor Rev 1 [2006] EWHC 3272 (Ch).

98 See Sheehan D, Rights of Recourse in Documentary (and other) Credit Transactions, JBL 2005 May pp 326–345.

99 Mann RJ, The Role of Letters of Credit in Payment Transactions, Mich L R 98 (2000) p 2502 and statistical appendix at p 2534. Cited by Sheehan D in footnote 3.

The Directive on Payment Services (PSD) provides that a payment service user may not normally revoke a payment order once it has been received by the payer's payment service provider.[100]

There is a distinction between the relationship between a payment systems user and a payment systems provider on one hand and a payment systems provider and a payee on the other. The payments service provider and the payment service user may agree on revocation, but such a revocation is applicable only in the relationship between those two parties (thus being without prejudice to the irrevocability and finality of payment transactions in payment systems). In addition, such irrevocability "should not affect a payment service provider's right or obligation under the laws of some Member States, based on the payer's framework contract or national laws, regulations, administrative provisions or guidelines, to reimburse the payer with the amount of the executed payment transaction in the event of a dispute between the payer and the payee."[101]

In payment settlement systems, a central counterparty's legal framework should support finality of settlement. Therefore, the funds transfers should be final (irrevocable and unconditional) when effected (when accounts are debited and credited).[102] The Settlement Finality Directive supports the provisions of a central counterparty's legal framework in this respect.

The Settlement Finality Directive, which is aimed at reducing the systemic risk associated with participation in payment and securities settlement systems,[103] provides that a "transfer order may not be revoked by a participant in a system, nor by a third party, from the moment defined by the rules of that system".[104] On the other hand, the provisions of the Directive do not "prevent a participant or a third party from exercising any right or claim resulting from the underlying transaction which they may have in law to recovery or restitution in respect of a transfer order which has entered a system, e.g. in case of fraud or technical error, as long as this leads neither to the unwinding of netting nor to the revocation of the transfer order in the system".[105]

Finality when securing payment. Irrevocability of payments is important, for example, when a contract party wants to secure payment by the other party.

In foreign trade, a frequent method of securing payment is the opening, by the purchaser, of one or a series of letters of credit which will normally be opened through a bank in the purchaser's country.[106] The parties may also use independent guarantees.

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[100] Article 66 of Directive 2007/64/EC (PSD).

[101] Recital 39 of Directive 2007/64/EC (PSD).

[102] BIS, Committee on Payment and Settlement Systems, Recommendations for Central Counterparties, CPSS Publications No. 64 (November 2004), paragraphs 4.1.7 and 4.9.7.

[103] For a definition of these systems, see Article 2 of Directive 98/26/EC (Settlement Finality Directive).

[104] Article 5 of Directive 98/26/EC (Settlement Finality Directive).

[105] Recital 13 of Directive 98/26/EC (Settlement Finality Directive).

[106] See, for example, Herzfeld E, Security for Payments under Major Overseas Projects, JBL 1986 pp 446–451.

The beneficiary should insist that the bank's undertaking be irrevocable. A seller should therefore insist that the letter of credit cannot be modified or rescinded after issuance without the seller's approval.

The UN Convention on Independent Guarantees and Stand-by Letters of Credit states that an undertaking is irrevocable unless otherwise stipulated.[107] The same principle can be found in the uniform rules adopted by the International Chamber of Commerce.[108]

Finality and capital requirements (Basel II). Payment finality influences capital requirements. The Capital Requirements Directives[109] lay down the general requirement for credit institutions and investment firms to hold total capital equivalent to at least 8% of their risk-weighted assets. The risk-weighting can be influenced by the transfer of risk where the transfer is irrevocable and unconditional.[110]

9.6.4 Set-off

Set-off is a common way to discharge monetary obligations.[111] It is governed by legal background rules (default rules). (a) As many of them are dispositive, it is normal to agree on the terms, modalities and limitations of set-off. (b) Set-off is also governed by mandatory provisions of law, such as rules on set-off in insolvency. It is therefore important to check that the commencement of insolvency proceedings would not influence the enforceability of the set-off.

Unless prohibited by the contract, set-off is normally possible where two parties have mature and liquidated claims of an identical nature vis-à-vis each other. (a) The parties may agree that payment may be made by using set-off as an alternative to a cash payment or payment through the banking system. For example, where the parties are dealing on a regular basis, it may be agreed that, at periodic intervals, sums due from one party shall be set off against sums due to that party by the other, and such set-off is then equivalent to a cash payment. (b) Set-off can be used as a mechanism for risk reduction. For example, market participants seek to reduce both credit risk and settlement risk (Herstatt risk) by set-off terms. (c) Netting is a particular form of set-off. Netting will be discussed in section 9.6.5 below.

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[107] Article 7 of the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit. See, for example, Gorton L, Draft Uncitral Convention on Independent Guarantees, JBL 1997 pp 240–253.

[108] Article 5 of Uniform Rules for Demand Guarantees, URDG 458. See also Uniform Customs and Practice for Documentary Credits, UCP 600.

[109] Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions (recast); Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions (recast).

[110] Paragraphs 140, 145 and 189 of the Basel II Accord; paragraphs 50 and 54 of Annex 11 of the Basel II Acccord. See also Edwards S, The Law of Credit Derivatives, JBL 2004 pp 617–655.

[111] See, for example, DCFR III.–6:101.

Harmonisation of substantive law, governing law. Although there is no general harmonisation of set-off rules in the EU, the basic principles of set-off are fairly similar in Europe and there are varying degrees of harmonisation of different aspects of set-off.

The substantive set-off rules share the same foundations in Europe. Set-off is also covered by the Principles of European Contract Law,[112] the Draft Common Frame of Reference,[113] and the UNIDROIT Principles of International Commercial Contracts.[114] It has not been mentioned in the CISG and is not covered by that Convention.

The governing law can be unclear. (a) The 1980 Rome Convention did not contain any separate rule on the law applicable to set-off. Contractual set-off was therefore subject to the general choice of law rules and be governed by the law applicable to the contract. (b) On the other hand, the claims of the parties can be based on two or more contracts governed by the laws of more than one country. (c) The question of governing law has now been clarified in the Rome I Regulation: "Where the right of set-off is not agreed by the parties, set-off shall be governed by the law applicable to the claim against which the right to set-off is asserted."[115]

Insolvency set-off is governed by the Regulation on Insolvency Proceedings. According to the Regulation, the permissibility of set-off in insolvency proceedings is governed by the insolvency laws of the country where the proceedings are opened.[116] There is an exception: "The opening of insolvency proceedings shall not affect the right of creditors to demand the set-off of their claims against the claims of the debtor, where such a set-off is permitted by the law applicable to the insolvent debtor's claim."[117] This exception does not preclude "actions for voidness, voidability or unenforceability".[118]

Conditions of set-off. The UNIDROIT Principles reflect the basic conditions of set-off between contract parties under the laws of many countries. The PECL and the DCFR resemble the UNIDROIT Principles.

The obligations of the parties can arise from different contracts[119] or from the same contract.[120]

One of the core conditions under legal default rules is that the payment obligations exist. For example, Article 1291 of the French Code Civil provides that set-off can only be asserted if both obligations are "liquide", i.e. ascertained as to both their existence and amount. This question has also been addressed by the

[112] PECL Chapter 13.
[113] DCFR III. Chapter 6.
[114] Articles 8.1–8.5 of the UNIDROIT Principles. For rules on assignment, see Articles 9.1.1–9.1.15.
[115] Article 17 of Regulation 593/2008 (Rome I) replacing the Rome Convention. The Rome I Regulation applies to contracts concluded after 17 December 2009.
[116] Article 4(2)(d) of Regulation 1346/2000 (Regulation on insolvency proceedings).
[117] Article 6(1) of Regulation 1346/2000 (Regulation on insolvency proceedings).
[118] Article 6(2) of Regulation 1346/2000 (Regulation on insolvency proceedings).
[119] Article 8.1.1 of the UNIDROIT Principles.
[120] Article 8.1.2 of the UNIDROIT Principles.

UNIDROIT Principles. It is easier to set off claims that arise from the same legal relationship than claims that arise from different legal relationships.[121]

Mutuality is a core condition of set-off. For example, where a borrower has a deposit with its lender (a bank), the borrower can in principle set this off against payments under the loan.[122]

In addition, national laws typically require that the performance of both obligations is due and that the obligations are of the same kind.[123]

One might ask whether payment obligations denominated in different currencies are payment obligations "of the same kind". The UNIDROIT Principles therefore contain a special rule on permitting foreign currency set-off in normal cases, unless the parties have agreed otherwise.[124] This rule resembles the rule applied, for example, in Germany as well as in the PECL/DCFR.[125]

If the parties have not agreed otherwise, the right of set-off is exercised by notice to the other party.[126] According to the UNIDROIT Principles, set-off takes effect as from the time of notice.[127] The UNIDROIT Principles also regulate the contents of notice.[128]

The questions of mutuality and notice are important especially where the original payment claim is assigned to an assignee. Until the obligor receives a notice of the assignment, it is discharged by paying the assignor.[129] In addition, the obligor

[121] Article 8.1.1 in combination with Article 8.1.2. Article 8.1.2: "If the obligations of both parties arise from the same contract, the first party may also set off its obligation against an obligation of the other party which is not ascertained as to its existence or to its amount." See also PECL Article 13:102; DCFR III.–6:102.

[122] See Cranston R, Principles of Banking Law. Second Edition. OUP, Oxford (2002) p 366.

[123] See PECL Article 13:101; DCFR III.–6:102.

[124] Article 8.2 of the UNIDROIT Principles: "Where the obligations are to pay money in different currencies, the right of set-off may be exercised, provided that both currencies are freely convertible and the parties have not agreed that the first party shall pay only in a specified currency."

[125] § 95(2) InsO; PECL Article 13:103; DCFR III.–6:104. For English law, see Proctor C, Mann on the Legal Aspect of Money, Sixth Edition. OUP, Oxford (2005) paragraph 7.51: "... there is no reason of substance which should prevent set-off in such a case. The method was indicated by Brandon J at first instance in The Despina R …" The Despina R [1979] AC 685 (House of Lords).

[126] Article 8.3 of the UNIDROIT Principles. See also PECL Article 13:103; DCFR III.–6:106.

[127] Article 8.5.3 of the UNIDROIT Principles.

[128] Article 8.4.1 of the UNIDROIT Principles: "The notice must specify the obligations to which it relates." Article 8.4.2: "If the notice does not specify the obligation against which set-off is exercised, the other party may, within a reasonable time, declare to the first party the obligation to which set-off relates. If no such declaration is made, the set-off will relate to all the obligations proportionally."

[129] Article 9.1.10.1 of the UNIDROIT Principles. See, for example, Article 1240 of the French Code Civil. In English law, there is a distinction between equitable assignment and statutory assignment of receivables. See The Law Commission, Registration of Security Interests: Company Charges and Property other than Land (A Consultation Paper) [2002] EWLC 164(6) (14 June 2002) paragraphs 6.28 and 6.36.

may assert against the assignee all defences that the obligor could assert against the assignor.[130] The obligor may exercise against the assignee any right of set-off available to the obligor against the assignor up to the time notice of assignment was received.[131]

The effect of set-off is that the obligations are discharged.[132] If obligations differ in amount, set-off discharges the obligations up to the amount of the lesser obligation.[133]

Contractual set-off arrangements. Contractual set-off may be aimed at extending rights of set-off beyond those given under legal default rules or limiting them. As a rule, the parties are free to agree on set-off outside insolvency.[134]

Sometimes a party may prefer to exclude the other party's set-off rights. In many commercial agreements, the use of a payment clause containing the terms "net cash" may be regarded as an explicit or implicit prohibition of set-off.

For example, a bank that lends money to a borrower may require that these must be paid into a deposit account with the bank. The bank wants to ensure that it has the right to set off the amount loaned against the sums it is bound to repay to the borrower under the deposit account.[135] Where a borrower has a deposit with its lender (a bank), the borrower can in principle set this off against payments under the loan. However, the bank may prefer to ensure that this is prohibited by a term in the loan agreement.[136]

Sometimes set-off is constrained by mandatory provisions of law. For example, the PECL and the DCFR provide that set-off cannot be effected against a claim to the extent that that claim is not capable of attachment and against a claim arising from a deliberate wrongful act.[137]

Even more important constraints can be found in national insolvency laws. It would be against the principle of pari passu distribution to use a purely personal cross-claim to ring-fence assets away from those available for unsecured creditors.[138]

The effect of insolvency laws. Where set-off rights are used as a mechanism for risk reduction in financial contracts, it is important that these rights are enforce-

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[130] Article 9.1.13.1 of the UNIDROIT Principles.

[131] Article 9.1.13.2 of the UNIDROIT Principles. See also Articles 9.2.7 and Article 9.3.6.

[132] Article 8.5.1 of the UNIDROIT Principles.

[133] Article 8.5.2 of the UNIDROIT Principles.

[134] This principle has been used also in Article 18 of the UN Convention on Independent Guarantees and Stand-by Letters of Credit: "Unless otherwise stipulated in the undertaking or elsewhere agreed by the guarantor/issuer and the beneficiary, the guarantor/issuer may discharge the payment obligation under the undertaking by availing itself of a right of set-off, except with any claim assigned to it by the principal/applicant or the instructing party." UCP and URDG contain no provisions related to set-off.

[135] The Law Commission, Registration of Security Interests, paragraph 6.48.

[136] See Cranston R, Principles of Banking Law. Second Edition. OUP, Oxford (2002) p 366.

[137] PECL Article 13:107; DCFR III.–6:108.

[138] The Law Commission, Registration of Security Interests, paragraph 6.48, footnote 80. For English law, see r 4.90 of the Insolvency Rules 1986 r 4.90.

able within insolvency.[139] Credit risk exposure is increased where insolvency set-off is not allowed.[140] It is therefore important to determine the law applicable to the insolvency proceedings and whether the substantive laws of the relevant countries have been harmonised.

The Regulation on insolvency proceedings designates the governing law in some respects. The Regulation adopts both the principle of universality and the principle of territoriality by providing for two types of insolvency proceedings: main proceedings with universal scope;[141] and secondary proceedings with a territorial scope.[142] According to the Regulation, "the law applicable to insolvency proceedings and their effects shall be that of the Member State within the territory of which such proceedings are opened".[143] The law of the State of the opening of proceedings determines the conditions for the opening of those proceedings, their conduct and their closure. For example, it determines "the conditions under which set-offs may be invoked".[144]

This means that one should check whether set-off is available under the applicable national insolvency laws. There are differences between Member States' insolvency laws as regards the permissibility of set-off.[145]

For example, set-off is permitted under the German Insolvency Act (Insolvenzordnung)[146] subject to certain restrictions.[147] In England, set-off between an insolvent company and its creditors is governed by rule 4.90 of the Insolvency Rules 1986.[148] According to the Insolvency Rules 1986, the set-off of mutual debts is mandatory in all liquidations and cannot be excluded by agreement between the parties. Both sums must be due.[149] Set-off is available

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[139] See, for example, BIS, Committee on Payment and Settlement Systems, Securities lending transactions: market development and implications, CPSS Publications No. 32 (July 1999), paragraph 3.2: "Another important legal concern is whether a jurisdiction's insolvency laws allow a set-off of mutual debts, ensuring the non-defaulting party can effectively take the benefit of the stock or collateral held." See also Elias RO, Legal Aspects of Swaps and Collateral, JIFM 3(6) (2001) pp 232–249.

[140] See, for example, Elias RO, Legal Aspects of Swaps and Collateral, JIFM 3(6) (2001) pp 232–249.

[141] Article 3(1) of Regulation 1346/2000 (Regulation on insolvency proceedings).

[142] Article 3(2) of Regulation 1346/2000 (Regulation on insolvency proceedings).

[143] Article 4(1) of Regulation 1346/2000 (Regulation on insolvency proceedings).

[144] Article 4(2)(d) of Regulation 1346/2000 (Regulation on insolvency proceedings).

[145] Recital 11 of Regulation 1346/2000 (Regulation on insolvency proceedings).

[146] § 94 and § 95 InsO.

[147] § 96 InsO provides that set-off is not permissible in insolvency proceedings, where: (a) the creditor becomes a debtor of the estate only after proceedings have commenced; (b) the creditor acquires its claim from another creditor after proceedings have commenced; or (c) if the creditor acquires the right of set-off by means of a voidable transaction.

[148] Rule 4.90(1) of the Insolvency Rules 1986: "This rule applies where, before the company goes into liquidation there have been mutual credits, mutual debts or other mutual dealings between the company and any creditor of the company proving or claiming to prove for a debt in the liquidation."

[149] Rule 4.90(2) of the Insolvency Rules 1986: "An account shall be taken of what is due from each party to the other in respect of the mutual dealings, and the sums due from one party shall be set off against the sums due from the other."

only in respect of debts that are proved in the liquidation, so that if a secured creditor elects to rely on its security and not prove its debt, that debt will not be subject to any right of set-off.

There is an exception to the main rule that set-off is governed by the law that governs the insolvency proceedings. The Regulation on Insolvency Proceedings contains a special rule in favour of the law governing the contract: "The opening of insolvency proceedings shall not affect the right of creditors to demand the set-off of their claims against the claims of the debtor, where such a set-off is permitted by the law applicable to the insolvent debtor's claim."[150] If the contract provides for the availability of set-off, the law that determines the admissibility of set-off is the law that governs the contractual obligations. There is a similar principle under German insolvency law.[151]

The exception in favour of the law that governs the contract will not preclude "actions for voidness, voidability or unenforceability".[152]

As the admissibility of insolvency set-off depends on the governing law under the Insolvency Regulation, a lender can manage risk by ensuring that the centre of its debtor's main interests[153] will remain in a Member State that allows set-off to the maximum extent possible[154] and has limited the grounds for challenging detrimental acts.[155] The firm may try to achieve this by using contractual covenants or otherwise. In addition, the lender should ensure that the choice of the law that governs the contractual obligations of the parties supports set-off.[156]

9.6.5 Netting

Netting is basically a form of set-off. It is used by participants in settlement or clearing systems. Netting can be defined as "the conversion into one net claim or one net obligation of claims and obligations resulting from transfer orders which a participant or participants either issue to, or receive from, one or more other participants with the result that only a net claim can be demanded or a net obligation be owed".[157] If there is doubt about whether netting will be enforceable in a certain

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[150] Article 6(1) of Regulation 1346/2000 (Regulation on insolvency proceedings).
[151] § 94 InsO: "Ist ein Insolvenzgläubiger zur Zeit der Eröffnung des Insolvenzverfahrens kraft Gesetzes oder auf Grund einer Vereinbarung zur Aufrechnung berechtigt, so wird dieses Recht durch das Verfahren nicht berührt."
[152] Article 6(2) of Regulation 1346/2000 (Regulation on insolvency proceedings).
[153] Article 3(1) of Regulation 1346/2000 (insolvency proceedings).
[154] Article 4(2)(d) of Regulation 1346/2000 (insolvency proceedings).
[155] Article 6(2) of Regulation 1346/2000 (insolvency proceedings).
[156] Article 6(1) of Regulation 1346/2000 (insolvency proceedings).
[157] Article 2(k) of Directive 98/26/EC.

jurisdiction, participants will stay clear of entering into transactions with parties subject to that legal framework.[158]

Forms of netting. One can distinguish between different forms of netting: on the basis of the number of parties (bilateral or multilateral netting); according to the nature of the underlying transaction (payment-system netting, foreign-exchange netting, derivatives-contracts netting, and so on); or on the basis of its legal nature (position or payment netting and close-out netting).[159] In addition, some participants may wish to net their net position against other financial transactions that they have conducted.[160]

Reasons to use netting. Netting is used for a number of reasons.

- Netting can reduce *transaction costs* by reducing the amount of value and the volume of transfers necessary to discharge payment obligations.[161]
- Netting will reduce *credit risk*, if it means that all of the losses and gains on the parties' contracts will be off-set against each other in the event that a counterparty fails.[162] For example, where a party to many foreign exchange contracts is in the process of being liquidated, the liquidator would prefer to disclaim any foreign exchange contract which, because of movements in exchange rates, the liquidator considers to be unprofitable, and would ask the other party to fulfil any contract which the liquidator considers to be profitable.[163]
- If a financial institution's credit exposures may be calculated on a net basis, the financial institution will need *less capital* and less collateral and its business will be less constrained by large exposure limits.
- For these reasons, the management and reduction of credit exposures arising from financial transactions on a net basis belongs to sound *risk management* in financial markets.[164]
- Netting can reduce the *systemic risk* associated with participation in payment and securities settlement systems, and in particular the risk linked to the insolvency of a participant in such a system.
- Netting may also be used in order to solve certain problems relating to the availability of normal *set-off*.

[158] See, for example, BIS, Committee on Payment and Settlement Systems, Securities lending transactions: market development and implications, CPSS Publications No. 32 (July 1999), section 3.2.
[159] Cranston R, Principles of Banking Law. Second Edition. OUP, Oxford (2002) pp 287–288.
[160] BIS, Committee on Payment and Settlement Systems, Securities lending transactions: market development and implications, CPSS Publications No. 32 (July 1999), section 3.2.
[161] See, for example, Cranston R, *op cit*, p 277.
[162] See for example, *ibid*, pp 288–289.
[163] Derham SR, Set Off and Netting of Foreign Exchange Contracts in the Liquidation of a Counterparty: Part 1, JBL 1991 p 463.
[164] Recital 14 of Directive 2002/47/EC.

Close-out netting. All standard master agreements that govern OTC derivates, swap contracts, and foreign exchange contracts for the sale and purchase of foreign currencies at a future date contain close-out netting provisions.

Close-out netting is an agreement that, upon default and termination of the master agreement, all transactions will be valued, the positive and negative values will be added together, and the resulting netted amount will be the sole remaining payment obligation of the parties.

In other words, the close-out netting mechanism adopted in the master agreements crystallises the non-defaulting party's net exposure in a four-step approach as follows: First, the redelivery date for all outstanding obligations is accelerated to coincide with the date of default (so they are immediately due and can be performed). Second, the obligations of the collateral-taker (for collateral, see section 11.6.3) to redeliver collateral (and any other obligation of the counterparty to deliver securities) are converted into an obligation to pay a cash sum equal to their market value. Third, all cash sums are converted into a base currency equal to their market value. Finally, all sums owed by each party to the other party under the arrangements are set off against each other so that only a net sum is payable.[165]

Legal problems. Although the parties may usually agree on the terms of set-off, set-off is constrained by mandatory provisions protecting third parties or applicable to set-off in insolvency. Set-off is not usually available, unless the claims: have been ascertained as to both their existence and amount; are mutual; are of the same kind; and are due. These basic conditions would not necessarily be fulfilled in netting.

For example, multilateral netting is most vulnerable to insolvency law and other mandatory provisions of law because of the lack of mutuality. Close-out netting may in some jurisdictions be regarded as void in the insolvency of the defaulting party because it makes claims due in an unusual way and reduces the assets available to the defaulting party's general creditors.[166]

In the worst case, the applicable insolvency laws could give the insolvency officer the power to select which contracts would be continued and which terminated. The creditor would have to make full payment in respect of its loss-making contracts and only receive a portion, if any, of the positive value of the remaining contracts. This worst-case scenario is known as "cherry-picking".

According to traditional insolvency law rules, the insolvency administrator may claim selective performance of the profitable contracts and repudiate the unprofitable ones.[167] This is what happened in the famous insolvency case of Bank Herstatt.

In financial transactions, netting agreements are complemented by financial collateral arrangements that consist of the transfer of securities. The collateral-taker becomes the owner of securities used as collateral and has only a redelivery obligation of equivalent securities at the end of the transaction. Financial collateral ar-

[165] Elias RO, Legal Aspects of Swaps and Collateral, JIFM 3(6) (2001), p 241.
[166] Cranston R, *op cit*, p 291.
[167] See, for example, Elias RO, Legal Aspects of Swaps and Collateral, JIFM 3(6) (2001), p 248.

rangements are constrained by insolvency laws. Although the collateral-taker, with the close-out netting mechanism, is released from its contractual redelivery obligation and owns the collateral, the insolvency administrator of the collateral-giver might still argue that set-off is not effective in discharging collateral redelivery rights.[168]

Enforceability of netting. In order to reduce systemic risk by increasing settlement finality in payment and securities settlement systems, netting is governed by special legislation. In the EU, the purpose of the Settlement Finality Directive is to reduce the systemic risk associated with participation in payment and securities settlement systems and in particular the risk linked to the insolvency of a participant in such a system. The Settlement Finality Directive is complemented by the Collateral Directive. The aim of the Collateral Directive is to limit credit risk in financial transactions through the provision of securities and cash as collateral.

The Settlement Finality Directive and the Collateral Directive help the parties to enforce a netting clause or a contractual collateral arrangement. Without a netting clause or a collateral arrangement based on contract, the parties cannot benefit from the provisions of those Directives.

The Settlement Finality Directive applies to payment and settlement systems.[169] The main rule under the Settlement Finality Directive is that transfer orders and netting shall be legally *enforceable* and, even in the event of insolvency proceedings against a participant, shall be *binding* on third parties, provided that transfer orders were entered into a system before the moment of opening of insolvency proceedings.[170] Furthermore, the Settlement Directive prohibits legal rules that lead to the *unwinding* of a netting.[171] In particular, insolvency proceedings shall not have retroactive effects on the rights and obligations of a participant.[172]

Enforceability of collateral arrangements. The Collateral Directive applies to certain financial collateral arrangements and to certain financial collateral.[173] In particular, the collateral-taker and the provider of collateral must typically belong to the categories of: a public authority; a central bank; a financial institution; or a central counterparty, settlement agent or clearing house. If one of the parties is such an institution, the other party may be any legal entity (for example, an industrial firm).[174] The Directive seeks to protect the validity of financial collateral arrangements which are based on the transfer of the full ownership of the financial collateral, such as by eliminating the so-called re-characterisation of such financial collateral arrangements (including repurchase agreements) as security interests.[175] The Directive also protects the enforceability of bilateral close-out netting, not only as an enforcement mechanism for title transfer financial collateral arrange-

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[168] See, for example, *ibid*, p 241.

[169] Articles 1 and 2(a) of Directive 98/26/EC (Settlement Finality Directive).

[170] Article 3(1) of Directive 98/26/EC (Settlement Finality Directive). For the moment of opening insolvency proceedings, see Article 6(1).

[171] Article 3(2) of Directive 98/26/EC (Settlement Finality Directive).

[172] Article 7 of Directive 98/26/EC (Settlement Finality Directive).

[173] Article 1(1) of Directive 2002/47/EC (Collateral Directive).

[174] Article 1(2) of Directive 2002/47/EC (Collateral Directive).

[175] Recital 13 of Directive 2002/47/EC (Collateral Directive).

ments including repurchase agreements but more widely, where close-out netting forms part of a financial collateral arrangement.[176]

The Collateral Directive simplifies formal requirements. Some requirements as to form are permitted. The Member States do not have to apply the provisions of the Directive to financial collateral unless "it has been provided", "that provision can be evidenced in writing", or "the financial collateral arrangement can be evidenced in writing or in a legally equivalent manner".[177] Other requirements as to form are prohibited.[178]

The purpose of the Collateral Directive is to make collateral arrangements *enforceable*. The enforcement of financial collateral arrangements[179] and the recognition of close-out netting arrangements[180] have therefore been mentioned in the Directive.

For example, the Directive provides: "Member States shall ensure that a close-out netting provision can take effect in accordance with its terms: (a) notwithstanding the commencement or continuation of winding-up proceedings or reorganisation measures in respect of the collateral provider and/or the collateral taker; and/or (b) notwithstanding any purported assignment, judicial or other attachment or other disposition of or in respect of such rights."[181]

Invalidity. All netting and collateral arrangements are not enforceable. The Settlement Finality Directive and the Collateral Directive do not prevent a participant or a third party from exercising its own rights. For example, it is possible that a transfer order is based on fraud[182] or that the provider of collateral had no capacity to provide it because the assets provided as financial collateral were owned by a third party.[183]

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176 Recital 14 of Directive 2002/47/EC (Collateral Directive).
177 Article 3(2) of Directive 2002/47/EC (Collateral Directive).
178 Article 3(1) of Directive 2002/47/EC (Collateral Directive).
179 Article 4 of Directive 2002/47/EC (Collateral Directive).
180 Article 6 of Directive 2002/47/EC (Collateral Directive).
181 Article 7(1) of Directive 2002/47/EC (Collateral Directive).
182 Recital 13 of Directive 98/26/EC (Settlement Finality Directive): "Whereas nothing in this Directive should prevent a participant or a third party from exercising any right or claim resulting from the underlying transaction which they may have in law to recovery or restitution in respect of a transfer order which has entered a system, e.g. in case of fraud or technical error, as long as this leads neither to the unwinding of netting nor to the revocation of the transfer order in the system ..."
183 Recital 6 of Directive 2002/47/EC (Collateral Directive): "This Directive does not address rights which any person may have in respect of assets provided as financial collateral, and which arise otherwise than under the terms of the financial collateral arrangement and otherwise than on the basis of any legal provision or rule of law arising by reason of the commencement or continuation of winding-up proceedings or reorganisation measures, such as restitution arising from mistake, error or lack of capacity."

10 Generic Forms of Payment Obligations

10.1 Introduction

Traditional legal rules governing payment obligations have been designed for the most basic form of payment obligations: the obligation to pay a fixed sum of money.

In addition, it is normal to distinguish between different forms of claims according to their transferability and the enforceability of transfer. For example, under English law, "receivables" are "assigned", but "negotiable instruments", rights, and obligations are "transferred". In German law, the transfer ("assignment") of receivables is called "Abtretung" (Abtretung von Forderungen).[1] The transfer of ownership is called "Übertragung" (Übertragung des Eigentums).[2] Transferability and enforceability of the transfer will be discussed in sections 11.4 and 11.5 in more detail.

There are even other ways to distinguish between different forms of payment obligations. Payment obligations can be divided into six basic categories. A payment obligation can belong to one category or consist of a combination of obligations that belong to two or more categories. As will be explained below, the categories are: (1) legally unenforceable cash flows; (2) payments known in advance; (3) variable payment obligations; (4) payments whose amount depends on the value of an asset; (5) payments that depend on the occurrence of an event; and (6) options. Finally, there is a category that consist of (7) a combination of payment obligations that belong to two or more categories.

The legal aspects of payment obligations and the management of counterparty risk depend on the form of the obligation in question.

10.2 Legally Not Enforceable Cash Flows

Some possible cash flows are not legally enforceable. (a) For example, a minor shareholder may not be able to force the company to pay dividends. The people who control the company tend to have plenty of discretion in this respect. Ultimately profits will be paid out to shareholders, but a shareholder does not know

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[1] See § 398(1) BGB: "Eine Forderung kann von dem Gläubiger durch Vertrag mit einem anderen auf diesen übertragen werden (Abtretung)."

[2] For example, § 929 BGB.

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when this will happen and how much will be paid out (Volume III). (b) Payment obligations under comfort letters provide another typical example of legally not enforceable cash flows. Many comfort letters are designed to create moral obligations (section 5.6.2) rather than payment obligations enforceable by the court. (c) Furthermore, many non-binding contracts can, in practice, influence the behaviour of the parties. This is often the case where failure to perform under a non-binding contract would have adverse consequences (for sanctions, see section 6.3.3).

10.3 Legally Enforceable Payment Obligations

The other categories of payment obligations contain legally enforceable obligations. The recognition and enforceability of payment obligations is important to contract parties, because it reduces risk and enables parties to contract on value transfer, future chance outcomes, and the transfer of financial claims.

Payments known in advance. The legal framework may lay down the sums to be paid and when the payments are due. This is the most basic case of legally enforceable payment obligations. For example, these payment obligations can be found in traditional customer credits, term loans, revolving facilities, and overdrafts.

Variable payment obligations. The legal framework may lay down when payments are due but leave the size of those payments dependent on future events. The firm may agree to use variable payments for many reasons. For example, it may be a way to increase the flexibility of a long-term contract (section 5.5.4).

Another example can be found in business acquisition contracts. Parties to a business acquisition contract may agree on an earn-out clause according to which part of the purchase price will depend on the target's performance and future earnings (Volume III).[3]

In mezzanine finance, an equity investor may sometimes prefer to use a back-ended fee instead of an equity kicker (Volume III).[4]

In football transfer contracts, part of the transfer fee may depend on the player's appearances, the buyer's trophies, whether the buyer qualifies for a certain competition, and other things. The seller may also insert a sell-on clause in the contract entitling the seller to part of the transfer fee if the player moves to a third club.

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[3] See, for example, Vischer M, Earn-out Klauseln in Unternehmensverträgen, SJZ 98 (2002) pp 509–517.

[4] See, for example, Barthold BM, Mezzanine-Finanzierung von Unternehmensübernahmen, SZW/RSDA 5/2000 pp 226–227: "In Deutschland ist zudem die 'back-ended fee' gebräuchlich. Dabei handelt es sich um eine Einmalzahlung zum Ende der Laufzeit des Mezzanine-Darlehens, die als ein Prozentsatz an der Wertsteigerung des finanzierten Unternehmens vereinbart wird und in Geld erfolgt. Der equity kicker wird in dieser Form ausgestaltet, um eine Verwässerung der Rechte der Aktionäre im Einzelfall zu vermeiden, die sonst infolge der Ausübung des Options- oder Wandelrechts durch den Investor eintreten würde."

Value of an asset. A special category of variable payment obligations consists of payment obligations whose size depends on the value (or changes in the value) of an asset. Derivatives are a typical example of payment obligations that belong to this category (section 11.7.4). Other common examples can be found in asset-backed finance. For example, the sums to be paid on termination of a sale and lease-back transaction or a financial leasing transaction may depend on the value of the leased asset.

Where the size of the payment obligation depends on the value of an asset, it is important who owns the asset. The parties may basically address this question in two ways. (a) First, payment obligations that belong to this category can be complemented by changes of title to the asset. Title to the asset may change hands roughly at the same time as money changes hands. For example, sale and lease-back transactions and financial leasing contain these kinds of payment obligations. (b) Alternatively, payment obligations that belong to this category can be separate from the ownership of the asset. There will be no delivery of assets when payments are made on the basis of their value. For example, such payment obligations can be found in many cash-settled derivatives.

Event (contingent claims). The obligation to make a payment can be triggered by the occurrence of an event. Some payment obligations cease to be enforceable upon the occurrence of an event. For example, a force majeure clause may relieve a party from liability to perform his obligations at least for the duration of the force majeure event.

Event and claim. Normally, the occurrence of an event is complemented by the right or duty to make a claim (or notification). If the debtor is unaware of the occurrence of the event or learns about it too late, the debtor may not be able to make the payment on due date. Normal insurance contracts, normal bank guarantees and credit default swaps are examples of payment obligations that are triggered by the occurrence of an event and the making of a claim.

Claim. Sometimes a claim is sufficient. Payment obligations are triggered by the making of a claim in demand guarantees and other undertakings that are independent of the principal contract the performance of which they are intended to safeguard.[5]

Event. In some cases, however, the payment obligation is triggered automatically without any need to make a claim or notify the other party in advance. For example, the requirement to make a claim or notify the other party would be regarded as a problem, if the purpose of the payment obligation were to protect the creditor against sudden and material adverse change such as the threatening insolvency of the debtor. For example, the parties may agree that close-out netting will be triggered automatically upon the occurrence of certain events of default.

Options. Some legally enforceable payment obligations may be classified as options. The creditor has an option where the creditor may choose from two or more previously determined alternatives.

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[5] See, for example, Cranston R, Principles of Banking Law. Second Edition. OUP, Oxford (2002) p 390.

An option may be distinguished from a unilateral right to choose the contract terms. The validity of such clauses is constrained by mandatory provisions of contract law, and many of them are void (sections 5.3.5 and 5.3.6).

The alternatives may relate to cash flows. For example, a convertible bond is a type of bond that can be converted into shares in the issuing company at some pre-announced ratio.[6]

The alternatives may also relate to the payer. This is the case in particular where two or more parties are each liable up to the full amount of the relevant obligation (joint liability) rather than each for only its own share of the relevant obligation (several liability). Legal rules on joint, several, or joint and several liability will be applied in a large number of cases.

The choice between joint liability, several liability, and joint and several liability is important, for example, in banking law, company law, and tort law.

In banking, lenders may prefer the joint liability of debtors to reduce risk. The parties may therefore agree on joint liability. In addition, some financial instruments will create the same effect. For example, a demand guarantee is a written undertaking of the bank to pay to the beneficiary a stated sum of money on written demand by the beneficiary according to the terms of the guarantee. Although technically not a form of joint liability, a demand guarantee nevertheless enables the beneficiary to choose between payment by its contract party (the bank's principal) and the bank.

In banking, debtors may prefer several liability to reduce risk. For example, the obligations of banks that participate in syndicate loans are always several. Where one bank fails to advance its agreed part of the loan to the borrower, the borrower can only sue that bank. The other banks in the syndicate have no liability.

A number of institutions like the Grameen Bank in Bangladesh have lent to groups. In group lending, the borrowers organise themselves into groups and each participant accepts joint responsibility for the loan. This enables financially weak participants to use their social capital as a credit enhancement.[7]

In company law, incorporation as a limited-liability company enables owners to separate their assets and liabilities from those of the company. There will thus not be any joint liability between the company and its shareholders.

In tort law, legislators have often adopted a joint and several liability regime. Under such a regime, a plaintiff may recover all the damages from any of the defendants regardless of their individual share of the liability. The liabilities are several between the obligors themselves. If the claimant pursues one party, and receives payment in full, that party can pursue the other obligors for a contribution to their share of the liability. The same rule can also be applied to contractual claims where the liability of many parties is joint.[8]

Combination. The firm may use separate payment obligations each belonging to a different category or create payment obligations that can be classified as belonging to more than one category at the same time. This can be illustrated by pay-

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[6] See Articles 25(1) and 25(4) of Directive 77/91/EEC (Second Company Law Directive).

[7] For a summary, see Tirole J, The Theory of Corporate Finance. Princeton U P, Princeton and Oxford (2006) pp 180–181. The Nobel Peace Prize for 2006 was awarded to Muhammad Yunus and Grameen Bank for their efforts to create economic and social development from below.

[8] For German law, see § 421 BGB and § 426 BGB.

ments under a business acquisition contract and payments made to a venture capital investor.

In a business acquisition contract, the seller might prefer an all-cash deal with immediate payment. However, the seller might be able to obtain a better price by using different kinds of payment obligations. (a) A fixed component of the purchase price may be payable on a certain date in the future. A promissory note from the buyer may be secured by the assets of the business or otherwise. (b) An earn-out clause may provide that part of the purchase price will be payable on a certain date in the future. This variable component will depend on sales or profitability. (c) The buyer furnishes a bank guarantee for the security of the payment of the purchase price. If the buyer defaults in paying the purchase price and the guarantee is claimed by the seller, the bank must pay.

A venture capital firm may use various kinds of payment obligations in order to increase return, reduce risk, and manage agency relationships. (a) The venture capital firm may subscribe for shares in the target company. This can entitle the firm to dividend payments in the future, provided that the target company has assets that can be distributed to shareholders. (b) The venture capital firm may invest some of the funds in the form of a loan. The loan can consist of a simple term loan or a convertible loan that can be converted into shares. (c) This means the payment obligations of the target consist of a combination of: legally not enforceable cash flows (dividend payments where the target company turns out to be a failure); legally enforceable cash flows to shareholders triggered by an event (depending on the governing law and the legal instruments used, the court may force the target company to pay dividends or distribute funds to the venture capital firm, or to reimburse the target company for loss); legally enforceable payment obligations with the amount of repayments and the repayment date known in advance (term loan); and an option (convertible loan).

Preliminary remarks about derivatives. Derivatives are financial instruments that derive their value from price movements in underlying reference assets, such as financial products or statistical indicators (including currencies, commodities, equities, equity indices, interest rates, securities or any combination thereof).[9] As derivatives do not fit within a particular area of law, the firm must take into account contract, company, commercial, property, insurance and corporate insolvency law and be aware of accounting, tax, credit and regulatory implications.[10] There are two kinds of derivatives: privately negotiated (over-the-counter) derivative trades and standardised derivatives. The legal aspects of derivatives will be discussed in section 11.7.4 in more detail.

[9] Edwards S, Legal Principles of Derivatives, JBL 2002 pp 1–32; Edwards S, The Law of Credit Derivatives, JBL, November 2004 pp 617–655.

[10] Edwards S, Legal Principles of Derivatives, JBL 2002 p 1.

11 Management of Counterparty Credit Risk

11.1 Introduction

An intertemporal value transfer gives rise to agency problems and counterparty credit risk.

Agency problems. There is an agency relationship between the creditor and the debtor. The creditor can incur particular agency costs when the debtor increases the creditor's exposure to counterparty credit risk. One can identify the agency costs of: claim dilution (the debtor raises more debt); asset withdrawal (the debtor reduces the amount of assets that can be used to repay the debt); asset substitution (there will be less profit generation in the future); and underinvestment (there will be less profit generation in the future).[1]

Management of counterparty credit risk. In addition to generic ways to manage risk (Volume I), generic ways to manage agency relationships (Volume I), and the typical ways to manage counterparty risk (Chapter 6), there are special legal tools and practices characteristic of payment obligations.

Cash flow and risk can be managed by choosing the form of payment obligations, and the choice of the form of payment obligations influences the choice of other legal tools and practices.

There are six particular methods to manage cash flow and risk in the context of contractual payment obligations: (1) choice of the form of payment obligation; (2) choice of the time of payment; (3) transfer or transferability of the claim; (4) the use of credit enhancements; (5) hedging; and (6) diversification or a combination of different methods. Different methods may overlap.

In the following, an analysis of the six basic methods will be followed by an introduction to credit risk transfer in general (section 11.8) as well as to tranching (section 11.8.4).

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[1] The three foundational studies are: Jensen MJ, Meckling WH, Theory of the firm: Managerial behavior, agency costs and ownership structure, J Fin Econ 3 (1976) pp 305–360; Smith CW, Warner JB, On financial contracting: An analysis of bond covenants, J Fin Econ 7 (1979) pp 117–161; and Myers SC, Determinants of corporate borrowing, J Fin Econ 5 (1977) pp 147–175. See also Bratton WW, Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process, EBOLR 7 (2006) pp 39–87.

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11.2 Choice of the Form of Payment Obligations

The firm may choose a payment obligation that belongs to one or more categories of payment obligations. The choice will influence cash flow and risk.

Payment finality. To begin with, payments that are unconditional, irrevocable and final not only between the payer and the payee but also in relation to third parties in the insolvency of the payer are subject to a lower risk than payments that are conditional or revocable or must be returned to the payer or its creditors in the event of insolvency.

In addition to the choice of unconditionality and irrevocability, payment finality may be increased by the choice of the payee and the location of the account to which the payment is made. This may enable the firm to separate the monies from the jurisdiction of the payer (according to the lex rei sitae rule). For example, the firm may ensure that: the payee is an offshore company controlled by the firm or acting on its behalf; the payee and the offshore account are located in a country whose laws support payment finality; and the payment will be made to the offshore account in the name of the payee.[2]

Legally not enforceable cash flows. It goes without saying that legally not enforceable cash flows are subject to a higher risk. Although not legally enforceable, the firm can try to enforce the cash flow anyway. This is not uncommon in business practice.

