The Empirical Missing Links in the Draft Common Frame of Reference

Fernando Gomez Pomar

School of Law
Universitat Pompeu Fabra
Abstract

The model rules in the Draft Common Frame of Reference (DCFR), as any other body of legal rules, in force or simply proposed, naturally have the intention of affecting, in the desired direction, the behavior of the relevant parties subject to them. Thus, it seems, at least prima facie, wise to consider the tools in our possession in order to get some estimate of how the latter would likely respond to the rules. In recent years, social scientists in several disciplines (economics and psychology primarily) have studied human interaction in contracting and similar environments. They have studied such types of behavior both in laboratory settings, but also in real-world markets using rigorous empirical techniques.

In this respect, the model rules in the DCFR look somewhat lacking in terms of the interest in the existing empirical knowledge of its subject matter. The main empirical source of information for the DCFR seems to be comparative legal analyses of EU Law and the Laws of European countries. This is indeed useful, but in order to understand the potential effects that the legal rules may have on the behavior of contracting parties, and, eventually, on the markets that link them, one should not disregard the amount of empirical knowledge that has been accumulated in recent years on how real people interact in a variety of contractual settings.

This importance of empirical knowledge for informed policy-making and for the design of legal rules does not imply that there is an Iron Law of empirical regularity, or that our current level of empirical understanding is perfect and final. It is undeniable that there is still much to learn empirically about contracting behavior. But if we take seriously—as I strongly believe we should—the impact of Contract Law on social welfare, empirical studies of contracting behavior, both in consumer markets and in firm-to-firm interaction, should carry some weight to assess legal solutions in Contract Law, and to craft them in an informed way.

Titulo: La falta de fundamentos empíricos en el Proyecto de Marco Común de Referencia

Keywords: Common Frame of Reference; European Contract Law; Empirical Knowledge; Distribution Contracts

Palabras clave: Marco Común de Referencia; Derecho contractual europeo; Conocimiento empírico; Contratos de distribución

Summary

1. Introduction
2. The empirical evidence concerning consumer behavior in consumer transactions
3. Empirical evidence on long-term distribution contracts
4. Conclusion
5. References

‡ I am grateful to participants at a workshop on the DCFR at the European University Institute for helpful discussions of the ideas reflected in the paper, to the Spanish Ministry of Innovation and Science for financial support, under grants SEJ2004-05059 and SEJ2005-10041, and to Marian GIL SALDAÑA for excellent research assistantship.
1. Introduction

The Principles, Definitions and Model Rules of European Private Law, known as the Draft Common Frame of Reference (DCFR for short)\(^1\) constitute the impressive output of an important academic and legal endeavor in the field of Private Law and, specially, of Contract Law,\(^2\) in the European context. Although largely academic in its inspiration and spirit, and almost entirely -if not hundred-per-cent- of academic manufacture, the DCFR is not the usual academic product: It is not a commentary, treatise, collection of essays or papers devoted to European Contract Law or Contract Law more generally. It is a body of proposed model rules -accompanied\(^3\) by a set of standard terms or definitions to facilitate comprehension, use and application- which may eventually lead to govern real-world behavior of individuals or firms, or at least, influence real-world law-makers in the drafting of such rules that will directly govern the behavior of economic agents in society.

Law -in the sense of the set of social institutions ruling behavior in organized, purposeful and intended ways, and not as an academic discipline or field for intellectual scrutiny- and Private Law in particular are essentially of a practical or pragmatic nature. If not entirely a blind exercise, Law tries to regulate the behavior of the agents under its rule in a form conducive to a recognizable social goal, whatever this may be -in the best scenario-, the promotion of social welfare in the relevant society. Thus, how the actual addressees of the proposed legal rules are expected to respond to the rules seems a crucial element of the whole enterprise.