For example, minority shareholders normally have little power to make the company pay dividends or increase share price, but shareholder activism can help. There are "activist funds" that invest in public companies that, they think, are lagging their peers because of what they regard as poor management practices. Through tactics ranging from gentle persuasion to shareholder revolt, they push these companies into making their corporate governance friendlier to shareholders and sell at a profit when the market notices the change.[3]

Legally enforceable payment obligations: general remarks. Different types of payment obligations lead to different levels of risk. For example, legally enforceable payment obligations lead to a lower risk than cash flows that cannot be enforced by the court, and payment obligations under a standard term loan lead to a lower risk compared with payment obligations triggered by an unlikely event.

Payments known in advance. Where - like in a simple term loan - the parties have agreed in advance that a certain sum of money will be payable on a certain date, the sums payable under the contract are clear. There is less risk in this respect.

Variable payments. The firm may nevertheless agree to use variable payments. There can be many reasons for this. For example, the parties might not have enough information to agree on the payment of a fixed sum of money.

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[2] For the application of this principle, see Raines M, Wong G, Aspects of Securitization of Future Cash Flows under English and New York Law, Duke J Comp Int L 12 (2002) p 453.

[3] Profit huggers, The Economist, April 2004.

If the firm is the seller, the firm may agree on a variable component of the sales price, for example, to achieve a higher total price. If the firm is the buyer in a long-term contract, the firm may prefer a variable component, for example, to mitigate market risk and to reduce the risk that the contract terms are too rigid (section 5.5.4).

It goes without saying that the method of determining the amount of the variable component is important to the firm. Let us assume that the firm is the creditor and the other party is the debtor. (a) Where the amount of the variable component depends on the actions of the other party, the firm should generally ensure that the other party is contractually bound to act in the interests of the firm and not contrary to its interests. For example, the contract may contain an open clause that sets out the general duties of the other party (duty to act in good faith, duty of care and similar general duties) and specific covenants that prohibit certain acts that are bound to be contrary to the interests of the firm (such as specific limits). (b) Where the firm can increase the variable component by its own actions, doing so to the detriment of the other party may be regarded as breach of a general duty of loyalty, good faith, or care, or a similar legal rule depending on the jurisdiction.

Value of an asset. The firm can do more, if the sum to be paid by the other party depends on the value of an asset.

The firm might want to make the value of the asset change to its own benefit and prevent changes to its detriment. However, the firm should observe any legal rules that lay down duties of good faith or duties to take the reasonable interests of the other party into account, fraud rules, and other mandatory provisions of law (section 5.3). For example, mandatory laws seek to prevent the manipulation of markets for the purpose of influencing the price of financial instruments.[4]

The choices that the firm will make depend at least partly on: (a) whether the firm will remain or become the owner of the asset; or (b) whether the firm will not end up owning the asset.

This reflects the fact that the actual value (market value) of the asset can be relevant directly and/or indirectly. (a) The actual value of the asset is relevant for the firm directly where the firm either is or will become the owner of the asset. (b) It may be relevant indirectly to the extent that the asset valuation method takes into account the actual value of the asset and the sum payable by the other party is based on it.

[4] Directive 2003/6/EC (Directive on market abuse).

Table 11.1 The Effect of Ownership Changes on the Relevance of the Value of the Asset

	After: not owner	After: owner
Before: not owner	A mere financial transaction (like a cash-settled option). The method of valuation is more important than the actual value of the asset.	A way to buy the asset (like a physically settled call option). Both the method of valuation and the actual value of the asset are relevant.
Before: owner	A way to sell the asset (like a physically settled put option). Both the method of valuation and the actual value of the asset are relevant.	A mere financial transaction (like a securities loan). A way to increase return. The method of valuation is more important than the actual value of the asset.

Where the firm will never own the asset, the transaction is a *derivative* (sections 11.6.4 and 11.7.4). The actual value of the asset is relevant for the firm only indirectly. What is more important is the agreed method to determine the sum payable by the other party.

This sum can be determined on the basis of the valuation of the asset at a certain point of time or, where the sum to be paid depends on the change of the value of the asset, that value in combination with the initial valuation of the asset at an earlier point of time. The parties can agree on the initial value of the asset, how its value will be determined during the term of the contract, and how changes in value influence the amount payable by the other party.

Where the firm owns the asset but the other party will automatically become its new owner under the contract, the transaction is a way to *sell* the asset (for exit, see Volume III). In this case, the actual value of the asset is relevant for the firm directly, because the firm will have to think about alternative and more effective ways to sell the asset.

For example, a futures contract is an agreement between a buyer (seller) and an established exchange or its clearing house in which the buyer (seller) agrees to take (make) delivery of something at a specified price at the end of a designated period. The price at which the parties agree to transact in the future is called the futures price. The designated date at which the parties must transact is called the settlement or delivery date. A forward contract is a contract between two parties to exchange a commodity at a set price on a future date. A forward contract differs from a futures contract in that most forward commitments are not actively traded or standardised and carry the risk from the creditworthiness of the other side of the transaction.

Where the other party controls the asset, the firm should ensure that the other party has a legal obligation to take the firm's interests into account. For example, where the firm sells all shares in a subsidiary, the firm may agree that the price payable by the buyer is based on the former subsidiary's profits during a specified period, usually after the closing of the sale. If the contract contains such an earn-out clause, the contract should also contain a covenant according to which the new owners have a legal obligation to maximise profits in some way.

Where the firm is not the owner of the asset but will become its new owner under the contract, the transaction is a way to *buy* the asset. (a) The firm will pay the purchase price. Before buying the asset, the firm will assess the actual value of the asset and whether it is possible to buy similar assets at lower cost. (b) It would be surprising if the other party (the seller) paid anything to the firm on the basis of the value of the underlying asset. The parties may nevertheless have agreed on payments made at an earlier date, and the later payment will be an adjustment of the purchase price.

For example, many business acquisition contracts contain a purchase price adjustment clause. A purchase price adjustment clause is a way to deal with information asymmetries. It can be difficult for the buyer to obtain useful information about the business prior to closing. For this reason, buyers and sellers of private companies and businesses often agree on a post-closing audit and purchase price adjustment complemented by the seller's representations and warranties and by indemnification clauses. The interpretation risk is lower where the parties have agreed on a clear and workable price adjustment mechanism, and higher where the valuation mechanism is open.

Where the firm owns the asset before closing and will remain its owner after the expiry of the contract, the transaction is a way to *release capital* and to increase return on funds invested in the asset (Volume III). Payment obligations may depend on the value of the asset, for example, in sale and lease-back transactions or in certain securitisation transactions.

Where assets will first be sold and then bought back by the firm, the valuation mechanism may influence recharacterisation risk. The recharacterisation risk depends on the jurisdiction. Typically, there is a reduced risk of recharacterisation of a sale as a security agreement that has been disguised as a sale, if the parties agree to use market values rather than a fixed price (Volume III).

Event. Where the payment obligations of the other party depend on the occurrence of an event, the firm should ensure that the event has been carefully defined in the contract. The firm may in some cases influence the other party's payment obligations by taking action to prevent the event from occurring or taking action to make its occurrence more likely.

First, sometimes the other party's payment obligation *will be triggered* by the occurrence of a certain event. The firm should ensure that such events have been defined broadly.

The other party's obligation to pay upon the occurrence of that event can be that party's main obligation. In this case, the firm pays a premium for protection against a negative event occurring (like in an insurance contract or a credit default swap) or a fee for the chance of a positive event occurring (like in betting contracts). The amount of the premium or fee depends on the probability of the event, the amount of the payment, and the market.

Where the other party has an obligation to pay upon the occurrence of a certain event, mandatory provisions of law normally prohibit the firm from trying to make that event happen. For example, it is clear that the insured must not commit insurance fraud by destroying its own property.

The other party's obligation to pay upon the occurrence of the event can be part of the remedies available to the firm (like close-out netting or acceleration by default or cross-default).

Second, sometimes the other party's payment obligations *will not be enforced* upon the occurrence of a certain event. Such clauses can include force majeure clauses and other clauses that address the possibility of a material adverse change in circumstances (section 5.5.5).

The firm should ensure (1) that the scope of such contract terms is as narrow as possible and (2) that such clauses are complemented by contract terms that make the other party act in the interests of the firm. This would make the occurrence of the event less likely or mitigate its adverse effects.

Options. Sometimes the firm may have a right to choose the nature, size or timing of payments from a pool of previously defined alternatives. This can help the firm to increase return and reduce risk.

For example, where the firm is a lender, the option to convert a loan with a fixed interest rate to a loan with a variable interest rate can help the firm to mitigate interest-rate risks. If rates fall, the firm is protected by the original fixed interest rate. If rates rise, the firm can convert the loan to a loan with a variable interest rate.

Another common way to manage risk by using options is by choosing between joint liability and several liability. Joint liability means that the contract can be enforced against one or more alternative debtors. The choice between the joint liability of several debtors and the several liability of each debtor is important in bank lending.

Conversion. There may be a right or duty to convert a payment obligation belonging to one category to a payment obligation that belongs to another category. A payment obligation that can be converted can be regarded as a combination of a variable payment obligation and an option.

For example, the firm may invest in convertible bonds that can be converted into shares, or in preference shares that can be converted into common shares.

11.3 Choice of the Time of Payment

Risk exposure can depend on the length of time. For example, all other things being equal, using a short-term loan reduces credit risk compared with a long-term loan. The firm can thus manage credit risk by choosing the time of payment.

Credit risk is caused by an intertemporal value transfer. The payee (the firm) is not exposed to credit risk if the payment obligation must be fulfilled in advance (advance payment). The credit risk is reduced if the payment obligation must be fulfilled when the firm must fulfil its own obligations (simultaneous payment). Generally, the credit risk is reduced where the obligations of the firm's counterparty are funded and increased where they are unfunded (section 11.8.1).

The timing of payments raises several questions: What is its effect on the liquidity of the firm? What events will trigger the payment obligation? When should the firm use advance payment and forfeiture clauses? Can the parties fulfil their obligations simultaneously (Zug-um-Zug)? Can credit risk be reduced by using a shorter payment term, for example, in bank lending and sales?

Liquidity, trigger events, settlement, credit risk. The timing of payments influences the liquidity of the firm. The firm should have sufficient funds on hand to fulfil its own payment obligations. The firm may have a liquidity problem unless it has matched its incoming cash flows with its own funding.

Whether the obligations of the counterparty are funded or unfunded plays a role, as does the nature of the events that trigger the payment obligation (trigger events).

The timing of payments is also influenced by the settlement that follows trigger events. For example, financial instruments that allow the counterparty much time to investigate whether it has an obligation to pay (for example, insurance contracts) will imply slower repayment than financial instruments that require immediate payment (like demand guarantees).

Payment will thus be affected by the settlement that follows trigger events and associated counterparty risks. Unfunded instruments leave open the possibility of counterparty default. Among unfunded instruments, those which provide more freedom for the other party to contest the claim embody a greater risk than those which require payment upon the trigger of the credit event.[5]

Trigger events. The governing law or the agreement may provide for various kinds of trigger events. The due date can be fixed in advance or left open: (a) The firm may refuse to contract with its counterparty unless payment is made in advance or simultaneously. (b) There can be a certain fixed due date like in so-called bullet loans.[6] (c) The due date can depend on the occurrence of an event. First, payments may have to be made at the request of the firm. Such payment obligations range from obligations normally payable on demand[7] to mandatory prepayment (acceleration at the request of the firm as lender after the debtor's default, change of control, or otherwise).[8] Second, the counterparty may have a right to choose when to pay. This could be the case where the parties have left the time of payment open[9] or where the parties have agreed on the terms of voluntary prepayment of claims.[10] Third, payments may become due automatically. For example, close-out netting provisions, default clauses, and mandatory laws may trigger a payment obligation automatically on the occurrence of a certain event. Further-

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5 BIS, CGFS, Credit risk transfer, January 2003 p 43. A related text is Kiff J, Michaud F-L, Mitchell J, Instruments of Credit Risk Transfer: Effects on Financial Contracting and Financial Stability (December 2002). Available at SSRN.

6 For German law, see § 488(1) BGB.

7 For example, the so-called "bis auf weiteres" loans in German law.

8 Diem A, Akquisitionsfinanzierungen. C.H. Beck, München (2005) § 15 number 5.

9 For German law, see § 488(3) BGB.

10 Diem A, *op cit*, § 15 numbers 12–15.

more, payments often become due on termination of the agreement.[11] (d) If the due date depends on the occurrence of an event, the payment may become due immediately or after the expiry of a certain period of time. For example, a debt may become due after the expiry of a notice period of three months[12] or immediately upon the receipt of notice.[13] (e) In addition, the governing law or the agreement may either prohibit prepayment without the consent of the creditor[14] or permit it even in the absence of the creditor's consent.[15]

Advance payment. Sometimes the firm's contract party may agree to pay in advance. In major and financial transactions, advance payments may be secured by guarantees or other collateral. The payer is exposed to a credit risk after an advance payment.

One of the methods to reduce this risk is the use of an escrow agent. The parties can arrange for monies to be paid to an escrow agent, who will only release the funds provided that the conditions agreed by the parties when entering into the escrow arrangement have been met.

Alternatively, the payer may require a demand guarantee. For example, the buyer may require an advance payment guarantee to secure any claims by the buyer on the seller for reimbursement of the buyer's advance payment in the event that the seller has failed to meet its contractual delivery obligations in full.

Forfeiture clauses. Where money is paid in advance of performance, it either will or will not be recovered in the event that the payer breaches its obligations. Whether the payment is recoverable on breach depends on how the contract is constructed.

According to *English* law, different consequences flow from the classification of the payment under the payment clause as either a deposit or a part payment.[16] As a general rule, a deposit will be forfeited to the payee on the default of the payer,[17] whereas a part payment can be recovered from the payee.[18] Where the recovery of the deposit is regarded as unreasonable in relation to the loss likely to be suffered, the law of penalty clauses will apply in fact[19] with the exception that the payee must repay all of the monies deposited plus interest.[20]

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11 § 488(3) BGB: "Ist für die Rückerstattung des Darlehens eine Zeit nicht bestimmt, so hängt die Fälligkeit davon ab, dass der Darlehensgeber oder der Darlehensnehmer kündigt. Die Kündigungsfrist beträgt drei Monate. Sind Zinsen nicht geschuldet, so ist der Darlehensnehmer auch ohne Kündigung zur Rückerstattung berechtigt."

12 For example, § 488(3) BGB.

13 For example, § 490(1) BGB.

14 § 488(3) BGB.

15 § 271(2) BGB.

16 The court will look at the intention of the parties to determine their objectives; Mayson v Clouet [1924] AC 980, at 985. See Miller L, Penalty Clauses in England and France: A Comparative Study, ICLQ 53 (2004) p 95.

17 Howe v Smith (1884) 27 Ch D 89.

18 Mayson v Clouet [1924] AC 980.

19 Workers Trust and Merchant Bank Ltd v Dojap Investments Ltd [1993] AC 573.

20 See Miller L, Penalty Clauses in England and France: A Comparative Study, ICLQ 53 (2004) pp 95–96.

In *France*, a distinction is made between a clause pénale and a clause de dédit. A clause de dédit is seen as the payment by the obligor for the freedom to unilaterally withdraw from the contract without incurring liability. It is regarded as the exercise of a right rather than as a sanction for breach of an obligation, and the law of penalty clauses (Article 1152 Code civil) would not apply.[21]

Simultaneous payment. Simultaneous payment, or matching payment with delivery, is the typical legal background rule (default rule) in contract law (Zug-um-Zug, cash against delivery).[22] The matching of payment with delivery can be facilitated by using various legal tools and practices.

There are particular legal instruments used in foreign trade or generally when goods are shipped to the buyer.

To reduce risk in sale of goods transactions, the firm may require a letter of credit (section 11.6.4) under a documents against payment clause (d/p). A d/p clause is complemented by a delivery clause (such as an Incoterms term).

With a letter of credit, the supplier obtains payment from a bank as soon as it presents complying documents. This can be at the time of shipment. The transport documents are the key documents to be presented, along with the invoice, an insurance policy, and certificates on matters such as aquality, inspection, and origin. Letters of credit are typically governed by the ICC's Uniform Customs and Practices for Documentary Credits (UCP). These will be incorporated into the letter of credit by reference.

With a bill of exchange, the goods may have reached their destination before it becomes clear that the buyer fails to accept the bill.[23] There is thus an obvious advantage to the supplier being paid under a letter of credit compared with a bill of exchange.

Payments may be matched with delivery by using staggered payments. The use of staggered payments over a period of time instead of a single lump-sum payment typically enables the parties to reduce the buyer's high initial costs and credit risk (up-front payment) or the seller's funding costs and credit risk (lump-sum payment after delivery of the whole project). They can also give the seller a financial incentive to fulfil its obligations. In a construction project, for example, 10% of the price might be due after closing, followed by staggered payments as the work progresses. The rights of the buyer might be secured by several demand guarantees (advance payment guarantee, payment guarantee, performance bond, guarantee for warranty obligations).

Periodical payments can be used in long-term supply relationships, supply contracts, leases, and similar long-term contracts. For example, in an operations and maintenance agreement, the operator may bill the owner for its services monthly in arrears.

Short maturity in bank lending. Typically, the use of short-term loans can reduce credit risk and the use of long-term loans can increase it. Credit risk is typically increased where the payment obligation is a bullet payment at the point of fi-

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21 *Ibid*, p 90.

22 CISG Articles 53 and 59. For German law, see §§ 298, 322, 348, 373 BGB.

23 Cranston R, Principles of Banking Law. Second Edition. OUP, Oxford (2002) p 385.

nal maturity. In bank lending, credit risk can be reduced, for example, by using revolving credit agreements.

A revolving credit is a legal commitment on the part of a bank to extend credit up to a maximum amount for a definite term. In commercial loans, the notes evidencing debt are short term, such as 90 days. As notes become due, the borrower can renew the notes, borrow a smaller amount, or borrow amounts up to the specified maximum throughout the term of commitment.

For the borrower, a short maturity or the use of bullet payments at the point of final maturity can increase refinancing risk. Refinancing risk (or rollover risk) is the possibility that a borrower cannot refinance by borrowing to repay existing debt. On the other hand, it may enable the borrower to benefit from falling interest rates.

The lender wants protection against prepayment caused by falling interest rates. Commercial loans and revolving credit lines often contain an early termination provision providing for a fee in the event of a prepayment by the borrower (a prepayment premium, yield maintenance premium, or early termination fee).

Tranching. Tranching (section 11.8.4) is a common way to manage risk in portfolio loans and Eurocurrency lending (section 9.5.2). Tranching means that multiple classes of claims are tranched with respect to seniority. Differences in the time of payment influence seniority. Typically, claims of the most senior tranche (subject to the lowest credit risk) will be paid first, followed by the mezzanine tranche and, finally, the equity tranche.[24] Tranching involves the use of the "equity technique" and the "mezzanine technique" (Volume III).

Excursion: Payment terms in sales. In sales contracts, the parties may agree on the time of payment.[25] The payment terms depend on the firm's credit management policy (Volume III) and they are influenced by European and local payment practices.

It is possible to distinguish between contractual payment *terms*, the length of payment *delays*, and the *age* structure of receivables (days of sales outstanding, DSO). The firm can reduce costs and increase return by reducing DSO to a reasonable minimum (for funding aspects, see Volume III).

There are differences in payment practices in individual Member States. Payments are typically made: within 30–60 days in the UK, the Netherlands, Germany and Belgium;[26] within 60–90 days in Italy, Spain and France; and within 90–120 days in Portugal. Payments are made faster and more reliably in the Nordic countries.

According to a study,[27] contractual payment *terms* were shorter than average in the Nordic countries and longer than average in Southern European and Eastern European countries. In the Nordic countries, the average payment term was

[24] Diem A, Akquisitionsfinanzierungen. C.H. Beck, München (2005) § 14 number 2.
[25] CISG Articles 53 and 59.
[26] See Dun & Bradstreet, Payments Performance (2003).
[27] Intrum Justitia, European Payment Index. 2004 - Spring Report. See also Bank of England, Domestic Finance Division, Quarterly Report on Small Business Statistics, January 2003; Rüetschi D, Zahlbar „30 Tage netto", SJZ 99 (2003) p 341.

around 24 days. In Germany, the average payment term was 31 days and in the UK 34 days. It was 51 days in France and 73 days in Italy. In the Nordic countries, payment *delays* were typically one week. In most Member States, payments were made two to three weeks late on average. Payment delays were typically longer in Portugal.

This means that the *age* structure of customer receivables depends very much on the country. With agreed payment terms of 48 days and a payment delay of more than 38 days, Portugal scored the worst. Portugal had the highest proportion of receivables older than 120 days, amounting to 15% of the portfolio. With agreed payment terms of 20 days and a payment delay of 6 days, Finland scored the best. The share of receivables older than 120 days was less than 2% in Finland. This seems to correspond with the amount of sleaze in these countries (section 4.2).

Differences in payment practices influence the choice of payment terms because local business culture is one of the factors that must be taken into account in customer credit management. (a) There is a risk that customers either will not accept too short payment terms (which will reduce sales) or will not comply with them (but pay late). (b) Payment practices influence the choice of whether to use open credit lines and the size of limits. In countries with long average DSO and bad payment behaviour, the firm may prefer to apply legal instruments that reduce DSO. For example, the firm may require advance payment, simultaneous payment (according to the Zug-um-Zug and cash against delivery principle) by using a letter of credit or otherwise, or prompt payment by using documentary credit. The firm may also have more reason to use factoring (section 11.6.3) or outsource collection functions in countries with long average DSO. (c) As payment practices influence credit risk, they should influence the use of credit enhancements in general (section 11.6). (d) In the long run, the remedies available to the firm for late payment should be structured and measured so that they deter bad customers and discourage bad payment practices but leave out normal payment practices of normal customers. One of the typical ways to filter normal customers is by sending one or two reminders soon after the due date.

Community institutions have addressed this problem by adopting the Directive on combating late payment in commercial transactions[28] (for penalty interest, see section 9.5.3; for customer credit management, see Volume III).

[28] Directive 2000/35/EC (Late Payment Directive).

11.4 Transferability

11.4.1 Introduction

All financial claims do not have to be held until maturity. Where a right to performance under a contract is "transferable", "assignable" or "negotiable" (see below for terminology, transferability is used here as a general term), it can be bought and sold. The transferability of financial claims makes them more liquid and reduces risk by its mere existence. The buying and selling of transferable claims can be used to reduce risk further.

The transferability of financial claims is a key aspect of the business model of banks. In the past, a bank might have been stuck with its loans and worried about the long-term creditworthiness of the borrower. New credit portfolio management practices have meant a change in the banking business model. Banks have moved from the traditional "buy-and-hold" model to the "originate-and-distribute" model. This means that they distribute portfolios of credit risks and assets to other market players. Other factors that have contributed to this development include the rise of securitisation (section 11.6.3 and Volume III) and the use of credit derivatives (section 11.6.4). Whereas the "buy-and-hold" model gives an incentive to ensure that portfolio loans are of good quality, the "originate-and-distribute" model does not. – There is thus reason to make originators hold on to a proportion of the assets (Volume III).

The liquidity of financial claims can be increased by negotiability (in addition to mere transferability and assignability). If financial instruments are negotiable, it will be easier to trade them on a secondary market (section 11.5.3). The negotiability of securities is one of the defining characteristics of the capital market.

Legal restrictions on transferability may increase transaction costs and liquidity risk and reduce the value of the claim. The management of the level of transferability of financial claims is thus a way to influence risk and valuation. In addition, ensuring that financial claims are transferable is one of the standard methods of managing the agency relationship between the obligor and obligee (debtor and creditor) (section 6.3.3; for the management of agency, see Volume I; for exit, see Volume III).

Liquidity and price. The liquidity of claims should influence their price. Like perceptions of risk, the liquidity of claims can change for other than purely legal reasons.[29]

Transferability, structured finance, securitisation. One of the many ways to manage risk is to transfer claims to a special purpose vehicle (SPV) and create asset-backed securities. Securitisation is a credit risk transfer instrument that offers the possibility of managing more effectively the liquidity risk of traditionally illiquid assets in the balance sheet.

[29] See, for example, Confessions of a risk manager, The Economist, August 2008.

The use of special purpose vehicles is characteristic of structured finance. Structured finance instruments can be defined through three key characteristics: (1) pooling of assets (either cash-based or synthetically created); (2) tranching of liabilities that are backed by the asset pool; and (3) de-linking of the credit risk of the collateral asset pool from the credit risk of the originator, usually through the use of finite-lived, standalone SPV.[30]

Banks and securitisation. Securitisation has been used by banks and financial institutions on a very large scale. For example, more than two-thirds of the sub-prime mortgage loans issued in the US market in 2006 were packaged in this way. Thanks largely to securitisation, global private-debt securities markets are now far bigger than stock markets.

For banks and financial institutions, securitisation can be a means of managing regulatory capital (Volume III). In practice, however, the benefits of securitisation will partly be lost, if a bank not only securitises its own loan portfolios but also invests in asset-back securities issued by other banks.

11.4.2 Basic Legal Aspects Relating to Transferability

Transferability is governed and constrained by a large number of legal rules because of the existence of different forms of transferability and the large number of relationships involved.

Legal rules must address: the relationship between the transferor and the transferee; the relationship between the transferor/transferee and the original debtor; and the relationship between the transferor/transferee/original debtor and third parties (such as the transferor's or the original debtor's creditors). In short, they must address each relationship between the transferor, the transferee, the original debtor, and relevant third parties.

In a normal contract, transferability can mean three things: the right to transfer a right to performance under the contract (assignment of contractual claims); the right to transfer a duty to perform under the contract (substitution as a debtor);[31] and the right to transfer the whole contract (substitution as a contract party).[32]

One of the aspects of transferability is under what circumstances the transferee of a claim can: enforce the transferred claim against the transferor; enforce the transferred claim against the original debtor; enforce the transferred claim against the transferor's or original debtor's creditors or other parties; and ensure that both the transfer of the claim and payments made under the transferred contract to the transferee are final. For example, the transfer may have to fulfil certain requirements as to form.

The answer to these questions depends on the form of the claim. It is possible to distinguish between negotiable claims and contractual claims generally.

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[30] BIS, CGFS, The role of ratings in structured finance: issues and implications, CGFS Publications No. 23, January 2005.

[31] See PECL Article 12:101.

[32] See PECL Article 12:201.

It depends also on the governing law. Different aspects of transferability may be governed by the laws of different countries.

Main rule: right to transfer rights but not duties. The main rule is that a party may transfer its contractual rights. For example, receivables may be assigned without the consent of the debtor, unless the assignment is prohibited by law, contractual non-assignment clauses, or the nature of the receivable. The same general rule on transferability has been adopted in the PECL and the DCFR.[33]

It is also a main rule that a party may not transfer its contractual obligations without the consent of the other party. The same general rule can be found in the PECL/DCFR (substitution as debtor).[34]

Whether the debtor can change depends on the terms of the debt itself. The parties may agree on substitution. In the absence of a prior agreement, the change of debtor will require the consent of all contract parties.

Substitution is usually in the interests of the debtor. It can be in the interests of the creditor. For example, a creditor might sometimes insist on a substitution clause in advance. A substitution clause can make it possible to transfer debts if there is a change in the ownership of the debtor company or a transfer of the trade of the debtor company. In this way, the creditor company can protect itself from changes brought about by the debtor's group.

The transfer of contractual rights and the transfer of contractual obligations can be distinguished from the transfer of the contract with all rights and obligations. The transfer of the whole contract requires the consent of all contract parties.[35]

The transfer of an obligation to repay a debt under a loan agreement is normally achieved by means of novation. An alternative way to change the parties would be to enter into a new agreement between the new parties and repay the original loan between the original parties.

Governing law: claims in general. In the EU, the laws that govern the contractual transfer of financial claims are determined by the Rome I Regulation which replaced the 1980 Rome Convention.

The Rome I Regulation applies to contracts concluded after 17 December 2009.[36] (a) However, it does not apply to "obligations arising under bills of exchange, cheques and promissory notes and other negotiable instruments to the extent that the obligations under such other negotiable instruments arise out of their negotiable character."[37] (b) The Rome I Regulation nevertheless applies to the voluntary assignment of other rights. (c) It applies even to many contracts relating to negotiable instruments.

For example, the Rome I Regulation can apply to a "share deal" business acquisition contract (Volume III). The Rome I Regulation excludes neither contracts for the purchase and

33 PECL Article 11:102(1); DCFR III.–5:105.
34 PECL Article 12:101(1); DCFR III.–5:203.
35 PECL Article 12:201; DCFR III.–5:302.
36 Articles 1(1) and 28 of Regulation 593/2008 (Rome I).
37 Article 1(2)(d) of Regulation 593/2008 (Rome I).

sale of negotiable instruments nor contracts pursuant to which negotiable instruments are issued.[38]

According to the Rome I Regulation, the contract between the original debtor and the assignor is governed by normal choice of law rules.[39] The law governing the assigned or subrogated claim "shall determine its assignability, the relationship between the assignee and the debtor, the conditions under which the assignment or subrogation can be invoked against the debtor and whether the debtor's obligations have been discharged".[40]

The relationship between the assignor and the assignee can be governed by the laws of the same or another country: "The relationship between assignor and assignee under a voluntary assignment or contractual subrogation of a claim against another person (the debtor) shall be governed by the law that applies to the contract between the assignor and assignee" under the Rome I Regulation.[41]

However, the Rome I Regulation does not set out under what circumstances the transfer is valid and enforceable against third parties. The Regulation only contains a review clause.[42]

The original proposal of the Commission contained such rules: "The question whether the assignment or subrogation may be relied on against third parties shall be governed by the law of the country in which the assignor or the author of the subrogation has his habitual residence at the material time."[43] The proposed rule thus referred to the law of the assignor's residence. The same solution was adopted in the UN Convention on the Assignment of Receivables in International Trade.[44]

According to traditional choice of law rules, this question would normally be governed by the law of the place where the assets are situated (lex rei sitae). Debts can be situated in different countries depending on the choice of law rules of the lex fori and the context. There can be alternative solutions. For example, a debt could be situated: in the country where the debt must be discharged (section 9.6.2); or in the country where it is recoverable (usually the country where the debtor resides).[45]

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38 Report by Mario Giuliano and Paul Lagarde, OJ C 282 31.10.1980 p 1–50.

39 Articles 3 and 4) of Regulation 593/2008 (Rome I).

40 Article 14(2) of Regulation 593/2008 (Rome I).

41 Article 14(1) of Regulation 593/2008 (Rome I).

42 Article 27(2) of Regulation 593/2008 (Rome I): "By 17 June 2010, the Commission shall submit to the European Parliament, the Council and the European Economic and Social Committee a report on the question of the effectiveness of an assignment or subrogation of a claim against third parties and the priority of the assigned or subrogated claim over a right of another person. The report shall be accompanied, if appropriate, by a proposal to amend this Regulation and an assessment of the impact of the provisions to be introduced." See also Articles 15 (legal subrogation) and 16 (multiple liability).

43 Article 13(3) of the Proposal for a Regulation of the European Parliament and the Council on the law applicable to contractual obligations (Rome I), COM/2005/0650 final.

44 Article 22 of the UN Convention on the Assignment of Receivables in International Trade.

45 Swiss Bank Corporation v Boehmische Industrial Bank [1923] 1 KB 673.

Governing law: negotiability. The legal aspects of transferability depend on whether the claims can be regarded as "negotiable" or not (section 11.5.3). The law governing the characterisation of a claim or document as being negotiable is not designated by the Rome I Regulation.[46]

In order to reduce variation, this question could be governed by the law governing the claim. For example, the negotiability of shares issued by a limited-liability company would then be governed by the law governing the company, and the negotiability of notes issued by the company would be governed by the law governing the notes.[47]

However, there can be alternative views. For example, the negotiability of claims could be governed by the substantive laws of lex fori or the law of the place where the instrument was issued.[48]

One could nevertheless say that the legal relevance of this characterisation depends on the legal context such as the relationship and the area of law.

For example, in the assignee-debtor relationship, the question is about the international scope of particular rules protecting the assigmee (Sachenrecht/property law). In the relationship between shareholders and a limited-liability company, the question is about the international scope of particular rules protecting the company and shareholders in general (company law). As regards the scope of the the Rome I Regulation, this is a question about the scope of choice of law rules (international private law).

For this reason, the characterisation of a claim or document as being "negotiable" should be governed by the law governing the legal effects of "negotiability" (property law: lex rei sitae; company law: the law governing the company; the scope of the Rome I Regulation: the international private law of the forum[49]). If this view is accepted, a claim can simultaneously be regarded as being negotiable and not negotiable depending on the context (contract law, Sachenrecht/property law, insolvency law, tax law, international private law).

Harmonisation. The substantive laws that apply to the transfer of claims have not been harmonised at the level of the EU. There have been international attempts to harmonise these rules. In 2001, the UN Convention on the Assignment of Receivables in International Trade was adopted.[50] The Convention has not yet entered into force. UNIDROIT has adopted two conventions relating to the transfer of claims: the UNIDROIT Convention on International Financial Leasing (Ottawa, 1988); and the UNIDROIT Convention on International Factoring (Ottawa, 1988).

46 See Article 1(2)(d) of Regulation 593/2008 (Rome I).

47 Zobl D, Internationale Übertragung und Verwahrung von Wertpapieren (aus schweizerischer Sicht), SZW/RSDA 3/2001 p 109, citing Kieninger EM, Übertragung von Gesellschaftsanteilen im englischen Internationalen Privatrecht, IPRax 6/1997 p 455.

48 For Swiss law, see Zobl D, *ibid*.

49 The Giuliano and Lagarde report states that it is for the private international law of the forum to determine whether a document is to be characterised as being negotiable. Giuliano M, Lagarde P, Report on the Convention on the law applicable to contractual obligations, OJ C 282, 31.10.1980, pp 1–50 at p 11.

50 See Kuhn H, Zur Neuordnung der grenzüberschreitenden Forderungsabtretung im Einheitlichen UN-Abtretungsrecht, SZW/RSDA 3/2002 pp 129–150.

Mergers and divisions, universal succession. One can distinguish between singular succession and universal succession.

Universal succession is a further way to transfer claims to another person. Universal successions by way of mergers, divisions, or changes of company form are facilitated by company laws.[51] However, parties to a contract may agree on the effects of such an event (for covenants, see section 11.6.2). In exceptional cases, such an event might even lead to the modification of the contract (section 5.5.3). There are particular provisions protecting employees in the event of transfers of undertakings.[52]

11.5 Enforceability of the Transfer

11.5.1 Introduction

The transfer of claims will not be meaningful unless the transfer can be enforced. What the enforceability of the transfer means depends on the context: against whom the transfer will be invoked; the area of law; the preferred degree of enforceability; the nature of the claim; and other factors.

The transferee may need to invoke the transfer against the transferor, the original debtor, their creditors, a company, other third parties, and the government.

The question of enforceability has been addressed by legal rules that belong to various areas of law (in particular contract law, legal rules on proprietary rights, insolvency law, and company law), and the transfer may have implications in other areas of law (such as accounting, tax, and regulatory implications).

There are different degrees of enforceability. For example, the transfer may be enforceable between the transferor and the transferee, against the debtor, against a company, and against third parties with competing interests in the claim. On the other hand, the transfer may be enforceable between the transferor and the transferee but neither against the debtor nor against third parties. In English law, this is reflected in the core distinction between legal and equitable assignments. In continental European laws, the basic distinction would be that between matters of contract law issues and matters of property law ("Sachenrecht").

This is how The Law Commission described the distinction between legal and equitable assignments in the context of factoring: "An assignment may be either legal or equitable and the relevant interest may also be legal or equitable. Once there has been a legal assignment, the factor acquires the legal right to the debt (subject to equities having priority), all legal

51 For the mergers of limited-liability companies, see Directives 78/855/EEC (Third Company Law Directive) and 2005/56/EC (Directive on cross-border mergers) as well as Regulation 2157/2001 (SE Regulation). For the division of limited-liability companies, see Directive 82/891/EEC (Sixth Company Law Directive).

52 Directive 2001/23/EC on the approximation of the laws of the Member States relating to the safeguarding of employees' rights in the event of transfers of undertakings, businesses or parts of undertakings or businesses.

and other remedies for the debt and the power to give a good discharge for the debt without the concurrence of the assignor. However a legal assignment requires a writing under the hand of the debtor and express notice in writing to the debtor, and it cannot be effective until the debt comes into existence. An equitable assignment, in contrast, can be of future debts and may be purely informal without even notice to the debtor. However a debtor who pays the assignor before learning of the assignment will be discharged. For this and other reasons a factor may still want to give notice of an equitable assignment to the debtor. In contrast to an assignment at law, any form of notice is sufficient, provided the fact of the assignment is definitely brought to the mind of the debtor. It is sufficient to show that the debtor has had knowledge of the assignment, regardless of the mode or source of that knowledge."[53]

The degree of enforceability of the transfer depends on many things. (a) It can depend on the nature of the claim, because: different rules apply to existing claims and future claims;[54] different rules apply to the assignment of receivables and the transfer of negotiable instruments;[55] there may be requirements as to form depending on the type of the claim;[56] some claims can be transferred in whole but not in part;[57] and some claims may not be transferred in the first place.[58] (b) It can depend on whether or how the transfer is disclosed to the debtor and third parties.[59] (c) It can depend on the purpose and intended finality of the transfer. For example, an assignment by way of security is in some jurisdictions enforceable against the assignor but not necessarily enforceable against the debtor or third parties such as the assignor's creditors. (d) In addition, enforceability depends on the area of law.

The terminology of the transfer of claims may depend on the type of the claim. According to English terminology, receivables are "assigned"; negotiable instruments, rights, and obligations are "transferred". There is a similar distinction in German law. Whereas the transfer ("assignment") of receivables is called "Abtretung" (Abtretung von Forderungen),[60] the transfer of ownership is called "Übertragung" (Übertragung des Eigentums).[61]

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53 The Law Commission, Registration of Security Interests, paragraph 6.27.

54 PECL Article 11:102(2); DCFR III.–5:106.

55 PECL Article 11:101(3)(b); DCFR III.–5:101(2).

56 PECL Article 11:104 in combination with PECL 11:101(3); DCFR III.–5:110.

57 See PECL Article 11:103 (partial assignment): "A claim which is divisible may be assigned in part, but the assignor is liable to the debtor for any increased costs which the debtor thereby incurs." DCFR III.–5:107.

58 For example, PECL Article 11:302; DCFR III.–5:109.

59 See PECL Article 11:303 (effect of the assignment on the debtor's obligations) and PECL Article 11:304. DCFR III.–5:119 and III.–5:120.

60 See § 398(1) BGB: "Eine Forderung kann von dem Gläubiger durch Vertrag mit einem anderen auf diesen übertragen werden (Abtretung)."

61 For example, § 929 BGB.

11.5.2 Assignment of Receivables

General Remarks

The way receivables will have to be assigned to ensure the enforceability of the assignment depends on whether the receivables are existing receivables or future receivables. Other typical questions that influence the enforceability of the assignment include: whether the assignment can be regarded as a "true sale" or whether it will be recharacterised as something else; as well as the reversal of certain transactions under insolvency laws.

Existing Receivables

The enforceability of the assignment of existing receivables is governed by well-established legal rules and is relatively unproblematic from a legal perspective. The core things to focus on are: whether the claim may be assigned under its terms; and whether the debtor is notified of the assignment.

Enforceability against the debtor. The main rule is that receivables may be assigned without the consent of the debtor, unless the assignment is prohibited by law, non-assignment clauses in the contract between the original creditor and the debtor, or the nature of the receivable.[62]

If there is a contractual prohibition on assignment, the assignment of receivables is ineffective against the debtor, unless the debtor has given his consent.[63] However, the good faith of the assignee may be relevant in some jurisdictions. According to the PECL, the assignee may invoke an assignment which is not in conformity with the contract under which the assigned claim arises where "the assignee neither knew nor ought to have known of the non-conformity".[64]

According to a traditional contract law rule, the debtor must be notified of the assignment. Without notification, a bona fide debtor may discharge his obligations to the original creditor.[65] Sometimes there are commercial reasons (such as the assignors close relationship with the debtor) not to notify the debtor;[66] this may mean that the transfer of receivables will not take effect in law because the statutory requirements are not complied with.

In addition to notification, there may be other requirements as to form depending on the jurisdiction.

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62 PECL Article 11:302; DCFR III.–5:109.

63 See PECL Article 11.301(1)(a); DCFR III.–5:108.

64 PECL Article 11.301(1)(b). See also PECL Article 11:301(2): "Nothing in the preceding paragraph affects the assignor's liability for the non-conformity." Compare DCFR III.–5:108

65 See PECL Article 11:303; DCFR III.–5:119.

66 See Ambery R, Bowmer S, Why Don King Needs a Haircut - Transfer and Assignment of Contracts: How to Sell Trade Receivables under English Law, JIBL 15(9) (2000) pp 216–220.

For example, assignments under English law may be legal or equitable. "Choses in action" (all personal rights of property which can only be claimed or enforced by action, and not by taking physical possession) such as receivables may be assigned in law pursuant to section 136 of the Law of Property Act 1925. Section 136 has three requirements: (a) that the assignment be expressed in writing; (b) that notice of the assignment is given to the obligor; and (c) that the assignment is of the whole of the obligations, i.e. not merely part of the choses or an assignment of future or contingent rights.

Under Swiss law, the assignment of receivables requires two acts: the commitment to assign the receivables; and the actual transfer, which must be in writing.[67]

The main rule is that the assignment of a receivable does not restrict the rights of the original debtor.[68] According to the DCFR, the debtor may: "invoke against the assignee all substantive and procedural defences to a claim based on the assigned right which the debtor could have invoked against the assignor";[69] and invoke against the assignee rights of set-off which would have been available against the assignor.[70] There may be exceptions to this main rule depending on the jurisdiction. According to the DCFR, the place of performance of monetary claims may change.[71]

An extreme case of the application of the main rule that the assignment of a receivable does not restrict the rights of the debtor is the rule that some assignments require the consent of the debtor in order to be enforceable against the debtor. (a) The contract may prohibit the assignment of rights otherwise prima facie assignable (the non-assignment clause). Such contractual provisions are legally effective. A party may have a genuine commercial interest to ensure that contractual relations are only with the person he has selected as the other party to the contract and no one else, and non-assignment clauses protect that interest. (b) In addition, the governing law may provide that contracts involving personal skill and confidence on the part of the purported assignor cannot be assigned unless the contract itself provides otherwise.[72]

Enforceability against the assignor. Enforceability of an assignment against the debtor is one thing and the contract between the seller and the buyer of the debt is another.

It is a traditional rule of contract law that the seller of rights is responsible for the existence (veritas)[73] of those rights but not for their quality (bonitas). The same rule can be applied to the sale of receivables. It does not mean the application of

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[67] Art. 165(1) OR: "Die Abtretung bedarf zu ihrer Gültigkeit der schriftlichen Form." Art. 165(2) OR: "Die Verpflichtung zum Abschluss eines Abtretungsvertrages kann formlos begründet werden."

[68] For consumer credit agreements, see Article 17(1) and recital 41 of Directive 2008/48/EC.

[69] DCFR III.–5:116(1); PECL Article 11:307(1).

[70] DCFR III.–5:116(3); PECL Article 11: 307(2).

[71] DCFR III.–5:117; PECL Article 11:306(1).