This makes empirical knowledge in the relevant field particularly valuable to inform the design, drafting and implementation of rules that, immediately or through the intermediation of other bodies or rules, pursue the regulation of behavior in society. The preceding statement does not imply that theoretical knowledge in its various forms -normative as to the desirable goals, historical as to the origin of existing arrangements, analytical in terms of how to craft the best framework to elucidate real-world behavior, and so forth- plays no role in the exercise. On the contrary, without that theoretical knowledge it is difficult not only to understand, but also to improve and operate social institutions such as the legal system. Although the theoretical background upon which the understanding of contracting behavior and Contract Law that prevails throughout the DCFR could raise some criticism, I will not pursue the issue here.\(^4\) Given the practical purpose of the legal enterprise, and that, consequently, our knowledge about how

---

1 All references will be made to the Interim Outline Edition of the DCFR, published by Sellier, Munich (2008).

2 Although the DFCR covers ground beyond Contract Law, and emphatically defends the choice of broad coverage (see, pp. 19 and following of the Introduction to the DCFR), the fact is that both quantitatively and qualitatively the bulk of the DCFR is Contract Law, and thus I will essentially devote my observations to Contract Law in the DCFR.

3 The model rules and the definitions should be considered inextricably linked, according to the drafters of the DCFR.

4 I have already raised some criticisms concerning the lack of a clear behavioral starting point in the DCFR process: See, GÓMEZ (2008, p. 89).
the real world in which the legal system is to be part, and how the agents are expected to interact with it seems of particular relevance, I will concentrate on the level and kind of empirical knowledge involved in the DCFR process.

According to the words of the drafters themselves, the DCFR is mainly the product of comparative studies of EU Law and the Laws of the Member States. These studies, as long as they are not –and I take them, or at any rate, I assume them, not to be- mere reflection of the Law in the Books, and not of how the Law in the Member States is currently applied to regulate behavior of individuals and firms, constitute empirical knowledge or evidence. In a broad –and, I believe, correct- sense, empirical knowledge covers the information concerning the outside world and based upon observation, experience or experiment carried on in an organized purposeful way.

Part of this collection of empirical knowledge is what one could call –at least under the prevalent criteria, or fashion, if one prefers, in the social sciences- the most sophisticated or fancy one, contained in studies using large amounts of data and subject to state-of-the-art statistical analyses. But this kind of evidence –quantitative and statistical-, though part of our empirical knowledge about a given field, does not exhaust the available empirical evidence. Also qualitative studies based on organized and informed observation, if adequately performed, usefully increase our empirical knowledge of the set of real world phenomena that may be of interest. Thus, comparative legal analyses can provide us with extremely helpful data about what legal rules are actually governing behavior, and the problems that their application encounters, thus allowing those in possession of such knowledge, under certain conditions, to draw inferences for future rules and future behavior.

It is clear, though, that legal-comparative analyses of EU Law and of the Law of the Member States, however accurate, exhaustive and thoughtful they may be, do not fill the entire repository of empirical knowledge at our disposal concerning Contract Law, and contracting behavior more generally. It is indeed the portion that is more quantitative in spirit, and makes use of the standard techniques of statistical analysis the one that is outside the scope of the traditional legal-comparative analysis which, in turn, lies at the core of the DCFR. Accordingly, one could conclude that the empirical knowledge upon which the DCFR is based, and without any positive nor pejorative connotations, is the “traditional” one -inside legal academia-, based upon the qualitative observation by legal experts of what rules are in place in a given jurisdiction, and what are the successes and failures of the actual rules applied. The less traditional and more