[72] See, for example, Ambery R, Bowmer S, *op cit*, pp 216–220.

[73] PECL Article 11:201.

the caveat emptor principle, because the seller is responsible for the existence of certain rights relating to the receivables.[74]

Therefore, the contractual undertaking of the seller to assign the receivables to the buyer can be valid between the seller and the buyer[75] even where the assignment cannot be invoked against the debtor because of a non-assignment clause or otherwise.[76] The seller will then be liable to the buyer for failure to fulfil its contractual obligations.

Under English law, an assignment which does not comply with the provisions of section 136 of the Law of Property Act 1925 is not void, but is regarded as an equitable assignment of the assignor's beneficial interest in the contract (section 136 applies to statutory assignment of choses in action such as receivables). (1) For example, legal assignments ordinarily are not used in the securitisation of receivables because they require, among other things, that notice be given to the debtor in order for the assignment to be effective. (2) However, equitable assignments may be effected with or without notice. An equitable assignment generally is effective as against the assignor and its unsecured creditors even without notice to the debtor.[77] (3) An equitable assignment could be considered inferior to a legal one in three fundamental respects: (a) there is no right conferred on the assignee to sue the obligor directly upon the debt; (b) the assignor may unilaterally waive or vary the terms of the contract; and (c) the obligor may set-off any obligations owed to it by the assignor under the contract or possibly otherwise.[78]

Enforceability against third parties. The enforceability of the assignment against third parties depends mainly on the applicable rules of property and insolvency law. Under contract law rules, notification to the debtor can play an important role.

According to the DFCR, the assignee whose assignment is first notified to the debtor has priority over any earlier assignee if at the time of the later assignment the assignee under that assignment neither knew nor ought to have known of the earlier assignment.[79]

Notification may be relevant even in the insolvency of the assignor. Failure to notify the debtor of the assignment may mean that the claims of the assignor's debtors take precedence over the assignee's claims.[80]

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74 DCFR III.–5:112; PECL Article 11:204.

75 See PECL Article 11:203(1). PECL Article 11:201(1): "The assignment of a claim transfers to the assignee: (a) all the assignor's rights to performance in respect of the claim assigned; and (b) all accessory rights securing such performance."

76 See PECL Article 11:203: "An assignment is effective as between the assignor and assignee, and entitles the assignee to whatever the assignor receives from the debtor, even if it is ineffective against the debtor under Article 11:301 or 11:302."

77 Raines M, Wong G, Aspects of Securitization of Future Cash Flows under English and New York Law, Duke J Comp Int L 12 (2002) p 453.

78 Ambery R, Bowmer S, *op cit*, pp 216–220.

79 DCFR III.–5:121; Article 11:401(1) of the PECL.

80 See PECL Article 11:401(4); DCFR III.–5:122.

Legal or equitable assignments under English law. Under English law, an assignment may be either legal or equitable, and the relevant interest may also be legal or equitable.

Once there has been a legal assignment, the assignee acquires the legal right to the debt (subject to equities having priority), all legal and other remedies for the debt, and the power to give a good discharge for the debt without the concurrence of the assignor. However, a legal assignment requires a writing under the hand of the debtor and express notice in writing to the debtor.

In contrast, an equitable assignment may be purely informal without even notice to the debtor. However, a debtor who pays the assignor before learning of the assignment will be discharged. For this and other reasons, the assignee may prefer to give notice of an equitable assignment to the debtor. Any form of notice is sufficient in this case, provided the fact of the assignment is definitely brought to the mind of the debtor. It is sufficient to show that the debtor has had knowledge of the assignment, regardless of the mode or source of that knowledge.[81]

Future Receivables

Sometimes the parties wish to assign future receivables. For example, the securitisation of receivables usually involves the sale of cash flows generated by the originator's existing pool of assets. So-called "future flow" transactions are backed by income to be derived in the future by an operating company.[82]

Enforceability against the assignor. The assignor and the assignee may agree on the assignment of future receivables. This contract can be enforceable between the parties. According to the DCFR, an assignment of a future claim "depends on its coming into existence".[83]

Enforceability against third parties. On the other hand, the assignment of future receivables is not always enforceable against third parties.

For example, the case law of the Swiss Federal Supreme Court distinguishes between future claims that have already come into existence before the commencement of the seller's bankruptcy and future claims that have not. Whereas the sale of the former by assignment is enforceable against third parties and bankruptcy-remote, the sale by assignment of claims that have not yet come into existence is not bankruptcy-remote. Receivables that have not yet come into existence fall within the bankruptcy estate of the seller. The buyer will be treated as an unsecured creditor and will therefore not be able to exercise any ownership rights over the future receivables.

Under English law, a legal assignment cannot be effective until the debt comes into existence. An equitable assignment, in contrast, can be of future debts.[84]

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[81] The Law Commission, Registration of Security Interests, paragraph 6.27.

[82] Raines M, Wong G, Aspects of Securitization of Future Cash Flows under English and New York Law, Duke J Comp Int L 12 (2002) p 453.

[83] DCFR III.–5:106; PECL Article 11:202(2). There is a similar rule, for example, in England. See Raines M, Wong G, *op cit*, pp 455–456.

[84] The Law Commission, Registration of Security Interests, paragraph 6.27.

Enforceability against the debtor. Existing claims are generally assignable, but there may be restrictions on the assignment of receivables that have not yet been earned (although they are based on an existing contract) or are based on a future contract. Some jurisdictions allow the assignment of future claims as long as they are sufficiently defined. The DCFR is fairly permissive in this respect.[85]

"True Sale" and Recharacterisation

This leads to the question of "true sale" and recharacterisation. There are some differences between common law countries and civil law countries.

English law. "True sale" is a concept used in common law countries. In England, one would ask whether the transfer of rights is a "true sale" enforceable as a sale or recharacterised as something else. The two major causes of concern under English law are the registration requirements of the Companies Act 2006, and the administration freeze under the Insolvency Act 1986. Recharacterisation is used in two contexts.

First, there is a risk that a purported sale will be recharacterised as a void security arrangement rather than a valid sale.[86] For example, the sale of receivables may under certain circumstances be regarded as a loan secured by receivables.

Avoiding recharacterisation is not only a matter of ensuring that legal title to the receivables is properly transferred but may also involve other aspects of the transaction such as recourse to the seller, representations and warranties given by the seller to the buyer, and the parties' intent.

In the English case of *Re George Inglefield Ltd*, Romer LJ prescribed three indicia that distinguish a (valid) sale transaction from a (void) transaction of mortgage or charge:[87] (1) In a sale transaction, the vendor is not entitled to get back the subject matter of the sale by returning to the purchaser the money that has passed between them. In the case of a mortgage or charge, the mortgagor is entitled to get back the subject matter of the mortgage or charge by returning to the mortgagee the money that has passed between them. (2) If a mortgagee realises the mortgaged property for a sum that is insufficient to repay him, the mortgagee is entitled to recover from the mortgagor any balance, whereas in a sale and purchase contract the purchaser has to bear any loss suffered on a subsequent sale of the asset by him. (3) If a mortgagee realises the subject matter of the mortgage for a sum more than sufficient to repay the money that has passed between him and the mortgagor, he has to account to the mortgagor for any surplus. Whereas, in a sale and purchase contract, any profit realised by the purchaser is for the purchaser's account.

Second, there is a risk that the sale will be set aside under one of the grounds of challenging antecedent transactions. Under English law, a transaction made at an

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85 DCFR III.–5:106; PECL Article 11:202(2).

86 In English law, the principles of recharacterization were set out in Re George Inglefield Ltd [1933] Ch 1, as considered and applied by the Court of Appeal in Welsh Development Agency v Export Finance Co Ltd [1992] BCC 270 (the Exfinco case).

87 See Raines M, Wong G, Aspects of Securitization of Future Cash Flows under English and New York Law, Duke J Comp Int L 12 (2002) pp 456–457.

undervalue may be challenged under the Insolvency Act; this is the ground of challenge of a sale to which most attention is paid in English law securitisation.[88]

Continental European laws. "True sale" is not a concept normally used in continental European laws. Instead, transactions may sometimes be unenforceable due to the mandatory provisions of insolvency law (see below) or property law ("Sachenrecht", section 11.6.3). For the parties, the risks are nevertheless the same, and the risks will usually be mitigated in similar ways.

Reversal of Transactions in Insolvency

There is a risk that the sale will be reversed under insolvency laws. This risk is increased where the seller is not legally independent from the buyer and acting in arm's length terms. The importance of this risk depends on the jurisdiction. Typically, the risk is increased where the transaction took place during a short period before the commencement of insolvency proceedings.

Community law. In Community law, the Regulation on insolvency proceedings seeks to make certain security instruments enforceable in cross-border insolvency proceedings.[89] However, its provisions do not prevent typical forms of reversal of transactions.

> The rules relating to "the voidness, voidability or unenforceability of legal acts detrimental to all the creditors" are determined by "the law of the State of the opening of proceedings".[90]

The reversal of transactions is partly governed by the Settlement Finality Directive and the Collateral Directive. However, they have a narrow scope (sections 9.6.3 and 9.6.5, Volume III).

Member States' laws. The reversal of transactions is therefore to a large extent governed by Member States' national laws. The reversal of transactions can be illustrated by German and English law.

German law. According to German law, a transaction can be avoided in the insolvency of the debtor on many grounds (Konkursanfechtung, § 129 KO). For example, the following transactions can be avoided: (a) all transactions that the debtor carried out during a period of ten years prior to the commencement of insolvency proceedings with the intention to cause damage to, where the other party knew about the threatening insolvency of the debtor and the causing of damage;[91] (b) transactions without remuneration made less than four years before the filing

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88 *Ibid*, p 456.

89 See Article 5 (third parties' rights in rem) of Regulation 1346/2000 (Regulation on insolvency proceedings) as well as Article 6 (set-off), Article 7 (reservation of title), and Article 9 (payment systems and financial markets).

90 Article 4(2) of Regulation 1346/2000 (insolvency proceedings). See also Articles 13 and 5(4). Articles 6(2) and 7(3) contain similar provisions. Article 9(2) applies to payment systems.

91 § 133(1) KO; for Swiss law, see Art. 286 Bankruptcy Act.

of the insolvency petition;[92] (c) the granting of collateral or the discharge of an obligation during a period of 1–3 months before the insolvency petition, depending on the case;[93] and (d) any transaction made during a period of three months prior to the insolvency petition, if it prejudiced creditors, the debtor was insolvent, and the other party knew that the debtor was insolvent.[94]

English law. In England, the reversal of transactions can be based on the Insolvency Act 1986. Transactions may be reversed or set aside, for example, where they have been entered into at an undervalue (where the insolvent party received no or insignificant consideration in return for the value which it provided) (section 238) or where they are security interests deemed to constitute preferences in favour of certain creditors (section 239). A security may be released or discharged on the same grounds (sections 238 to 240, transaction at undervalue and preference). The Insolvency Act 1986 also prevents the enforcement of a security interest during administration without the consent of the administrator or the leave of the court (administration freeze).[95] Breach of this freeze may involve criminal contempt of court.

11.5.3 Transfer of Negotiable Instruments

Some instruments are designed to be traded in financial markets. For this purpose, these instruments must be transferable, it must be easy for the transferee to enforce the transfer against the debtor or obligor as well as against third parties,[96] and it must be difficult for the debtor or obligor to use defences against the transferee.[97] Typically, these instruments are bearer instruments and, like in English law, regarded as "negotiable instruments"[98] or, like in German law, as "Wertpapiere".

[92] § 134 KO.

[93] §§ 130 and 131 KO. For Swiss law, see Art. 287 Bankruptcy Act.

[94] § 132 KO. For Swiss law, see Art. 286 Bankruptcy Act.

[95] Section 11(3)(c) of the Insolvency Act 1986.

[96] § 793(1) BGB.

[97] § 796 BGB.

[98] See Fuller G, Corporate Borrowing. Third Edition. Jordans, Bristol (2006) paragraph 15.3: "A negotiable instrument has three essential characteristics: (a) it is transferable by mere delivery, with no notice needing to be given to the borrower; (b) a full legal title to the instrument passes to the transferee, who may sue the borrower in his own name without joining the transferor as a party; and (c) the title passes free from all equities between the borrower and any prior holder and all defects in title (including an absence of title altogether) if the transferee takes in good faith value and without notice of the equities or defects (a 'holder in due course')." See also paragraph 15.4: "Not all bearer instruments are negotiable, and negotiability should be contrasted with both 'transferability' and 'assignability'. An instrument which is merely 'transferable' has characteristics (a) and (b), but not (c). Examples include bills of lading and postal orders. An instrument which is merely 'assignable' can have characteristics (b) (but not (a) or (c)), include registered shares, life policies, government stock, registered bonds and notes and registered stock."

The concept of "Wertpapier" (literally: a paper that carries value, a valuable paper) has no direct English equivalent.[99]

It is characteristic of "negotiable instruments" and "Wertpapiere" that the rights attached to them can only be transferred by the physical delivery of the instrument and that the rights are not divisible.[100]

An instrument can only acquire "negotiability" or the characteristics of a "Wertpapier" by law and not merely by agreement between the parties.

Under *English* law, the Bills of Exchange Act 1882 recognises the negotiability of bills of exchange, cheques and promissory notes. In addition, an instrument can acquire negotiability by mercantile usage. For example, bearer bonds and notes have been recognised as negotiable. Under *German* law, a document is a Wertpapier where its bearer is entitled to receive payment under its terms.[101] Under Swiss law, it is is a Wertpapier where it symbolises a right that cannot be enforced nor transferred to others without the document.[102]

11.6 The Use of Credit Enhancements

11.6.1 Introduction

The use of credit enhancements is a basic way to mitigate credit risk. It is in the interests of both parties to use hem. First, the credit transaction will not take place, where the creditor believes that the risk associated with a particular proposed extension of credit is too high. Credit enhancements make the extension of credit more attractive for the creditor by increasing the perceived rewards and/or decreasing the perceived risk. Second, the credit transaction will not take place, if the debtor believes that the interest rate is too high. By improving the risk-reward relationship, credit enhancements enable even higher risk debtors to borrow money at a reasonable cost.[103]

Forms of credit enhancement. There are many types of legal tools and practices that may be used to reduce the perceived credit risk of an obligation.

Credit enhancement can be legally enforceable or unenforceable. In addition, some credit enhancements improve the risk-reward relationship in fact, whereas others improve just the perceived risk-reward relationship.

The four main types of credit enhancement are: (1) general ways to manage the agency relationship between the creditor and the debtor (covenants and other contract terms); (2) securing the obligation by the value of assets (collateralisation, the use of a special purpose vehicle); (3) securing the obligation by the payment

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[99] There are three types of Wertpapier: bearer, order and non-negotiable (straight). A Wertpapier is transferred by endorsement and physical transfer.

[100] § 797 BGB.

[101] § 793(1) BGB.

[102] Art. 965 OR.

[103] See Cohen NB, Internationalizing the Law of Secured Credit: Perspectives from the U.S. Experience, U Penn J Int Econ L 20 Fall (1999) pp 429–430.

obligation of a third party (for example, third party guarantees, credit insurance, letters of credit, and derivatives); and (4) choosing the debtor.

These four main types of credit enhancement are different. In the first case, the creditor's focus is on the debtor as agent. In the second case, the creditor focuses on claims to collateral and the enforceability of the creditor's own claims against competing claims of third parties. In the third case, the creditor turns to a third party for payment. And finally, a fundamental way to reduce counterparty credit risk is to choose a better debtor.

Credit risk transfer (funded or unfunded). A particular form of credit enhancement is credit risk transfer. Traditional forms of credit risk transfer include financial guarantees and credit insurance. The range of credit risk transfer instruments and the circumstances in which they are used widened considerably in the 1990s.[104] For example, credit derivatives belong to the most important financial innovations of that decade.

The transfer of credit risk to a third party can be funded or unfunded. It is funded if the payment obligation of the risk taker is discharged by the risk taker in full at the start of the transaction by making a payment or by providing collateral to secure the obligation. Where the risk taker's obligation is not paid in advance or collateralised, the structure is unfunded (section 11.8.1).

Tranching. Tranching is a form of portfolio risk transfer. It is an arrangement that creates "waterfall structures" in portfolio instruments and transactions (section 11.8.4 and Volume III).

Regulatory capital and credit enhancements. In the EU, provisions on credit institutions' and investment firms' regulatory capital are based on the two Capital Requirements Directives[105] (Volumes I and III) implementing the Basel II framework.[106] Some forms of credit enhancement enable banks to manage their regulatory capital more efficiently and to lend more or at a lower cost. This means that borrowers will benefit, if they use credit enhancements recognised by the Basel II Accord and implementing legislation for regulatory capital purposes.

According to the Basel II Accord, the credit exposure and capital requirements of banks depend on many things. First, they depend on the choice of the *debtor*.

Claims on sovereigns,[107] non-central government public sector entities (PSEs),[108] multilateral development banks,[109] banks,[110] securities firms,[111] and on corporates,[112] and claims

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[104] See BIS, CGFS, Credit risk transfer, January 2003.
[105] Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions (recast); Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions (recast).
[106] International Convergence of Capital Measurement and Capital Standards: a Revised Framework (the Basel II Accord).
[107] Paragraph 53 of the Basel II Accord.
[108] Paragraph 57 of the Basel II Accord.
[109] Paragraph 59 of the Basel II Accord.
[110] Paragraphs 61–64 of the Basel II Accord.
[111] Paragraph 65 of the Basel II Accord.
[112] Paragraph 66 of the Basel II Accord.

included in regulatory retail portfolios[113] are subject to different capital requirements because of different risk weightings.

Second, the credit exposure and capital requirements also depend on the nature of the *claims*.

They depend on whether the claims are: claims secured by residential property,[114] claims secured by commercial real estate,[115] past due loans,[116] claims belonging to higher-risk categories,[117] other assets (such as securitisation exposures),[118] or off-balance sheet items (for example, direct credit substitutes, sale and repurchase agreements and asset sales with recourse, securities lending, demand guarantees and standby letters of credit).[119]

Third, the Basel II Accord mentions a number of *credit risk mitigation techniques* that will be recognised for regulatory capital purposes. The credit risk mitigation techniques mentioned in the Basel II Accord include the use of: collateralised transactions;[120] on-balance sheet netting;[121] and guarantees and credit derivatives.[122]

In order to be recognised, these techniques must meet certain requirements. First, they must meet general requirements for legal certainty.[123] These requirements relate to legal documentation, the documentation being binding and enforceable on all parties and in all relevant jurisdictions, and the bank having conducted a sufficient legal review to verify this.[124] Second, there should not be any maturity mismatch, because maturity mismatch will influ-

[113] Paragraph 69 of the Basel II Accord.
[114] Paragraph 72 of the Basel II Accord.
[115] Paragraph 74 of the Basel II Accord.
[116] Paragraph 75 of the Basel II Accord.
[117] Paragraph 79 of the Basel II Accord.
[118] Paragraph 81 of the Basel II Accord.
[119] Paragraphs 82–89 of the Basel II Accord.
[120] Paragraph 119 of the Basel II Accord: "A collateralized transaction is one in which banks have a credit exposure or potential credit exposure; and that credit exposure or potential credit exposure is hedged in whole or in part by collateral posted by a counterparty or by a third party on behalf of the counterparty."
[121] Paragraph 139 of the Basel II Accord: "Where banks have legally enforceable netting arrangements for loans and deposits they may calculate capital requirements on the basis of net credit exposures eubject to the conditions in paragraph 188."
[122] Paragraph 140 of the Basel II Accord.
[123] Paragraph 110 of the Basel II Accord.
[124] Paragraph 117: "In order for banks to obtain capital relief for any use of CRM techniques, the following minimum standards for legal documentatino must be met." Paragraph 118: "All documentation used in collateralized transactions and for documenting on-balance sheet netting, guarantees and credit derivatives must be binding on all parties and legally enforceable in all relevant jurisdictions. Banks must have conducted sufficient legal review to verify this and have a well founded legal basis to reach this conclusion, and undertake such further review as necessary to ensure continuing enforceability."

ence recognition.[125] Third, there are special requirements for different kinds of credit risk mitigation techniques.

Legally not enforceable credit enhancements. Many credit enhancements are meaningful without being legally enforceable. Legally not enforceable credit enhancements are typically based on the debtor's or its owner's reputation.

For example, a parent company is not legally responsible for the debts of a subsidiary, where the subsidiary has been incorporated as a limited-liability company. However, a parent company may prefer to ensure that its subsidiaries are in a position to fulfil their obligations, because default by one subsidiary may have a negative impact on the funding of the group as a whole. Sometimes the parent agrees to state this in a comfort letter (section 5.6.2).

Ratings are a mechanism that links the reputation of the debtor with its funding costs (Volume I). Many debtors prefer favourable ratings in order to reduce their external funding costs. In practice, some credit enhancements might signal better creditworthiness without being legally enforceable.

Market practice. The choice of credit enhancements and their characteristics depend on market practice, and market practice is influenced by the legal framework.

For example, French banks respond to a creditor-unfriendly bankruptcy code by requiring more collateral than lenders elsewhere, and relying on certain collateral forms that minimise the statutory dilution of their claims in bankruptcy. Such particular forms of collateral include accounts receivable and personal guarantees.[126]

11.6.2 Management of Counterparty Commercial Risk

Introduction

Debtors can increase agency costs in many ways. First, there are many post-contractual methods of transferring wealth from creditors to debtors and their shareholders or reducing the value of creditors' claims. Bad management of the debtor can generally reduce the value of claims. Second, there are also typical sources of conflict between a debtor's creditors and shareholders. Managers might favour shareholders to the detriment of creditors: by choosing an excessive divi-

[125] Paragraph 143 of the Basel II Accord: "Where the residual maturity of the CRM is less than that of the underlying credit exposure a maturity mismatch occurs. Where there is a maturity mismatch and the CRM has an original maturity of less than one year, the CRM is not recognized for capital purposes. In other cases where there is a maturity mismatch, partial recognition is given to the CRM for regulatory capital purposes as detailed below in paragraphs 202 to 205. Under the simple approach for collateral maturity mismatches will not be allowed."

[126] Davydenko SA, Franks JR, Do Bankruptcy Codes Matter? A Study of Defaults in France, Germany and the UK, J Fin 63 (2008) pp 565–608.

dend policy; by excessive borrowing; by asset substitution; and by underinvestment.[127]

Typical sources of conflict between bondholders and shareholders include the following: (a) Distribution of funds to shareholders can reduce the value of bonds where the payments are excessive. Typical examples include excessive dividend payments and the distribution of funds to the buyer in the course of refinancing after a takeover. (b) Creditors' claims are diluted by raising additional debt with an equal or prior claim on the same assets. One of the situations where this may happen is a takeover. Whereas shareholders that are purely financial investors mostly welcome the company becoming a takeover target, bondholders do not, because a successful takeover usually means a load of new debt, relegating their claims and cutting the price of their bonds. (c) The value of bonds can be reduced by substituting existing assets with more risky assets or (d) by failing to undertake profitable projects where it is felt that the benefit from accepting the project accrues to bondholders rather than the debtor or its shareholders.

Rational creditors recognise this. They can seek protection in many ways: (1) by refusing to extend credit; (2) by requiring a higher interest rate to reflect a higher risk level; (3) by requiring security through collateral; and/or (4) by inserting restrictive covenants and information covenants in contracts.

Choosing a better debtor. To begin with, a creditor can try to choose better debtors. Information management and the use of external information intermediaries will therefore play an important role (Volume I).

A creditor can also use its own terms as a screening device (section 7.1). For example, by accepting the lender's contract terms and/or by giving collateral, a potential debtor can signal its willingness and ability to comply with them. Relatively safe debtors can indicate their good quality by agreeing to provide collateral, whereas risky debtors that lack assets may refuse to do so.[128]

Collateral as a form of credit enhancement. Collateral can be used as a credit enhancement or credit risk transfer mechanism.

Collateral and security belong to traditional credit enhancement methods. An unsecured creditor has no certainty about the amount that will be paid to him in the bankruptcy of the debtor. Collateralisation acts to reduce credit risk by providing assets to which the non-defaulting party (collateral-taker) has recourse in respect of the obligations of a defaulting party (collateral-giver) in a bankruptcy scenario. (a) Collateral mitigates credit risk by supporting a claim (which may be defeated by insolvency) with a right of recourse against identified assets (which should not be defeated by insolvency). (b) In addition, collateral is a way to manage the agency problem (and the risk of default). The more collateral the debtor has given to the collateral-taker, the more the debtor/collateral-giver has to lose in

[127] Smith C Jr, Warner JB, On Financial Contracting: An Analysis of Bond Covenants, J Fin Econ 7 (1979) pp 117–161 at pp 118–119.

[128] BIS, Collateral in Wholesale Financial Markets: Recent Trends, Risk Management and Market Dynamics (March 2001) p 18; Elias RO, Legal Aspects of Swaps and Collateral, JIFM 3(6) (2001) p 234.

the event of default. Therefore, the debtor/collateral-giver has an incentive to reduce its risk level.[129]

Collateral has important benefits as a credit enhancement method. First, collateralisation equalises disparities in creditworthiness and enables counterparties with a low or deteriorating credit rating and unrated counterparties to participate in financial transactions together with highly rated market participants. Second, collateralisation can lessen the credit spread that is charged to a counterparty. Third, collateralisation may reduce regulatory capital requirements (section 11.6.3).[130]

However, collateralisation can raise some concerns. First, the debtor may not always have access to collateral. Second, there are costs in a collateral program (such as professional fees, operational costs, custodian's fees, and financing costs). The net benefit of the collateral depends on the size of these costs compared to the reduction in credit risk achieved by collateralisation. Third, the collateral itself may be subject to credit risk (for example, where the collateral consists of a bank guarantee). Fourth, the provision of collateral implies risks for the collateral-giver, because the collateral-giver has credit exposure with respect to the collateral-taker.[131]

The credit exposure of the collateral-giver can be illustrated by the collapse of Lehman Brothers in 2008. Lehman's customers – many of which were other banks and hedge funds – had pledged assets as collateral in return for financing from Lehman. After the commencement of Lehman's bankruptcy, administrators first had to determine the owners of assets and could therefore not return collateral without a long delay. Some assets disappeared because of the standard industry practice of rehypothecation, in which prime brokers use clients' collateral to raise financing of their own.[132]

Collateral as a form of credit risk transfer. Where the collateral-giver is not the debtor, the taking of collateral is a way to transfer credit risk to the collateral-giver (section 11.8).

Default clauses and remedies clauses. The definition of "default" and fault-based remedies can act as a credit enhancement. For example, the terms of an international term loan or an international bond or note will define events of default which enable the lender or trustee to cause payments to be accelerated (section 6.3.3), and a swap agreement will have a detailed termination clause specifying what amounts will be payable. For many reasons, parties very rarely resort to formal legal proceedings in international financial transactions.[133]

Covenants. The use of covenants is a form of credit enhancement. Debt covenants are a typical creditor protection mechanisms according to the Anglo-

[129] See Elias RO, Legal Aspects of Swaps and Collateral, JIFM 3(6) (2001) p 234.
[130] See *ibid*, pp 234–235.
[131] *Ibid*.
[132] Do the brokey-cokey, The Economist, October 2008.
[133] Cranston R, Remedies in International Transactions: Why so few formal legal proceedings, JIBL 4 (1989) pp 65–69.

American contract model.[134] Debt covenants have traditionally been less widely used in continental Europe[135] but can now be said to belong to normal practice in corporate finance.[136]

The most important reasons to use covenants are: the size of counterparty credit risk (covenants provide additional protection); the "buy-and-hold" model (the longer a bank must hold on to a loan instead of selling it to investors, the more it may need to be protected by covenants);[137] the lack of security in non-recourse or limited recourse finance or the use of cash flow as collateral (covenants tell the debtor what to do and what not to do); and market practice (contract practice, covenants are usual in many contract types).

For example, junk bonds (high yield notes) may contain very extensive covenants. Standardised financial loan instruments traded on the capital market (for example, Eurobonds) tend to contain only a negative pledge. The use of covenants in normal bank loans depends on the case. Covenants can be extensive if the debtor is a firm that has no assets that could be used as collateral. A domestic loan agreement between a bank and a middle-sized firm might not contain any extensive covenants in continental Europe.

In the years leading to the financial crisis of 2007–2009, banks used to lend large amounts of money without insisting on strong financial covenants. It goes without saying that covenant light loans offer less protection to lenders if the borrower's financial position deteriorates.

Loans were light on covenants for many reasons. First, interest rates were low. Second, investors who could sell their claims in the secondary market did not ask for strong covenants (originate-and-sell). Third, often investors were "forced" to accept whatever terms borrowers offered: the flood of liquidity washed away the tight operating restrictions that banks once demanded for financing highly leveraged deals. Fourth, borrowers often had a right to simply refinance their deals if they no longer liked them.[138]

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[134] See Bratton WW, Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process, EBOLR 7 (2006) pp 39–87.

[135] Day J, Ormrod P, Taylor P, Implications for Lending Decisions and Debt Contracting of the Adoption of International Financial Reporting Standards, JIBLR 19 (2004) p 476.

[136] See, for example, Köndgen J, Financial Covenants – "Symbiotische" Finanzierungsverträge im Spannungsfeld von Vertrags-, Gesellschafts- und Insolvenzrecht, in: Prütting H (ed), Insolvenzrecht 1996. RWS, Köln (1997) pp 127–157; Fleischer H, Covenants und Kapitalersatz, ZIP 1998 pp 313–321; Diem A, Akquisitionsfinanzierungen. C.H. Beck, München (2005) § 22.

[137] Switching off the lites, The Economist, October 2007: "Because banks held on to fewer loans, they relaxed their guard … But as the credit markets have slowed and institutional investment has clammed up, banks have returned, keeping more loans on their books. And they have also brought back covenants."

[138] Going naked, The Economist, April 2006; Buttonwood, "Buddy, just hand over that dime", The Economist, March 2007.

Covenants

Covenants are an integral part of corporate debt contracts (see also Volume III).[139] According to the mainstream agency theory of financial covenants, their primary purpose is to restrict certain key aspects of the behaviour of the management of corporate borrowers in order to prevent managers from acting in ways which benefit shareholders to the detriment of the interests of creditors (see above).[140]

Market practice. The actual use of covenants varies widely. One can identify three patterns.[141] First, the contracting practice correlates directly with the level of risk. Second, market practice depends on the size of the lender group. When the lender group consists of a relatively small number of institutional investors, there are similarities between covenants and shareholders' rights. In contrast, bondholders tend to rely on monitoring, exit, and diversification. Bond markets shut out the riskiest borrowers. Third, there is a benchmark. Borrowers and lenders negotiate against the background of the "state of the art" menu of protections, trading off the borrower's interest in business flexibility against the lender's interest in financial security.

Conflicting objectives. Covenants can provide a general framework of control. The protected party (the lender) and the contract party (the borrower) may have different objectives.

The contract party may regard covenants as an unwanted intrusion into corporate management's freedom to run the business. The contract party may want to minimise the intrusiveness and cost of covenants while obtaining whatever advantage is to be had by surrendering to the wishes of the protected party to include covenants in the contract.[142]

The protected party may be concerned about how far the covenants which it is able to insert into the contract: give it control over the claim; give it influence over the contract party; or afford it protection otherwise. On the other hand, too much control may increase legal risk (see below).

Control mechanism. The control mechanism can resemble the control mechanism available to shareholders.

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139 See, for example, Bradley M, Roberts MR, The Structure and Pricing of Corporate Debt Covenants (2004), available at SSRN; Bratton WW, Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process, EBOLR 7 (2006) pp 39–87.

140 Day JFS, Taylor PJ, Loan Documentation in the Market for UK Corporate Debt: Current Practice and Future Prospects, JIBL 12(1) (1997) p 7.

141 According to Bratton WW, *op cit*.

142 Day JFS, Taylor PJ, Bankers' Perspectives on the Role of Covenants in Debt Contracts, JIBL 1996, 11(5) pp 201–203.

Table 11.2 Control Framework

	Management, extensive discretion	Consent for actions (affirmative covenants)	Restrictions on actions (negative covenants)	Disclosure (information covenants)
Initiation	X			
Veto	X	X		
Remedies	X	X	X	(X)

Typically, the mechanism of control is based on three things: (1) the regular duty of the contract party to keep the protected party informed about its financial status (information covenants); (2) the duty of the contract party to notify the protected party about events that may influence risk (information covenants); (3) and the obligation not to take action that may have an adverse effect on risk (negative covenants) or the obligation not to take such action without the consent of the protected party (affirmative covenants; for the ratification strategy, see section 6.3.3 and Volume I).[143]

Covenants that are not appropriately restrictive are unlikely to control potential opportunism on the part of the debtor. On the other hand, covenants are too restrictive when they severely reduce the debtor's flexibility.

Furthermore, too restrictive covenants may trigger a breach of contract (default) that is not warranted[144] or, depending on the governing law, recharacterisation of the debt as equity, or lender liability. On the other hand, covenant-lite loans may lack an effective early-warning mechanism; as a result, default will have more serious consequences.

The US. In the US, lenders tend to avoid interference with the governance of the debtor company and the use of affirmative covenants. US bankruptcy law permits a bankrutcy court to subordinate the claim of a lender to that of other claimants if the lender was responsible for improper business decisions that improved its own position at the expense of other claimants (in other words, if the lender's behaviour was inequitable). Furthermore, control over the debtor may trigger lender liability according to the instrumentality theory. Lenders therefore seek control indirectly by using negative covenants and specifying events of default.[145]

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[143] See Kraakman R, Davies PL, Hansmann H, Hertig G, Hopt KJ, Kanda H, Rock EB (eds), The Anatomy of Corporate Law. OUP, Oxford (2004) p 26.

[144] Mather P, The Determinants of Financial Covenants in Bank-Loan Contracts, JIBLR 2004, 19(2) pp 33–39.

[145] Bratton WW, Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process, EBOLR 7 (2006) pp 39–87. In the US, the classic case is Martin v. Peyton, 246 N.Y. 213, 158, N.E. 77 (1927).

Europe. Generally, there are weaker constraints on the use of affirmative covenants in Europe (for mezzanine funding, see Volume III).[146]

The protected party is nevertheless responsible for its own actions. There are cases of the liability of the creditor for the mismanagement of the debtor company. In extreme cases, the contract party may be regarded to have acted as the protected party's agent or representative, or the protected party can be regarded as a de facto representative of the debtor company.

Under German law, discretion must be used in good faith law (§ 242 BGB, Treu und Glauben, see section 5.3.6). The liability of lenders to other creditors could be based on § 826 BGB which applies to the wilful causing of harm. Where a lender has acted on the debtor GmbH's behalf in its dealings with third parties, the lender may be regarded as a de facto managing director with the same general duties as other managing directors before the insolvency of the GmbH.[147]

In England, courts will only reluctantly imply additional duties into the contract.[148] However, the lender should exercise care and skill in the performance of the terms of the loan. The lender should also avoid the status of a shadow director; it should not lean on the directors to follow any advice that it gives.[149]

Sub-categories. There are various ways to divide covenants into sub-categories. From a legal perspective, covenants tend to address four issues:[150] (1) *compliance* with laws and the existence of all necessary regulatory consents; (2) the preservation of the *liquidity* of the contract party (for example, restrictions on dividend payments, the disposal of assets to shareholders, financial indebtedness, extension of credit, and speculative derivative transactions); (3) the preservation of the *assets* of the contract party (for example, restrictions on asset disposals and the granting of guarantees, the negative pledge clause, the pari passu clause, insurance coverage clause, prohibition of transactions other than transactions in the ordinary course of business); and (4) the preservation of the *existence* of the contract party or its corporate *identity* (restrictions on formal mergers,[151] formal divisions,[152] and business acquisitions).

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[146] See, for example, Fleischer H, Covenants und Kapitalersatz, ZIP 1998 p 316, citing BGHZ 119, 191, 196; Habersack M, Grundfragen der freiwilligen oder erzwungenen Subordination von Gesellschafterkrediten, ZGR 2000 pp 394–400.

[147] BGHZ 104, 44; BGHZ 150, 61; BGH, judgment of 11 July 2005 - II ZR 235/03.

[148] For an introduction to lender liability under English law, see Cranston R, Principles of Banking Law. Second Edition. OUP, Oxford (2002) pp 221–228.

[149] Section 251(1) of the Companies Act 2006.

[150] Diem A, Akquisitionsfinanzierungen. C.H. Beck, München (2005) § 22 numbers 36–64.

[151] For formal mergers, see Article 3 ("merger by acquisition") and Article 4 ("merger by the formation of a new company") of Directive 78/855/EEC (Third Company Law Directive). For German law, see § 20(1) UmwG.

[152] For formal divisions, see Article 2 ("division by acquisition") and Article 21 ("division by the formation of new companies") of Directive 82/891/EEC (Sixth Company Law Directive).

Information covenants and restrictive covenants. Usually, the agreed covenants consist of information covenants and restrictive covenants (consisting of financial covenants and non-financial covenants).[153]

Depending on the contract, information covenants and restrictive covenants are combined with different remedies. Breaching a restrictive covenant will typically trigger an event of default. Breaching a mere information covenant is not usually regarded as serious enough to trigger an event of default.

Information covenants. Information covenants allow the creditor to watch the borrower's performance and to step in before a collapse looks likely.[154] Financial institutions may have a duty to monitor their large borrowers under banking laws.[155] Loan documentation often contains terms concerning the provision of information to lenders.

Restrictive covenants in general. Restrictive covenants limit the debtor's right to weaken its balance sheet voluntarily. They can also act as an early warning mechanism.

The usual "full set" of restrictive covenants include: restrictions on debt; restrictions on prior claims; restrictions on dividends and other payments to shareholders; restrictions on mergers and on the sale of assets; restrictions on investments; and early warning covenants (financial covenants) or acceleration terms.[156]

Financial covenants. For the creditor, financial covenants serve three main purposes.

Like other covenants, financial covenants do not provide direct protection for the credit but rather offer some assurance that the debtor will remain able to meet its obligations.

Like information covenants, financial covenants work as an early warning system. For example, financial covenants can be combined with the right of the protected party to declare the contract party to have defaulted if its ratio of cash flow to debt-service payments, debt to equity, expenses to revenues, or other factors fall outside the specified limits.[157]

Financial covenants can also help banks to adjust the margin to reflect changes in the risk level of the debtor.

In England, the incidence of financial covenants in loan documentation is dominated by three conventional indicators of a company's financial position and performance derived from the balance sheet and the profit and loss account. The three most frequently occurring financial covenants relate to minimum tangible net worth, interest cover and gearing. Al-

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[153] The general contract terms of LMA contain the following covenants (undertakings): (a) Information. Audited accounts; Half year accounts; Compliance certificate; Accounting principles; Shareholder information; Litigation; Other information; Default notification; No default certificate. (b) Financial covenants. Pari passu; Negative pledge; Disposals.

[154] Going naked, The Economist, April 2006.

[155] Articles 22(1) and 109 of Directive 2006/48/EC (Capital Requirements Directive). For German law, see § 18 KWG.

[156] Bratton WW, *op cit*.

[157] Going naked, The Economist, April 2006.

though a number of other financial covenants may be used in loan documentation, they are not as common.[158]

Financial covenants are typical accounting-based contracts.[159] This means that there can be drafting problems arising from the accounting aspects of loan documentation. For example: the regulatory regime can be flexible and permit accounting policy choices; financial reporting by the debtor depends partly on the debtor's accounting policy choices; financial reporting is to some extent based on accounting estimates that are subjective; and accounting for goodwill and pension costs can be complex issues.[160]

Sweeps. Mandatory repayment (acceleration) clauses called "sweeps" can be used as an alternative, in particular in shorter-term loans. A subsequent borrowing, equity offering, or asset sale will then trigger a duty to pay down all or part of the loan. Such "sweeps" tie the magnitude of the triggering event to a percentage of the loan to be paid down. [161]

Event risk covenants. Event risk covenants are a form of financial covenants. They seek to ensure that certain events will not happen or that certain other events will happen.

Typical events relate, for example, to: interest coverage ("The obligor shall ensure, that its ratio of earnings before interest and tax to interest expense is not less than ..."); minimum net worth ("The obligor shall ensure, that its tangible net worth is not less than ..."); and asset preservation ("The obligor shall ensure that no member of the group shall sell, lease or otherwise dispose of the whole or any part of – the book value of which is 30% or more of the book value of the whole – its revenues or its assets ...").

Non-financial covenants in general. Credits may be enhanced through non-financial as well as financial covenants. There is a wide range of non-financial covenants. The most frequently occurring headings of non-financial covenants include: material adverse change; change of control, restrictions on acquisitions; restrictions on asset disposal; cross-default; negative pledge; pari passu; and the reporting of material litigation.[162]

Change of control clauses. Change of control clauses have been important in normal times because of the high level of takeover activity and because a takeover is often financed by loading the target with new debt ("refinancing"). If the borrower is loaded with debt after a takeover, the credit rating of the borrower will be

[158] See Day J, Ormrod P, Taylor P, Implications for Lending Decisions and Debt Contracting of the Adoption of International Financial Reporting Standards, JIBLR 19 (2004) p 480.

[159] Generally, see Cleaver K, Ormrod P, Accounting-based Contracts and Regulatory Change, Comp Lawyer 1994, 15(6) pp 169–172.

[160] Day JFS, Taylor PJ, Loan Documentation in the Market for UK Corporate Debt: Current Practice and Future Prospects, JIBL 12(1) (1997) pp 10–13.

[161] Bratton WW, *op cit*, pp 39–87.

[162] Day JFS, Taylor PJ, Loan Contracting by UK Corporate Borrowers, JIBL 11(8) (1996) pp 318–325 at 322–323.

ruined. Even where covenants are weak, bondholders tend to arm themselves against takeovers.[163]

Asset disposal covenant. An asset disposal covenant means that the debtor may not sell or transfer its assets other than in the normal course of its business. It is usual to prohibit substantial asset disposals. Under English law, "substantial" could mean 10%-15% or more. An asset disposal covenant can be complemented by a dividend restriction clause.

A sample asset disposal covenant could contain the following obligation: "... the Borrower will not sell, transfer, lend or otherwise dispose of or cease to exercise direct control over any part of their present or future assets or revenues otherwise than by transfers, sales or disposals of assets made for full consideration in the ordinary course of business ..."

Absence of cross-default. Cross-default clauses mean that the debtor must not breach its obligations under other contracts. For example, a loan agreement may provide that it is breached where the contract party breaches its terms or the terms of another loan agreement. The use of such clauses would be dangerous for the debtor, because it would result in the simultaneous acceleration of many loans.[164] A cross-default clause can often be found under the heading "Events of Default" or a similar section of the contract containing definitions of default.

The following definition of events of default would be a cross-default clause: "... any indebtedness of the Borrower is not paid when due, any indebtedness of the Borrower is declared to be or otherwise becomes due and payable before its specified maturity, or any creditor or creditors of the Borrower become entitled to declare any indebtedness of the Borrower due and payable before its specified maturity ..."

Negative pledge. Negative pledge clauses are usual in bank lending. Negative pledge clauses prohibit the debtor from creating competing collateral.[165]

It may look like this: "The Company covenants that it shall not ... directly or indirectly create, incur, assume or permit to exist any Lien on or with respect to any property or assets ... of the Company ..." Negative pledge clauses can often be found under the heading "encumbrances": "The Borrower will not create or allow to exist any Encumbrance over its present or future assets, rights or revenues ..."