5 See, p. 12 of the Introduction of the DCFR.
6 See, Epstein/King (2002, pp. 2 and following).
7 As the drafting of the CFR was not supposed to take place without involving stakeholders and practitioners, the Commission created the “Network of stakeholder experts” (CFR-net) to ensure that the practical context and the needs of users were taken into account in the drafting procedure. The CFR-net would comprise 177 members who would provide the Commission and researchers with practical technical input on CFR drafts. Nevertheless, their influence in the drafting of the DCFR has proven unsatisfactory. For details of the establishment of the CFR-net and the organisation of its work, see the Commission’s “First Annual Progress Report on European Contract Law and the Acquis Review”, COM (2005) 456 final of 23.9.2005.
modern –again, no praise or blame attached- knowledge about contracting and Contract Law, based upon quantitative and statistical analyses, has been essentially overlooked by the DCFR. The result of this oversight is that the proposed rules in the DCFR may be, at least in certain areas covered by its scope, flawed by the absence of adequate empirical support of the hypothesis or conjectures about the expected behavior of the agents subject to the rules and the likely effects of these on the future situation of individuals and firms. It may be true that the amount of quantitative empirical literature statistically testing precise hypothesis about content of general rules in contract law is still relatively scarce, but there is a large body of quantitative evidence that sheds light on contracting behavior –in the broad but also in the narrow sense, subject to Contract Law rules- and the likely effects on the reactions of individuals and firms of rules such as those proposed in one or the other Book of the DCFR.

The DCFR contains model rules for both B2B and B2C transactions. I will explore my claim in two areas that are particularly relevant for one and the other kind of transactions. In section 2 I will present how the existing knowledge concerning about consumer behavior in markets does not seem to have informed the model rules on consumer protection and the role of consumers in contracting. In section 3 I will present how the quantitative evidence on long-term contracts in distribution chains has not been duly considered in Book IV, Part E, dealing with commercial agency, franchising and distributorship, a central area of B2B contractual relationships. Finally, section 4 briefly draws some implications for the future steps in the process of building European Contract Law.

2. The empirical evidence concerning consumer behavior in consumer transactions

In the past quarter century psychologists and economists have been systematically exploring how human beings in actual situations depart in their actions and choices from the requirements of rational calculation, will-power and self-interest that characterize a rational-based approach to understanding human behavior. Given the typically high –though not always insurmountable- obstacles to observing real-world behavior in many circumstances by a sufficient number of individuals similarly situated, these studies have heavily relied on experimental methodologies. Thus, most of this literature is grounded on the statistical analysis of data concerning actual behavior by individuals in very diverse sets of circumstances through the use of experiments designed by researchers to confirm or refute a given hypothesis about human behavior. A non-trivial part of this knowledge can be relevant for understanding how individuals, essentially consumers, behave in a wide variety of circumstances similar to those that they may encounter in consumer markets.

---

8 This is the claim by KOROBKIN (2002, p. 1036).

9 See, on this claim in the broader perspective, KOROBKIN (2002, pp. 1035-1036); GEIS (2008, p. 452).

10 See, for a useful survey of this literature, and of its applications to the Law –also beyond Consumer and Contract Law- CAMERER/TALLEY (2007, p. 1619).
In laboratory settings it has been well documented that some phenomena\textsuperscript{11} repeatedly appear in observed individual behavior. People seem to show bounded rationality, that is, limited capacity to acquire and process information, as revealed by the use of cognitive heuristics that can lead to errors in judgment and decision-making. For instance, the hindsight heuristic –that attaches over-dimensioned likelihoods to events that have actually occurred with respect to the true or actual likelihood- may lead to decisions ex-post facto that do not correspond with the best course before the events happened. Or the availability heuristic, that relies excessively on easily available data or information, thus leading to reactions that follow too closely, and may be mistakenly the limited amounts of information that are not hard to recall with immediacy, particularly if it has been widely publicized or the object of media attention. The representative heuristic –excessive representativeness of small samples- may lead to judge events and courses of action too quickly based on how the externally resemble a typical or representative example within the category we are operating. Agents have also been consistently shown to behave with clear over-optimism when facing events that are less than certain, that is, they overtly underestimate the probabilities of bad outcomes that may affect them.

Psychologists and economists have also uncovered and experimentally confirmed other important expressions of bounded rationality –as departure from pure or perfect rationality is commonly labeled. Individuals have been shown to suffer from inconsistencies in the valuation of outcomes that are time related, due to hyperbolic discounting -too little weight attached to future and uncertain outcomes in decisions made presently, and excessive weight to immediate or present outcomes. Other sources of departure in observed behavioral responses from the axioms of expected utility in the neoclassical sense have been identified: Individuals tend to show loss aversion, that is, they give special weight and importance to what is presented to them, or is perceived by them, to be losses with respect to a given benchmark, larger than the importance they attach to missed opportunities to gain measured against the same baseline. Moreover, an endowment effect –valuation of an asset not as it really is, but depending on the set of entitlements owned by the agent over the asset- implies that individuals would ask higher amounts to depart from something they consider their own, than to acquire the same thing from someone else. And a statu quo bias –reticence to alter the existing state of the world due to attaching some unidentified intrinsic value to it- makes existing situations particularly sticky and likely to persist, even if agents can introduce changes at low cost.

These findings should not lead us to think that all individuals, in all situations, are subject to these shortcomings or departures from rational behavior. Even if we disregard individuals integrated in large organizations that have incentives to overcome such biases, such as firms,\textsuperscript{12} it would be unfounded to assume that every consumer in all potential consumer markets will be afflicted by those observed regularities of “irrational” behavior.

\textsuperscript{11} See, among many surveys helpful for legal audiences, SUNSTEIN (2000); JOLLS/SUNSTEIN (2006, p. 199).

The first reason lies in the fact that it has been well documented that the presence and incidence of those cognitive and behavioral biases are not identical across individuals. Cognitive abilities, education, experience, and context that may have some debiasing properties do play a role, even if they do not make those mistakes or departures from rationality disappear completely.13

Moreover, even if one takes the magnitude and relevance of the experimental findings relative to those behavioral biases for granted, as I do, an assumption of consumer misperception and mistake of universal application does not hold due to problems in generalizing the finding of experimental psychology and experimental economics: One thing is to identify some bias in a laboratory setting, even repeatedly, a very different one is to test the statistical significance of such bias on real-world markets using rigorous empirical techniques.14 And even if the empirical tests do not confirm that economic agents, consumers for instance, behave rationally, this by itself is not an empirical confirmation as such of the presence and magnitude of the behavioral biases, given that the data may be influenced by some other unobserved variable.

Several empirical studies have tested some of the implications of bounded rationality models of consumer behavior in different settings, and have not found empirical support for the hypothesis based on the pervasive presence of certain behavioral biases in such consumer markets15: credit card markets, testing for (i) evidence of highly borrowing consumers paying higher interest rates but enjoying low introductory teaser rates16; (ii) the true causal factor behind the correlation between credit card debt and filings for personal bankruptcy17; (iii) the factors explaining the “Borrow High Lend Low” Puzzle18; allocation of shelf space in supermarkets, and testing whether it is a result of manipulation by retailers of cognitive biases afflicting consumers, or else responds to manufacturer margins for different lines of products19; choice of calling plans when different pricing options are introduced20.

13 See, for a summary of this evidence, Rachlinski (2006, p. 216).

14 The issue of the general validity of the findings in the laboratory for the real world phenomena that one is trying to analyze is not exclusive of experimental psychology or experimental economics, also the natural sciences encounter this epistemological matter. It is true, however, that due to the nature of the underlying subject matter—human behavior and choice— one is particularly aware of the need to justify why the environment in the laboratory is sufficiently similar to the outside world as to provide a basis to make inferences about the latter based on the former: See, Posner (2001, pp. 263 and following).

15 A good summary of such studies, in Wright (2007, p. 470).


18 The puzzle refers to the observation that many people borrow on their credit cards—at high interest rate—while holding positive balances on their accounts—yielding no or little interest: Gross/Souleles (2002, p. 149). Massoud/Saunders/Scholnick (2006) find that traditional demographic (age, educational level, country of origin if immigrant) and economic variables (income) seem to be the major factors explaining the puzzle, and not so much the various cognitive and behavioral biases that afflict human choice.