Negative pledge clauses can be legally problematic, because laws and other contracts may create liens almost automatically in the normal course of the debtor's business. For example, a lien may be created for the benefit of a freight forwarder or carrier when goods are transported from A to B.

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[163] Control freaks, The Economist, March 2006.

[164] Cirio folks, The Economist, November 2002.

[165] See, for example, Hobbs T, The Negative Pledge: A Brief Guide, JIBL 8(7) (1993) pp 269–274; Crosthwait J, Boardman N, Wither the Negative Pledge, JIBL 1(3) (1986) pp 162–164.

In the Nordic countries, the General Conditions of the Nordic Association of Freight Forwarders (NSAB) provide that the "freight forwarder has a lien on the goods under his control, for fees and expenses in respect of such goods – remuneration and warehousing charges included – as well as for all other amounts due from the customer under contracts" with the customer.[166]

Although a negative pledge clause seeks to prohibit the debtor from creating competing security interests, it cannot prevent them from being created. Breach of a negative pledge is typically regarded as a breach of contract: it is an event of default. The main rule is that the validity of a competing security interest does not depend on the existence of the negative pledge clause.[167]

Pari passu. Pari passu clauses are very usual in bank lending. A pari passu clause deals with the ranking of claims and seeks to ensure that the claims of the creditor will not rank below other unsubordinated debts of the debtor.

This is a typical pari passu clause: "All the obligations and liabilities of the Borrower hereunder rank, and will rank, either pari passu in right of payment with or senior to all other unsubordinated Indebtedness of the Borrower."

On the other hand, the ranking of claims is partly based on insolvency laws and similar mandatory provisions. For example, a bankruptcy estate's own indebtedness ranks higher than the bankrupt's indebtedness,[168] and secured debts rank higher than unsecured debts.[169]

For this reason, a pari passu clause must, in practice, be diluted with a list of exceptions.[170] It is often stated expressly that the pari passu clause or covenants in general are subject to provisions of law that regulate creditors' rights in general. On the other hand, this could render the pari passu clause meaningless.

Where an issuer has issued debt securities admitted to trading on a regulated market, the issuer must ensure that "all holders of debt securities ranking pari passu are given equal treatment in respect of all the rights attaching to those debt securities".[171] According to EU securities markets law, the principle of equal treatment applies not only to holders of equity instruments that belong to the same class but also to holders of debt instruments that rank pari passu.[172]

Enforceability against third parties. The enforceability of covenants against the contract party is governed by the law that governs contractual obligations in general. The covenants can only in very exceptional cases be enforced against third parties that are not party to the contract.[173]

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166 § 14 NSAB.

167 See § 137 BGB.

168 For German law, see §§ 53 and 55 InsO.

169 For German law, see §§ 49, 50 and 170(1) InsO.

170 For German law, see Diem A, Akquisitionsfinanzierungen. C.H. Beck, München (2005) § 22 numbers 54–57.

171 Article 18(1) of Directive 2004/109/EC (Transparency Directive).

172 Recital 22 of Directive 2004/109/EC (Transparency Directive).

173 For a comparative a study in Swedish, see Norrgård M, Avtalsingrepp. Om otillbörliga ingripanden i kommersiella affärsförhållanden. Swedish School of Economics and Business Administration, Research Reports 61, Helsinki (2006).

The enforceability of covenants against third parties may simultaneously be governed by the laws of different countries. Although the parties cannot make covenants binding on third parties and enforceable against them, the parties may agree that the covenants may not be enforced against third parties. In practice, such contract terms are very rare. Whether the parties have agreed on the scope of covenants is a matter of interpretation and governed by the law applicable to the contract. In the absence of a specific substantive contract term to that effect, the legal background rules will govern the matter. They may be found in various areas of law, and the law that governs this question depends on the classification of the issue as a question of procedural law (governed by lex fori), tort law, competition law, or another area of law.

For example, under German law, a contract party may resort to provisions of unfair competition law (Gesetz gegen den unlauteren Wettbewerb, UWG) in order to prohibit a third party from contributing to the other party's breach of contract. This may be possible in exceptional cases under the catch-all provision of the UWG[174] or the list of examples of unfair competition in the UWG.[175]

Under English law, a contract party may have alternative causes of action against a third party, provided that the third party had actual knowledge of the breach of covenant.[176] (a) One possible remedy against a third party in the event that the borrower breaches a negative pledge clause that prohibits the borrower from giving any security is obtaining an injunction on the basis of the De Mattos principle[177] (purchaser of an interest in property may not use it so as to breach contractual rights of which he was aware when he acquired the interest) where the third party had actual notice of the contract. (b) Another is the tort of inducing breach of contract. Liability for inducing breach of contract was established by the famous case of *Lumley v Gye*.[178]

11.6.3 Securing Obligations by the Value of Assets

Introduction

Securing the obligation by the value of assets is the second of the four main types of credit enhancement. In this case, the creditor focuses on claims to collateral and

[174] § 3 UWG: "Unlautere Wettbewerbshandlungen, die geeignet sind, den Wettbewerb zum Nachteil der Mitbewerber, der Verbraucher oder der sonstigen Marktteilnehmer nicht nur unerheblich zu beeinträchtigen, sind unzulässig."

[175] § 4 UWG: "Unlauter im Sinne von § 3 handelt insbesondere, wer 1. Wettbewerbshandlungen vornimmt, die geeignet sind, die Entscheidungsfreiheit der Verbraucher oder sonstiger Marktteilnehmer durch Ausübung von Druck, in menschenverachtender Weise oder durch sonstigen unangemessenen unsachlichen Einfluss zu beeinträchtigen; ... 10. Mitbewerber gezielt behindert; …"

[176] See, for example, Cranston R, Remedies in International Transactions: Why so few formal legal proceedings, JIBL 4 (1989) pp 65–69.

[177] Stated by Knight Bruce LJ in De Mattos v Gibson (1859) 4 De G. & J. 276. See also Browne-Wilkinson J in Swiss Bank Corporation v Lloyds Bank [1979] Ch 548.

[178] Lumley v Gye (1853) 2 E & B 216. See also Douglas & Ors v Hello! Ltd & Ors [2007] UKHL 21.

the enforceability of the creditor's own claims against competing claims of third parties. The two main methods that belong to this category are collateralisation and the use of special purpose vehicles (incorporation).

Collateralisation. Collateralisation means that one or more parties agree to post collateral. Collateral levels may be fixed or vary over time to reflect the market value of the parties' obligations.

Basel II. Basel II influences the value of collateralisation by influencing its effect on banks' capital requirements. The Basel II Accord recognises collateral in two ways.

First, the credit exposure and capital requirements depend on whether the claims are: claims secured by residential property,[179] claims secured by commercial real estate,[180] securitisation exposures or other such assets,[181] or off-balance sheet items (for example, direct credit substitutes, sale and repurchase agreements and asset sales with recourse, securities lending, demand guarantees and standby letters of credit).[182] There should be a substantial margin of additional security over the amount of the loan.[183]

Second, the Basel II Accord lays down the financial collateral instruments that are eligible for recognition.[184] Those financial collateral instruments are: cash, gold, debt securities which have a sufficient credit rating, debt securities which are unrated but have sufficient quality, certain equities, and certain UCITS. In this case, a "haircut" must be applied. Haircut means the difference between the market value of a security and its value when used as collateral. Using haircuts, banks are required to adjust both the amount of the exposure to the contract party and the value of any collateral received in support of that contract party to take account of possible fluctuations in the value of either, occasioned by market movements.[185]

For example, the Eurosystem applied the valuation of haircuts and variation margins (marking to market) as risk control measures in 2009. If required to ensure adequate risk protection, even the following measures could be applied: initial margins; limits in relation to issuers/debtors or guarantors; additional guarantees; and exclusion.[186]

Ring-fencing, incorporation, special purpose vehicles. Collateralisation is not the only way to secure obligations by the value of assets. Assets can be ring-fenced (pooled).

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[179] Paragraph 72 of the Basel II Accord.
[180] Paragraph 74 of the Basel II Accord.
[181] Paragraph 81 of the Basel II Accord.
[182] Paragraphs 82–89 of the Basel II Accord.
[183] Paragraph 72 and paragraph 73, footnote 29, of the Basel II Accord.
[184] For financial collateral instruments eligible for recognition in the simple approach, see paragraph 145 of the Basel II Accord. For financial collateral instruments eligible for recognition in the comprehensive approach, see paragraph 146.
[185] Paragraph 130 of the Basel II Accord.
[186] Section 6.4.1 of Annex I of the Guideline of the European Central Bank of 31 August 2000 on monetary policy instruments and procedures of the Eurosystem (ECB/2000/7) (as amended by Guideline ECB/2008/13).

Even incorporation can be used as a credit enhancement. The use of a legal entity distinct from its shareholders helps to pool assets and enables creditors and counterparties to participate in the transaction through a bankruptcy remote and over-capitalised legal entity. The bankruptcy remoteness of that legal entity is increased where the legal entity really is a legal person distinct from its shareholders, and where it is not owned by the firm's contract party.

Protection of client assets. Other ways of ring-fencing assets are used when protecting client assets from the insolvency of the service provider. Asset-protection rules are very important to customers of investment firms and law firms.

Collateral: Introduction

The use of collateral can bring many benefits: it equalises the disparity in creditworthiness between different debtors; it can lessen the credit spread that is charged to a counterparty; and collateralised transactions may reduce regulatory capital requirements.

On the other hand, there are also costs inherent in a collateral program: professional fees; operational costs; custodians' fees; and financing costs.[187] One should also remember that collateral does not turn a bad contract party into a good one.[188]

The types of collateral and security interests and their regulation depend on the jurisdiction and have only to a limited extent been harmonised at Community level.

There is plenty of variation. One can distinguish between legal *techniques* for providing collateral and the *assets* to which these techniques relate. Based on the distinction between *personal* rights (such as debts) and *proprietary* rights (such as ownership), there are also legal differences between various categories of collateral.[189]

The type of security interest available in any given case, and the formalities required in the case of legal security, will to a large extent depend on the nature of the asset to be secured (land, shares, contracts, goods, bearer securities, ships, aircraft, goodwill, and intellectual property).

Legal questions. Collateral arrangements raise many legal questions. The most important of them include: the perfection of the collateral; the form of granting security interests; registration requirements; the use of ownership as security or functional equivalent to security; the enforcement of collateral; the priority ranking of the collateral; rehypothecation; and the governing law.

Creation and perfection. The perfection of security (or functional equivalents to security) encompasses any of the actions that may be necessary to ensure the formal validity, enforceability and (often) the priority of a collateral arrangement

[187] For key features of credit exposure, see ISDA, Guidelines for Collateral Practitioners (1996) pp 6–7.
[188] ISDA, Guidelines for Collateral Practitioners (1996) p 3 and 10.
[189] Elias RO, Legal Aspects of Swaps and Collateral, JIFM 3(6) (2001) p 235.

over the interests of third parties.[190] In practice, the perfection of the collateral arrangement depends on the nature and location of the collateral and the nature and location of the counterparty.

In order to perfect the collateral arrangement, the collateral-taker should ensure that the security or functional equivalent to security has been: validly created under its governing law (which in many cases is the law chosen by the parties); validly perfected in each jurisdiction where collateral is deemed to be located; and validly perfected in each jurisdiction where the counterparty is deemed to be located.[191]

Legal framework. Secured credit must typically be supported by a complicated legal framework. The framework will be more complicated in cross-border transactions.

Secured credit transactions are created by contract. However, the legal framework cannot consist of contract law alone. The main reason for this is that the value of collateral and its effect on the credit relationship depend on the enforceability of the collateral not only against the debtor but also against other potential claimants such as other creditors in general, other secured creditors, lien creditors, buyers of the collateral, and, most importantly, administrators or other parties acting on creditors' behalf in the debtor's or collateral owner's insolvency.[192]

The legal framework must thus address three issues to support secured credit effectively. First, the regime must determine how a debtor and creditor may create inter se an enforceable *agreement* that certain property of the debtor will serve as collateral for the debtor's obligation.[193] Second, a secured credit regime must set out the ground rules for *enforcement* of the secured party's interest.[194] Third, a secured credit regime must delineate the rights of the secured party against *other claimants* of the collateral. A security interest that is enforceable against the debtor, but is subordinate to the rights of another creditor, has much less economic value than an interest that is superior to competing rights. Both moral and eco-

[190] ISDA, Guidelines for Collateral Practitioners (1996) p 30: "Examples of such actions include: having 'control' of the collateral; registration of the pledge or filing of a statutory notive with a relevant government official; notification of the pledge to a custodian holding the relevant collateral; transfer of collateral in the form of book-entry securities to a special 'pledged account'; and delivery of possession of collateral to the secured party."

[191] ISDA, Guidelines for Collateral Practitioners (1996) pp 29–31.

[192] Cohen NB, Internationalizing the Law of Secured Credit: Perspectives from the U.S. Experience, U Penn J Int Econ L 20 Fall (1999) pp 430–431.

[193] *Ibid.:* "Not only must the necessity of such formalities as signed writings be addressed, but also such issues as the ability of debtors to encumber disparate items of property in a single grant of a security interest and the ability to encumber anticipatorily property not yet owned by the debtor."

[194] *Ibid.:* "For example, how may the secured party obtain physical possession of the collateral (if it is tangible) or control of the collateral (if it is not tangible)? May self-help be utilized, or must the secured party resort to the courts? What limits exist on the methods by which the secured party reduces the collateral to money and applies that money to the debtor's obligation?"

nomic value judgments are required to determine the rules that establish priority among competing claimants.[195]

Enforceability inter partes and against third parties. One of the core legal questions is to what extent the security interests can be enforced between the parties and to what extent they can be enforced against third parties.

Between the parties, the enforceability of security interests is typically based on contract.

Against third parties, the enforceability of security interests is typically constrained by mandatory laws such as: the laws under which the counterparty is organised; insolvency laws; and legal rules on property rights (Sachenrecht).

For example, English common law distinguishes between "legal" security rights (enforceable between the parties and against third parties) and "equitable" security rights (enforceable only between the parties but not against third parties).[196]

A security interest typically cannot be enforced against third parties, unless both requirements have been fulfilled. There should therefore be a valid, binding, and enforceable collateral agreement between the collateral-taker and the collateral-giver. The collateral-taker should also receive such proprietary rights that are enforceable against third parties generally as well as in insolvency proceedings.

Transparency. According to a general principle, security interests will not bind third parties unless they are apparent to them. For example, a security interest is often not enforceable against third parties, where the collateral-giver remains in possession of the collateral asset.

Typical ways to ensure sufficient transparency are transfer of possession of the collateral asset or registration of the security interest (for example, registration of a real estate mortgage or, under English law, registration of company floating charges and charges on book debts under the Companies Act 2006).

According to another general principle, the same transparency requirements do not have to apply to functional equivalents to security that are ownership-based. Transparency requirements are likely to make functional equivalents to security look more attractive, because the use of ownership-based devices helps the parties to avoid both requirements as to form (registration, documentation, transfer of possession, as the case may be) and publicity (for example, having details of charges set out in a public register).

Change over time. The content of security interests may change over time. Typically, the security interest can be enforced after the occurrence of an event such as payment default by the debtor, enforcement claim by the creditor, or the commencement of insolvency or similar proceedings. The enforcement of the security interest can mean that an originally "floating" security interest becomes "fixed" (English law knows the distinction between floating charges and fixed

195 *Ibid.*

196 For example, an equitable mortgage is weaker in priority than a legal mortgage, because a subsequent legal interest for value has priority over a prior equitable interest without notice. Hence, an equitable mortgage is exposed to double-dealing as a subsequent legal mortgagee of the instruments would take priority.

charges) and that eventually assets will be sold or taken over by the collateral-taker.

Priority. The priority of competing claims to the collateral depends very much on the governing law, the collateral, the security device, and other factors. The rules for determining priorities are complex under every system of law. There are nevertheless some general principles that apply across different jurisdictions and different types of security interest (subject to many exceptions):

- Assets that are validly owned by the creditor do not belong to the debtor, and there are no competing claims relating to those assets.[197]
- Public enforcement costs typically have the best priority ranking.
- Specific security interests that belong to the same category and relate to the same asset typically rank in order of creation (qui prior est tempore, potior est jure).[198]
- Security interests in specific assets rank higher than security interests in a pool of assets the contents of which vary in the course of the debtor's or the collateral-giver's business (the security interest in the pool of assets thus being in a floating state and having not yet become fixed).[199]
- The claims of preferential creditors may have a higher priority ranking even without the use of any particular security device.[200]
- The claims of unsecured creditors typically have the same priority ranking after the claims of secured creditors.
- Subordinated claims have the lowest priority ranking.[201]

Types of security interests, form. The form of granting a security interest depends on the jurisdiction, the asset, and the type of security interest. As the parties cannot regulate the rights and obligations of third parties, there can be a numerus clausus of security interests.[202]

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[197] For German law, see § 47 InsO (Aussonderung).

[198] See Fuller G, Corporate Borrowing. Third Edition. Jordans, Bristol (2006), paragraph 6.89.

[199] See *ibid*, paragraph 6.90: "The general rule is that a duly registered floating charge will rank after all prior and subsequent charges and other interests (legal or equitable) arising before crystallisation ..."

[200] See *ibid*, paragraph 6.91.

[201] For German law, see § 39 InsO.

[202] For German law, see § 232(1) BGB: "Wer Sicherheit zu leisten hat, kann dies bewirken durch Hinterlegung von Geld oder Wertpapieren, durch Verpfändung von Forderungen, die in das Bundesschuldbuch oder Landesschuldbuch eines Landes eingetragen sind, durch Verpfändung beweglicher Sachen, durch Bestellung von Schiffshypotheken an Schiffen oder Schiffsbauwerken, die in einem deutschen Schiffsregister oder Schiffsbauregister eingetragen sind, durch Bestellung von Hypotheken an inländischen Grundstücken, durch Verpfändung von Forderungen, für die eine Hypothek an einem inländischen Grundstück besteht, oder durch Verpfändung von Grundschulden oder Rentenschulden an inländischen Grundstücken."

There are basically four main types of consensual security interests: (1) retention of title; (2) transfer of ownership by way of security; (3) retention of a security interest other than title; and (4) granting of a security interest other than ownership.

The law typically requires the granting and existence of security interests to be apparent to third parties. The four main types of consensual security interests can be combined with five different forms of disclosure of security interest: (a) retention of possession; (b) delivery of possession; (c) notification to a third party; (d) registration of a security interest; or (e) mere contract.

Both the terminology and the security instruments can vary depending on the jurisdiction. For example, there are five main types of consensual security interests under English law: retention of title, mortgage, charge, pledge and the contractual lien.[203]

A *pledge* is the delivery of possession by way of security. A pledge does not need to be registered. However, it is not possible to take a pledge over securities which are not reducible to possession.

A *mortgage* is the delivery of title by way of security. It means a conveyance of property subject to a right of redemption. Mortgages can be legal or equitable. Under a legal mortgage, the collateral-taker acquires full legal and equitable title. The transfer of legal title over registered securities requires them to be registered in the name of the collateral-taker. An equitable mortgage is similar to a legal mortgage, but transfer of title is not legal, but equitable. Mortgages may not be suitable where the collateral pool of assets changes rapidly.

Whereas a mortgage is a conveyance of property subject to a right of redemption, a *charge* conveys nothing and merely gives the chargee the right to appropriate the charged property for the discharge of the secured obligation. A charge may be fixed or floating. According to the Companies Act 2006, every limited company must keep at its registered office a register of charges, and enter in it particulars of all charges specifically affecting property of the company and of all floating charges.[204] In addition, the Companies Act 2006 requires particulars of certain charges created by English companies to be delivered to the Registrar of Companies.[205] A charge that must be registered is void if it has not been registered.[206] For example, there is a well established principle that a charge is created where, under agreed terms for the sale of goods, property passes to the buyer who then confers on the seller rights over that property or things derived from it.[207]

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[203] Cohen NB, Internationalizing the Law of Secured Credit: Perspectives from the U.S. Experience, U Penn J Int Econ L 20 Fall (1999) pp 424–425: “Gilmore identified eight different personal property security devices used in the United States in the late nineteenth century and early twentieth century. These devices were the pledge, the chattel mortgage, the conditional sale, the trust receipt, the factor's lien, field warehousing, security interests in intangible property, and accounts receivable financing.” Gilmore G, Security Interests in Personal Property (1965). See also Ferran E, Principles of Corporate Finance Law. OUP, Oxford (2008) p 362.

[204] Section 891(1) of Companies Act 2006.

[205] Section 878(7) of Companies Act 2006.

[206] Section 889 of Companies Act 2006.

[207] Clough Mill Ltd v Martin [1984] 3 All ER 982.

In addition, a *lien* involves possession of the asset by the creditor. The difference between a pledge and a lien is that in the case of a pledge the owner delivers possession to the creditor as security, whereas in the case of a lien the creditor retains possession of goods previously delivered to him for some other purpose.[208]

Under German law, it is usual to distinguish between security interests in immovable property (Grundpfandrechte) and security interests in movable property (Pfandrecht an beweglichen Sachen). There are four main types of consensual security interests: retention of title (der Eigentumsvorbehalt);[209] the transfer of ownership of movables[210] or rights[211] by way of security (die Sicherungsübereignung, die Sicherungsabtretung/Sicherungszession); a pledge in movable property (das Pfandrecht an beweglichen Sachen)[212] or rights (das Pfandrecht an Rechten);[213] and a mortgage in immovable property (die Hypothek).[214]

Functional equivalents to security. Ownership has become increasingly important as a functional equivalent to security. There are four reasons for this.

First, security interests that do not require the transfer of possession are easier to use in financial transactions.

Second, there is a vast amount of sale of goods transactions. Many popular functional equivalents to security in sales or purchase transactions (hire-purchase, conditional sales, finance leases, consignment of goods and retention of title clauses) are ownership-based.

Third, one can use the same assets as a source of funding and security. Sale and repurchase transactions (repos) represent significant forms of financing, and there are many types of receivables financing (such as factoring, discounting of receivables and securitisation) that seem to perform a security function.[215]

Fourth, ownership-based functional equivalents to security can bring a number of other benefits.[216] For example, true security arrangements may be governed by stricter requirements as to form as ownership-based quasi-security arrangements.[217] The use of the latter may clarify the legal framework and reduce legal risk.[218] A further advantage relates to the value of the asset. If the arrangement is a true security agreement and the asset is sold for more than is owed to the creditor, the surplus may have to be returned to the debtor, but if the arrangement is an ownership-based quasi-security interest and the creditor repossesses the asset on

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208 Re Cosslett (Contractors Ltd [1998] Ch 295 at 508 per Millett LJ. See Fuller G, Corporate Borrowing. Third Edition. Jordans, Bristol (2006), paragraph 6.9.

209 Der Eigentumsvorbehalt, § 449 BGB.

210 Die Sicherungsübereignung, § 929 BGB.

211 Sicherungsabtretung/Sicherungszession.

212 Das Pfandrecht an beweglichen Sachen, § 1204 BGB.

213 Das Pfandrecht an Rechten, § 1273 BGB.

214 Die Hypothek, § 1113 BGB. Related rights: Die Grundschuld, § 1191 BGB; die Rentenschuld, § 1199 BGB.

215 The Law Commission, Registration of Security Interests, paragraph 6.2.

216 *Ibid*, paragraphs 6.3–6.7.

217 *Ibid*, paragraph 6.3.

218 *Ibid*, paragraphs 6.5–6.6.

default or breach of condition, the creditor may be able to keep the surplus on any future sale of the asset.[219]

At the same time, traditional types of collateral that require the transfer of possession have become less important in business-to-business transactions, because businesses need assets in their operations and will not hand them over to any collateral-taker.[220] For the same reason, legislators and courts have developed security interests that do not require the transfer of possession. Sometimes disclosure to the public is ensured by filing requirements. New types of security interests are recognised in some jurisdictions even without any disclosure requirements (for example, Sicherungsübereignung, Sicherungsabtretung, retention of title clauses in sales contracts). Finance leases are functionally equivalent to security arrangements.[221]

Ownership as security. As said above, ownership has become more and more important as security. The way ownership is used as security depends on the jurisdiction. It is easier in jurisdictions such as Germany and Switzerland that have adopted the doctrine of separation of sales contract[222] and transfer of ownership contract,[223] and the separation of the physical delivery of assets and the transfer of ownership ("Trennungslösung").[224] It is more difficult in jurisdictions such as France[225] and England[226] in which a sales contract also transfers ownership ("Einheitslösung").[227] In practice, businesses have mostly learnt to take such differences into account.[228]

Generally, the laws of the Member States of the EU differ in three respects as regards the transfer of ownership in the context of a contract for the sale of movable goods: the event that triggers the passing of ownership over to the buyer; whether an additional contract ("dinglicher Vertrag") is required for the delivery of possession; and, if it is required, whether the validity of that contract depends on the validity of the underlying sales contract.[229]

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[219] *Ibid*, paragraph 6.4.

[220] See *ibid*, paragraph 6.7. For example, rather than transfer the possession of an asset by way of security, a company may agree to sell it to a finance firm and then to take it back on hire-purchase or under a finance lease ("sale and lease-back").

[221] Drobnig U, Security Rights in Movables. In: Hartkamp A, Hesselink M, Hondius E, Joustra C, Duperron E, Feldman M (eds), Towards a European civil code. Ars aequi libri. Kluwer Law International, Nijmegen (2004) pp 741–755.

[222] § 433 BGB.

[223] § 929 BGB.

[224] In German: Trennung von Kaufvertrag und abstraktem dinglichen Rechtsgeschäft.

[225] Art. 1138(2) and 1583 code civil.

[226] In England, property to goods passes according to the intention of the parties. Sections 17–19 of the Sale of Goods Act 1979.

[227] In German: Einheit von Kaufvertrag und Übereignung. See Larenz K, Lehrbuch des Schuldrechts. Zweiter Band. Besonderer Teil. 1. Halbband. Beck, München (1986) II § 39.

[228] Drobnig U, *op cit*, pp 317–349.

[229] See Drobnig U, *op cit*, pp 725–740.

Security interest v title transfer. The granting of security interests and the transfer of ownership are functional alternatives. The granting of security interests may nevertheless require greater formality in its creation and perfection than title transfer, and there may be formalities and other constraints to comply with on enforcement. The transfer of ownership may be easier. The principal potential disadvantages of title transfer are that it may not be enforceable in jurisdictions that do not recognise the concept and it may be recharacterised in certain jurisdictions.[230]

Enforceability in insolvency and company law. As regards the enforceability of collateral arrangements in the insolvency of the counterparty, the most important jurisdiction is, in practice, the jurisdiction in which the counterparty is organised. This is where the primary insolvency proceeding in relation to the counterparty is most likely to take place (see below).[231]

The enforcement of collateral. The rules on the enforcement of security interests are generally very complex. Security interests can be enforced in different ways depending on the jurisdiction, the asset, and the security device used: (a) the security taker will take control of the asset; (b) the security taker will sell the asset; (c) someone other than the security taker will take control of the asset and make a payment to the security taker; (d) someone other than the security taker will sell the asset and make a payment to the security taker.

One of the main questions is to what extent the governing law allows the collateral-taker to dispose the collateral assets without the intervention of the court.

The main method of enforcing security interests is the sale of the collateral assets and the application of the proceeds in discharge or reduction of the secured obligations. Whether this can be done by the collateral-taker or must be done by a third party (such as a government authority or an insolvency or bankruptcy administrator), depends on the asset, the security device, and the governing law. For example, in some cases the collateral-taker may agree with the collateral-giver that the collateral-taker may sell the collateral in the event of default; it is also possible that the collateral will by law be administered and eventually sold by an administrator, administrative receiver, a public authority, or a similar third party. The collateral-taker will not always become the owner of the collateral or be entitled to take the asset in his possession or sell it himself.[232]

For example, under German law, security in real property is typically enforced by auctioning off the property. The creditor is being paid out of the auction proceeds. Security in movable property is enforced either by auction or a free sale under German law.

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[230] ISDA, Guidelines for Collateral Practitioners (1996) pp 14–15. Title transfer is not a widely used method of collateralisation in the US.

[231] *Ibid*, p 18.

[232] See, for example, Burns T, Structured Finance and Football Clubs: an Interim Assessment of the Use of Securitisation, Entertainment and Sports L J, December 2006. The author discusses the effect of the following provisions: section 10(2)(b) of the Insolvency Act 1986 (veto right vested in holders of a floating charge under previous law); section 72A of the Enterprise Act (floating charge holder prohibited from appointing an administrative receiver); and section 72B of the Enterprise Act (the "Capital Market" exception).

English law typically allows the collateral-taker to dispose the collateral assets without the intervention of the court if demand for payment is made before enforcement, and provided that the best price reasonably obtainable is obtained in the market when the assets are sold. There may be restrictions applicable, for example, to real estate mortgages and company failure.[233]

In the US, liquidation of collateral and the application of proceeds can occur without court approval with respect to certain corporate counterparties and banks.[234] US subprime mortgages also provide an example of enforcement costs. Foreclosure is time-consuming and expensive, taking 18 months on average and costing an estimated 20%-25% of the loan balance.[235]

Governing law. Many collateral agreements have a cross-border element in financial transactions because of the location of the assets or the counterparty.

Questions of governing law can be particularly complicated in this context. The applicable choice of law rules may provide that the laws of different jurisdictions apply to different aspects of the collateral arrangement. The enforceability of collateral can depend on legal aspects that belong to contract law, company law, legal rules on property rights (Sachenrecht), insolvency law, or other areas of law, each with its own choice of law rules. In addition, the governing law may depend on where the collateral assets are deemed to be located under the choice of law rules of the forum: some aspects of the transaction are governed by the law of that place (lex situs).[236] This question can be particularly complicated where collateral assets are held by a depository.[237] Further complications are caused by the fact that the choice of law rules of different jurisdictions may vary.[238]

For example, a collateral arrangement is not enforceable, unless (a) the collateral contract is valid and binding under the governing law of the contract and (b) the arrangement is enforceable under the applicable property and insolvency laws.

A retention of title clause is thus valid and enforceable in the insolvency of the debtor if it is valid and enforceable: (a) as a contract term under the law applicable to the contract; (b) as a collateral transaction under lex situs; and (c) under the applicable insolvency law.[239]

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[233] See section 103 of the Law of Property Act 1925 and section 11(3) of the Insolvency Act 1986.

[234] ISDA, Guidelines for Collateral Practitioners (1996) p 15.

[235] Buttonwood, It's a Wonderful Mess, The Economist, October 2007. The article cites Mason J, Mortgage Loan Modification: Promises and Pitfalls.

[236] For English law, see Macmillan Ltd v Bishopsgate Investment Trust Plc (No. 3) [1996] 1 WLR 387.

[237] ISDA, Guidelines for Collateral Practitioners (1996) p 30: "A single security may, for example, be deemed to be located where the issuer of the security has its head office or, if the security is registered, where the relevant register is kept or, if in physical form, where the physical securities are located or, if held through a chain of intermediaries, where the intermediary closest to the collateral giver or taker is located."

[238] For a summary of choice of law rules applied by English courts, see Elias RO, Legal Aspects of Swaps and Collateral, JIFM 3(6) (2001) p 247 (referring to Dicey and Morris).

[239] See also recital 21 of Directive 2000/3.

Another example is a New York bank and a French corporation entering into a collateral agreement where the collateral consists of UK gilts held in London. New York law will govern the enforceability of close-out netting and other bankruptcy or insolvency proceedings in relation to the bank. French company law will regulate the same things with regard to the French corporation. English law will govern the perfection requirements that apply in relation to the securities (lex situs).[240]

Community law. There is only piecemeal harmonisation of questions relating to collateral. The Member States still have plenty of discretion. On the other hand, there are some common choice of law rules and some common substantive rules.

Approximation of choice of law rules applicable to collateral. The choice of law rules that designate the law that governs the enforceability of financial collateral against third parties have not been subject to general harmonisation in Community law.

All Member States recognise the *lex rei sitae* rule, according to which the applicable law for determining whether a financial collateral arrangement is properly perfected and therefore good against third parties is the law of the country where the financial collateral is located.

There is a similar rule, for example, in Swiss private international law (IPRG/PIL):[241] (a) The pledgor and pledgee of receivables are basically free to elect the law that governs the grant of the security interest in receivables, because this is a contractual matter.[242] (b) However, this choice will not be binding on the debtor[243] and bona fide third parties such as third party creditors.[244] The law governing the receivables will apply as between the parties of the pledge and the debtor.[245] The law of the jurisdiction where the pledgee is resident will govern the pledge of receivables with regard to bona fide third parties.[246]

The Collateral Directive (sections 9.6.3 and 9.6.5) recognises the lex rei sitae rule and determines the location of *book entry securities* provided as financial collateral and held through one or more intermediaries. In addition, the Directive broadens the scope of that law:[247] "If the collateral taker has a valid and effective collateral arrangement according to the governing law of the country in which the relevant *account* is maintained, then the validity against any competing title or interest and the enforceability of the collateral should be governed solely by the law of that country, thus preventing legal uncertainty as a result of other unforeseen legislation."[248]

[240] Elias RO, Legal Aspects of Swaps and Collateral, JIFM 3(6) (2001) p 242.
[241] Bundesgesetz über das Internationale Privatrecht (IPRG, Swiss Federal Act on Private International Law, PIL).
[242] Art. 105, 116 and 145 PIL.
[243] Art. 105(3) PIL.
[244] Art. 105(1) PIL.
[245] Art. 105(3) PIL.
[246] Art. 105(1) PIL.
[247] Article 9 of Directive 2002/47/EC (Collateral Directive).
[248] Recital 8 of Directive 2002/47/EC (Collateral Directive).

The Late Payment Directive provides for an exception to the lex rei sitae rule. According to its preamble, it is "desirable to ensure that creditors are in a position to exercise a *retention of title* on a non-discriminatory basis throughout the Community, if the retention of title clause is valid under the applicable national provisions designated by private international law."[249] The main rule is that a retention of title clause in a sales contract will be recognised in a Member State provided that it is valid as a contract clause under the governing law of the *contract*.[250]

Approximation of substantive laws. Different jurisdictions have widely different legal systems to govern secured credit. This can cause legal friction in commerce. Legal friction resulting from inconsistent legal regimes is of three types. First, there is substantial uncertainty as to the law or laws that will govern various aspects of a secured cross-border transaction. Second, the substantive law differs from jurisdiction to jurisdiction. Third, even within a particular jurisdiction, the rules differ depending on the type of the security device utilized.[251] This is likely to add to costs and increase risk in cross-border transactions.

Generally, there is relatively little harmonisation of laws in this area. Some mostly unsuccessful attempts have been made over the years.

Professor Ulrich Drobnig of the Max Planck Institute for Foreign and Private International Law[252] has catalogued prior attempts to achieve some degree of international uniformity with respect to security interests. They include: (1) a uniform conditional sales act enacted by three Scandinavian countries (Norway, Sweden, and Denmark) during 1915–1917; (2) the UNIDROIT draft provisions of 1939 and 1951 concerning the impact of reservation of title in the sale of certain goods; (3) provisions in the draft European Economic Community Bankruptcy Convention of 1970 regarding the effect in bankruptcy of reservation of title in the sale of goods; and (4) model reservation of title clauses contained in several "General Conditions" elaborated by the United Nations Economic Commission for Europe; and proposals for the harmonization of secured credit law submitted to the Council of Europe by UNIDROIT in 1968 and the Service de recherches juridiques comparatives of the Centre National Recherche Scientifique of Paris in 1972. In addition, (5) the European Bank for Reconstruction and Development (EBRD) has drafted and proposed for adoption a model act governing secured transactions. The EBRD Model Act is compatible with the structure of the secured transactions system created by UCC Article 9 in the US and deviates from many traditional European norms. (6) The World Bank and other organizations have actively pushed for modernization of the secured credit laws of many countries.[253]

In 2001, the UN Convention on the Assignment of Receivables in International Trade was adopted.[254] The Convention has not yet entered into force. UNIDROIT has adopted several conventions relating to security or quasi-security: the

[249] Recital 21 of Directive 2000/35/EC (Late Payment Directive).
[250] Article 4(1) of Directive 2000/35/EC.
[251] Cohen NB, Internationalizing the Law of Secured Credit: Perspectives from the U.S. Experience, U Penn J Int Econ L 20 Fall (1999) pp 423–424.
[252] Max-Planck-Institut für ausländisches und internationales Privatrecht, Hamburg.
[253] Cohen NB, *op cit*, pp 436–437.
[254] See Kuhn H, Zur Neuordnung der grenzüberschreitenden Forderungsabtretung im Einheitlichen UN-Abtretungsrecht, SZW/RSDA 3/2002 pp 129–150.

UNIDROIT Convention on International Financial Leasing (Ottawa, 1988); the UNIDROIT Convention on International Factoring (Ottawa, 1988); the Convention on International Interests in Mobile Equipment (Cape Town, 2001); the Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment (Cape Town, 2001);[255] and the Luxembourg Protocol to the Convention on International Interests in Mobile Equipment on Matters specific to Railway Rolling Stock (Luxembourg, 2007).

Governing law and approximation of laws in insolvency cases. The enforcement of security interests in the insolvency of the debtor depends on the governing law.

International insolvency typically gives rise to difficult questions of governing law. Laws address these questions in two ways. First, there are rules on classification. Insolvency raises questions that can belong to many different areas of law. It is therefore necessary to classify each cause of action as one of a certain area of law (such as insolvency law or company law). Second, there can be special rules on insolvency depending on the area of law (company law, contract law, tort law, and so forth).[256]

In *Gourdain v Nadler*,[257] the ECJ said that questions which "derive directly from the bankruptcy or winding-up" and are "closely connected" with such proceedings are excluded from the scope of the 1980 Rome Convention.[258] They are therefore governed by "the law relating to bankruptcy and winding-up" for the purposes of the Rome Convention[259] and the Rome I Regulation that replaces it.[260]

The judgment of the ECJ in Gourdain v Nadler influenced the Regulation on insolvency proceedings. In the Member States of the EU (apart from Denmark[261]), the law governing insolvency proceedings is determined by that Regulation, provided that the centre of the debtor's main interests is located in the Community. The questions classified as questions of insolvency proceedings contain not only the conditions for the opening, conduct and closure of the insolvency proceedings but also questions "deriving directly from the insolvency proceedings and which are closely linked with them".[262]

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[255] See Schmalenbach D, Sester P, Internationale Sicherungsrechte an Flugzeugen auf Basis der Kapstadt-Konvention: Umsetzungsprobleme und praktische Vorwirkungen, Wertpapier-Mitteilungen 7/2005 pp 301–311.

[256] See Trunk A, Grenzüberschreitende Insolvenz von Gesellschaften im Verhältnis EG-Schweiz: Folgerungen aus Centros, Überseering und Inspire Art, SZIER/RSDIE 4/2004 pp 531–557 at p 533.

[257] Case 133/78 Gourdain v Nadler [1979] ECR 733.

[258] Paragraph 4.

[259] Paragraph 5.

[260] Article 28 of Regulation 593/2008 (Rome I): "This Regulation shall apply to contracts concluded after 17 December 2009." See also Articles 24 and 25.

[261] See recital 33 of Regulation 1346/2000 (Regulation on insolvency proceedings).

[262] Article 25(1) of Regulation 1346/2000 (insolvency proceedings). See Trunk A, Grenzüberschreitende Insolvenz von Gesellschaften im Verhältnis EG-Schweiz: Folgerungen aus Centros, Überseering und Inspire Art, SZIER/RSDIE 4/2004 pp 531–557 at p 539.

The Regulation contains rules on international jurisdiction and choice of law. They are based on two main principles: (1) the universality principle; and (2) the lex loci concursus principle. (1) Provisions on international jurisdiction enable the main insolvency proceedings to be opened in the Member State where the debtor has the centre of his main interests.[263] Forum shopping will therefore require moving those interests.[264] Secondary proceedings may be opened in the Member State where the debtor has an establishment. The effects of secondary proceedings are limited to the assets located in that State.[265] (2) The law that governs the proceedings is the law of the Member State of the opening of the proceedings (lex concursus). This choice of law rule is valid both for the main proceedings[266] and for local proceedings.[267] The lex concursus applies to what can be classified as typical issues of insolvency law. It determines all the effects of the insolvency proceedings, both procedural and substantive, on the persons and legal relations concerned. It governs all the conditions for the opening, conduct and closure of the insolvency proceedings.[268]

The provisions of the Regulation can sometimes have a surprising effect. For example, they do not distinguish between the effects of insolvency proceedings on current contracts to which the debtor is a party and the rights of the other party to repudiate contracts due to the debtor's anticipated breach of contract. Whereas the former is a traditional issue of insolvency law (and governed by the lex concursus), the latter is a traditional question of contract law (which should usually be governed by the law applicable to the contract but may still be governed by the lex concursus).

However, both main principles have been qualified. There are a number of exceptions to the main principle of lex concursus. They relate in particular to rights in rem,[269] set-off,[270] and reservation of title.[271] The exceptions to the application of the lex concursus apply generally in favour of the laws of other Member States. In the absence of sufficient connection with the Member States, the forum is - according to the Virgos/Schmit Report[272] - free to follow its own national conflict rules.

Because of the exceptions, the main choice of law rules do not designate the rules that apply to certain forms of collateral.

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[263] Article 3(1) of Regulation 1346/2000 (insolvency proceedings).
[264] See, for example, Nückles B, Nach Frankreich des Konkurses wegen, FAZ, 20 January 2008 p 11.
[265] Article 3(2) of Regulation 1346/2000 (insolvency proceedings).
[266] Article 4 of Regulation 1346/2000 (insolvency proceedings).
[267] Article 28 of Regulation 1346/2000 (insolvency proceedings).
[268] Article 4(2) and recital 23 of Regulation 1346/2000 (insolvency proceedings).
[269] Article 5 of Regulation 1346/2000 (insolvency proceedings).
[270] Article 6 of Regulation 1346/2000 (insolvency proceedings).
[271] Article 7 of Regulation 1346/2000 (insolvency proceedings).
[272] Report on the Convention on Insolvency Proceedings by Miguel Virgos (who contributed the background and general introduction and the comments on Articles 1 to 26, 43 to 46, territorial application and Article 48) and Etienne Schmit (who contributed the comments on Article 3(2) to 3(4) and Articles 27 to 42, 47 and 49 to 55).

First, there are specific provisions on set-off. The Regulation provides that the opening of insolvency proceedings "shall not affect the right of creditors to demand the set-off of their claims against the claims of the debtor, where such a set-off is permitted by the law applicable to the insolvent debtor's claim".[273] The Regulation thus seeks to ensure that "set-off will acquire a kind of guarantee function based on legal provisions on which the creditor concerned can rely at the time when the claim arises".[274]

Second, there are specific provisions on the effect of insolvency proceedings on the rights and obligations of the parties to a payment or settlement system or to a financial market. Such rights and obligations will be governed solely by the law of the Member State applicable to that system or market.[275] This applies, for example, to the position-closing agreements and netting agreements to be found in such systems as well as to the sale of securities and to the guarantees provided for such transactions.