19 See, Klein/Wright (2007, p. 421).

There are, of course, a number of serious empirical studies showing how data on actual behavior in a given consumer market seems to give support to the presence of a certain behavioral bias as an important factor behind observed patterns of market behavior. Among others, such studies include evidence with respect to: (i) credit card markets and hyperbolic discounting; (ii) fitness club markets and time-inconsistent preferences with unsophisticated consumers who cannot self-realize their own time inconsistency; (iii) internet purchases of computer equipment using price search engines and consumer myopia concerning hidden terms and attributes.

The sensible response to this apparently conflicting set of pieces of evidence is not to weigh it in a sort of purely quantitative fashion, but to conclude, at least tentatively, that the evidence is still inconclusive regarding the real world impact in consumer markets of many of the behavioral biases present in laboratory settings. Arguably, it should lead us to consider that there is no single answer empirically satisfactory for the entire range of biases and for the entire set of circumstances and markets in which consumers may exhibit those biases.

There is an additional factor, however, that would seem to be important for the actual behavior of consumers in real world markets—and thus for the design of the legal rules governing such markets—even if one would assume the universal presence of cognitive and behavioral biases in consumers. That factor is learning. People may learn from their prior mistakes, at least when they possess good feedback mechanisms that allow them to be aware of the consequences of mistakes, and induce them to avoid the same errors in later rounds of trade or future market interactions. Given that their own pockets—sometimes, their own life and limb—are at stake, the incentives to draw lessons from past mistakes, and to improve performance in later transactions are powerful and effective. The likelihood of learning taking place and being effective in eliminating the negative consequences of bounded rationality features is greater the more standardized the product or service (thus allowing learning not only from past own experience, but also from other consumers’ experience) and the higher the routine nature of the transaction. Learning by consumers is important not just for the empirical relevance of behavioral biases in consumer markets, but also for the normative consequences of the observed level of their presence: if learning is to be expected, the benefits of a regulatory or legal intervention in the relevant market are lower, for a given initial level of biased behavior among consumers. Although conceptually different from learning, other kinds of consumer reactions to biases, such as developing personal rules to guide behavior precisely to counteract the former, may also lead to results that resemble those of learning.

There is a substantial amount of empirical evidence showing that consumers learn from mistakes and improve their behavior in a wide range of consumer markets: credit card markets\textsuperscript{26}, video rental markets\textsuperscript{27}, telephone markets\textsuperscript{28}. Still, of course, learning may take time, and may be costly, so I do not imply that consumer learning is a magic formula that would always restore markets to the functioning that full rationality and full information would characterize. In fact, it is clear that firms can interfere with learning processes of consumers through several means, and they would do so when it is in their interest to pursue that strategy, and the environment is able to sustain such shrouding behavior by firms. For instance, they can hide and make less accessible the elements of the transaction on which consumers are more likely to be misled about; they can create artificial non-standardization and product multidimensionality to retard and increase learning costs; they can engage in bundling to discourage learning and comparison shopping, they can engage in loss-leader tactics. Even in a non-bounded rationality environment, firms may engage in some of these tactics, to increase consumer search costs, but behavioral biases and learning may provide them with additional reasons for them.\textsuperscript{29}

In sum, consumer learning does not eliminate the relevance of behavioral biases for consumer markets, but may recommend a more parsimonious attitude towards their magnitude and effects, and points at the importance of the context and conditions of the market in order to make consumer learning possible, or to make firm tactics opposing learning feasible for a full understanding of real world consumer markets.

All the above added together, and specially the empirical evidence just reviewed, suggest that it would not be wise \textit{-at least at this moment-} to make the model of consumer behavior arising from the experimental literature in behavioral psychology, behavioral economics, and behavioral Law \& Economics, the cornerstone of consumer policy and of the rules in Consumer Law and Contract Law dealing with B2C transactions. Thus, one should not criticize the DCFR for not embracing once and for all as the starting point to regulate consumer transactions the behavioral account of consumer choice and decision-making, and for not rewriting Consumer Law and Contract Law under that light.