Third, lex concursus does not cover creditors' or third parties' rights in rem "in respect of tangible or intangible, moveable or immoveable assets - both specific assets and collections of indefinite assets as a whole which change from time to time - belonging to the debtor which are situated within the territory of another Member State at the time of the opening of proceedings".[276] The basis, validity and extent of such a right in rem should therefore normally be determined according to the lex situs and not be affected by the opening of insolvency proceedings.[277] Rights in rem have been defined in the Regulation and include, for example, a "lien" or a "mortgage".[278]

Fourth, there are specific provisions on reservation of title. The opening of insolvency proceedings against the purchaser of an asset "shall not affect the seller's rights based on a reservation of title where at the time of the opening of proceedings the asset is situated within the territory of a Member State other than the State of opening of proceedings".[279] According to a similar rule, the opening of insolvency proceedings against the seller of an asset will not prevent the purchaser from acquiring title.[280]

Fifth, there are specific provisions on contracts relating to immovable property. The effects of insolvency proceedings on a contract conferring the right to acquire or make use of immoveable property are governed solely by the law of the Mem-

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[273] Article 6(1) of Regulation 1346/2000 (insolvency proceedings).
[274] Recital 26 of Regulation 1346/2000 (insolvency proceedings).
[275] Article 9(1) of Regulation 1346/2000 (insolvency proceedings). See also recital 27: "… This provision is intended to prevent the possibility of mechanisms for the payment and settlement of transactions provided for in the payment and set-off systems or on the regulated financial markets of the Member States being altered in the case of insolvency of a business partner. Directive 98/26/EC contains special provisions which should take precedence over the general rules in this Regulation."
[276] Article 5(1) of Regulation 1346/2000 (insolvency proceedings).
[277] Recital 25 of Regulation 1346/2000 (insolvency proceedings).
[278] See Article 5(2) of Regulation 1346/2000 (insolvency proceedings).
[279] Article 7(1) of Regulation 1346/2000 (insolvency proceedings).
[280] Article 7(2) of Regulation 1346/2000 (insolvency proceedings).

ber State within the territory of which the immoveable property is situated (lex rei sitae).[281]

Sixth, there are specific provisions on the effect of insolvency proceedings on rights subject to registration. The effect of insolvency proceedings on the rights of the debtor in immoveable property, a ship or an aircraft subject to registration in a public register is determined by the law of the Member State under the authority of which the register is kept.[282]

In addition to the Regulation on insolvency proceedings, harmonisation attempts include in particular rhe UNCITRAL Model Law on Cross-Boarder Insolvency. The UNCITRAL Model Law has been adopted by three Member States of the EU and some other countries.[283]

Collateralisation, Collateral Management, Rehypothecation

Before discussing the various forms of collateral, it is useful to mention the concepts of collateralisation, collateral management, and rehypothecation as they can help to explain part of the behaviour of firms in this area.

The value of collateral in circulation worldwide amounts to more than $1,000bn daily.[284] Since the mid-1990s, the growing complexity of deals and implicit hidden risks has meant financial institutions have been demanding collateral assets to cover their exposure. The process through which institutions receive and deliver assets – cash, bonds or equities – to cover their exposure to financial risk is called collateralisation. The process of collateralisation is the first step to effective collateral management. Financial institutions with effective collateral management can make profits by treating the assets they hold as if they were their own for trading purposes.

Collateral management is not limited to financial institutions. The debtor will have to manage collateral. Generally, collateral management can be used by non-financial creditors depending on the nature of their business.

Selection of collateral. Where the firm is the creditor, selecting appropriate collateral will potentially give the firm better protection against counterparty risk and may perhaps reduce its capital costs. Poorly selected collateral can contribute to unacceptable levels of price risk, liquidity risk, operational risk, and legal uncertainty.[285]

For collateral to be of value to the collateral-taker, the taker should accept collateral only provided that (a) there is a high degree of legal certainty concerning

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[281] Article 8 of Regulation 1346/2000 (insolvency proceedings).

[282] Article 11 of Regulation 1346/2000 (insolvency proceedings).

[283] Colombia (2006), Eritrea, Japan (2000), Mexico (2000), New Zealand (2006), Poland (2003), Romania (2003), Montenegro (2002), Serbia (2004); South Africa (2000), Great Britain (2006), British Virgin Islands, overseas territory of the United Kingdom of Great Britain and Northern Ireland (2005), and United States of America (2005).

[284] Cane A, The smarter way to manage collateral, Financial Times, 24 November 2005.

[285] ISDA, Guidelines for Collateral Practitioners (1996) p 19.

rights to the collateral and (b) the collateral can be enforced in the event of default or insolvency.[286]

Haircuts are typically based on the quality of the assets being used as collateral, and not on the credit risk of the collateral-giver. For example, haircut rates for securities are designed to cover loss of value due to the worst expected price move over the holding period, as well as costs likely to be incurred in liquidating the assets.[287] Haircuts have been addressed by the Basel II framework.[288]

In normal market conditions, it is assumed that a well diversified collateral portfolio is better protected against general market downturns and gives the collateral holder the confidence to accept a wider range of collateral quality and smaller haircuts.[289] When market conditions are not normal, counterparties tend to require bigger haircuts and accept assets only at a greater discount.

Re-use of collateral, rehypothecation. The ability to re-use collateral is commercially valuable. The same institutions which receive collateral for their exposures under certain transactions are required to deliver collateral to secure their own obligations under other contracts. Therefore, there are strong commercial pressures to use as collateral the same collateral that was received. If the parties in all transactions are the same, the result can be achieved by the netting provisions of the agreement. If they differ, the same result may be achieved by rehypothecation.[290]

Re-use or rehypothecation means the use by the security taker of collateral for its own purposes, such as the onward provision of collateral to a third party.

Rehypothecation is constrained by the law. (a) According to the MiFID, an investment firm shall, when holding financial instruments belonging to clients, prevent the use of a client's instruments on own account except with the client's express consent.[291] When holding funds belonging to clients, it must make adequate arrangements to prevent the use of client funds for its own account (unless it is a credit institution).[292] The restrictions apply even to securities lending (see below). (b) The legal constraints are not limited to investment firms.

Under German law, rehypothecation is permitted with the consent of the owner of the security.[293] There are special provisions for banks.[294] Under English law, the ability to rehypothecate collateral delivered by way of security interest (not outright transfer) is narrowly

[286] *Ibid*, p 27.
[287] *Ibid*, p 21.
[288] See, for example, paragraph 130 of the Basel II Accord.
[289] ISDA, Guidelines for Collateral Practitioners (1996) p 26.
[290] Elias RO, Legal Aspects of Swaps and Collateral, JIFM 3(6) (2001), pp 232–249.
[291] Article 13(7) of Directive 2004/39/EC (MiFID). See also Articles 16(2), 17 and 19 of Directive 2006/73/EC.
[292] Article 13(8) of Directive 2004/39/EC (MiFID).
[293] § 185 BGB.
[294] § 12 DepotG (Gesetz über die Verwahrung und Anschaffung von Wertpapieren, Depotgesetz).

restricted by equitable rules,[295] the rule against clogs in the equity of redemption, and the rule against collateral benefits.[296]

Rehypothecation has partly been made possible by the Collateral Directive which provides:

"If and to the extent that the terms of a security financial collateral arrangement so provide, Member States shall ensure that the collateral taker is entitled to exercise a right of use in relation to financial collateral provided under the security financial collateral arrangement."[297] "Where a collateral taker exercises a right of use, he thereby incurs an obligation to transfer equivalent collateral to replace the original financial collateral at the latest on the due date for the performance of the relevant financial obligations covered by the security financial collateral arrangement. – Alternatively, the collateral taker shall, on the due date for the performance of the relevant financial obligations, either transfer equivalent collateral, or, if and to the extent that the terms of a security financial collateral arrangement so provide, set off the value of the equivalent collateral against or apply it in discharge of the relevant financial obligations."[298]

Collateral management. Collateral management is an essential part of a financial institution's framework for risk and regulatory compliance. Different agreement types (such as collateralised lending as well as traditional OTC derivatives and repo collateralisation) and different asset classes may need different processes of collateral management. For example, while collateral management may be relatively uncomplicated in a relationship between two parties under one agreement for one line of business, it may be more complicated in the OTC derivatives market.[299]

Custodial arrangement and the monitoring system. At the inception of a collateral management programme, the firm needs to choose a custodial arrangement and the system of monitoring collateral positions and tracking collateral movements.

The firm may have its own custody service (in particular, where the firm is a financial institution).

A counterparty may nevertheless require that its collateral be held by a third party agent. This can protect it against the insolvency of the collateral-taker and ensure the security of the collateral. The use of a third party custodian generates additional credit considerations since there is the possibility of the custodian's insolvency or delay in delivery upon default of one of the counterparties. In order to assess legal risk, the firm should also ascertain the jurisdiction of incorporation of the third party custodian and the jurisdiction in which its principal custodian activities are conducted.[300]

[295] Spurgeon v Collier (1758) 28 All ER 605; De Beers Consolidated Mines v British South Africa Company [1912] AC 52.
[296] See Elias RO, *op cit*, pp 232–249 at 239–240.
[297] Article 5(1) of Directive 2002/47/EC (Collateral Directive).
[298] Article 5(2) of Directive 2002/47/EC (Collateral Directive).
[299] ISDA, Guidelines for Collateral Practitioners (1996) p 34.
[300] *Ibid*, pp 34–35.

The Repo Mechanism, Securities Lending

Collateral arrangements in the financial markets may be based either on the creation of a security interest or on the transfer of title to the relevant collateral.[301] Repos (sale and repurchase arrangements) and other forms of title transfer are the dominant forms of transactions in relation to investment securities.[302] There are a number of reasons for using the repo form rather than more traditional forms of security.[303]

Liquidity. A key feature in a repo transaction is liquidity. Liquidity (i.e. the ability to trade swiftly in assets) is one of the essential features of the financial markets. Security over investment securities is particularly attractive due to their liquidity and ease of valuation.

Parties to security arrangements will try to maintain this liquidity. They can achieve it by managing a portfolio of assets rather than having "frozen" securities. Liquidity will be increased if: either the secured party will be able to deal with the assets as its own (perhaps by using the securities as collateral in further transactions with third parties, or by being allowed to redeliver securities of the same number and type); or the party granting the security will be able to continue to deal with them and have a right of substitution; or both.[304]

In addition, the parties may increase liquidity by using master agreements under which a number of transactions are secured or supported by the same collateral arrangement and pool of collateral assets. The collateral arrangement is then designed to secure or support the net exposure of a party. In some circumstances, this net exposure varies over time, so that at different times a party may be a net debtor or a net creditor. Therefore, the collateral arrangements may be bilateral, in that at any given time during the term of the master agreement either party may be required to provide collateral (in the form of security or by transfer of title) to the other party.[305]

Repos. Now, repos (sale and repurchase arrangements) are a form of title finance whereby a seller raises capital on an asset by selling it to a buyer. The buyer will pay the purchase price. The agreement requires the seller to repurchase the asset, or equivalent assets, at a future date or possibly upon demand. The seller will pay a repurchase price equal to the purchase price and a financing charge.

Repos are normally used where the assets are investment securities (instruments that a borrower uses to acknowledge debt) or investments such as shares, debentures, stock, bonds, bills of exchange and other forms of tradeable debt.[306]

Under a repo contract, the "chargee" (buyer) is the registered owner of the investment securities. It thus has the power to deal with or dispose of them as it wishes, and will be able to redeliver equivalent securities under the terms of the repo agreement. Meanwhile the "charger" (seller) will be given the right to termi-

[301] The Law Commission, Registration of Security Interests, paragraph 6.40.
[302] *Ibid*, paragraph 6.45.
[303] *Ibid,* paragraph 6.40.
[304] *Ibid*, paragraph 6.41.
[305] *Ibid*, paragraph 6.39.
[306] *Ibid*, paragraph 6.38.

nate the transaction early, thereby accelerating its right to the delivery of equivalent securities (provided that it is prepared to replace the securities with other acceptable securities). [307]

Securities lending. Securities lending works in a similar way (for the use of securities lending in takeovers, see Volume III).[308] Like other repo transactions, securities lending consists of two sales and is usually supported by a master agreement. In securities lending, a "lender" transfers securities to a "borrower" with an agreement to replace the securities in due course on a specified future date. A typical agreement would require the "borrower" to pay a fee to the lender and also provide collateral in the form of cash or other securities. The collateral is transferred through a title transfer arrangement, which enables the collateral to be further used. It is usual to require the value of the collateral to be adjusted to the market value of the main securities during the term of the agreement. If this is a two-way collateral transfer and either party defaults, the other party can set off the obligation against the assets that are held.[309]

Securities lending is a product typically used by professional investors and investment firms.[310] It provides liquidity to the equity, bond and money markets. (a) For example, securities lending gives shareholders an opportunity to "lend" shares to a "borrower" and to increase return. The borrower will have to return the same amount and kind of shares to the lender after a certain period of time or on demand, but the lender receives a premium. (b) The securities borrower can profit from a decrease in share price. Securities lending enables investors to "short" shares they believe are over-valued. The borrower of shares will have to return the same amount and kind of shares rather than the same shares. The borrower can thus sell the shares, invest the funds, and buy similar shares before returning then to the lender. (c) The borrower of shares can also profit from the rights attaching to the shares. The borrower of shares can become a shareholder who is entitled to the economic benefits of owning the shares and has a right to vote at the general meeting (see Volume III).

The opportunities provided by securities lending can be illustrated by the case of Northern Rock, the Newcastle-based lender, and the Volkswagen case.

In February 2007, the shares of Northern Rock fetched £12.58. On 21 September 2007, the shares changed hands for 195p. Northern Rock's share-price collapsed since it became known that Northern Rock had applied to the Bank of England for emergency funding. However, hedge funds and London City investment banks had been betting heavily for months that Northern Rock was facing serious funding problems and its shares were on

[307] *Ibid*, paragraph 6.44.

[308] Generally, see Faulkner MC, An Introduction to Securities Lending. Spitalfields Advisors, London (2004).

[309] The Law Commission, Registration of Security Interests, paragraph 6.46.

[310] See Article 5(1), Article 4(1)(2), Section C of Annex I, recital 26, and Article 28(3)(b) of Directive 39/2004 (MiFID). Any person conducting stock borrowing or lending business in the United Kingdom would generally be carrying on a regulated activity according to the terms of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, and would therefore have to be authorised and supervised under that Act. See Faulkner MC, *op cit*, p 11.

their way down. Hedge funds had borrowed Northern Rock's shares from long-term investors for a premium and sold them. Later, they bought back the same number of shares and returned them to the securities lender on the agreed date. Because the price had fallen, the difference between the price at which the hedge funds sold the shares and bought them back was profit.

Investors who sold Volkswagen AG's shares short in 2008 incurred losses after Porsche announced plans to raise its stake in Volkswagen to 75% and short-sellers had to buy from a shrinking pool of stock. For a day, Volkswagen became the largest company in the world by market capitalisation (see Volume III).

Most securities loans are collateralised, either with other securities or with cash deposits. Where lenders take securities as collateral, they are paid a fee by the borrower. By contrast, where they are given cash as collateral, they pay the borrower interest but at a rate (the rebate rate) that is lower than market rates, so that they can reinvest the cash and make a return.[311] Many of the large securities lending losses have been associated with reinvestment of cash collateral.[312]

Retention of Title

Many firms supply physical goods, and most suppliers employ retention of title clauses in their conditions of sale especially in continental Europe.[313] Retention of title is a technique linked to property law. It means that the seller transfers ownership under the suspensive condition of payment of the price. The transfer of ownership takes place at the moment of payment of the price.[314]

Benefits. For a trade creditor such as a supplier, a retention of title clause may be attractive for many reasons: (a) Retaining title involves a simple standard contractual term not requiring general disclosure. (b) Requests for retention of title are not perceived by customers as requests for security. In addition, both business customers and consumers are used to retention of title clauses.[315] (c) When approached for security, the customer might refuse and look elsewhere for supply.

[311] Faulkner MC, An Introduction to Securities Lending. Spitalfields Advisors, London (2004) p 9.

[312] *Ibid*, p 11.

[313] Milo JM, Retention of Title in European Business Transactions, Washburn L J 43 (2004) p 131: "Retention of title has its historic roots in Roman law, but having been rejuvenated, it entered into positive 'European' law in nineteenth century Germany, fulfilling legal practice's need for securing purchase prices." For German law, see § 449 BGB (Eigentumsvorbehalt) and § 323 BGB (Rücktritt). Retention of title clauses were rare in the UK before the Bonalpa decision. Aluminium Industrie Vaassen BV v Bonalpa Aluminium Ltd [1976] 1 WLR 676. See Finch V, Corporate Insolvency Law. Perspectives and Principles. Cam U P, Cambridge (2002) pp 110–111; Hicks A, Retention of Title – Latest Developments, JBL 1992 pp 398–415. The statutory basis for title retention is now section 19 of the Sale of Goods Act 1979. For the US, see Article 9 of the UCC.

[314] Milo JM, *ibid*, p 121.

[315] For English law, see the Consumer Credit Act 1974. The Consumer Credit Act 1974 regulates consumer credit and consumer hire agreements for amounts up to £25,000. For German law, see §§ 502 and 449 BGB.

The customer might fear that offering security signals a lack of creditworthiness or financial instability to others in the market. Requests for security might also be seen as hostile actions evidencing a lack of goodwill and trust.[316]

The value to the creditor/owner of retention of title is that on the insolvency of the debtor the assets at issue do not belong to the debtor, cannot be claimed by the insolvency practitioner, and are not available for distribution among the creditors. The creditors of an insolvent company cannot make any claim against goods that are owned by third parties. Powerful trade suppliers of goods are thus well placed to use their bargaining power to avoid the severe consequences of being an unsecured creditor in the insolvency of a customer.[317]

Terms. The effectiveness of the retention of title clause depends on its contents and the governing law. There is no effective retention of title unless three things apply: the retention of title clause is valid as a contract term under the law that governs contractual matters; the retention of title is enforceable under the law that governs property law matters; and the retention of title is enforceable under the law that governs insolvency matters.[318] According to Member States' national laws, retention of title clauses are upheld in insolvency.[319]

The transfer of ownership can be conditional upon the payment of the price of the goods ("einfacher Eigentumsvorbehalt")[320] or, where permitted by the governing law, upon the payment of all other sums due to the seller ("all sums" clauses, "verlängerter Eigentumsvorbehalt"). All sums clauses can be necessary, for example, where the goods sold will be consumed in the manufacturing of other goods.[321] The use of all sums clauses can be subject to restrictions depending on the governing law.

German law allows clauses which secure more than just the purchase price. They can be used in pre-formulated contract terms between firms but not necessarily in relation to consumers.[322] They may also be regarded as unreasonable and unenforceable in the circumstances.[323] English law has permitted the possibility of all-sums retention of title clauses since 1990.[324]

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316 Finch V, Corporate Insolvency Law. Perspectives and Principles. Cam U P, Cambridge (2002) pp 110–111.

317 *Ibid*, pp 110–111.

318 See Milo JM, *op cit*, p 131.

319 With the exception of Luxembourg. See Milo JM, Retention of Title in European Business Transactions, Washburn L J 43 (2004) p 132.

320 § 449 BGB.

321 See § 950 BGB (Verarbeitung).

322 § 307(2) BGB.

323 § 138 BGB; § 307(1) BGB.

324 For English law, see Armour v Thyssen Edelstahlwerke AG [1990] 3 WLR 810; Finch V, *op cit*, pp 110–111. The Law Commission, Registration of Security Interests, paragraph 6.18: "… the supplier may retain title to the goods supplied not only until the particular goods have been paid for but also until other obligations, whether under further sale contracts or otherwise, have been discharged. It has been held by the House of Lords in a Scottish case that such an 'all monies' clause does not convert the transaction into a charge and thus the clause need not be registered in order to be valid."

The parties may also limit the use of the goods and agree that the occurrence of certain events will enable the seller to repossess the goods and realise their value.[325] The security provided by clauses under which the sale is a mere conditional sale is less effective compared with the security provided by retention of title clauses.[326]

Depending on the governing law, particular restrictions on the effectiveness of retention of title clauses can apply where: the objects sold under the retention of title clause are meant to be resold or consumed by the buyer in the ordinary course of business.[327]

Community law. The purpose of the Late Payment Directive is to ensure that "creditors are in a position to exercise a retention of title on a non-discriminatory basis throughout the Community, if the retention of title clause is valid under the applicable national provisions designated by private international law".[328] This – and the general duty of Member States to comply with their obligations under the EC Treaty[329] - will influence the interpretation of the provisions that govern the validity and enforceability of retention of title clauses under Member States' laws.

The Late Payment Directive requires Member States to recognise retention of title clauses in contracts for the sale of goods, "if a retention of title clause has been *expressly* agreed between the buyer and the seller *before the delivery* of the goods".[330]

However, the Late Payment Directive does not harmonise Member States' retention of title provisions completely. For example, the laws of a Member State may provide that, in order to be enforceable against creditors of the purchaser, a retention of title clause must be confirmed on individual invoices for successive supplies bearing a date that is prior to any attachment procedure.

The Late Payment Directive is silent on the scope of retention of title clauses (the obligations secured by the clause, the assets covered by the retention of title, the permitted uses of goods covered by the retention of title clause).

The Directive does not expressly state whether the parties should have agreed on: mere retention of title; the scope of the retention of title (obligations secured

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[325] The Law Commission, Registration of Security Interests, paragraph 6.12.

[326] *Ibid*, paragraph 6.13: "Under the Sale of Goods Act 1979, a buyer who has been given possession of the goods that are still owned by the seller, and who resells them to an innocent party, can in certain circumstances pass good title to the innocent buyer. Thus the 'security' of a conditional sale can be destroyed if the goods are resold. A major reason for the development of the hire-purchase agreement was to avoid the risk that the creditor would lose title to an innocent buyer: selling goods subject to a hire-purchase agreement will not pass title (unless, in some circumstances, the hire-purchase relates to a motor vehicle)."

[327] Milo JM, *op cit*, p 128.

[328] Recital 21 of Directive 2000/35/EC (Late Payment Directive); see also Article 4(1).

[329] Article 10 of the EC Treaty.

[330] Article 4(1) of Directive 2000/35/EC (Late Payment Directive). Further requirements as to form may apply under other directives in instalment sales and consumer sales. See Directive 2008/48/EC (consumer credit) and Article 5 of Directive 97/7/EC (distance contracts).

by the clause, assets covered by the clause, the permitted use of assets covered by the clause); retention of title in such way that it can be enforced between the parties to the contract under the law that governs the contract; or retention of title in such a way that it can be enforced both between the parties to the contract and against third parties under the law that governs the contract and the law of the country where the goods are situated (lex rei sitae).

The Late Payment Directive does not state what obligations will be secured by the retention of title clause and to what extent the Member States must enforce the parties' agreement on obligations secured by the clause.

The parties may have agreed that the supplier retains title to the goods supplied not only until the particular goods have been paid for but also until other obligations, whether under further sale contracts or otherwise, have been discharged (all sums).[331]

The parties may also have agreed that the retention of title will secure liabilities other than to the supplier. (c) According to the wording of the Directive, a Member State must recognise the retention of title clause at least to the extent that the parties agreed on a contract term that is valid between the parties. However, the Directive does not set out to what extent the parties may agree on retention of title between themselves, and the Directive is silent on the scope of the retention of title clause in the event that the parties have not agreed on its scope. Clearly, the purpose of the Directive is not to make all retention of title clauses valid. The purpose of the Directive is to shorten excessive payment periods and combat late payment, and the Directive should not go beyond what is necessary to achieve that objective.[332]

Neither does the Late Payment Directive state how the buyer may use the goods. According to the wording and purpose of the Late Payment Directive, a Member State must ensure that an express retention of title clause is recognised even where the goods are supplied on the understanding that the buyer will resell them or use them in its production process (materials, stock-in-trade or inventory), provided that the retention of title clause is valid between the contract parties under the governing law. This must apply at least where the goods are still in the possession of the buyer and have not yet been consumed in its production process.

The Late Payment Directive has not expressly addressed the question how to deal with retention of title clauses where the goods have been resold or consumed in the production process of the buyer. In contract practice, the retention of title clause may: purport to give the supplier the property to products made using the goods supplied[333] or the right to any proceeds of re-sale of the goods;[334] be silent on those situations; or exclude those situations from its scope.

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[331] A decision of the House of Lords has given broad approval to "all monies" clauses retaining title until all sums payable by the buyer have been paid. Armour v Thyssen Edelstahlwerke AG [1991] 2 AC 339.

[332] Recitals 7 and 12 of Directive 2000/35/EC (Late Payment Directive).

[333] The Law Commission, Registration of Security Interests, paragraph 6.19: "… the clause may purport to give the supplier the property to products made using the goods supplied. It has been said in the Court of Appeal that such a provision may in theory be valid and not constitute a registrable charge, though in practice this outcome is unlikely. This is because it would mean that the supplier would be exclusively entitled to the new goods

Transfer of Ownership by Way of Security

The sale of assets and the transfer of ownership typically give the buyer protection against competing claims to the assets in the later insolvency of the seller (provided that the sale was a bona fide sale and not at undervalue). The owner of assets can also grant a security interest in the assets. The security interest can be granted through a pledge (Pfandrecht, engagement) or assignment by way of security (movable goods: Sicherungsübereignung or transfert à titre de sûreté; receivables: Sicherungsabtretung/Sicherungszession or cession à titre de sûreté). A pledge typically requires the delivery of possession, and an assignment by way of security is sometimes chosen in order to circumvent this requirement.

Importance of the governing law. The enforceability of assignments by way of security depends very much on the jurisdiction. (a) In some jurisdictions they are regarded as unenforceable against third parties, in particular because they are regarded as circumvention of pledge rules and recharacterised. (b) In some jurisdictions the nature of assignments by way of security is not clear and it is uncertain whether the assignee can enforce such assignments against third parties. This places the assignee's security position at great risk once the debtor is in default. (c) In jurisdictions such as Germany[335] and Switzerland, assignment by way of security can be enforced even against third parties.

For example, assignment by way of security is the usual way to establish a security interest in accounts receivable in Switzerland. Unlike the pledge that provides for a limited security interest in the accounts receivable, the assignment by way of security provides for a transfer of full ownership in the accounts receivable, limited only by the contractual undertaking of the assignee that the rights inherent in such ownership will not be exercised other than as security for the secured obligations and in accordance with the terms of the underlying security assignment agreement. Full ownership of the accounts receivable is generally preferable from the perspective of an assignee, in that it leaves more flexibility in terms of available foreclosure proceedings, and will de facto usually lead to the earlier completion of foreclosure proceedings. In Switzerland, the sale of existing receivables by way of assignment is bankruptcy-remote, which means that the existing receivables will not fall within the bankruptcy estate of the seller.[336]

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despite the input of labour and possible materials by the buyer and of materials by other suppliers, which is not thought to be a result that the parties would have intended. It will almost invariably be found that the parties cannot have intended that the supplier should be entitled to a greater interest in the goods than would reflect what is owing to it - which constitutes a charge that must be registered if it is to be valid."

[334] *Ibid*, paragraph 6.20: "… the clause may purport to give the supplier the right to any proceeds of re-sale of the goods … A 'proceeds' clause is more likely to be construed as a charge on book debts in that the assumed intention is that the seller will receive or retain only such part of the proceeds as equals what is due to it."

[335] Kittner M, Schuldrecht. Rechtliche Grundlagen – Wirtschaftliche Zusammenhänge. 2. Auflage. Verlag Franz Vahlen, München (2002) Rn 417.

[336] Rayroux F, Kühni B, Switzerland (Lenz & Staehelin), in: Global Legal Group, Securitisation 2006, Chapter 41 pp 297–304.

Even in countries like Germany, assignment by way of security may give rise to a number of legal problems due to the fact that the asset is in the possession of its owner.

The problems include the following: (a) There is the risk of competing assignments by way of security (Doppelübereignung). (b) A supplier may have retained title to goods sold to the buyer/debtor, in which case the creditor will not obtain any title before the title has passed to the buyer/debtor (Eigentumsvorbehalt). (c) Assets located in leased premises may be subject to the landlord's statutory lien (Vermieterpfandrecht), in which case banks usually try to convince the landlord to waive the lien or ensure that the debtor pays the rent. (d) Accessories of real estate may be subject to security interests in real estate. (e) The sale of the asset to a bona fide third party may mean that the security taker will lose title to the asset. (f) The market value of the asset may decrease. (g) The realisation of the asset may be difficult.

In England, the transfer of ownership can be used as a functional equivalent to security, for example, in securities loan transactions.

This has been described as follows: "In practice, the collateral giver transfers full legal title in securities and/or cash to the collateral taker, and grants the collateral taker the right to set off or net, upon the default of the collateral giver, the collateral taker's net exposure to the collateral giver against the value of the collateral transferred. The collateral taker owns the collateral assets, and is subject only to a personal obligation to return equivalent collateral to the collateral giver upon satisfaction of the underlying obligation. The collateral giver, if it performs in full, is only entitled to the return of equivalent securities and/or repayment of the same amount of cash in the same currency as a personal right. Thus, the collateral giver's property right over the collateral assets is transformed into a contractual claim (personal right) against the collateral taker. Although legally the original securities are transferred outright to the collateral taker, the collateral giver retains, from the economic point of view, the benefits and burdens of ownership. In other words, the transaction is 'balance sheet neutral' for the collateral giver, which means that the assets continue to appear in his balance and not in that of the collateral taker."[337]

Recharacterisation and "true sale". Transfer of ownership by way of security typically raises the question of recharacterisation. There is a risk that the transaction will not be regarded as a "true sale" (section 11.5.2).

Approximation of laws. The regulation of assignment by way of security has only to a limited extent been subject to harmonisation.

The use of assignments by way of security is influenced by IFRS in entities that apply IFRS. The entity may continue to recognise an asset (to the extent of its continuing exposure) if the entity has not transferred substantially all the risks and rewards of ownership of the asset and control has not passed to the transferee. An entity must derecognise the asset if it transfers substantially all the risks and rewards of ownership (for example, in an unconditional sale of a financial asset).

The 2001 Convention on International Interests in Mobile Equipment (Cape Town Convention) provides for the assignment of the international interest or an

[337] Elias RO, Legal Aspects of Swaps and Collateral, JIFM 3(6) (2001) p 240.

assignment by way of security without the assignment of the underlying debt.[338] This can be an unknown concept in jurisdictions where a security interest is an accessory to the underlying debt and cannot be separately assigned.

In addition, Chapter 11 (Assignment of Claims) of the PECL also applies to assignment by way of security.[339]

Delivery of Possession by Way of Security

The delivery of possession by way of security (the pledge, das Pfandrecht an beweglichen Sachen) is a robust form of security interest because it allows the collateral-taker to enforce the security interest by selling the collateral assets which are possessed by him. However, the delivery of possession is not possible unless it is physically possible to possess the assets. The delivery of possession is not possible where the assets are intangible.

The delivery of possession by way of security is still relevant for some modern securities collateral arrangements.[340]

Bearer securities may be pledged by deposit. Perfection of security interests in bearer securities such as marketable debt securities can thus require physical delivery of the securities (in the case of bearer instruments) together with their endorsement (in the case of instruments drawn to the order of a person). The perfection of security interests in share certificates requires the delivery of the possession of the share certificates and a signed transfer form.

In the case of cash provided as collateral, there may be delivery to the collateral-taker or its custodian, in effect creating a possessory security interest.[341]

Granting of a Security Interest in Intangible Assets Without Delivery of Possession or Transfer of Ownership

Often the security interest is granted in intangible assets such as receivables (or other rights) without the delivery of possession or transfer of ownership. There is again a difference between existing claims and future claims.

Existing claims. Claims and other rights can be used as security if they are assignable (for assignability, see section 11.4).

For example, under Swiss law, accounts receivable can be pledged to a third party, if they are assignable.[342] There are requirements as to form. A pledge agreement for accounts receivable may have to be in writing in order to be valid,[343] and the pledge of other rights requires, in addition to a written pledge agreement, compliance with requirements as to form which apply to the transfer of those rights.[344] Neither the validity nor the perfection of the

[338] Articles 31–34.
[339] PECL Article 11:101(4).
[340] Elias RO, Legal Aspects of Swaps and Collateral, JIFM 3(6) (2001) p 236.
[341] The Law Commission, Registration of Security Interests, paragraph 6.45.
[342] Art. 899(1) ZGB (Zivilgesetzbuch, the Swiss Civil Code).
[343] Art. 900 (1) ZGB.
[344] Art. 900 (2) ZGB.

pledge is technically dependent on whether the debtor is notified of the pledge.[345] However, a debtor may validly discharge its obligations by payment to the pledgor unless the debtor is notified of the pledge.

Future claims. The granting of security interests in claims that have not yet come into existence (future claims) may not be enforceable against third parties. For example, under Swiss law, the sale of future receivables is not bankruptcy-remote. Future receivables fall within the bankruptcy estate of the seller.

In *England*, a distinction is made between legal interests and equitable interests. In the 1862 decision in *Holroyd v Marshall*,[346] the House of Lords addressed the problem that companies needed more capital but traditional security in the form of legal or equitable charges on the borrowers' fixed assets could not meet the lenders' need for security for their loans. The House of Lords recognised that the greater part of entrepreneurial companies' assets consisted of circulating assets which were replaced in the normal course of business and constantly changing (raw materials, work in progress, stock-in-trade, and trade debts). The House of Lords held that future property could be used as security in equity. The agreement on the granting of security on future property becomes effective "the moment the property comes into existence".

Securing Obligations by the Value of Assets Through Incorporation

Collateralisation is not the only way to secure obligations by the value of assets. The other main method is the use of incorporation. The use of a special purpose vehicle or a project company helps to pool and "ring-fence" assets. Where the special purpose vehicle or project company that owns the assets is a legal entity distinct from the originator of assets or the project's sponsors, the assets will be more bankruptcy-remote.

The use of incorporation as a risk management tool is characteristic of project finance, securitisation, structured finance, and asset-backed finance in general. One of the more exotic applications is the rescuing of banks by using special purpose vehicles for "toxic assets" ("bad banks").

Project company in project finance. Project finance is provided for a legally and economically self-contained (ring-fenced) project through a special purpose legal entity whose only business is the project.[347] It is thus usual to form a single-purpose project company to build and operate the project.

The shares in the project company are owned by the project sponsors. A syndicate of banks provides most of the funding. The project company grants the lenders security over the project assets. The rest of the funding is provided by the project sponsors by way of shareholders' capital (equity subscriptions) and/or

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[345] Art. 900 (1) ZGB.

[346] Holroyd v Marshall (1862) 10 HLC 191. See also Ferran E, Principles of Corporate Finance Law. OUP, Oxford (2008) pp 358–361.

[347] Yescombe ER, Principles of Project Finance. Academic Press, San Diego London (2002) § 2.2.

subordinated debt. The project sponsors may guarantee the loans under full or limited guarantees during the high-risk pre-completion period.[348]

The lenders rely on the ring-fenced future cash flow projected to be generated by the project for interest and debt repayment. The main security for lenders is the assets that generate the cash flow: the project company's contracts, licences, or ownership of rights to natural resources.[349]

For example, when the old Finnish Highway 1 between Turku and Helsinki was replaced by a motorway, a public-private partnership was used to build and operate the 50-kilometre section from Muurla to Lohja. The project was ordered by the Finnish Road Administration (the offtaker) from Tieyhtiö Ykköstie Oy (the project company). Finnra paid a service fee to the project company from the moment the road was completed and opened to traffic. The term of the concession was 21 years. Shares in the project company were owned by two construction companies (Skanska and Lemminkäinen) and an English investment company (John Laing Infrastructure Ltd) which provided equity capital. The project company commissioned engineering, construction and maintenance from a consortium formed by subsidiaries of those construction companies. The financing syndicate for the project consisted of European Investment, Nordic Investment Bank, and other banks. Additional financing was provided by the shareholders of the project company in the form of subordinated loans. Traditional security in the form of share pledges and floating charges was used. Even more important, appropriate waterfall structures were created. All cashflows due to the project company from its contracts in the project were used as collateral. All monies due to the project company were paid to a designated blocked bank account.

Special purpose vehicles. Special purpose vehicles (SPVs) are legal entities which engage in financial activities and whose main purpose is to raise money on behalf of a third party (such as a non-financial company, a credit institution, or an investment fund).

The ownership of the SPV may depend on the nature of the transaction. An SPV may be legally owned by the company to which it is providing funds (the SPV may be a holding company, a company that manages licences, patents or film rights, or a company that raises funds and lends or invests them within companies that belong to the same group). Alternatively, it may be without capital links to that company. In the latter case, it is established to facilitate a particular financial transaction (in which case it may be called a special finance vehicle).

In corporate finance, an SPV usually acts solely as a single-purpose "conduit" for channelling funds from many lenders to a certain borrower. The separate legal personality of the SPV protects investors in the event that the original owner of the assets (the originator) becomes insolvent. To reduce risk even further, the constitutional documents of the SPV prohibit it from engaging in activities other than the transaction for which it was established.

The use of an SPV can bring benefits not only to investors but also to the originator. An SPV can obtain a higher credit rating than the originator, because the assets are separated from the credit risk of the originator and the credit quality of the

[348] David Cohen, Project Finance: The Position of Lending Banks under Political Risk Insurance Policies, Int Ins L R 1997, 5(2) pp 35–39.

[349] Yescombe ER, *op cit*, § 2.2.

asset pool can be complemented with one or more types of credit and/or liquidity support. This means that firms with a low rating, or no rating at all, can gain access to institutional investors, which are often restricted to investment in high-rated bonds, and obtain cheaper finance (for securitisation, see also Volume III).

Special finance vehicles are usually set up in jurisdictions which are more favourable in terms of the bankruptcy-remote principle, security arrangements provided for the investors, and tax treatment.

In the euro area, a traditional jurisdiction in which to establish special finance vehicles has been the Netherlands, which on average between 1990 and 2002 accounted for around 30% of the total volume issued by such vehicles. Other common jurisdictions used for establishing special finance vehicles are Ireland, Italy and Luxembourg. In addition, securitisation entities are established in the same jurisdiction as the originator in Spain, France and Italy.[350]

Special purpose vehicles in structured finance. Special purpose vehicles are generally used in structured finance. A major part of structured finance is the use of asset securitisation.

Structured finance instruments can be defined through three key characteristics: (1) pooling of assets (either cash-based or synthetically created); (2) tranching of liabilities that are backed by the asset pool (this property differentiates structured finances from traditional "pass-through" securitisations); and (3) de-linking of the credit risk of the collateral asset pool from the credit risk of the originator, usually through the use of finite-lived, standalone SPV.[351]

Table 11.3 Creation of an Asset-backed Security

Originator	
Assets ↓	↑ Payment
Special purpose vehicle	
Assets ↓	↑ Payment
Investors	

Special purpose vehicles and asset-backed securities. The assets purchased by the SPV are usually illiquid and private in nature. Securitisation can transform illiquid assets into tradeable securities. To finance its purchase of assets, the SPV can issue marketable securities usually known as asset-backed securities. Asset-backed securities are securities which are linked to identified pools of underlying assets.

Securitisation also helps to transform risk. Segregating the risk of the asset pool from the risk of the originator is a core commercial requirement of securitisation. The combination of a pool of homogeneous assets and bankruptcy-remoteness contributes to a clearer risk profile and higher-quality securities.

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[350] Recent developments in financial structures of the euro area. ECB, Monthly Bulletin, October 2003.

[351] BIS, CGFS, The role of ratings in structured finance: issues and implications, CGFS Publications No. 23, January 2005.

Excursion: Basel II and the securitisation framework. There are particular rules on securitisation for banks and financial institutions.

A bank may be exposed to a securitisation as an originator[352] or otherwise (for example, by retaining or assuming a securitisation exposure and providing some degree of added protection to other parties to the transaction).[353] The securitisation exposures of banks can be related, for example, to: asset-backed securities; mortgage-backed securities; credit enhancements; liquidity facilities; interest rate or currency swaps; and credit derivatives or tranched cover.[354]

Banks must use the securitisation framework set out by the Basel II Accord for determining regulatory capital requirements on exposures arising from traditional and synthetic securitisations or similar structures that contain features common to both. Since securitisations may be structured in many ways, the capital treatment of a securitisation exposure must be determined on the basis of its economic substance rather than its legal form.[355]

A bank can obtain a credit risk mitigant on a securitisation exposure. Credit risk mitigants include guarantees, credit derivatives, collateral and on-balance sheet netting. Collateral in this context refers to that used to hedge the credit risk of a securitisation exposure rather than the underlying exposures of the securitisation transaction.[356]

Toxic assets, bad banks (or companies). One of the ways to rescue a bank that has distressed loans is to create a separate entity which takes ownership of its non-performing assets and then manages them in order to maximise their value.[357] Taking such assets off the balance-sheet leaves behind a bank with a sounder financial basis. This and increasing the bank's equity capital can help the bank to raise new capital from the market. The separate entity can manage the non-performing assets more effectively because of specialisation and the lack of reputational or other constraints relating to the originating bank's business. In other words, a bad bank can be more ruthless. The bank bail-out model used by Sweden in the early 1990s was copied in other countries in 2008.

Securing Obligations by Securitisation and Tranching

Securitisation can be used as a source of collateral even in other ways. For example, banks established in a member state of the Eurozone can use asset-backed securities in money-market transactions with the European Central Bank (ECB). The ECB has specified criteria which must be satisfied for asset-backed securities to be eligible. One of them is that a tranche is not eligible if it is subordinated to other tranches of the same issue. If the other criteria are met, a bank can use its underlying assets as security when: the bank securitises them; the transaction is a true-sale

[352] Paragraph 538 of the Basel II Accord.
[353] See paragraphs 544–552 of the Basel II Accord.
[354] Paragraph 541 of the Basel II Accord.
[355] Paragraph 538 of the Basel II Accord.
[356] Paragraph 583 of the Basel II Accord.
[357] Stockholm syndrome, The Economist, November 2008.

transaction; the bank buys the other tranches from the SPV; and the ECB buys the senior tranche from the SPV.[358]

Securing Obligations by the Value of Assets Through Ring-fencing Otherwise

In principle, assets can be ring-fenced even without incorporation. This can be illustrated by the use of covered bonds in Europe.[359]

Covered bonds are "dual recourse" bonds issued by (or offering recourse to) a credit institution and with priority recourse to a cover pool of collateral.[360] They are "dual recourse" bonds for two reasons.

Covered bonds are repaid from the issuer's cash flows. The key difference between covered bonds and securitisation is that covered bonds do not involve credit risk transfer. The credit stays with the originator who continues to have incentives for prudent credit risk evaluation and monitoring.[361]

Covered bonds are also secured against a ring-fenced pool of assets, such as mortgage loans, in the event of default. This makes covered bonds "senior secured debt".

The European Covered Bond Council has isolated the following essential features of covered bonds: (1) The bond is issued by – or bondholders otherwise have full recourse to – a credit institution which is subject to public supervision and regulation. (2) Bondholders have a claim against a cover pool of financial assets in priority to the unsecured creditors of the credit institution. (3) The credit institution has the onoing obligation to maintain sufficient assets in the cover pool to satisfy the claims of covered bondholders at all times. (4) The obligations of the credit institution in respect of the cover pool are supervised by public or other independent bodies.[362]

Segregation of Client Assets

Another method of ring-fencing assets is used when client assets are protected from the insolvency of a service provider through segregation or identification procedures. Rules on the segregation of assets are very important to customers of investment firms, law firms, and other firms that handle other people's money. If client assets are not kept separate from the service provider's general assets but will be mixed with them, the client will become a normal unsecured creditor in the

[358] Guideline of the ECB of 31 August 2000 on monetary policy instruments and procedures of the Eurosystem (ECB/2000/7) (as amended), Annex I, Chapter 6. See also ECB, The implementation of monetary policy in the euro area: General documentation on Eurosystem monetary policy instruments and procedures, 12 November 2008 p 35.

[359] The covered bond market in the EU had grown to over €2 trillion by the end of 2007. ECB, Covered bonds in the EU financial system, December 2008 p 4. See also From Prussia with love, The Economist, September 2008.

[360] ECB, Covered bonds in the EU financial system, December 2008 p 6.

[361] *Ibid*, p 4.

[362] *Ibid*, p 7.

service provider's insolvency. The law can require some services providers – like regulated law firms – to keep client assets separate.

MiFID. The MiFID requires investment firms to protect client assets.[363] The MiFID requires both asset segregation and record-keeping.

An investment firm must, when holding financial instruments belonging to clients, "make adequate arrangements so as to safeguard clients' ownership rights, especially in the event of the investment firm's insolvency, and to prevent the use of a client's instruments on own account except with the client's express consent".[364] When holding funds belonging to clients, it must "make adequate arrangements to safeguard the clients' rights and, except in the case of credit institutions, prevent the use of client funds for its own account".[365]

An investment firm also has an obligation to "arrange for records to be kept of all services and transactions undertaken by it which shall be sufficient to enable the competent authority to monitor compliance with the requirements under [the MiFID], and in particular to ascertain that the investment firm has complied with all obligations with respect to clients or potential clients".[366]

The rules on the segretation of client assets under the MiFID do not prevent a firm from doing business in its own name but on behalf of the client, where this is required by the very nature of the transaction and the client is in agreement. Te preamble of the MiFID names securities lending as an example.[367]

On the other hand, where a client transfers full ownership of financial instruments or funds to an investment firm for the purpose of securing or otherwise covering its obligations, such financial instruments or funds will no longer be regarded as belonging to the client.[368]

11.6.4 Payment Obligations of a Third Party

Introduction

As said above, the four main types of credit enhancement are: (1) the general ways to manage the agency relationship between the creditor and the debtor (sections 6.3.3 and 11.6.2); (2) securing the obligation by the value of assets (section 11.6.3 above); (3) securing the obligation by the payment obligation of a third party (this section); and (4) choosing good debtors (for information intermediaries, see Volume I; for customer credit management, see Volume III; for due diligence, see Volume III).

One of the main differences between securing obligations by the value of assets and securing obligations by the payment obligations of a *third party* is cost. A third party will not usually undertake any secondary or primary payment obliga-

[363] Generally, see Moloney N, EC Securities Law. OUP, Oxford (2008) pp 486–495.
[364] Article 13(7) of Directive 2004/39/EC (MiFID).
[365] Article 13(8) of Directive 2004/39/EC (MiFID).
[366] Article 13(6) of Directive 2004/39/EC (MiFID).
[367] Recital 26 of Directive 2004/39/EC (MiFID).
[368] Recital 27 of Directive 2004/39/EC (MiFID).

tions unless it gets paid for its risk-taking services. Although additional protection is likely to make cash flow more predictable, its cost can make the transaction less profitable for both the creditor and the debtor. This can be contrasted with some forms of asset-backed finance in which the debtor's assets can be used as collateral free of charge.

Instruments. Payment obligations may be secured by various kinds of third-party obligations. Third-party payment obligations can be based on third-party loan guarantees, credit insurance policíes, letter of credits, demand guarantees, credit default swaps, or other instruments. From a legal perspective, there are fundamental differences between such devices.

First, there are differences regarding the connection to the underlying payment obligation. Some payment obligations are linked to the underlying payment obligations, but others are separated from them.

Second, the payment obligations may be triggered by different events. The event that triggers the payment obligation may be the underlying payment obligation becoming due, default of the underlying payment obligation, verification of the default by the court or someone else, breach of contract by the third party, a payment claim, or some other event.

Third, the sum payable by the third party may be determined on the basis of different things. It may be a primary obligation to pay capital and interest in full according to the terms of the primary payment obligation. This obligation may also be complemented by an additional obligation to hold the creditor harmless against loss. On the other hand, it could also be: a secondary obligation to hold the creditor harmless against loss of capital and interest in the event that the primary debtor does not fulfil his payment obligations; an obligation that is limited to a certain sum or otherwise; or an obligation to reimburse for loss or damage caused by the third party's own breach of contract.

Fourth, the defences available to the third party may vary. In some cases defences available to the third party consist of defences available to the original debtor complemented by other defences. In other cases defences available to the original debtor are not available to the third party.

Fifth, there are differences as regards the right of recourse of the third party.

Further mitigation of risk. The firm can benefit from such differences and choose instruments which help to mitigate risk further. (a) For example, the payment obligation of the third party can be independent of the underlying payment obligation (if it is linked to the underlying payment obligation, more defences will be available to the third party). (b) It can be triggered by a payment claim made by the beneficiary, or automatically by the underlying payment becoming due without any formalities being necessary (the existence of formalities can delay the payment). (c) Generally, the firm should ensure that defences available to the third party are limited and do not include defences available to the original debtor. (d) In practice, obligations undertaken by the third party as a primary debtor (such as demand guarantees and credit default swaps)[369] mitigate the beneficiary's counter-

[369] With the exception of insurance policies. Insurance policies tend to be narrow in scope, and the insurance company tends to pay slow.

party credit risk better than obligations undertaken by the third party as a secondary debtor (such as traditional third-party loan guarantees).

Indemnity from the principal debtor. The third party will typically take an express indemnity from the principal debtor.

A bank will often take an express indemnity from its customer (the applicant) enabling the bank to debit the customer's accounts and protecting the bank against all losses, expenses, and liabilities. In practice, there will often be a chain of indemnities (counter-indemnities) from the customer to its bank, and then from the customer's bank, through intermediate banks, to the bank in the beneficiary's country which actually issues the instrument (for example, a demand guarantee).[370]

Basel II. The Basel II Accord recognises guarantees and credit derivatives as a way to reduce banks' exposure and to reduce capital requirements. However, such guarantees or credit derivatives must be direct, irrevocable and unconditional,[371] and the protection must be provided by an entity with a lower risk weight than the counterparty.[372]

There are operational requirements common to guarantees and credit derivatives,[373] additional operational requirements for guarantees,[374] and additional operation requirements for credit derivatives.[375]

Third Party as a Secondary Debtor (Third-party Loan Guarantees)

The third party usually undertakes an obligation to pay as a secondary debtor. It is characteristic of such obligations that they are linked to and dependent on the underlying transaction. Third-party loan guarantees are a typical example of obligations that belong to this category.

Traditional guarantees. A traditional guarantee is an undertaking that, if the principal debtor fails to pay, the guarantor will pay the amount instead.

The events and formalities triggering the duty to pay and other modalities depend on the guarantee and may vary. (a) For example, the guarantor may promise to pay after the insolvency of the principal debtor has been verified by the court. This requirement can also be based on the provisions of the governing law.[376] (b) Alternatively, the guarantor may promise to pay the debt "as a principal debtor";

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[370] See Cranston R, Principles of Banking Law. Second Edition. OUP, Oxford (2002) p 394.

[371] Paragraph 140 of the Basel II Accord: "Where guarantees or credit derivatives are direct, irrevocable, and unconditional, and supervisors are satisfied that banks fulfil certain minimum operational conditions relating to risk management processes, they may allow banks to take account of such credit protection in calculating capital requirements."

[372] Paragraph 141 of the Basel II Accord.

[373] Paragraph 189 of the Basel II Accord.

[374] Paragraph 190 of the Basel II Accord.

[375] Paragraph 191 of the Basel II Accord.

[376] § 771 BGB (Einrede der Vorausklage).

this term can be based on an express undertaking by the guarantor[377] and/or the provisions of the governing law.[378]

Such a distinction is made in the laws of many countries. For example, in Swedish law, a distinction is made between "enkel borgen" (a "simple guarantee" under which the guarantor must pay when it is proved that the main debtor cannot pay) and "proprieborgen" (under which the guarantor undertakes to pay "as for its own debt").[379]

The guarantee may also be limited in many ways. In any case, the liability of a traditional guarantor is secondary and dependent on the borrower's default.[380] This means two things. (a) Unless the guarantor has agreed otherwise, the liability of the guarantor will be extinguished if: the borrower is not liable to pay;[381] or there is a material variation of the borrower's liability, such as an extension of time to pay, an amendment to the terms of the underlying debt that could prejudice the guarantor, a release of the borrower, or a set-off, counterclaim or defence available to the borrower. (b) In addition, the guarantor may raise the same defences as the principal debtor, unless the guarantor has agreed otherwise. [382]

There are usually no or few requirements as to form.[383]

Member States' laws. Guarantees are regulated in different ways depending on the Member State.

Civil law countries tend to have legislation on Bürgschaft, Kaution, Garantie or whatever concept is used in the particular jurisdiction. In civil law countries, the existence of guarantee legislation means that there is a clear distinction between, first, guarantees that are issued as a secondary obligation and governed by a statute and, second, guarantees that are issued as a primary obligation and not governed by any statute. The latter are not necessarily regarded as "guarantees".

In common law countries, the law on guarantees has developed in case law. In the absence of legislation, the distinction between guarantees that are issued as a secondary obligation on one hand and obligations issued as a primary obligation on the other is less clear. The term "guarantee" can refer to secondary or primary obligations such as indemnities (see below).[384]

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[377] § 773 BGB ("selbstschuldnerische Bürgschaft").

[378] § 349 HGB: "Dem Bürgen steht, wenn die Bürgschaft für ihn ein Handelsgeschäft ist, die Einrede der Vorausklage nicht zu. Das gleiche gilt unter der bezeichneten Voraussetzung für denjenigen, welcher aus einem Kreditauftrag als Bürge haftet."

[379] See Gorton L, Draft Uncitral Convention on Independent Guarantees, JBL 1997 p 240.

[380] See, for example, Fuller G, Corporate Borrowing. Third Edition. Jordans, Bristol (2006), paragraph 11.2. For German law, see BGB Titel 20.

[381] In Germany, §§ 765, 767, 768, 770 BGB.

[382] § 768 BGB (Einreden des Bürgen).

[383] In England, section 4 of the Statute of Frauds (1677) provides that a guarantee is unenforceable by action unless the agreement or some memorandum or note thereof is in writing and signed by the guarantor or his authorised agent.

[384] See Gorton L, Draft Uncitral Convention on Independent Guarantees, JBL 1997 pp 240-242.

Third Party as a Primary Debtor: Introduction

Obligations that the third party undertakes as a primary debtor protect the creditor better than obligations undertaken as a secondary debtor. However, the third party would demand to be paid for taking the risk. Typical instruments that belong to this category include: documentary credit; letters of credit; demand guarantees; credit insurance and other insurance; and credit default swaps. Some of them are customarily used in trade finance. The third party can also act as one of many principal debtors and give various kinds of indemnities.

Third Party as One of Many Principal Debtors

The third party can be responsible for payment as one of two or more principal debtors. In this case, the liability of the third party is primary and not secondary. The payment will be due under the terms of the original payment obligation. On the other hand, the third party will be able to use all defences available to principal debtors. A practical application of this method is that a party can undertake "joint" liability instead of "several" liability (section 12.2).

Trade Finance

If the firm is involved in the export-import business, it will be confronted with a wide range of risks. It is usual to turn to banks for help.

Open-account trading. Often a supplier is confident that there is little risk of not being paid and agrees to open-account trading. Open-account trading is widely used for trade between many European countries (for differences in payment behaviour, see section 11.3; for the management of accounts receivable, see Volume III).

Documentary collection. Open-account trading can be complemented by documentary collection. Documentary collection means that the supplier retains control of the goods by not handing over the transport documents until the buyer pays (documents against payment, D/P) or accepts a bill of exchange (documents against acceptance, D/A). Documentary collections are often governed by the Uniform Rules for Collections issued by the International Chamber of Commerce (ICC; for incorporation, see below).[385]

Documentary credit. Sometimes the supplier does not want to deliver the goods, unless the buyer pays the purchase price first, and the buyer does not want to pay the purchase price, unless the supplier delivers the goods and the buyer has had an opportunity to inspect the goods first (cash against delivery, the Zug-um-Zug principle).[386] This problem can be solved by using documentary credit. A

[385] Cranston R, Principles of Banking Law. Second Edition. OUP, Oxford (2002) p 377.
[386] Article 58 of the CISG.

documentary credit can be an appropriate means of meeting the security requirements of the various parties in transit operations or international trade.[387]

A straight documentary credit is essentially a bank's guarantee of payment against specified documents. Its duty is to pay when the beneficiary presents certain documents to it. The documents entitle the buyer to take delivery of the goods.[388]

The Uniform Customs and Practice for Documentary Credits (UCP) issued by the ICC[389] will often be incorporated into documentary credits by reference.[390] In the US, the UCC lays down similar rules.

Documentary credits are separate transactions from the sales or other contracts on which they may be based. Banks are in no way concerned with or bound by such contracts: "Banks deal with documents and not with goods, services or performance to which the documents may relate."[391] Consequently, the undertaking of a bank to pay under documentary credit is not subject to claims or defenses by the buyer (the applicant) resulting from his relationships with the seller (the beneficiary).[392]

This brings benefits to the beneficiary. However, the bank may only pay out against documents which are credit compliant. It is the bank's job to check whether the documents: meet the documentary credit requirements; are not inconsistent; and conform to the UCP. If the documents contain discrepancies of any kind, the issuing bank's obligation to pay will no longer apply. This means that the beneficiary loses the security.

Letters of credit. A letter of credit is a form of documentary credit. The requirement for a letter of credit will be contained in the underlying contract between the supplier and the buyer. The letter of credit is an arrangement whereby a bank (the issuing bank), acting at the behest of its customer (typically the buyer), undertakes to pay a beneficiary (the supplier). Payment is against stipulated documents and in compliance with the terms and conditions of the credit.[393]

A letter of credit mitigates counterparty risk, because the goods will not be shipped to the buyer unless the bank already has paid the purchase price. The supplier may therefore prefer to use a letter of credit where: the counterparty credit risk is high; the shipment of the goods is expensive; or it is part of normal business practice in the buyer's country. Sometimes the law requires the use of a letter of credit. The government might insist on payment by letters of credit in a country

[387] ICC Guide to Documentary Credit Operations (ICC No. 515, 1994) provides a summary of the parties' objectives in choosing to effect payment by documentary credit.
[388] See Articles 30–32, 34 and 58 of the CISG.
[389] UCP 600 came into effect on 1 July 2007 and modernised the UCP 500 rules that were approved in 1993.
[390] UCP 600 Article 1.
[391] UCP 600 Article 5.
[392] UCP 600 Article 4.
[393] See Cranston R, *op cit*, pp 384–385.

that still applies exchange controls (Member States of the EU and members of the OECD have liberalised capital movements).[394]

Letters of credit are typically, and presumptively, irrevocable.[395] They can be neither amended nor cancelled without the agreement of the beneficiary. Once issued, a buyer cannot have its bank revoke.

The issuing bank - the bank that issues a credit and undertakes a payment obligation at the request of an applicant or on its own behalf[396] - is not the only participating bank. The credit may be transmitted to the supplier through an intermediary bank in its own country. The intermediary will act as an advising and/or confirming bank.[397]

An advising bank that is not a confirming bank undertakes no payment obligations: “By advising the credit or amendment, the advising bank signifies that it has satisfied itself as to the apparent authenticity of the credit or amendment and that the advice accurately reflects the terms and conditions of the credit or amendment received.”[398]

A confirming bank adds its confirmation to a credit upon the issuing bank’s authorization or request. A confirming bank undertakes to pay, provided the stipulated documents are presented and that the terms of credit are complied with.[399]

Demand guarantees. It is difficult to use documentary credit where the supplier does not supply goods that can simply be handed over to the buyer. This may be the case in construction contracts and contracts for the sale and installation of equipment. Such contracts will often be complemented by demand guarantees. Typically, the use of demand guarantees enables the supplier to receive payment before delivery and the buyer to get its money back if the supplier does not fulfil its obligations.

Demand guarantees are usually governed by the ICC’s Uniform Rules for Demand Guarantees (URDG). They will be incorporated into the demand guarantee by reference.[400]

There is also a 1995 UN Convention on Independent Guarantees and Stand-by Letters of Credit. However, the UN Convention has not entered into force for any of the Member States of the EU.[401] The URDG are by far more important in business practice. The UN Convention is modelled on both UCP and URDG.

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[394] Article 57 of the EC Treaty; OECD, The Code of Liberalisation of Capital Movements and the Code of Liberalisation of Current Invisible Operations; Cranston R, *op cit*, p 385.

[395] UCP 600 Articles 2, 3, 7(b), 8(b), 10(b), 11(b)..

[396] UCP 600 Articles 2, 7

[397] UCP 600 Article 2.

[398] UCP 600 Article 9(b).

[399] UCP 600 Article 8.

[400] URDG Article 1.

[401] It has entered into force for Belarus, Ecuador, El Salvador, Gabon, Kuwait, Liberia, Panama, and Tunisia.

Demand guarantees are by their nature separate from the contract(s) or tender conditions on which they may be based.[402]

They are based on the principle "pay first, argue later". A demand guarantee can be defined as: "any guarantee, bond or other payment undertaking … given in writing for the payment of money on presentation in conformity with the terms of the undertaking of a written demand for payment and such other document(s) … as may be specified in the Guarantee".[403] It is easy for the beneficiary to cause the bank to pay: "The duty of a Guarantor under a Guarantee is to pay the sum or sums therein stated on the presentation of a written demand for payment and other documents specified by the guarantee which appear on their face to be in accordance with the terms of the Guarantee."[404]

Usual demand guarantees include: the repayment/advance-payment guarantee (to ensure the beneficiary's right to repayment of the advance if performance is not furnished); the performance guarantee (given for a specified percentage of the contract sum to ensure that the supplier will perform its obligations in due time); and the maintenance/warranty period guarantee (to ensure that the supplier will continue to fulfil its obligations during the maintenance/warranty period).[405] There are also other forms of demand guarantees (such as bid bonds, customs bonds, and freight bonds).

Because of their nature, demand guarantees should be clear and precise. They should also avoid excessive detail. All demand guarantees should stipulate: (a) the Principal; (b) the Beneficiary; (c) the Guarantor; (d) the underlying transaction requiring the issue of the Guarantee; (e) the maximum amount payable and the currency in which it is payable; (f) the Expiry Date and/or Expiry Event of the Guarantee; (g) the terms for demanding payment; and (h) any provision for reduction of the guarantee amount.[406]

The beneficiary's right to demand payment under a demand guarantee is not assignable unless the parties have agreed otherwise.[407]

Particular remarks: abusive or unfair callings. Independent payment obligations such as documentary credits and demand guarantees can give an incentive to make abusive or unfair callings. It is technically possible for the beneficiary to demand payment even where the beneficiary has no such right under the terms of the underlying transaction.

The parties may have conflicting interests in such a situation. A party can be: the bank that has issued the instrument; the beneficiary; or the debtor in the underlying transaction.

The bank will prefer a simple mechanism that triggers the bank's payment obligation and a simple duty to inspect the text of short key documents.

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402 URDG Article 2(b).

403 URDG Article 2(a).

404 URDG Article 2(b). See also Article 2 of the UN Convention on Independent Guarantees and Stand-By Letters of Credit.

405 Pierce A, Demand Guarantees in International Trade. Sweet & Maxwell, London (1993) p 81.

406 URDG Article 3.

407 URDG Article 4.

The beneficiary wants to get paid against a simple demand or against a simple document without risking various obscure objections.

The debtor in the underlying transaction, however, wants protection against unfair callings. Aggrieved suppliers have been quick to approach the courts to obtain injunctions to prevent banks from paying claims that are unjustified and unfair.

Banks, on the other hand, have been anxious to ensure that their international reputation is not prejudiced by any action which prevents them from fulfilling their obligations to the beneficiary.[408]

Typically, Member States' courts have granted injunctions to prevent banks from making payments under documentary credits or demand guarantees in cases of *fraud*, i.e. when the claim is manifestly improper (contrary to the principles of "good faith" or "Treu und Glauben"[409] or otherwise). In principle, the bank's right to refuse to pay because of fraud could be based on circumstances relating to: the contents and purpose of the guarantee; the terms of the underlying transaction between the principal and the beneficiary; or the terms of the security arrangement between the principal and the beneficiary.[410]

This question has been addressed in the UN Convention on Independent Guarantees and Standby Letters of Credit which provides for exceptions to the bank's obligation to pay. The guarantor/issuer may withhold payment, if: (1) it is manifest and clear that: (a) any document is not genuine or has been falsified; (b) no payment is due on the basis asserted in the demand and the supporting documents; or, (c) judging by the type and purpose of the undertaking, the demand has no conceivable basis; and (2) the guarantor/issuer acts in good faith.[411] The UN Convention lists examples of situations in which a demand has no conceivable basis.[412] In addition, the UN Convention states that the principal/applicant may be entitled

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[408] See, for example, Pierce A, *op cit*; Cranston R, *op cit*, p 390.

[409] For German law, see § 242 BGB (Treu und Glauben). For Swiss law, see Art. 2 ZGB: "(1) Jedermann hat in der Ausübung seiner Rechte und in der Erfüllung seiner Pflichten nach Treu und Glauben zu handeln. (2) Der offenbare Missbrauch eines Rechtes findet keinen Rechtsschutz." In Roman law, Iulius Paulus wrote: "Dolo facit, qui petit quod redditurus est."

[410] See Fischer G, Schutz vor missbräuchlicher Nutzung der Bürgschaft auf erstes Anfordern, WM 2005 pp 529-536; Kupisch B, Bona fides und Bürgschaft auf erstes Anfordern, WM 2002 pp 1626-1632.

[411] Article 19(1) of the UN Convention on Independent Guarantees and Stand-By Letters of Credit.

[412] Article 19(2) of the UN Convention: "... : (a) The contingency or risk against which the undertaking was designed to secure the beneficiary has undoubtedly not materialized; (b) The underlying obligation of the principal/applicant has been declared invalid by a court or arbitral tribunal, unless the undertaking indicates that such contingency falls within the risk to be covered by the undertaking; (c) The underlying obligation has undoubtedly been fulfilled to the satisfaction of the beneficiary; (d) Fulfilment of the underlying obligation has clearly been prevented by wilful misconduct of the beneficiary; (e) In the case of a demand under a counter-guarantee, the beneficiary of the counter-guarantee has made payment in bad faith as guarantor-issuer of the undertaking to which the counter-guarantee relates."

to provisional court measures in some cases of abuse.[413] Neither UCP 600 nor the URDG contain similar rules.

Bank's duty to inspect documents. The bank has a duty to inspect the documents before making any payments. It has no liability if it has acted in good faith and showed reasonable case.

According to the URDG, a bank has a duty to examine with reasonable care whether documents specified and presented under a demand guarantee "appear on their face to conform with the terms of the Guarantee".[414] The liability of a bank is limited,[415] but a bank is liable for its failure to act in good faith and with reasonable care.[416]

UCP 600 set out the standard for examination of documents: [a bank] "must examine a presentation to determine, on the basis of the documents alone, whether or not the documents appear on their face to constitute a complying presentation".[417] The liability of a bank is limited under UCP 600: "A bank assumes no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any document, or for the general or particular conditions stipulated in a document or superimposed thereon …"[418]

Other instruments and practices in trade finance. The firm can use banks to mitigate risk even in other ways in trade finance. For example, the firm can use factoring, have trust or escrow accounts, or turn to export-credit agencies.[419]

Insurance

Taking out an insurance policy is a traditional way to transfer or mitigate risk.

First, the firm can shed risk by taking out an insurance policy. This is subject to legal constraints. It is characteristic of insurance policies that the insured must have an *insurable interest* and can only claim up to its actual *losses* on the exposure to risk. For example, the firm can take out a credit insurance policy to mitigate its exposure to counterparty credit risk.

Second, the firm and its counterparty can agree that the counterparty shall arrange insurance protection. This will indirectly mitigates the firm's risk exposure.

Third, insurance claims can be used as a security. In this case, the firm will be either the beneficiary or the security holder.

Insurance in trade finance and asset-backed financing. In trade finance and asset-backed financing, the firm looks primarily to the asset which is being financed for its security.

This means that the firm will take a security interest in the asset itself. For example, the firm will ensure that it will have the right to sell the asset or cause the asset to be sold and a right to the sale proceeds.

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[413] Article 19(3) of the UN Convention.
[414] URDG Article 9.
[415] URDG Articles 11–14.
[416] URDG Article 15.
[417] UCP 600 Article 14(a).
[418] UCP 600 Article 34.
[419] Cranston R, *op cit*, p 377.

On the other hand, the security interest does not provide the intended protection, unless the asset continues to exist in an undamaged condition. An insurance policy can help.

The firm will try to ensure that the asset is properly insured so that the potential lack of, or a reduction in, the sale proceeds can be made up by the insurance proceeds. This raises several legal questions.

Where the insurance policy is taken out by the other party as the owner of the asset, the rights of the owner under the insurance policy should be *assigned* to the firm. The assignment should comply with the legal requirements as to the assignment of debts and the terms of the policy.

Where the policy is taken out by the other party as the owner of the asset, the firm should pay attention to whether its rights to claim against the insurer are *original rights* (which will not be tainted by the misconduct of the other party) or merely *derivative rights* (in which case the insurer may have a right to refuse to pay because of the misconduct of the other party).

For example, section 14 of the English Marine Insurance Act provides that the mortgagee of a ship has his own insurable interest in the ship.

The firm should therefore pay attention to the wording of the policy in order to determine its rights.

Where a bank acts as the lender and mortgage holder, the naming of the bank as co-assured is often combined with an assignment in favour of the bank. The bank will try to ensure that it has separated its rights from all duties under the insurance policy.

For example, bank practice in ship and aircraft finance has been described as follows: "To reinforce the intention to create separate rights in the insurances for the owners and the bank, breach of warranty cover is usually insisted on by the bank and a cross liability clause is often inserted. In this widest form, a breach of warranty clause will provide that the insurances will not be invalidated in respect of the interest of the bank by any action or inaction of the owners or any other person, and that the interests of the bank will be preserved regardless of any breach or violation in the insurance policy by the owners or any other person. A cross liability clause will make it clear that the inclusion of more than one assured is not in any way to affect the rights of any other assured with regard to any claim to be made by the assured in the same manner as though a separate policy had been issued to each without, of course, increasing the overall limit of the underwriters' liability under the policies … The bank should also ensure that the underwriters acknowledge the bank has no operational interest in the aircraft or ship, that the bank will not be liable for any premiums in respect of the policies and that the underwriters will waive any rights of subrogation against the bank which they might have if a claim has been paid out to the owners. As is usual, the bank should be named sole loss payee."[420]

Credit insurance. Credit insurance contracts can be functional equivalents to guarantees. They are not standardised. The terms of credit insurance contracts tend to emphasise the interests of the risk taker (insurer).[421]

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[420] Smith D, Using Insurance as Security, JIBL 1992 pp 217–224.

[421] BIS, CGFS, Credit risk transfer, January 2003.

Typically, a credit insurance contract defines credit events in a narrow way. Because of the narrow definition, the scope of protection is limited as well. The limited scope of protection and the investigation of claims before payment mean that insurance/reinsurance companies can write insurance at a relatively low cost to the risk shedder.

Insurers are generally protected by mandatory provisions of law. Mandatory laws provide for extensive pre-contractual duties of disclosure[422] and duties of disclosure during the term of the contract. These duties of disclosure are complemented by a general duty to take the other party's interests into account. For example, an insurance contract requires "utmost good faith" (uberrimae fides) under English law.

If the risk shredder fails to comply with its statutory duties of disclosure and good faith by withholding material information, the insurer may refuse to pay.

This has happened even in credit insurance contracts: "Two celebrated examples are (i) the so-called Hollywood Funding case, in which insurance companies refused payment on insurance policies designed to protect investors in a series of films, on the grounds of misrepresentation and breach of contract terms, requiring a certain number of films to be made; and (ii) the surety bonds provided to JP Morgan Chase by insurance companies on behalf of Enron to back its obligation to deliver on prepaid natural gas contracts, where the insurers claimed misrepresentation on the grounds that the underlying transaction was essentially provision of credit rather than commodities delivery."[423]

Financial guarantee insurance. Financial guarantee insurance ("wraps") is a particular form of credit insurance. A financial guarantee insurance is typically an unconditional and irrevocable commitment to pay interest and principal on a bond according to the original payment schedule (no acceleration) if the borrower fails to make payments when due.[424] Financial guarantee insurance (or reinsurance) contracts are in other words contracts issued by insurance enterprises that provide protection to the holder of a financial obligation from a financial loss in the event of a default.

The policyholder (holder of the financial guarantee insurance contract) will vary. (a) In some cases, the policyholder may be the issuer of the insured financial obligation. The issuer of the financial obligation may seek to increase the marketability of the insured financial obligation while reducing future interest costs (by attaining a higher credit rating for the insured financial obligation through the financial guarantee insurance contract). (b) In other cases, the policyholder may be the holder of the insured financial obligation. The holder of the financial obligation may want to protect itself from a financial loss in the event of a default.

Community law. The regulation of insurance is a large area of Community law. For example, there is a single system for the authorisation and financial supervision of insurance undertakings by the Member State in which they have their head

[422] In German law, §§ 16, 17 VVG (Gesetz über den Versicherungsvertrag, Versicherungsvertragsgesetz, Insurance Contract Act).
[423] BIS, CGFS, Credit risk transfer, January 2003.
[424] See BIS, CGFS, Credit risk transfer, January 2003.

office (the home Member State). There is no room to discuss the regulation of insurance in this book.

Credit Derivatives

Credit derivatives allow investors to buy or sell protection against the borrower's default. The price of protection depends on perceptions about the borrower's creditworthiness. Credit derivatives behave a bit like insurance contracts. However, they are not insurance contracts. This means that there is no requirement to actually hold an asset, have an insurable interest, or suffer a loss.[425] As a result, they can be used for speculation.

Change of market structure. The use of credit derivatives has changed the capital market:[426]

Credit derivatives and structured credit markets have changed the way banks decide on the granting of credit. They help banks to manage both pricing and liquidity risks better. For example, price discovery in the credit derivatives market reduces the risk of mispricing loans.

Credit derivatives and structured credit markets are transforming the way banks operate in the market. Banks have been able to move from the traditional "buy-and-hold" model to the "originate-and-distribute" model by distributing portfolios of credit risks and assets to other market players. Credit derivatives can be pooled into collateralised debt obligations (CDOs).

Credit derivatives and structured credit markets are transforming the financial system, whereby risk allocation is becoming just as important as capital allocation.

Credit-default swaps (CDSs) are the most important form of credit derivatives and one of the most significant risk distribution methods to emerge in recent years. According to the Bank for International Settlements, the nominal amount of credit-default swaps had reached $20 trillion by June 2006. Other forms of credit derivatives that facilitate the trading of credit risk include credit default options, credit spread swaps, total return swaps, and credit-linked notes.[427]

Credit derivates enable market participants to mitigate credit risks by hedging. As they can also be used for speculation, their widespread use can magnify systemic risks when financial conditions seriously deteriorate.[428]

Regulatory capital and credit derivatives. Credit derivatives enable banks to sell on the risk of loans turning bad, manage their regulatory capital more efficiently, and lend more.[429]

In the EU, provisions on banks' regulatory capital are indirectly based on the Basel II framework and directly on the Capital Requirements Directive. Basel II

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[425] For differences between credit derivatives and insurance contracts, see Edwards S, The Law of Credit Derivatives, JBL, November 2004 pp 617–655.

[426] Trichet JC, Some reflections on the development of credit derivatives, Keynote address at the 22nd Annual General Meeting of the International Swaps and Derivatives Association (ISDA), Boston, 18 April 2007.

[427] Edwards S, The Law Of Credit Derivatives, JBL 2004 p 620.

[428] In the shadows of debt, The Economist, September 2006.

[429] In the shadows of debt, The Economist, September 2006.

allows a wider range of credit risk mitigants to be recognised for regulatory capital purposes than the earlier rules set out in Basel I.[430]

Credit derivatives may be recognised on certain conditions. First, only credit default swaps and total return swaps that provide credit protection equivalent to guarantees will be eligible for recognition.[431] Second, such credit derivatives must meet certain requirements for legal certainty.[432] Third, they must be direct, irrevocable and unconditional,[433] and certain additional conditions must be fulfilled.[434]

Credit default swaps: introduction. A credit default swap is a swap designed to transfer the credit exposure of fixed income products between the parties. It is the most widely used credit derivative. There is in theory no limit on the amount of default swaps that can be created.

Credit default swaps were first employed to mitigate risk for bonds, notes, loans, and similar instruments related to central bank transactions. Corporate entities soon began to use credit default swaps, because they found that credit default swaps could lead to low spreads on borrowing and low fees for the issuance of standby letters of credit issued for their account.

Credit-default swaps (CDS) and collateralised-debt obligations (CDO) are closely intertwined.[435] Traditional CDO tranches were so popular that there were not nearly enough corporate bonds to satisfy demand. This led to the creation of synthetic CDOs. In a synthetic CDO, the portfolios consist of credit-default swaps. When a party wants to issue more CDOs, it simply creates some more CDSs.

The CDS has become the product of choice for market participants investing in credit as an asset class. The invention of the CDS increased the liquidity of the bond market and allowed investors to take "short" positions on bonds. Investors who believe that credit conditions will deteriorate for a particular company can buy a CDS on the bond, whether or not they own the bonds.[436]

A credit default swap is an agreement between a protection *buyer* (seller of risk, risk shedder) and a protection *seller* (buyer of risk, risk taker) whereby the protection buyer pays a *periodic fee* in return for a *contingent payment* by the protection seller upon a *credit event* (such as a default or failure to pay) happening in the reference entity.

[430] Paragraph 110 of the Basel II Accord.
[431] Paragraph 193 of the Basel II Accord.
[432] Paragraph 117 of the Basel II Accord: "In order for banks to obtain capital relief for any use of CRM techniques, the following minimum standards for legal documentatino must be met." Paragraph 118: "All documentation used in collateralized transactions and for documenting on-balance sheet netting, guarantees and credit derivatives must be binding on all parties and legally enforceable in all relevant jurisdictions. Banks must have conducted sufficient legal review to verify this and have a well founded legal basis to reach this conclusion, and undertake such further review as necessary to ensure continuing enforceability."
[433] Paragraph 189 of the Basel II Accord.
[434] Paragraph 191 of the Basel II Accord.
[435] See, for example, Buttonwood, Swap shop, The Economist, April 2008.
[436] Buttonwood, Swap shop, The Economist, April 2008.

Credit default swaps are OTC contracts usually governed by *standardised documentation* issued by the International Swaps and Derivatives Association (ISDA). In credit default swap contracts, the core documents consist of the 2002 Master Agreement, the Schedule, the 2003 Credit Derivatives Definitions, and the Confirmation (for derivatives documentation, see section 11.7.4). The confirmation typically specifies a reference entity (a corporation or sovereign which generally, although not always, has debt outstanding), a reference obligation (usually an unsubordinated corporate bond or government bond), and the period over which default protection extends (defined by the contract effective date and scheduled termination date).

Payments. Credit default swaps are usually *unfunded* contracts (section 11.8.1). If the contract is unfunded, both buyers and sellers of protection incur the credit risk of financial non-performance.

The seller of protection receives a *premium* at pre-set intervals in consideration for guaranteeing to make a specific payment should a negative credit event take place.

In other words, the buyer of protection (or transferor of risk) pays a periodic fee or fixed payments to the seller of protection (or transferee of risk) in return for the transfer of credit risk in relation to one or more reference obligations and/or reference entities. Premium payments are usually made quarterly in arrears.

Under the terms of the ISDA documentation, the seller's obligation to make a payment is contingent upon the occurrence of a specified *credit event* and performance of the reference entity (the underlying obligor).

The credit default swap confirmations specify the credit events that will trigger a payment obligation. Typical credit events include: bankruptcy with respect to the reference entity; failure to pay with respect to its direct or guaranteed bond or loan debt; and restructuring (restructuring means here that the reference entity tries to change the terms of its debts with its creditors as an alternative to formal insolvency proceedings).

A negative credit event is usually pegged to an obligor's performance on a reference obligation, like a bond or a loan. The credit event is usually a default, bankruptcy or restructuring. When credit default swaps are used, it is important to determine whether that credit event must be public in order to trigger the protection (it is possible that a trade default is not a public event, but rather a bilateral or private event).

A credit event in respect of a credit derivative transaction must be distinguished from a similar event under the Master Agreement. Whereas the former does not affect any other derivative deal governed by the Master Agreement, the occurrence of an Event of Default in relation to the Master Agreement means that all derivatives governed by the Master Agreement will be subject to the close-out provisions.

The seller's obligation to make a payment is separate from the transaction between the risk seller and the underlying obligor (the reference entity).

The seller makes no floating payments. If a specified credit event does not occur within the term, the credit derivative transaction terminates on the later of the scheduled termination date and any grace period extension date. However, if a credit event does occur within the term, the notifying party should make certain notifications within an agreed period of time: a credit event notice; a notice of physical settlement (if applicable); and a notice of publicly available information (if applicable). All notifications are irrevocable.[437]

Settlement types. Under the terms of the ISDA documentation, the seller's obligation to make a payment is also contingent upon the fulfilment of the applicable conditions to *settlement*. There are two types of settlement when credit default swaps are used: cash and physical.

Under a *cash* settlement, there is no delivery of the reference obligation. A market auction of the reference obligation takes place after the credit event occurs, the benefits of which go to the protection buyer. The seller of protection then makes a cash payment to the buyer for the difference, if any, between the calculation amount and the recovery value of the reference obligation.

Most credit default swap contracts are *physically* settled. Under a physical settlement, subject to receipt of any required consents, the buyer of protection delivers title to its claim against the reference entity to the seller of protection. The seller of protection then has a claim on the reference entity. The protection seller pays the face value of the reference obligation.

Important considerations about risk. Credit default swaps raise particular questions about risk.

The protection buyer can be exposed to a relatively high counterparty commercial risk where the counterparty is small and the nominal amount of the underlying loans or bonds for which it has sold protection is large. The failure of debtors to comply with the terms of the underlying loans or bonds could trigger large payment obligations by the protection seller. The protection seller might then not be able to fulfil its obligations to the protection buyer under the swap contract. As protection sellers typically have swap contracts with a vast nominal amount in their books, the failure of a protection seller to fulfil its obligations under one swap contract could potentially put the whole banking system at risk.

For this reason, the protection seller is asked to furnish a deposit as collateral. The protection buyer may be asked to furnish a deposit as collateral as well because of the risk of falling market prices of underlying loans or bonds. Counterparty risk is reduced if the parties can contract with a central counterparty that acts as a clearing organisation.

At another level, the buyer of protection (seller of risk) should take into account the following particular questions that influence risk: (a) Does the amount of cover provided by a credit default swap match the amount of the underlying transaction? (b) Does the definition of what triggers a credit event in the ISDA documentation work with the transaction? For example, a credit default swap without a trigger for restructuring can be less valuable than one with such a trigger; on the other hand, there can be a moral hazard if restructuring is a credit event and the buyer of protection can collect fees from the debtor in the event of restructuring and decide whether to deliver the restructured loan to the protection seller at face value. For

[437] Edwards S, The Law of Credit Derivatives, JBL 2004 pp 626–627.

this reason, there have been credit default swaps "with restructuring" and "without restructuring".

Basket swaps. The basket swap (or first-to-default, second-to-default or third-to-default swap) is a structured form of credit default swap. Under a basket swap, the protection seller must make a protection payment after a specified first, second, or third event determination date has occurred.[438]

Other swaps. There is large number of other structured credit market innovations. They can be complicated, and it can be difficult to rate them.

For example, Moody's was found to have given an incorrect triple-A rating to several Constant Proportion Debt Obligations (or CPDOs).[439]

Community law. The credit derivatives market is global and standards issued by ISDA have played a substantial role in promoting the development of this market. Community law supports the enforceability of close-out netting and collateral arrangements. This reduces counterparty risk. Credit derivatives have been addressed in Basel II and international accounting standards. Derivatives business is governed by the MiFID (section 11.7.4).

Indemnities and Other Primary Obligations

A third party may give an indemnity. The parties are free to agree on its terms. For example: the indemnifier may undertake an obligation that is linked to the underlying obligation (and depends on whether the primary debtor fulfils his obligations) or independent; the obligation may be legally enforceable against the indemnifier or not legally enforceable; and breach of the indemnity may give rise to an action for damages (with a duty on the part of the creditor to mitigate his loss) or trigger a conditional payment obligation.

Keepwell agreements and letters of comfort are typical examples of independent indemnities. For different reasons, neither keepwell agreements nor letters of comfort create enforceable legal obligations (see section 5.6.2).

Comfort letters. Comfort letters are usually issued to external creditors. The indemfifier may issue a comfort letter where it is not willing to accept a legally enforceable commitment (sections 5.6.2 and 6.2.3).

The obligations of the indemnifier under the comfort letter tend to be too vague to be legally enforceable. On the other hand, the intention to create legal relations will often be presumed in commercial transactions.[440] Even where the creditor would be able to enforce those obligations, the only claim would be a claim for damages for breach of contract.[441]

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[438] Edwards S, The Law Of Credit Derivatives, JBL 2004 pp 620–621.

[439] Jones S, Tett G, Davies PJ, Moody's error gave top ratings to debt products, Financial Times 21 May 2008; Schulz B, Fehr B, Moody's wehrt sich gegen Betrugsvorwurf, FAZ, 23 May 2008 p 21.

[440] See Fuller G, Corporate Borrowing. Third Edition. Jordans, Bristol (2006), paragraph 11.10.

[441] *Ibid*, paragraph 11.11.

Keepwell agreements. A keepwell agreement is usually an agreement between the borrower and its parent company. The parent undertakes: (a) to keep the borrower as a subsidiary; (b) to ensure that the borrower has a positive net worth at all times; and (c) to ensure that the borrower has sufficient funds to meet its commitments on time.[442] As external creditors are not party to the keepwell agreement, it is not enforceable by them.

Under English law, a keepwell agreement is sometimes enforceable by a third party (such as a lender) against the issuer under the Contracts (Rights of Third Parties) Act 1999, unless it is clear from the agreement that the parties did not intend that the third party be able to enforce the agreement.[443] In addition, the third party may ensure that the parent's failure to fulfil the terms of the keepwell agreement triggers an event of default under the agreement between the third party and the debtor.[444]

11.7 Hedging

11.7.1 Introduction

As described above, there are six particular methods to manage cash flow and risk in the context of contractual payment obligations: (1) choice of the form of the payment obligation (section 11.2); (2) choice of the time of payment (section 11.3); (3) transfer or transferability of the claim (sections 11.4 and 11.5); (4) use of credit enhancements (section 11.6); (5) hedging; and (6) diversification or a combination of different methods.

The firm does not want to avoid all risks in investment transactions. The goal of *hedging* is to ensure that any loss on one transaction is offset by the profit on another transaction. The firm can search for pairs of transactions that are balanced enough to be safe but unbalanced in one or two very particular aspects, so as to offer a potential for profit. For example, a hedge fund may want exposure to one or two risk factors in each transaction. The fund can eliminate a risk factor through the spot sale of the risk or through a contract that represents an obligation to sell the risk in the future.

Different kinds of hedging instruments. There are various kinds of hedging instruments. One can divide them into four main categories.

First, the firm may choose a second transaction which is *linked* to the first transaction in the sense that payment obligations under the second transaction will be *triggered* by an event related to the first transaction. Where the first transaction (the underlying transaction) creates legally enforceable obligations, the firm may mitigate credit risk related to the underlying transaction through a credit derivative, an insurance policy (or reinsurance), a bank guarantee, or assets that are used

[442] *Ibid*, paragraph 11.7.
[443] *Ibid*, paragraph 11.8.
[444] *Ibid*, paragraph 11.9.

as security. This means that the underlying transaction is a *collateralised transaction*.[445]

Second, the firm may also choose a second transaction that is *not linked* to the first transaction in the sense that payment obligations under the second transaction would be triggered by an event related to the first transaction. (1) Sometimes the firm prefers a transaction under which payment obligations will be triggered by another event. For example, derivatives are a usual way to mitigate risk by hedging. (2) Alternatively, the second transaction can be a transaction under which payment obligations will not be triggered by any particular future event. For example, where the firm invests in an asset the value of which can change, the firm can mitigate risk by investing in an asset the value of which is likely to change in the opposite direction. (3) Where the first transaction creates legally unenforceable cash flows rather than legally enforceable payment obligations, the firm can invest in financial instruments (derivatives) that create legally enforceable payment obligations the value of which depends on those cash flows.

Third, it is also usual to mitigate risk by contract terms that provide for close-out *netting and set-off*.

Fourth, the hedges can be unfunded or funded (see section 11.8).

Legal aspects. As there are various kinds of hedging instruments, the legal aspects of hedging depend on the instrument chosen by the firm. However, some general remarks can be made.

To what extent a second transaction works as a hedge depends on many legal things. It depends on the *form* of payment obligations under the first transaction and the form of payment obligations under the second transaction (degree of finality, legal enforceability, payments known in advance, variable payment, payments that depend on the value of an asset, payments triggered by an event, and options). The transaction is more secure as a hedge where the payment obligations of the firm's counterparty are enforceable and irrevocable and payments made under the transaction are final. Payment obligations under the second transaction do not have to be of the same kind as those under the first transaction.

The *time* when the firm's counterparty must make payments under the second transaction may vary in particular depending on whether the second transaction is separate from the first transaction or linked to the first transaction. This will influence the firm's own liquidity risk.

For example, close-out netting and set-off can be fast. Payments under demand guarantees and other independent payment obligations will be made relatively fast (in a few banking days).

This can be illustrated by the URDG and the UCP 600. URDG Article 10(a): "A Guarantor shall have a reasonable time within which to examine a demand under a Guarantee and to decide whether to pay or to refuse the demand." UCP 600 Article 14(b): "A nominated bank acting on its nomination, a confirming bank, if any, and the issuing bank shall each

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[445] Paragraph 119 of the Basel II Accord: "A collateralised transaction is one in which: banks have a credit exposure or potential credit exposure; and that credit exposure or potential credit exposure is hedged in whole or in part by collateral posted by a counterparty or by a third party on behalg of the counterparty."

have a maximum of five banking days following the day of presentation to determine if a presentation is complying. This period is not curtailed or otherwise affected by the occurrence on or after the date of presentation of any expiry date or last day for presentation." UCP 600 Article 15(a): "When an issuing bank determines that a presentation is complying, it must honour."

In contrast, the firm will have to wait longer for payments made under a credit insurance policy or a bank guarantee which are not separate from the underlying claim, because it will take the payer longer to examine whether the payment obligation is triggered and the sum that it has to pay. The sale of collateral may take a long time in particular where the collateral may not be sold by the firm as collateral-taker.

There is the question of *cost*. Unlike the use of ownership-based functional equivalents to security, the use of hedging can be expensive. The firm must typically pay a fee or premium for unfunded protection (such as guarantees and credit derivatives).

In addition, the firm may have to deliver financial *collateral* where it pays for unfunded protection (for financial collateral, see section 11.6.3). The Collateral Directive applies to certain financial collateral arrangements and to certain financial collateral.[446]

Financial institutions may use certain techniques to mitigate their credit risk on outstanding claims under the *Basel II Accord*. Its credit risk management (CRM) framework sets out what requirement the CRM techniques must meet in order to qualify for a reduction of capital requirements.[447] These questions have already been discussed in section 11.6 above.

11.7.2 Hedges Linked to the First Transaction

In some cases, payment obligations under the second transaction are triggered by an event related to the first transaction. Bank guarantees, insurance policies (or reinsurance), credit derivatives, and security arrangements (collateral) have already been discussed in the context of credit enhancements (section 11.6).

Taking collateral is one of the principal ways by which the participants in the financial markets can reduce credit risk.

Bank guarantees range from easily enforceable independent payment obligations to payment obligations which are not separate from the underlying claim. The latter may be time-consuming and difficult to enforce.

The scope of insurance policies is typically limited to a few narrowly defined events. Insurance policies require an insurable interest and the insurer will not make any payments unless the insured has sustained loss. Payments under an insurance policy will typically be made after a thorough examination of loss.

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[446] Article 1(1) of Directive 2002/47/EC (Collateral Directive).

[447] See, for example, Section II (Credit risk mitigation) of Annex II (The Simplified Standardised Approach) of the Basel II Accord.

The broad purpose of reinsurance is for the direct insurer to be covered in respect of its liability under an original insurance policy. The reinsurer takes a share of those risks and a share of the premium, thus spreading the consequences of the losses should a risk event take place. Reinsurance brings business advantages to a direct insurer. Reinsurance enlarges the direct insurer's underwriting capacity and enables it to insure a volume, type or size of risk it would not be able to cover in the absence of reinsurance. Reinsurance also increases the capital available to the direct insurer which would otherwise be earmarked to cover potential losses.[448]

Credit derivatives (section 11.6.4) are more flexible than bank guarantees and insurance or reinsurance contracts.

11.7.3 Netting, Close-out Netting, Set-off

A particular credit enhancement and hedging mechanism that can be employed for reducing credit risk involves the use of netting, set-off, or close-out netting.

Basel II. The use of netting or set-off agreements as a credit enhancement tool has been recognised by the Basel II framework. According to the Basel II Accord, a bank may use the net exposure of loans and deposits as the basis for its capital adequacy calculation, where the bank: (a) "has a well-founded legal basis for concluding that the netting or offsetting agreement is enforceable in each relevant jurisdiction regardless of whether the counterparty is insolvent or bankrupt"; (b) "is able at any time to determine those assets and liabilities with the same counterparty that are subject to the netting agreement"; (c) "monitors and controls its roll-off risks"; and (d) "monitors and controls the relevant exposures on a net basis".[449]

Availability of set-off. Between the parties, set-off is governed by provisions of contract law and the particular terms of the contract. The enforceability of set-off against third parties is typically constrained by mandatory provisions of law. Set-off is not always available in the insolvency of the counterparty because of core conditions of set-off (that the claims are mutual, of the same kind and due, section 9.6.4).

Availability of netting. Unlike set-off, netting can only be based on contract. Like set-off, netting may not always be enforceable against third parties or in the insolvency of the counterparty (section 9.6.5).

Close-out netting. Close-out netting reduces exposure and credit risk. The ISDA Master Agreement and similar master agreements provide for close-out netting.

Close-out netting is an agreement by the parties that, upon default and termination of the master agreement, all the transactions (outstanding or not) will be valued pursuant to an agreed methodology, the positive and negative values will be added together, and the resulting netted amount will be the sole remaining payment obligation of the parties.

[448] Edelman C, Burns A, Craig D, Nawbatt A, The Law of Reinsurance. OUP, Oxford (2005) paragraphs 1.06, 1.07, 1.08.

[449] Paragraph 188 of the Basel II Accord. For the formula to be applied, see paragraph 147.

Close-out netting is viewed by regulators as a means to limit systemic risk. (a) According to the Basel II framework, banks are rewarded for having legally enforceable close-out netting agreements by the reduction of the amount of capital they need to keep in reserves. (b) Close-out netting provisions may or may not be enforceable according to the law of the jurisdiction in which bankruptcy or insolvency proceedings for a party would take place. In some jurisdictions, the insolvency officer has the power to select which contracts will be continued and which will be terminated. This leads to the problem of "cherry-picking", because the insolvency officer has an incentive to claim selective performance of the profitable contracts and repudiate the unprofitable ones. In the EU, the legal enforceability of close-out netting provisions is supported by the Settlement Finality Directive[450] and the Collateral Directive.[451]

11.7.4 Derivatives

Introduction

Derivatives are the most important type of instruments which can be used for the purpose of hedging and which are not necessarily related to the first transaction.

Derivatives (such as forwards, futures, options, swaps and credit derivatives) are financial instruments that derive their value from price movements in underlying reference assets, such as financial products or statistical indicators (including currencies, commodities, equities, equity indices, interest rates, securities or any combination thereof).

Derivatives have been designed for the purpose of hedging. As the value of a derivative instrument is derived from the value of an underlying asset, a derivative is a risk-shifting agreement. Derivatives help the firm to isolate one particular risk from a transaction or business, and to seek protection against that risk.

Derivatives can also be used for the purpose of speculation, because derivatives can exclude the possibility of physical delivery of the underlying asset. For example, derivatives may enable the firm to replicate the result of trading on an underlying financial market by entering into an off-market transaction with a financial institution.[452]

The derivatives market therefore serves the needs of: parties who wish to hedge (parties who take a position in a derivative financial instrument which has opposite return characteristics of the item being hedged); parties who wish to speculate

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[450] Directive 98/26/EC (Settlement Finality Directive).

[451] Directive 2002/47/EC (Collateral Directive).

[452] There are four basic reasons for entering into a derivative transaction: 1. Speculation. 2. Hedging. 3. Asset liability management: investment managers may use derivatives whose movements will match and set off (if possible) substantive positions within the portfolio of investments. 4. Arbitrage: derivatives make it possible for an investor to take advantage of mismatches in prices or market conditions. Alistair Hudson, Swaps, Restitutions and Trusts, Sweet & Maxwell (1999) p 22; Elias RO, Legal Aspects of Swaps and Collateral, JIFM 3(6) (2001) p 232.

(parties who take an open position in a derivative product); and arbitrageurs (parties who attempt to lock in near riskless profit from price differences by simultaneously entering into the purchase and sale of substantially identical financial instruments).

Standardised derivatives and OTC derivatives. Derivatives fall into two main categories on the basis of standardisation.

First, there are standardised derivatives, which are generically known as futures. (a) As standardised contracts, futures can be traded on an exchange. (b) The terms of a futures contract are standardised for each type of contract. Questions like delivery places and dates, technical specifications, and trading and credit procedures are governed by the rules of the exchange. (c) Futures are generally subject to a single regulatory regime in one jurisdiction. (d) Futures contracts are made with a central counterparty, and parties are exposed to default by the central counterparty (see below). The contract party of those who engage in futures transactions is the exchange's clearinghouse. (e) Credit risk mitigation measures (such as regular marking to market and margining) are automatically required for futures. To protect itself against potential failure of traders, the exchange typically requires traders to deposit an initial margin. Positions are daily (and sometimes even intraday) marked to market and variation margin calls are made when prices move.[453]

In the EU, regulated markets in financial instruments such as derivatives[454] are governed by the MiFID.[455] According to the MiFID, a regulated market needs an authorisation and trading rules.[456]

The MiFID also lays down a choice of law rule. The main rule is that the public law governing the trading conducted under the systems of the regulated market is that of the home Member State of the regulated market.[457] This means that trading in foreign standardised derivative instruments normally follows the rules and conditions in the country where the trading and the clearing are organised.

The issuing of standardised derivatives to the public will require the publication of a prospectus (for prospectus requirements, see Volume III). The use of a base prospectus increases flexibility in the EU.[458]

Second, there are privately negotiated and customised derivatives, which are known generically as over-the-counter (OTC) derivatives. (a) OTC derivatives are not designed to be traded on an exchange. (b) The terms of an OTC derivative are

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453 Board J, Goodhart C, Power M, Schoenmaker D, Derivatives Regulation. Financial Markets Group, London School of Economics, March 1995, paragraph 2.2.

454 The MiFID contains a list of derivative instruments to which it applies. Annex I, Section C. Financial Instruments.

455 Article 1(1) of Directive 2004/39/EC (MiFID).

456 Articles 5(1), 4(1)(14), and 14(1) of Directive 2004/39/EC (MiFID).

457 Article 36(4) of Directive 2004/39/EC (MiFID).

458 Regulation 809/2004 implementing Directive 2003/71/EC (Prospectus Directive). The use of base prospectuses and increased flexibility have contributed to the growth of the German certificates (Zertifikate) market. Papon K, Streben nach Sicherheit, FAZ, 10 September 2006 p 29: "Von der Anlageidee bis zum fertigen Wertpapier vergehen oft nur wenige Tage."

subject to negotiation by the parties to the contract. (c) As an OTC derivative contract can have links to many jurisdictions, different aspects of the transaction can be governed by the laws of different jurisdictions. The parties typically choose the law that governs the contractual relations between the parties. A choice of law clause will suffice. Where the parties cannot choose the governing law by a choice of law clause, the parties influence the question of governing law by adapting the transaction to existing choice of law rules and structuring the transaction in order to make it fall within the scope of the laws of the inteded jurisdiction in some respects. (d) There is no central counterparty. Each party is exposed to default by its own counterparty. (e) Credit risk mitigation measures are optional for OTC derivatives.

OTC derivatives are not governed by the MiFID as such.[459] However, in practice, even privately negotiated OTC derivatives tend to be standardised, because the parties usually choose a standard contractual framework or a legal platform (ISDA) and agree, in advance, that all trades are entered into on the basis of that standard framework.

The ISDA Master Agreement is a legal platform which reduces transaction costs and legal uncertainty (for platforms, see section 2.2.2). It leaves counterparties free to negotiate the core commercial terms (such as rate or price, notional amount, maturity, and collateral) but lays down the basic legal framework for the transaction (such as representations and warranties, events of default, and termination events). The most important contract terms set out by the ISDA Master Agreement include provisions that facilitate payment netting and close-out netting.

The ISDA Master Agreement is complemented by detailed Definitions. For example, trade date means the date on which the parties agree to the terms of a contract. The effective date is the date on which the parties begin calculating accrued obligations (such as fixed and floating interest payment obligations on an interest rate swap). Notional principal, or notional amount, of a derivative contract is a hypothetical underlying quantity upon which interest rates or other payment obligations are computed.

It is also complemented by a Schedule. The Schedule indicates the various elections and additions that are necessary, for example, because of mandatory provisions of law.

The economic terms of the trade are evidenced in the form of a Confirmation. Trading is usually conducted by telephone and the oral agreement is binding on both parties, provided that the criteria for the creation of a contract are satisfied.

As a means of avoiding any inconsistency between the documentation which combine to form the contractual foundation to derivatives trading, the Master Agreement states that the Confirmation is paramount with regard to any transactions and the Schedule takes precedence over the Master Agreement. However, for the avoidance of potential disputes, counterparties often insert a clause in the Schedule stating that, if a discrepancy exists, the Confirmation shall take priority, followed by the Schedule, the Definitions and then the Master Agreement.[460]

[459] Recital 53 of Directive 2004/39/EC (MiFID).
[460] Edwards S, Legal Principles of Derivatives, JBL 2002 pp 4–5.

Different aspects of an international derivatives trade may be governed by the laws of different countries. (a) Contract law issues are usually governed by the law chosen by the parties. The parties may choose either New York law or English law to govern the standard ISDA documentation; sometimes the parties choose New York law to govern the ISDA Master Agreement but part of the contractual framework to be governed by English law, where this is thought to be more favourable.[461] (b) Company law issues are typically governed by the law governing the company, insolvency law issues by lex fori, and property issues by the law of the country where the assets are situated (lex situs). This will be taken into account in the Schedule.

Credit risk. Derivatives can be used as a way to mitigate risk, but derivatives give rise to a credit risk. Each party will have credit risk on the other. The credit risk is increased by the risk of cherry-picking that exists where set-off or netting cannot be enforced against the counterparty (see below and section 9.6.5).

The nature of the derivatives market has an effect on credit risk exposure. According to the Bank for International Settlements, the total notional amount outstanding of OTC derivatives was $516,407 billion in June 2007. However, the gross credit exposure was only $2,669 billion, i.e. roughly 0.5% of the total notional amount, because of the netting of claims.[462] Whereas some banks have been said to be “too big to fail”, some market participants are “too interconnected to fail”. They are likely to be rescued by the supervisory authorities.[463] This was the case with Long-Term Capital Management, Bear Stearns, and AIG.

Financial collateral. Taking collateral is one of the principal ways by which the participants in the financial markets may reduce credit risk.

In futures contracts, collateral is employed to protect futures exchanges from the default of their members. As the counterparty is often an institution with a high credit rating or a special purpose entity structured and capitalised so as to obtain a very high credit rating, a party does not always require collateral in an OTC derivative transaction. However, the introduction of various ISDA credit support documents have increased the use of collateral.

In principle, credit risk can be mitigated even by other credit enhancement techniques (section 11.6).[464]

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[461] See Article 3(1) of Regulation 593/2008 (Rome I): “… By their choice the parties can select the law applicable to the whole or to part only of the contract.”

[462] See BIS Quarterly Review, March 2008, Statistical annex, A 103. See also The great untangling, The Economist, November 2008.

[463] See Die Angst vor der Kernschmelze, FAZ, 17 April 2008 p 24.

[464] Elias RO, Legal Aspects of Swaps and Collateral, JIFM 3(6) (2001) p 234. In addition to collateral and close-out netting, the author lists the following credit enhancement techniques: “1. transaction exposure reduction (which may provide topical relief for particular transactions that generate high exposure) which includes elective termination rights and single swap resets; 2. direct credit support through cash or securities collateral; 3. third party credit support with instruments such as letters of credit or guarantees; and 4. credit risk transfer through credit insurance or credit derivatives.”

Netting and close-out netting. Arguably the most important clause in the ISDA Master Agreement is the clause that provides for close-out netting (section 9.6.5). In Community law, close-out netting is supported by the Settlement Finality Directive[465] and the Collateral Directive.[466]

Payment netting reduces payments due on the same date and in the same currency to a single net payment. If a counterparty to an ISDA Master Agreement defaults, the close-out netting provisions of the ISDA Master Agreement provide that offsetting credit exposures between the two parties will be combined into a single net payment from one party to the other. Important clauses that support the close-out netting clause include the two-tier method of contractually ending the derivatives trading relationship: (a) the fault-based Events of Default clause; and (b) the no-fault Termination Events clause. Other important clauses include the tax gross-up clause.

Without close-out netting provisions that are valid and enforceable under the law of the counterparty's jurisdiction in the event that it defaults on its obligations or becomes insolvent, financial collateral would not always be enforceable against third parties. Enforceability can typically be constrained by mandatory provisions on insolvency set-off in the jurisdiction of the collateral-giver as well as recharacterisation (sections 9.6.4 and 11.5.2; Volume III).

Central counterparty. The use of a central counterparty (CCP) will reduce risk further. The use of a CCP has three main advantages. First, netting increases *liquidity* in the market as it reduces the number of settlement transfers and thus the associated risks and operational costs. Second, novation (alternatively, the use of open offers) transfers to the CCP the management of counterparty risk, as the CCP becomes the *single trading counterparty* to all its members. To mitigate its own exposure to counterparty risk, the CCP implements risk control measures, such as membership requirements, margin calls and guarantee funds. Third, novation allows *anonymity* of counterparties to be maintained in the post-trading processing, as trading parties no longer need to know with whom they were originally trading.[467]

Usually, traders on derivative markets offset their positions on the derivatives' underlying assets before the settlement date (derivative maturity) by undertaking offsetting derivatives transactions. The netting and clearing of these interconnected transactions is therefore crucial. When a CCP is used, netting and clearing often lead to simple cash payments (from net debtors to net creditors) without any securities settlement. Furthermore, the CCP can mitigate risk by requiring daily payments in accordance with margin calls for each day from the trade date until the delivery date.[468]

Speculation and counterparty corporate risk. Although derivatives can also be used for the purpose of speculation, the laws under which the counterparty is incorporated and its constitutional documents may limit the use of derivatives to

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[465] Directive 98/26/EC (Settlement Finality Directive).
[466] Directive 2002/47/EC (Collateral Directive).
[467] ECB, The euro bonds and derivatives markets (June 2007) p 48.
[468] *Ibid*.

hedging. In the worst case, a transaction entered into by the counterparty is void. This was the case in the landmark decision of the House of Lords in *Hazell v London Borough of Hammersmith and Fulha*m[469] (section 6.2.2).

Particular Legal Aspects of OTC Derivatives

As derivatives do not conveniently fit within a particular area of law, derivatives lawyers are required to apply contract, company, commercial, property, insurance, and corporate insolvency law to the business of derivatives. At the same time, they should be aware of any possible accounting, tax, credit and regulatory implications.[470]

Derivatives v gaming or wagering. Derivatives can also be used for the purpose of speculation or arbitrage. On the other hand, contracts by way of gaming or wagering may be void, and a promise to pay money in respect of such contracts may be unenforceable as well.[471] This question has been discussed in detail in English case law.[472] Typically, derivative contracts are not regarded as wagering where they are entered into by way of business and a form of business activity.

Contract. OTC derivatives are ordinarily governed by the ISDA Master Agreement.[473] The Master Agreement is supplemented by a Schedule. The Schedule indicates the various elections and additions that are required either for business reasons[474] or because of the need to adapt the contractual framework to mandatory law. Trading is usually conducted by telephone. The economic terms are recorded on a deal ticket and the oral contract is thereafter evidenced in the form of a Confirmation.

Fast exchanges of confirmation letters would not be possible unless the parties had agreed on the contractual framework in advance. Confirmations do not include provisions covering representations and warranties, covenants, events of default, liquidated damages, assignment judgment currency, consent to jurisdiction and closing documents. Neither do they contain provisions for the netting of payment obligations. Such provisions can be found in the ISDA Master Agreement and the Schedule.

As a means of avoiding any inconsistency between the documentation which combine to form the contractual foundation to derivatives trading, the Master Agreement states that the Confirmation is paramount with regard to any transactions and the Schedule takes precedence over the Master Agreement. However, for

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469 Hazell v London Borough of Hammersmith and Fulham [1992] 2 AC 1

470 Generally, see Edwards S, Legal Principles of Derivatives, JBL 2002 pp 1–32.

471 For English law, see section 18 of the Gaming Act 1845 and section 1 of the Gaming Act 1892. Edwards S, Legal Principles of Derivatives, JBL 2002 p 3.

472 Morgan Grenfell v Welwyn Hatfield District Council [1995] 1 All.E.R. 1. This case is part of the litigation that followed Hazell v Hammersmith and Fulham London Borough Council [1992] 2 AC 1.

473 For an introduction, see Allen & Overy, An Introduction to the Documentation of OTC Derivatives, May 2002, available on the website of ISDA.

474 See Taylor-Brill B, Negotiating and Opining on ISDA Masters, PLI, 1147 PLI/Corp pp 79–98.

the avoidance of potential disputes, counterparties often insert a clause in the Schedule stating that, if a discrepancy exists, the Confirmation shall take priority, followed by the Schedule, the Definitions and then the Master Agreement (for interpretation generally, see section 5.2.5).[475]

The foundation of the contractual relationship is that all trades are entered into on the basis that the Master Agreement and Schedule combine with all Confirmations to form a Single Agreement.

Payment netting. Rather than counterparties settling each particular payment separately, the ISDA Master Agreement provides for payment netting. Any matured derivatives payment between counterparties on a particular date in the same currency and either in respect of one or more transactions (depending on the election) is paid net. In addition to a risk mitigation mechanism, this method of paying net rather than gross is a matter of administrative convenience as it is better to set off amounts to be paid rather than force parties to make payments separately on the same payment date.[476]

Collateral. In a derivative transaction, the credit exposure amount is the potential mark-to-market exposure over the life of the transaction. Although participants in the OTC derivatives markets do not always collateralise their transactions, they are increasingly requiring collateral to be committed in order to reduce the risks inherent to default. Usually, the collateral is cash.[477] ISDA documentation can facilitate this. Collateral relationship in the OTC derivatives markets are typically documented under ISDA's credit support documents. The core credit support document is the 2001 ISDA Margin Provisions.[478] If collateral is taken to cover a net exposure under a Master Agreement, it is important to ensure that the close-out netting provisions of the Master Agreement are enforceable upon the insolvency of the counterparty.[479]

There are two principal forms of collateral arrangement used in the OTC derivatives market: one based on creation of a pledge or other security interest in the collateral; the other based on title transfer. The legal form and effect of each approach will vary according to the governing law of the collateral arrangement, the nature of and location of the collateral and the nature and location of the parties.[480]

Mitigation of the risk of cherry-picking. The risk of cherry-picking (section 9.6.5) is mitigated in two ways. First, there is the Single Agreement approach. However, the Single Agreement approach may not prevent cherry-picking in the

475 Edwards S, Legal Principles of Derivatives, JBL 2002 pp 4–5.

476 See *ibid*, p 6.

477 For key features of credit exposure, see ISDA, Guidelines for Collateral Practitioners (1996) pp 4–6.

478 See Edwards S, Legal Principles of Derivatives, JBL 2002 p 4. The 2001 ISDA Margin Provisions are intended to replace previous documents such as: 1994 Credit Support Annex (Bilateral Form) – New York law; 1995 Credit Support Annex (Bilateral Form – Transfer) – English law; 1995 Credit Support Deed (Bilateral Form – Security Interest) – English law; 1995 Credit Support Annex (Bilateral Form – Loan and Pledge) – Japanese law.

479 ISDA, Guidelines for Collateral Practitioners (1996) p 18.

480 *Ibid*, p 14.

insolvency of the counterparty. Second, the Master Agreement provides for close-out netting. Although not all jurisdictions recognise the enforceability of close-out netting, close-out netting provisions are enforceable in accordance with the Settlement Finality Directive[481] and the Collateral Directive[482] (sections 9.6.3 and 9.6.5).

Termination. The ISDA Master Agreement provides for a two-tier method of contractually ending the derivatives trading relationship.

First, there are "fault-based" Events of Default and "no-fault" Termination Events (matters that may arise during the course of derivatives trading which adversely affect dealings between the parties but are outside the influence of either party). The occurrence of either an Event of Default or a Termination Event may, subject to different notice periods, result in a fundamental breach of condition which entitles the Non-defaulting or Affected Party to end the contractual relationship and either make or receive a close-out payment.

Second, the notice provisions are bypassed where Automatic Early Termination applies. An Early Termination Date is deemed to occur upon the happening of a specified Bankruptcy term and it takes effect at the point in time immediately prior to the commencement of the relevant proceeding. This mechanism is intended primarily as a means of avoiding making derivative payments to an insolvent counterparty and may be a very useful way of asserting rights outside the rigours of insolvency. An Early Termination Date is likely to have occurred without the knowledge of the Non-defaulting Party.

The main consequences of termination are that the executory derivative contracts are terminated, the payment and delivery obligations are accelerated, the delivery obligations are converted into monetary equivalents, each monetary amount is set off in order to determine a net sum payable from one counterparty to the other, and close-out netting may take effect.

Where the termination follows an Event of Default, the aggrieved party may recover its loss. The amount to be payable has been determined in the ISDA Master Agreement. The parties have the opportunity at the time of entering into the Agreement to choose between different formulae for calculating and paying the amount due from one to the other. These provisions are long and complex.[483]

One of the most important questions is again whether close-out netting and set-off are enforceable between the parties and – in particular in the insolvency of the counterparty - against third parties.

Scope of the ISDA Master Agreement, legal opinions. The ISDA Master Agreement can be used to document a range of different types of transactions (it is "multi-product"). On the other hand, different legal rules may govern different types of transactions.

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481 Directive 98/26/EC (Settlement Finality Directive).

482 Directive 2002/47/EC (Collateral Directive).

483 They were applied, for example, in the English case of Peregrine Fixed Income Ltd v Robinson Department Store Public Co. Ltd [2000] EWHC Commercial 99. See Edwards S, Legal Principles of Derivatives, JBL 2002 pp 8–10.

For this reason, legal opinions on the ISDA Master Agreement are typically limited to a particular transaction type. A legal opinion on, for example, an interest rate swap is worthless for an equity swap, although both may be governed by the ISDA Master Agreement.

Excursion: liability risks for banks. The leading participants in the OTC market are banks and their customers. Derivatives transactions can involve increased liability risks for banks.

Liability issues may arise in two distinct contexts. A bank may be claiming for moneys due, and be met with a counterclaim based on its handling of a derivatives transaction. Alternatively, the counterparty may itself be a plaintiff seeking a variety of remedies against the bank (for example, damages and perhaps rescission of the contracts at issue).

Particular risks arise generally in the banker-customer relationship and when the bank has assumed an advisory role. Typical liability issues relate to:

- the power of the counterparty to enter into the transaction (counterparty corporate risk);[484]
- compliance with regulatory rules such as conduct of business rules;[485]
- misrepresentation that gives rise to damages in contract or in tort;[486] and
- liability in contract (for example, the scope of the bank's contractual duties such as duty of care, disclosure duties, and duty to assess the suitability of the instrument).[487]

Depending on the scope of the service that the bank holds itself out as providing, the bank may have fiduciary duties and a general duty of care as well as special duties to advise and propose suitable transactions.

For example, the German City of Würzburg bought interest derivatives from Deutsche Bank, a German bank. As short-term interest rates rose, the City of Würzburg incurred a loss. In 2007, the city sued the bank and claimed reimbursement of the loss or that the contracts be declared null and void. The City of Würzburg argued that: it had not had any power to enter into such speculative contracts in the first place; the bank had not complied with its disclosure obligations; in particular, the bank had not complied with its duties to advise its customer; and the contracts were unfair.[488]

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[484] Section 6.2. The leading case is Hazell v London Borough of Hammersmith and Fulham [1992] 2 AC 1

[485] The EU: Article 19 of Directive 2004/39/EC (MiFID). Germany: the Securities Trading Act (WpHG). The UK: the Financial Services Act 1986 and the Financial Services and Markets Act 2000. The US: the Securities Act of 1933, the Securities Exchange Act of 1934, and the Commodity Exchange Act.

[486] See Volume I for the principles of Hedley Byrne & Co v Heller & Partners [1964] AC 465 (House of Lords) and Caparo Industries v Dickman [1990] 2 AC 605 (House of Lords) as well as similar principles under German law.

[487] Blair W, Liability Risks in Derivatives Sales, JIBL 1 (1996) p 19.

[488] Würzburg gegen die Deutsche Bank, FAZ, 5 July 2007 p 20.

Particular Legal Aspects of Exchange-traded Derivatives

EU securities market directives apply to some extent to derivatives business. In addition, particular legal aspects of exchange-traded derivatives include the existence of a central counterparty, and the requirement of collateral.

Community law. Unlike OTC derivatives, exchange-traded derivates are subject to extensive legal regulation by the Member Stastes and exchanges. These legal rules have to a large extent been approximated by EU securities markets directives.

The main purpose of EU securities markets directives is to ensure the development of a single securities market that is both integrated and efficient.[489] They regulate the initial and on-going conditions for service providers (investment firms), establish requirements for the issuance of securities (both as regards public offers of securities and requirements for securities to be listed on an exchange) and co-ordinate the conditions applicable to investment funds. The conditions for the setting-up of investment firms and their on-going business are similar to those for banks, and provide for a level playing field between non-bank investment firms and banks providing investment services. The legislation on issuance of securities lays down minimum requirements for the information that must be disclosed to the public and facilitates cross-border issuance of securities. The legislation on investment funds (UCITS) facilitates the distribution of units of such funds across the Community.

In particular, derivatives business may be covered by the MiFID,[490] the Capital Requirements Directives (Basel II);[491] the Directive on market abuse,[492] the Prospectus Directive,[493] and the Transparency Directive.[494]

In practice, the underlying commodity markets and the derivatives markets are very closely intertwined. However, the regulation of the underlying markets differs markedly (at least at a European level) from the regulation of financial markets. MiFID harmonises the provision of investment services in relation to most commodity derivatives, while the trading and other activities in relation to the underlying commodities remain under the domain of national regulation even when this trading is undertaken by firms licensed under MiFID.[495]

Central counterparty. Parties make contracts for the purchase or sale of exchange-traded derivatives with a central counterparty. In the EU, the business of

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[489] See, for example, recitals 1–2 of Directive 2003/6/EC (Directive on market abuse).

[490] Directive 2004/39/EC (MiFID).

[491] Directive 2006/48/EC and Directive 2006/49/EC.

[492] Directive 2003/6/EC (Directive on market abuse).

[493] Directive 2003/71/EC (Prospectus Directive).

[494] Directive 2004/109/EC (Transparency Directive). The Transparency Directive repealed Council Directive 88/627/EEC on the information to be published when a major holding in a listed company is acquired or disposed of.

[495] European Commission, Call for Evidence. Review of Commodity and Exotic Derivatives and Related Business as Required by MiFID and recast CAD, 1 December 2006, p 9.

central counterparties is governed by the provisions of the MiFID applicable to multilateral trading facilities (MTF).

"Multilateral trading facility" (MTF) means "a multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments - in the system and in accordance with non-discretionary rules - in a way that results in a contract".[496] Member States must require that investment firms or market operators operating an MTF: establish transparent and non-discretionary rules and procedures for fair and orderly trading and establish objective criteria for the efficient execution of orders;[497] establish transparent rules regarding the criteria for determining the financial instruments that can be traded under its systems;[498] provide, or are satisfied that there is access to, sufficient publicly available information to enable its users to form an investment judgement, taking into account both the nature of the users and the types of instruments traded;[499] establish and maintain transparent rules, based on objective criteria, governing access to its facility;[500] clearly inform its users of their respective responsibilities for the settlement of the transactions executed in that facility;[501] and put in place the necessary arrangements to facilitate the efficient settlement of the transactions concluded under the systems of the MTF.[502] The provisions of the MiFID have been complemented by an implementing Regulation.[503]

Prudential regulation. The MiFID establishes the framework of the prudential regulation for investment firms in regulated markets.[504] The financial instruments covered by the MiFID include, for example, derivatives.[505]

The scope of prudential regulation under the MiFID is limited to those entities which, by virtue of running a trading book on a professional basis, represent a source of counterparty risk to other market participants. For this reason, entities which deal on their own account in financial instruments are excluded from the scope of the MiFID (provided that their main business is not the provision of investment services within the meaning of the MiFID).[506]

Furthermore, not all transactions concluded by members or participants of the regulated market or MTF are considered as concluded within the systems of a regulated market or MTF.

Transactions which members or participants conclude on a bilateral basis and which do not comply with all the obligations established for a regulated market or an MTF under the MiFID are considered as transactions concluded outside a regulated market or an MTF for the

[496] Article 4(1)(15) of Directive 2004/39/EC (MiFID) (in accordance with the provisions of Title II). See also recitals 5, 6 and 49.
[497] Article 14(1) of Directive 2004/39/EC (MiFID).
[498] Article 14(2) of Directive 2004/39/EC (MiFID).
[499] Article 14(2) of Directive 2004/39/EC (MiFID).
[500] Article 14(4) of Directive 2004/39/EC (MiFID).
[501] Article 14(5) of Directive 2004/39/EC (MiFID).
[502] Article 14(5) of Directive 2004/39/EC (MiFID).
[503] Regulation 1287/2006 implementing Directive 2004/39/EC.
[504] Article 1(1) of Directive 2004/39/EC (MiFID).
[505] Annex 1, Section C of Directive 2004/39/EC (MiFID). See also recital 4.
[506] Article 2(1)(d), (i), (k) and (l) of Directive 2004/39/EC (MiFID). See also recital 25.

purposes of the definition of systematic internaliser.[507] In such a case the obligation for investment firms to make public firm quotes should apply if the conditions established by the MiFID are met.[508]

The Commission is obliged to re-examine the provisions relating to criteria for determining which OTC derivative contracts relating to commodities and "exotic derivatives" are to be treated as financial instruments for the purposes of MiFID.[509]

The MiFID exemptions do not prohibit Member States from imposing a specific regulatory regime on the exempted entities. This presents the possibility of a patchwork of regulatory regimes and can – according to the Commission – result in the creation of new barriers to provision of services.[510]

Regulatory capital. Most firms that fall within the scope of the MiFID will also have to comply with the Capital Requirements Directive (Basel II) which requires regulatory capital.

In the EU, prudential regulation and capital requirements are imposed even on investment firms which do not accept deposits or grant credits. According to the European view, investment firms and banks carry on identical or similar activities and are exposed to identical or similar risks from their activities. Furthermore, the large scale failure of investment firms could have systemic consequences. Finally, investment firms and banks often act as direct competitors and so imposing similar or identical levels of regulation avoids distortion of competition.[511]

The capital requirements under the Capital Requirements Directive are based on the higher of: (1) a base capital requirement; and (2) the sum of credit risk, market risk and operational risk (Volume I).

Article 48 of the Capital Requirements Directive introduced a transitional provision which exempted a number of investment firms carrying out commodities business from the capital requirements established in that Directive until 31 December 2010.[512] This Article also states that the Commission should report on an appropriate regime for the prudential supervision of investment firms whose main business consists exclusively of the provision of investment services or activities in relation to commodity derivatives or derivatives contracts. According to the Commission, the existence of two sets of parallel rules applying to the same activities risks both over-regulation and a system of inconsistent organisational requirements for regulated entities.[513]

Conduct of business rules. The MiFID lays down the key duties of investment firms when dealing with their clients. The MiFID contains three approaches for in-

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[507] Article 4(1)(7) of Directive 2004/39/EC (MiFID)

[508] Article 27 and recital 49 of Directive 2004/39/EC (MiFID)

[509] Article 40(2) of Regulation 1287/2006 implementing Directive 2004/39/EC; Annex 1, Section C(1) of Directive 2004/39/EC (MiFID). See also European Commission, Call for Evidence. Review of Commodity and Exotic Derivatives and Related Business as Required by MiFID and recast CAD, 1 December 2006, p 4.

[510] European Commission, Call for Evidence, p 11.

[511] *Ibid*, p 12.

[512] Article 48(1) of Directive 2006/49/EC; Section C of Annex I to Directive 2004/39/EC.

[513] European Commission, Call for Evidence, p 27.

formation gathering on the sales process: "suitability" applies to investment advice and discretionary portfolio management; "appropriateness" applies to all non-advised services; and "execution only"[514] forms an exception to the requirement for appropriateness in certain circumstances (Volume I).

Admission of financial instruments to trading, prospectuses. The formalities relating to admission of derivates to trading are governed by the MiFID and the Prospectus Directive.

The MiFID requires Member States to ensure that regulated markets have clear and transparent rules regarding the admission of financial instruments to trading. These rules must ensure that any financial instruments admitted to trading in a regulated market are capable of being traded in a fair, orderly and efficient manner and, in the case of transferable securities, are freely negotiable.[515] In the case of derivatives, the rules "shall ensure in particular that the design of the derivative contract allows for its orderly pricing as well as for the existence of effective settlement conditions".[516]

The purpose of the Prospectus Directive is to harmonise requirements for the drawing up, approval and distribution of the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market situated or operating within a Member State.[517] The Prospectus Directive can be applied to some derivatives.[518]

Transparency of trading. The MiFID increases the transparency of trading. According to the MiFID, transactions in any financial instrument admitted to trading on a regulated market (whether or not the transactions were carried out on a regulated market) must be reported to the competent authority.[519] For example, this will include commodity derivatives, interest rate derivatives and foreign exchange derivatives that are admitted to trading on regulated markets, as well as equity and debt instruments.

Transparency of issuers. The Transparency Directive lays down disclosure obligations for issuers' shares and securities other than shares, where the securities are already admitted to trading on a regulated market situated or operating within a Member State.[520]

Issuers of shares must make public without delay any change in the rights attaching to the various classes of shares, including changes in the rights attaching to derivative securities issued by the issuer itself and giving access to the shares of that issuer.[521]

Issuers of securities other than shares must make public without delay any changes in the rights of holders of those securities.[522]

[514] Article 19(6) of Directive 2004/39/EC (MiFID).
[515] Article 40(1) of Directive 2004/39/EC (MiFID).
[516] Article 40(2) of Directive 2004/39/EC (MiFID).
[517] Article 1(1) of Directive 2003/71/EC (Prospectus Directive).
[518] Article 1(2)(f) of Directive 2003/71/EC as well as Articles 1(2)(j) and 7(2).
[519] Article 25(3) of Directive 2004/39/EC (MiFID).
[520] Article 1(1) of Directive 2004/109/EC (Transparency Directive).
[521] Article 18(1) of Directive 2004/109/EC (Transparency Directive).
[522] Article 18(2) of Directive 2004/109/EC (Transparency Directive).

Market integrity. In the EU, market integrity is supported by the MiFID, which enables competent authorities to monitor market participants,[523] and the Directive on market abuse, which harmonises the regulation of insider dealing and market manipulation in relation to: financial instruments admitted to trading on a regulated market; and their issuers (Volume III).

The Market Abuse Directive can thus apply to trading in exchange-traded derivatives.[524] This is also reflected in the definition of inside information.[525] "Front running" in commodity derivatives is one of the examples of market manipulation covered by the Market Abuse Directive.[526]

In addition, the Market Abuse Directive can apply to some derivative instruments not admitted to trading.[527] The Directive applies both to traded derivatives[528] such as traded commodity derivatives,[529] and to untraded derivatives that relate to financial instruments that are traded.[530]

11.8 Credit Risk Transfer in General

11.8.1 Introduction

Risk can be avoided, mitigated, transferred, or accepted. A large number of different ways to mitigate or transfer risk have been discussed in the previous sections of Chapter 11. A summary of credit risk transfer (CRT) can help to understand the full scope of credit transfer techniques.

General methods. There is a wide range of general ways to transfer credit risk. For example, business activities can be transferred to a limited-liability company controlled by the risk shedder (a subsidiary, an SPV) or to an outsource provider. However, there are also specific ways to transfer credit risk separately.

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523 Article 25 of Directive 2004/39/EC (MiFID).
524 Article 1(3) of Directive 2003/6/EC (Directive on market abuse).
525 Article 1(1) of Directive 2003/6/EC (Directive on market abuse).
526 See recital 19 of Directive 2003/6/EC (Directive on market abuse).
527 See recital 35 of Directive 2003/6/EC (Directive on market abuse).
528 Articles 1(1) and 1(3) of Directive 2003/6/EC (Directive on market abuse).
529 Article 1(1) of Directive 2003/6/EC (Directive on market abuse): "… In relation to derivatives on commodities, 'inside information' shall mean information of a precise nature which has not been made public, relating, directly or indirectly, to one or more such derivatives and which users of markets on which such derivatives are traded would expect to receive in accordance with accepted market practices on those markets."
530 Article 1(1) of Directive 2003/6/EC (Directive on market abuse): "… and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments ..." Article 1(3): "'Financial instrument' shall mean: … - financial-futures contracts, including equivalent cash-settled instruments, - forward interest-rate agreements, - interest-rate, currency and equity swaps, - options to acquire or dispose of any instrument falling into these categories, including equivalent cash-settled instruments. This category includes in particular options on currency and on interest rates, - derivatives on commodities …"

Specific methods. Specific techniques for transferring credit risk have been a long-standing feature of financial markets. Traditional CRT instruments include collateral, financial guarantees, and credit insurance. In the 1990s, the range of credit risk transfer instruments and the circumstances in which they were used widened considerably. New CRT instruments include in particular credit default swaps and other credit derivatives[531] as well as ABS CDOs (see below).

Risk shedder and risk taker. The commercial transfer of risk involves two parties. The risk shedder acts as a protection buyer, risk seller, or insured. The risk taker – the institution that takes on credit risk – acts as a protection seller, risk buyer, guarantor, or insurer.

Categorisation of instruments. According to a BIS report, CRT instruments can be classified according to a relatively small number of key features.[532]

One distinction relates to the *number of borrowers*, i.e. whether the CRT instruments transfer credit risk associated with an individual borrower (single name) or a number of borrowers (portfolio).

Another relates to *funding*. CRT can be funded or unfunded. The distinction between funded and unfunded CRT instruments can be drawn either from the perspective of the risk shedder (i.e. whether the risk shedder receives funds in the transaction), or from the perspective of the risk taker (i.e. whether the risk taker has to provide upfront funding in the transaction). For example, the sale of a loan in the secondary market is a funded risk transfer from the risk shedder's perspective. An insurance contract is an unfunded risk transfer from the risk shedder's perspective, because the risk taker does not provide funds at the time the risk is transferred.

Finally, risk can be transferred *directly* between the risk shedder and the risk taker or *indirectly* through a special purpose vehicle (SPV) in *structured* CRT transactions.

[531] BIS, CGFS, Credit risk transfer, January 2003.
[532] *Ibid*, p 5.

Table 11.4 Credit Risk Transfer (CRT) Mechanisms

	Funded	*Unfunded*
Single name.	Collateral. Loan trading.	Guarantees and letters of credit. Insurance policies such as surety bonds, credit insurance and financial guarantee insurance. Derivatives such as credit default swaps and total return swaps.
Portfolio.		
Direct risk transfer (ie liability of risk shedder).	Credit-linked notes.	Portfolio credit default swaps, baskets.
Risk transfer via SPV.	Asset-backed securities, collateralised debt obligations (cash CDOs).	Collateralised debt obligations (synthetic CDOs).

There can be several layers of SPVs and securitisations. Corporate CDOs (collateralised debt obligations) are "one-layer" securitisations with exposures directly to the debt of corporate issuers. ABS CDOs are "two-layer" securitisations, i.e. securitisations that invest in securitisations. A CDO is a security whose principal and interest are repaid by the cash flows generated by a portfolio of assets (usually loans and bonds), and an ABS CDO is a CDO whose portfolio is comprised of asset-backed securities (ABS).[533]

There are even other ways to classify CRT instruments, because there are six basic methods to manage return and risk in the context of contractual payment obligations (section 10.1).[534]

For example, the *speed of payment* can be a distinguishing factor. For insurance-based contracts, loss verification and compliance checks are typically carried out before any payment is made. Many other contracts are based on the principle "pay first, sue later".

Furthermore, like the payment obligations of the protection seller, the payment obligations of the *protection buyer* are transaction-specific. There are different forms of premium. For example, the payment can be fixed, variable, or contingent, and it does not always have to be made or settled in cash. An incorporated firm can use its shares as a means of payment.

In September 2008, Citigroup was in the process of acquiring Wachovia, another bank. The FDIC agreed to bear losses that exceed a certain threshold in return for preferred stock and

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[533] See BIS, Basel Committee on Banking Supervision, Credit Risk Transfer. Developments from 2005 to 2007. Consultative Document, April 2008 pp 4 and 37.

[534] They are: (1) choice of the form of payment obligation; (2) choice of the time of payment; (3) transfer or transferability of the claim; (4) the use of credit enhancements; (5) hedging; and (6) diversification or a combination of different methods.

warrants entitling it to a stake in Citigroup.[535] Wachovia was nevertheless acquired by Wells Fargo.[536]

Incentive issues. The transfer of credit risk leads to changes in the incentives which the different parties to a credit transaction face. CRT can create moral hazard problems and/or conflicts of interest.

The risk taker has a clear interest in minimising credit losses on the exposures it assumes. Depending on the extent of CRT and the design of the CRT mechanism, CRT may result in the reduction of the risk shedder's incentives to minimise credit losses.

Therefore, the risk taker will need to address incentive issues. Incentive issues relating to the risk shedder-risk taker relationship can be divided into three types:[537] (1) an asymmetric information problem (the risk shedder may have better information about the creditworthiness of the underlying debtor than the risk taker); (2) principal/agent problems (the risk shedder may retain a relationship with the borrower following CRT as an agent of the risk taker); and (3) an incomplete contracting problem.[538]

11.8.2 Incentive Issues: Risk Shedder's Perspective

The transfer of credit risk from the risk shedder to a risk taker (for example, from a lender to another financial institution) gives the risk shedder more discretion in its behaviour towards the debtor but gives rise to a new form of counterparty risk.

Counterparty risk, risk taker as counterparty. Unfunded risk transfer instruments create counterparty risk. The risk shedder can mitigate it by requiring collateral or otherwise.

There can be legal constraints on the provision of collateral. Some counterparties have undertaken covenants (negative pledges) which prohibit the provision of collateral (section 11.6.2). In some countries, insurance firms and mutual funds are prevented by regulatory rules from providing collateral.[539]

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535 FDIC, Citigroup Inc. to Acquire Banking Operations of Wachovia, Press release of 29 September 2008: "The FDIC has entered into a loss sharing arrangement on a pre-identified pool of loans. Under the agreement, Citigroup Inc. will absorb up to $42 billion of losses on a $312 billion pool of loans. The FDIC will absorb losses beyond that. Citigroup has granted the FDIC $12 billion in preferred stock and warrants to compensate the FDIC for bearing this risk."

536 The bailiff, The Economist, October 2008.

537 BIS, CGFS, Credit risk transfer, January 2003 p 17.

538 *Ibid*, p 17.

539 *Ibid*, p 28.

11.8.3 Incentive Issues: Risk Taker's Perspective

The risk taker will have to address problems relating to asymmetric information, agency, and incomplete contracts.[540] Many of the features of CRT instruments have been designed to limit conflicts between the risk shedder and the risk taker and better align their incentives.

Asymmetric information. If the risk shedder has better information about the creditworthiness of its debtors, it may exploit this at the time of the risk transfer to overstate the credit quality of the transferred exposures. The risk taker may be faced with adverse selection and moral hazard problems. Screening, monitoring and tranching can help to mitigate them.[541]

First, the risk taker may mitigate risk by doing business with risk shedders about which a significant amount of financial information is available. Some risk shedders are subject to public disclosure obligations (for the disclosure regime for listed companies, see Volume III). In addition, the risk taker may be able to rely on a third party credit opinion; large risk shedders tend to be rated (for rating agencies, see Volume I).

Second, the risk taker may perform its own detailed credit review. CRT can lead to weak origination standards.[542]

Third, the risk taker may require the risk shedder to disclose any material facts and make its own obligations conditional upon such disclosures being complete and accurate (for usefulness, see Volume I). For example, in the case of credit insurance, the insurer (risk taker) will typically require the insured (risk shedder) to disclose any material facts about the creditworthiness of borrowers, with the insurance void if it subsequently emerges that such disclosures were incomplete or inaccurate.[543]

Fourth, where portfolio CRT transfers risk on retail loans, the risk taker may ensure that the risk shedder selects the loans randomly from its portfolio.

Fifth, in portfolio CRT, the risk taker will often require the risk shedder to retain some proportion of the first-loss tranche (section 11.8.4 below). Sometimes the risk shedder may also retain a small proportion of the risk of more senior

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540 *Ibid*, p 16.

541 *Ibid*, pp 17 and 40.

542 See BIS, Basel Committee on Banking Supervision, Credit Risk Transfer. Developments from 2005 to 2007. Consultative Document, April 2008 p 12.

543 BIS, CGFS, Credit risk transfer, January 2003 p 19: "Two celebrated examples are (i) the so-called Hollywood Funding case, in which insurance companies refused payment on insurance policies designed to protect investors in a series of films, on the grounds of misrepresentation and breach of contract terms, requiring a certain number of films to be made; and (ii) the surety bonds provided to JP Morgan Chase by insurance companies on behalf of Enron to back its obligation to deliver on prepaid natural gas contracts, where the insurers claimed misrepresentation on the grounds that the underlying transaction was essentially provision of credit rather than commodities delivery."

tranches to preserve monitoring incentives should losses exceed the equity tranche.[544]

Sixth, reputational risk and the desire to shed further credit risk in the future may mean that it is not in the long-term interests of the risk shedder to exaggerate the credit quality of transferred assets. For example, this aspect is particularly relevant for asset-backed securities used as a regular funding device.

Agency problems. The risk shedder may have an incentive to change its behaviour towards the debtor after reducing its risk exposure. Such an incentive may exist even where the credit relationship remains formally intact (for example, where the lender has used credit derivatives or insurance).[545]

Generally, to what extent the behaviour of the risk shedder will be constrained after CRT depends on the precise terms on which it has transferred the risk and on the management of incentive issues by the risk taker (see below).

In addition, the behaviour of the risk shedder may be constrained by the original creditor-debtor relationship. For example, some corporate borrowers have been reluctant to accept the transfer of their loans by banks. There is a risk that market participants would interpret the transfer of risk as a negative signal about a borrower's creditworthiness.[546]

Monitoring. One of the usual changes relates to monitoring. In theory, the firm will invest in monitoring the credit risk on an exposure up to the point where the marginal cost equals the marginal benefit in terms of lower expected credit losses (for investment in information gathering, see Volume I).[547] CRT is likely to reduce the risk shedder's incentives to monitor credit risk.

Banks selling loans will therefore try convince loan buyers of their commitment to monitor borrowers (Gorton and Pennacchi 1995).[548] In order to align the interests of the loan seller and the loan buyers, the originating bank can retain a portion of the loans or the equity tranche of the loan portfolio (see below), or provide a guarantee.[549] Alternatively, the bank may use covered bonds (without CRT, see section 11.6.3) instead of securitisating its loan portfolio (which would lead to CRT).[550]

Behaviour towards distressed borrowers. Dealing with distressed borrowers raises similar questions. Loss protection changes the risk/return profiles of various alter-

[544] *Ibid*, p 42: "Pooling and tranching through portfolio structure may be optimal when the shedder has superior information (DeMarzo and Duffie (1999)). The tranching process allows the shedder to concentrate the 'lemon's premium' in the small first-loss or equity tranches and create relatively large, low-risk senior tranches. Also, the shedder's retention of the subordinate tranches reduces the total lemon's premium by creating an incentive to align the interests of the shedder and the investors."

[545] BIS, CGFS, Credit risk transfer, January 2003 p 21.

[546] *Ibid*, p 21.

[547] *Ibid*, p 21.

[548] Gorton G, Pennacchi G, Banks and loan sales: marketing non-marketable assets, Journal of Monetary Economics 35 (1995) pp 389–412, cited in BIS, CGFS, Credit risk transfer, January 2003 p 41.

[549] BIS, CGFS, Credit risk transfer, January 2003 p 41.

[550] ECB, Covered bonds in the EU financial system, December 2008.

native actions. For example, the originator of loans may have weak incentives to reduce losses by early action after CRT.[551]

Involvement. Additional agency problems arise where: the risk shedder retains some involvement in the relationship between the risk taker and the debtor; and the risk taker relies on the risk shedder to monitor the creditworthiness of the debtor and to manage the relationship with the debtor.[552]

This agency problem can be avoided where the risk taker has no continuing relationship with the risk shedder and steps into the creditor's position vis-à-vis the debtor on unchanged terms (for example, in the case of a simple loan sale).

The risk taker often mitigates agency problems by ensuring that the risk shedder retains some interest in the performance of the debtor and therefore some incentive to monitor the debtor's performance carefully. This can be achieved in two ways. First, the risk taker can require the risk shedder to retain some exposure to the debtor (such as contractual requirements in insurance and guarantee contracts or first-loss tranches in collateralised debt obligations).[553] Second, the risk taker can require risk shedding to be separated from debt administration. The incentives of the risk taker will be aligned with those of the risk shedder, if the people that act on the risk shedder's behalf do not know whether risk is transferred or not.

In addition, risk takers often rely on third-party monitors of credit risk such as rating agencies. Many risk takers rely on rating agencies, because: fewer and fewer holders of credit risk have a direct relationship with debtors; risk takers that have reduced credit risk by diversification have less incentive to monitor the creditworthiness of individual borrowers; and the Basel II framework has made ratings more important.[554]

Incomplete contracting. A further problem is how to define the scope of the parties' obligations (section 2.5) and mitigate interpretation risk (section 5.2.5). The objective of the parties is to draft a wording which is unambiguous in all plausible circumstances. There may nevertheless be a situation which was not anticipated at the time the contract was drawn up.

In CRT, such incomplete contracting issues can be a particular problem when the risk transfer is achieved through a separate agreement (such as a credit derivative or credit insurance policy) between the risk shedder and the risk taker rather than by the sale of the underlying loan.[555] This can be illustrated by three usual examples: (1) It can be difficult to define "credit events". (2) Risk shedders may have some influence over the occurrence of a future credit event, so that the agreement needs to protect both parties (but particularly the risk taker) against the moral hazard of actions vis-à-vis the debtor. (3) Credit insurance tends to empha-

[551] BIS, CGFS, Credit risk transfer, January 2003 p 21.

[552] *Ibid*, p 18.

[553] *Ibid*, p 42: "Once its exposure is fully hedged/transferred, the lender may stop monitoring the borrower, as the protection seller cannot costlessly observe whether the lender still monitors or not. The severity of this problems depends on whether the lender retains a first-loss position, on the maturity of the credit derivative relative to the underlying loan, and, finally, on whether the instrument is standardised/tradeable."

[554] *Ibid*, pp 23 and 26.

[555] *Ibid*, p 18.

sise the interests of risk takers (insurers). Typically, it defines credit events relatively narrowly.[556]

11.8.4 Tranching

Tranching describes the process used in portfolio instruments and transactions such as collateralised credit obligations (CDOs)[557] and credit linked notes (CLNs)[558] to re-engineer the risk/return profile of a pool of assets or credit risk exposures into multiple risk classes with different payment schedules, different terms on the timing of default, with different degrees of seniority in bankruptcy, and with different governance rights.[559]

The capital and seniority structure of portfolio instruments includes equity, mezzanine and senior tranches. Allocation starts with the most senior tranche. These arrangements are often referred to as waterfall structures.

Different degrees of seniority can be complemented by different degrees of governance rights.

For example, the governance rights of investors who hold securities issued by a structured investment vehicle (SIV) depend on the tranche. Senior credit may be enhanced by giving senior creditors as a class more powerful control rights complemented by additional control rights which are triggered when the value of the assets of the SIV falls below a certain threshold. Typically, the class of senior creditors can then require that all payments generated by the asset portfolio of the SIV must be used to repay senior class prematurely and that the asset portfolio of the SIV must be liquidated immediately.[560]

Tranching is useful in portfolio instruments, because a pool of assets consists of many claims and some of those claims may turn out to be bad. An investor will pay more for a portfolio instrument, if the investor has a share in good claims only

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556 *Ibid*, p 19.

557 *Ibid*, p 32: "In CDOs credit risk is transferred from the risk shedder to an SPV either in a transfer of the assets or synthetically using credit derivatives. Although there is no common agreed definition in the literature, CDOs backed by loans are often referred to as collaterilised loan obligations (CLOs) whereas CDOs backed by bonds are labelled collateralised bond obligations (CBOs). CDO exposure to assets can be achieved by cash purchase of the assets (cash CDOs) or using credit derivatives (synthetic CDOs)."

558 *Ibid*, p 32: "Credit-linked notes (CLNs) are funded balance sheet assets that offer (synthetic) credit exposure to a portfolio of reference assets. CLNs embed credit derivatives in a security issued by the risk shedder. The performance of the note is linked directly to the performance of the reference pool. The investor receives coupon payments that include a risk premium and par redemption at maturity. The risk taker has a counterparty risk on the risk shedder but not vice versa as the proceeds of the note issuance are passed on directly to the risk shedder. If the risk taker wants to avoid counterparty risk an SPV may be used and the structure becomes a synthetic CDO …"

559 *Ibid*, p 33.

560 See Fehr B, Leitzinssenkung. Die Fed zieht die Notbremse. FAZ, 3 December 2007 p 28.

and no share in the bad ones. As the instruments are divided into different risk classes, they can be sold to a wider range of investors depending on their tolerance for risk.

For example, traditional collateralised debt obligation (CDO) portfolios are split into tranches, depending on investors' appetite for risk. Some investors want a higher return and are therefore willing to take the first hit from bond defaults. They hold equity class bonds in their portfolio. Other investors are more concerned about the safety of their capital and will therefore accept a lower return.[561] They hold senior class bonds in their portfolio.

One of the factors that increased demand for CDOs was the implementation of the Basel II framework, which encouraged banks to swap risky loans on their books for CDO tranches to avoid higher capital requirements.

Equity tranche. The equity tranche is the lowest tranche in the capital structure. It is the tranche with the highest risk. It carries the risk of payment delays and defaults first, and reduces the risk of the other tranches. The equity tranche is expected to pay the highest returns.

Mezzanine tranche. The next more senior tranche is called the mezzanine tranche. Mezzanine tranche investors are protected by the equity tranche and will incur losses only if the equity tranche is exhausted. On the other hand, their claims are subordinated claims of the senior tranche that in turn will only be affected if the equity and mezzanine tranches are exhausted.

Senior tranche. The highest tranche offers a lower yield, because a lot of defaults would be needed to trigger losses in this tranche.

Rating. Senior tranches are more likely to achieve an AAA rating. Mezzanine tranches can carry an investment grade rating. The equity tranche is typically unrated. For example, in a CDO transaction, the equity tranche might absorb up to 3% of losses, the mezzanine tranche the remaining losses up to 6%, and the equity tranche the remaining losses.

Ratings may nevertheless signal different things about the quality of portfolio instruments (Volume I). The rating may measure the odds of default on a debt instrument that is held to maturity (credit risk). Such a rating does not measure market risk or liquidity risk. This means that investors would be wrong to assume that all instruments with the same rating would be equally liquid. For example, a super senior CDO tranch with an AAA rating would seem to be relatively safe. It is not, if investors refuse to buy any CDOs and it becomes impossible to sell the instruments without a large discount.

Probability of default, correlation, pricing. Credit spread is regarded as a function of two variables, i.e. default probability and recovery rate. Different tranches present different degrees of risk in these respects. In addition, default correlation can play a role, because it affects different tranches backed by the same underlying pool differently.

Correlation affects the likelihood of extreme events. A higher level of correlation causes defaults to cluster and increases the probability of very few defaults (i.e. most credits sur-

[561] See Buttonwood, Swap shop, The Economist, April 2008.

viving) and very many defaults (i.e. most defaulting). While correlation does not affect the level of expected losses to the overall portfolio, it significantly affects tranche losses. The equity (first loss) tranche benefits from higher correlation, which increases the probability of zero defaults. Higher correlation hurts the senior tranche by increasing the likelihood of extreme outcomes such as a large number of defaults wiping out part of the senior tranche.[562]

Investors. Banks are typical investors in senior and super-senior tranches. Insurance companies and asset managers tend to be the largest investors in mezzanine CRT tranches. Typical equity investors include asset managers, active traders, and institutional investors.[563]

[562] Nomura Fixed Income Research, Tranching Credit Risk, 8 October 2004 p 9. See also Fehr B, Die Risikostreuung entpuppt sich als Pferdefuß, FAZ, 9 October 2007 p 26.

[563] BIS, Basel Committee on Banking Supervision, Credit Risk Transfer. Developments from 2005 to 2007. Consultative Document, April 2008 pp 9–10.

12 Other Contract Types

12.1 Introduction

The purpose of this short chapter is to provide a brief introduction to problems relating to multi-party contracts. Syndicated loans are a well-known form of multi-party contracts. They will be discussed in Volume III in more detail. In addition to multi-party contracts, this chapter will highlight some contract law aspects of Islamic finance.

12.2 Multi-Party Contracts

Most contracts are contracts between two parties. For example, a bilateral bank loan is a loan between one bank and one debtor. Some contracts are contracts between three or more parties (multi-party contracts).

A multi-party contract can be a contract between one party and a block of two or more parties. For example, a bank may lend money to two or more parties under the same contract (one bank – many debtors), or a debtor may borrow money from many banks under the same contract (many banks - one debtor). A syndicated loan is a typical example of the latter. A syndicated loan means a loan agreement between one debtor and many banks (the syndicate).

The contract can also be a contract between three or more separate parties. In corporate finance law, contracts between three or more separate parties range from simple shareholders' agreements to complex master agreements in project finance or venture capital finance.

Legal aspects. Parties to a multi-party contract must address the same legal questions as contract parties in general. The number of parties nevertheless raises additional legal questions. Many traditional legal questions have already been discussed in DCFR which addresses the plurality of both debtors and creditors.[1] Some general remarks can nevertheless be made.

At a high level of abstraction, many of these questions are the same as the core questions in corporate governance (Volume I). Although a block of two more parties might not be regarded as a legal entity or a business organisation that must regulate its governance structure, it is useful to organise the actions, rights and obligations of the parties in advance.

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[1] DCFR, Chapter 4 of Book III.

P. Mäntysaari, *The Law of Corporate Finance: General Principles and EU Law*,
DOI 10.1007/ 978-3-642-03055-0_12,

One should therefore address the following questions in the legal framework: Who represents the parties? How should the parties' representatives act? How are the representatives remunerated, and what sanctions are available to the parties in the event of breach of duty? How should the parties act? How is power distributed between the parties? How is risk distributed between the parties? How is information managed? Exit and entry raise further legal questions.

Representation. Although two or more contract parties share the same interests, each of them may prefer to act on its own behalf.

Alternatively, contract parties may be represented according to the principles of agency. One of the contract parties or a third party will then act as agent on the behalf of all contract parties. To overcome administrative disadvantages, the contract parties may decide to use a separate legal entity.

In financial transactions, the parties may often use a trust construction. Their counterparty will try to make those parties confirm in advance that the agent's actions will be attributable to them.

For example, a syndicated loan agreement could contain the following clause: "The Borrower shall, unless it is aware or should be aware of any irregularity, be entitled to assume that the Agent represents the Banks, and that all the necessary permission and consents have been obtained."

Duties of the representative. The duties of the representative depend on the case. In syndicated loans, for example, the lead bank may sometimes be regarded as an agent of the syndicate banks. In this case, the lead bank can owe fiduciary duties to the syndicate banks.[2]

There is often an agreement setting out the duties of the agent. The agent must, in practice, ensure that its duties have been defined in detail the agreement contains limitations of liability. The agent will try to ensure that its obligations are mainly of a mechanical or administrative nature, and that it will not assume any responsibility for the usefulness of information disclosed to the parties that it represents.[3]

For example, a syndicated loan agreement could contain the following clause on the duties of the agent: "Each Manager and each Bank (other than the Agent) hereby irrevocably appoints the Agent to act as its agent under, and in connection with, this Agreement and irrevocably authorises the Agent to exercise such rights, powers and discretions as are specifically delegated to the Agent by the terms of this Agreement, together with all such rights, powers and discretions as are reasonably incidental thereto. The Agent has only those duties which are expressly specified in this Agreement and those duties are solely of a mechanical and administrative nature."

The law governing agency. The law that governs agency has partly been left unclear in the Rome I Regulation.

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2 See Cranston R, Principles of Banking Law. Second Edition. OUP, Oxford (2002) p 59.

3 See *ibid*, p 61. See also Daeniker D, Stellung der federführenden Bank bei Obligationenanleihen, SJZ 99 (2003) pp 365–370.

Three legal relationships arise from a contract concluded by an agent: the first between the principal and the agent, the second between the principal and a third party, and the third between the agent and a third party.

Only the first is clearly governed by the Rome I Regulation. The main rules apply. [4] The Commission had originally proposed a rule according to which a counterparty should look to the law of the agent's country of habitual residence to determine the law governing the agent's authority to bind the principal (section 6.2.2).[5]

Attribution, liability for the acts of the representative. The attribution of, and the liability for, the agent's acts can depend on: the relationship between the block and the agent; and the relationship between the block and the third party. As the agent is not an "organ" of the block (Article 9(1) of the First Company Law Directive), members of the block can restrict attribution and limit their own liability for the agent's acts by limiting the extent to which they hold the agent out as their representative.[6]

Rights and duties of the parties. Generally, parties that belong to the same block have both rights and obligations.

In a bilateral contract relationship, each party is responsible for its own obligations. It is important to define the exact obligations of both parties.

In a multi-party contract, it becomes important to define whether the obligations of parties that belong to the same block are joint or several. If they are several, it becomes necessary to define the exact obligations of each party.[7]

For example, a syndicated loan agreement always provides that the responsibilities of the banks are "several" rather than "joint". A bank will thus not be responsible for the fulfilment of other banks' duties: "The obligations of each Bank under this Agreement are several. The failure of any Bank to carry out its obligations under this Agreement shall not relieve the Borrower of any of its obligations under this Agreement, nor shall any Bank be responsible for the obligations of any other Bank under this Agreement."

According to the terminology used in the DCFR, an obligation can be "solidary", "divided", or "joint":[8] "An obligation is solidary when each debtor is bound to perform the obligation in full and the creditor may require performance from any of them until full performance has been received." "An obligation is divided when each debtor is bound to perform only part of the obligation and the creditor may claim from each debtor only full performance of that debtor's part." "An obligation is joint when the debtors are bound to perform the obligation together and the creditor may require performance only from all of the together."

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4 Articles 3 and 4 of Regulation 593/2008 (Rome I). See also Article 1(2)(g).

5 Article 7(2) of the proposal. Proposal for a Regulation of the European Parliament and the Council on the law applicable to contractual obligations (Rome I), COM/2005/0650 final.

6 Assmann HD, Zur Haftung von Konsortien für das rechtsgeschäftliche Handeln ihrer Vertreter, Bemerkungen zum Urteil des BGH vom 9.7.1984 (II ZR 193/83, Köln), ZHR 152 (1988) pp 371–385.

7 See also DCFR III.–4:104; III.–106(1) (liable in equal shares).

8 DCFR III.–4.102.

The parties must address the question of the exercise of rights in a similar way. If the claims of all block members will be fulfilled by the same counterparty, each block member may try to enforce its claims against the counterparty faster than competing claimants. This will create a moral hazard problem. If each party could freely enforce its claims to the detriment of any other party, there might be a race to enforce sanctions against the counterparty and secure a higher ranking of claims. The risk of litigation would increase, and the impact of a suspected default would be more severe. All parties could lose.

The parties will therefore address four fundamental questions: (1) To what extent are a party's duties owed to each party separately and to what extent are they owed to other parties collectively? (2) To what extent may a party exercise rights independently and to what extent may they be exercised only collectively? (3) If the rights may be exercised only collectively, how will the parties decide on exercising them? (3) And in that case, how will the rights be exercised in practice?

Parties tend to manage this question in two main ways. First, the parties tend to employ an agent or a trustee. The agent or trustee will administer the contract on behalf of the whole block. The use of an agency or trust construction will help to prevent a race to enforce sanctions against the counterparty.

Second, the use of an agent or a trustee is complemented by "sharing". The purpose of sharing is to make it more difficult for one contract party to enforce claims just for its own benefit and more difficult for the counterparty to favour one creditor at the expense of others. For example, in a syndicated loan, "sharing" means that funds repaid by the borrower are "shared" by the lenders. Sharing will be applied to all forms of repayment. The forms of repayment covered by the sharing clause range from regular payments by the borrower to set-off, proceeds of litigation, and collection.

A sharing clause could look like this: "Redistribution of payments. If, at any time, the proportion which any Bank (a 'Recovering Bank') has received or recovered (whether by payment, the exercise of a right of set-off or combination of accounts or otherwise) in respect of its portion of any payment (a 'relevant payment') to be made under this Agreement by the Borrower for account of that Recovering Bank and one or more other Banks is greater (the amount of that excess being called in this Clause an 'excess amount') than the proportion thereof received or recovered by the Bank or Banks receiving or recovering the smallest proportion thereof, then: (a) that Recovering Bank shall pay to the Agent an amount equal to that excess amount; (b) there shall thereupon fall due from the Borrower to the Recovering Bank an amount equal to the amount paid out by that Recovering Bank and the amount so due shall be treated as if it were an unpaid part of that Recovering Bank's portion of that relevant payment; and (c) the Agent shall treat the amount received by it from that Recovering Bank as if that amount had been received by it from the Borrower in respect of that relevant payment and shall pay the same to the persons entitled thereto (including that Recovering Bank) pro rata to their respective entitlements thereto."

Flexible terms. Where the firm contracts with a block of many parties, the firm has more reason to avoid flexible terms, as there is a risk that at least one of the members of the block will interpret a flexible term contrary to the firm's interests. The same can be said of other members of the block. The agent representing the block has reason to avoid discretion to fix the contents of flexible terms after the fact, as the existence of such discretion can increase the likelihood of liability claims and its own legal risk.

This can be illustrated by material adverse change clauses in bond issues. For two principal reasons, MAC clauses are only very rarely included in bond issues. First, the trustee representing the mass of holders of these bonds often will not wish to take on such a wide discretion as to the potential exercise of this clause. Second, a borrower will generally not wish to see its fate depend on a multitude of disparate investors.[9]

Distribution of power. Where an agent or a trustee acts on behalf of members of a block, the parties need to agree on the distribution of power both inter se and between members of the block and their representative.

Where an agent or a trustee acts on behalf of members of a block, decisions on the exercise of the parties' rights can be taken in various ways. (a) The agent may have discretion to decide on minor technical and administrative things. For example, the agent would not be empowered to decide on the premature termination of the contract.[10] (b) Some things may require a decision taken by the parties whom the agent represents. In less important cases a majority decision will suffice. In a syndicated loan transaction, this majority could be 50% or 66% of the capital. The majority can decide on: the use of remedies in the event of breach of contract; waivers of breaches of covenant; relaxation of covenants (for example, a negative pledge); and whether an event is "material" or not. Some events such as "incorrect representation" or "adverse change" must be "material" before they trigger something. (c) Core commercial matters would normally require consensus. In a syndicated loan, such questions include: the waiver of conditions precedent; the extension of maturities; any reduction in the amount of payments; any reduction in the interest rate; and any change of currency.

Distribution of risk. In a bilateral contract relationship, each party is responsible for its own obligations and the parties agree on the distribution of risk inter se. In a bilateral contract relationship, counterparty risk refers to the other party failing to fulfil its obligations. In a multi-party contract, counterparty risk changes.

First, counterparty risk changes in the relationship between a party and members of a block of contract parties. A party contracting with a block of contract parties can mitigate risk by agreeing that members of the block are jointly liable for the performance of their contractual obligations. In contrast, members of the block can mitigate risk by agreeing that their responsibility for the performance of contractual obligations is separate rather than joint.

Second, there is a counterparty risk in the relationship between members of the block inter se. (a) This counterparty risk is reduced if the obligations of the parties are several rather than joint. (b) If block members nevertheless are jointly liable to a contract party for the performance of their obligations, block members typically agree on rights of recourse, i.e. to what extent the other parties are liable, if the ob-

[9] Julien F, Lamontagne-Defriez JM, Material Adverse Change and Syndicated Bank Financing: Part 1, JIBLR 19(5) (2004) pp 172–176.

[10] Diem A, Akquisitionsfinanzierungen. C.H. Beck, München (2005) § 23 numbers 54–56.

ligation is performed by one member of the block. A block member can mitigate risk by agreeing that it can ask any of the other parties to reimburse him for the whole amount that exceeds, for example, his pro rata share of the obligations; the party that reimbursed him for that amount can then turn to the one of the remaining parties in a similar way. (c) There is a risk that one of the block members will be unable to fulfil its own share of the parties' joint obligations. One of the ways to address this problem is to agree that the pro rata share of other members will increase accordingly.

Third, flexible terms will give rise to a higher legal risk and will influence agency relationships (see above).

Exit and entry. The management of exit and entry will influence risk. For example, in a bilateral contract relationship, the change of a contract party can clearly influence the remaining contract party's counterparty risk. In a multi-party contract, the assignment of a block member's rights and obligations to a third party could have an adverse effect on the rights and obligations of the remaining members and their risk exposure.

There are three main ways for members of the block to mitigate this risk in advance.

First, the contract may provide that the party may not assign its claims to a third party unless the third accepts the original terms of the agreement. For example, a shareholders' agreement may prohibit a party from selling its shares to a third party unless that party accepts the terms of the shareholders' agreement.

Second, where the contract terms that a party is prepared to accept depend to a large extent on the identity and personal characteristics of another contract party or parties, the parties might agree that rights or obligations under the contract may not be assigned without the prior consent of the other parties. In addition, they might agree to whom the contract may be assigned and that the consent may not unreasonably be withheld.

Third, the parties might ensure that a third party to whom the claims or rights or obligations under the contract are assigned will automatically become bound by the terms of the original agreement. For example, the third method is used in multilateral exchange or clearing systems. New members of an existing exchange or clearing system will be admitted on the basis of adherence to the existing provisions. This means that bilateral contracts between banks as members of exchanges or clearing systems are stitched together and subsumed within a framework of multilateral rights and duties.[11] The statutes of legal entities are another example of the same thing. Parties to a shareholders' agreement might ensure that the statutes of the company contain its core terms; whereas a shareholders' agreement is binding on its parties but not on third parties, the statutes of the company will bind even future shareholders.

Management of information. A multi-party contract can contain plenty of rules on information. The parties will have to regulate duties of disclosure, the attribution of information, and liability for the accuracy and usefulness of information (for information management, see Volume I).

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[11] Cranston R, *op cit*, pp 51–52.

The parties often use an information agent as an intermediary to transfer information. The information agent will normally accept technical and administrative duties to transfer information that has expressly been made available to it for the purpose of disclosure to other contract parties. The information agent will often exclude: the attribution of other information; all duties to analyse information; and its liability for the accuracy and usefulness of information.

For example, the lenders' agent could limit its liability in the following manner in a syndicated loan agreement (in addition to the general limitations discussed above): "The Agent may assume that any representation made by the Borrower in connection with this Agreement is true." "Notwithstanding anything to the contrary expressed or implied in this Agreement, the Agent shall not be bound to enquire as to whether or not any representation made by the Borrower in connection with this Agreement is true." "The Agent shall: promptly inform each Bank of the contents of any notice or document received by it from the Borrower under this Agreement; and promptly notify each Bank of the occurrence of any Event of Default or any default by the Borrower in the due performance of, or compliance with, its obligations under this Agreement of which the Agent has actual knowledge or actual notice."

The agreement to use an agent is complemented by the duty to disclose information to the agent. For example, in international bond issues, the issuer covenants to supply information to the trustee. [12]

12.3 Islamic Finance

12.3.1 General Remarks

Interest can be prohibited for religions reasons. All three of the Abrahamic religions prohibit usury, but charging or paying interest is nowadays banned only in Islamic banking. The Koran prohibits "making money from money".[13] Interest (riba) refers to any predetermined fixed payment that is guaranteed where the rate of return is tied to the maturity and principal, rather than the performance, of an investment.[14]

Riba v profit. Based on the Sharia law (Islamic law), Islamic finance is a way of making investments and raising capital without the payment and receipt of interest (riba). On the other hand, Islamic law does not condemn all types of interest. Islamic law endorses transactions that replicate the economics of interest-based lending. Islamic finance is thus a strategy to exploit unresolved tensions within Islamic law regarding riba.

[12] Rawlings P, The Changing Role of the Trustee in International Bond Issues, JBL 2007, January pp 43–66.
[13] The Koran, sura 2, verse 275.
[14] Kianfar S, Mohammed A, Understanding Islamic finance, The European Lawyer (March 2007).

If the owner of capital wants to make a profit, he must undertake some of the risk in the enterprise that is using the money. Investment income should come from profits actually generated by an enterprise.

In Islamic banking, deposit accounts operate like unit trusts, with funds invested on the depositor's behalf and a share of the profits replacing interest payments. Islamic mortgages and loans can use a "hire-purchase" scheme whereby the bank buys goods on the customer's behalf. The customer then pays the bank a series of instalments until the cost, plus a profit for the bank, has been met.[15]

The use of Sharia-compliant arrangements is not limited to Islamic finance. The same techniques can be used by all firms under the laws of any country. For example, as Islamic financial instruments are backed by physical assets, they are well suited for project finance.

12.3.2 Basic Principles

Islamic finance refers to the network of financial institutions and commercial activities that conform to a number of core Sharia principles, including: (a) prohibiting the receipt and payment of interest (riba), (b) avoiding uncertainty (gharar); (c) discouraging speculative behaviour (maisir) and (d) promoting wholesome commercial activity (haraam).[16]

Halal. What is "halal" is by definition Sharia-compliant. Sharia scholars give opinions on what is halal and what is not.

Fatwa. Sharia scholars, i.e. Muslim legal experts, give fatwas to financial instruments they deem Sharia-compliant. Fatwa is the final religious act of approval.[17] In practice, Islamic financial institutions need a reputable sharia board to decide whether instruments are Sharia-compliant and to signal to Muslim investors that this is in fact the case.[18]

There is an element of subjectivity in the approval process. Although some structures win more widespread approval than others, subjectivity and differing interpretations mean that it is difficult to standardise Islamic financial instruments.

Gharar (uncertainty). Islamic law does not recognise the validity of contracts where gain is the result of chance. For example, the purchase of fish in the sea is gharar. It is generally not permissible to enter into a sales contract where the existence or material characteristics of the asset are unknown. Contracts containing obligations to insure or indemnify another person or grant an option to purchase an asset may not be Sharia-compliant as such contracts rely on the occurrence of a conditional yet uncertain event.[19]

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15 Sharianomics, The Economist, August 2004.

16 Kianfar S, Mohammed A, Understanding Islamic finance, The European Lawyer (March 2007); Saleem S, International Islamic Banking, Islamic Law and Law of the Muslim World Paper No. 07–05. Available at SSRN.

17 How to be Islamic in business, The Economist, June 2007.

18 *Ibid*.

19 Kianfar S, Mohammed A, Understanding Islamic finance, The European Lawyer (March 2007).

Maisir (speculation). In order to protect weak investors from exploitative schemes, Sharia prohibits financial transactions which are extremely speculative.[20]

Haraam (forbidden). In addition to restraints on how a transaction may be structured, Sharia also places limits on the nature of the enterprise to be invested in. Essentially, funds cannot be used to promote forbidden (haraam) activities, such as alcohol consumption, but should be channelled towards permissible (halal) business operations.[21]

Permitted contracts. Islamic law nevertheless permits several contract types. The most important financing techniques include the murabaha contract (the purchase and sale of an asset), the mudaraba contract (an arrangements for the sharing of profits), the musharaka contract (a joint venture), and the ijara contract (a traditional lease).

Such financing techniques can be combined in order to structure Sharia-compliant products whose performance resembles conventional instruments. For example, the performance of sukuk resembles the performance of conventional fixed-income debt securities.

Murabaha. The murabaha is the most important form of Islamic finance. For example, Turkish "participation banks" primarily offer two types of Islamic finance products:murabaha and ijara.[22]

Murabaha could be called a mark-up sale or cost-plus financing. Instead of extending a loan, a finance provider acts as an intermediary that purchases a halal asset and immediately re-sells it to the firm at a higher price. The firm will pay the price in instalments or in one lump some at a later date.

The murabaha thus enables the firm to finance the purchase of a fixed asset. The finance provider and the firm have agreed on the general terms of the transaction, the obligation of the firm to identify the asset and to purchase it from the finance provider, the mark-up, and the payment of the purchase price. Title to the asset will pass from the original seller to the finance provider and to the firm. The finance provider bears the risk of ownership after the firm purchases the asset and before the finance provider sells the asset to the firm. The mark up will reflect the risk exposure of the finance provider.

The murabaha also enables the firm to raise capital. In this case, the firm typically buys halal commodities from the finance provider and re-sells them on the market.

Reverse murahaba contracts can be used by banks to provide a return on customer bank deposits.

Mudaraba. Both mudaraba and musharaka are essentially profit sharing agreements. However, a mudaraba is more flexible than the musharaka.

Mudaraba resembles mezzanine capital provided by a silent partner. Under a mudaraba contract, a mudarib manages the finance provider's money for a fee

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[20] *Ibid.*

[21] *Ibid.*

[22] Gaupp D, A Brief Overview of Secular Turkey's Framework for Islamic Banking and Finance Transactions: Basis for Big Business or Negligible Side Issue, JIBLR 23(2) (2008) pp 90–95.

paid by the finance provider. The mudarib may use the capital contributions to invest in a specific enterprise or to make discretionary investments. The finance provider is entitled to a share of the profits arising from the use of the money but bears the risk of loss of capital.

The investor (rabb al-mal) is typically an Islamic bank and the manager is an entrepreneur. The entrepreneur has the exclusive right to manage the business. Both the investor and the entrepreneur are entitled to profits. The parties may have agreed on the allocation of profits according to a certain ratio. Only the investor bears the risk of loss.

The mudarib may also make capital contributions, although it may not receive remuneration beyond compensation for reasonable business expenses and its share in the profits.

Musharaka. Musharaka bears resemblance to a partnership. It is characteristic of musharaka that investors invest in a specified venture and that each member shares in the profits or losses of the venture.

Each member has the right to participate in managing the venture, although they may delegate management duties to other partners or third parties.

Members share profits according to their capital contribution or according to an agreed profit ratio. If the venture loses money, members bear the loss in direct proportion to their investment. This means that loss ratios are not necessarily linked to profit ratios.

Ijara. An ijara is a traditional lease with a specified asset made available in exchange for rental payments. Under an ijara, title to the asset remains with the lessor, and the lessor is responsible for maintaining and insuring the assets.

Sukuk. Sukuk are Islamic debt securities (bonds).[23] They are in effect asset-backed securities. From a legal perspective, however, sukuk are not debt securities. Sukuk investors purchase an ownership interest in an asset. Sukuk represent a profit and risk-sharing partnership between the issuer and the investor. Because of rules on riba and gharar, sukuk returns must be linked to the performance of the underlying asset and the underlying asset must be sufficiently tangible.

The lack of a central control authority can lead to different interpretations of sharia-compliance and increased risks for firms. In February 2008, the Shariah Board of the Accounting and Auditing Organisation for Islamic Financial Institutions, an organisation hosted by Bahrain, studied three common sukuk products and found them sharia-conform only on certain conditions.[24]

There is a high risk that repo clauses are not Sharia-compliant. For example, a repurchase undertaking by the "borrower" guaranteeing repayment of the securi-

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[23] Article 2 of the AAOIFI (Accounting and Auditing Organisation for Islamic Financial Institutions) Sharia Standard (17) on Investment Sukuk: "Definition of Sukuk: Investment Sukuk are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity, however, this is true after the receipt of the value of the Sukuk, the closing of the subscription and employment of funds for the purpose for which the Sukuk were issued."

[24] Fehr B, Ruhkamp S, Gläubiger geraten in Teufels Küche, FAZ, 5 September 2008 p 23.

ties at face value on maturity or in the event of default can violate the risk- and profit-sharing requirement.[25]

[25] Under the microscope, The Economist, March 2008.

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