But cautious treatment is pretty different from utmost disregard. Policy-making \textit{-and the DCFR is, who can doubt it, policy-making in consumer and other markets-} cannot turn its back to the evidence on the outside world that the policy measures are trying to influence in pursuit of one or the other normative goal. This implies that the experimental literature, together with the rest of the empirical evidence \textit{-based on data on real-world contracting behavior-} is not irrelevant for the design of the most adequate legal toolkit, in the present European context, for the consumer

\textsuperscript{26} See, AGARWAL/CHOMSISENGPHET/LIU/SOULELES (2006); AGARWAL/DRISCOLL/GABAIX/LAIBSON (2008).

\textsuperscript{27} See, FISHMAN/POPE (2007).

\textsuperscript{28} See, MIRAVETE (2003, p. 297).

\textsuperscript{29} See, for additional factors why learning by consumers may not be feasible to substantially make-up for initial consumer mistakes, and why sellers don’t have incentives to provide learning opportunities or even to correct the mistakes by their actions, BAR-GILL (2007, p. 9).
markets of the 21st century. Policy-makers ignore empirical evidence at their own risk, and that is traceable in the DCFR.

The model rules, thus, could have been better tailored to what seem to be the major –and more resistant to improvement as an effect of improved competition or available information on products and services- informational and behavioral obstacles for the adequate functioning of consumer markets that the empirical evidence has uncovered or highlighted: consumer misperception of non-salient features and elements of the transaction as a whole –and not just of the product or service, or of the firm providing them; consumer misevaluation of patterns of future use or utility from the product due to hyperbolic discounting of the future, over optimism or self-serving biases; consumer misperception of features that are probabilistic in their outcomes, and additionally so if they are way ahead in the future –which suggests greater caution with long-term B2C contracts than with spot transactions; the importance of obstacles –such as product differentiation, bundling and other “de-standardizing” strategies- preventing the operation of instruments that have “debiasing” or equivalent effects for consumers, instruments, such as learning from past experience, comparison shopping, and seller’s branding and reputation.

When one looks at model rules proposed in the DCFR to deal with the imbalance of information between contracting parties, one still clearly perceives the emphasis placed on physical and other attributes of the good or service, identity of the seller or provider, contract terms, and eventually legal means of redress: Art. II.-3: 102 (2) and II.-3: 103 DCFR. It is true that in this field the DCFR also contains some general formulations, such as “information that the other person can reasonably expect” in Art. II.-3: 101; or “material information as the average consumer needs in a given context to take an informed decision on whether to conclude a contract” Art. II.-3: 102 (1); or “all the relevant information” in Art. II.-3: 102 (2). But again they are either implicitly or explicitly centered on attributes of the good or service, or do not realize that part of the problem lies in the fact that consumers –and human beings more generally- under certain conditions, which are the ones more troublesome for the functioning of consumer markets, may need a little help –in terms of specific information, learning or other tool- to make them actually reasonable and rational.

One can contrast this approach in the DCFR with recent proposals by empirically informed scholars who, with varying degrees of sympathy towards the actual relevance for real-world markets of the experimental findings, agree that disclosure rules should be crafted to tackle consumer biases concerning their own uses of goods and services, and thus including, when it is feasible, information on actual average features of use,30 and even, when the latter is not sufficient, past information on individual use by that same consumers.31 For instance, the efficiency of the personal credit market could be improved upon, it is suggested, by encouraging,

---


31 See, BAR-GILL (2007, p. 57). It is true, however, that the DCFR contains general rules of Contract Law and it is not specific regulation of a given consumer market, the realm in which this kind of individualized information disclosure could be more adequately imposed eventually: JOLLS / SUNSTEIN (2006, p. 209).
and even mandating, more personalized information (already in possession of lenders) which may improve the way in which consumers make credit choices.32

Similarly, a closer look at the empirical evidence could have saved the model rules proposed in the DCFR from the time and trouble of trying to solve unsolvable and even, maybe, not so relevant problems in the field of consumer contracting, instead of focusing on other problems on in more innovative and adept legal tools for those problems.

The DCFR still places emphasis on the opportunity of the contracting party –not only the consumer, but the issue of standard form contracting and e-transactions may be considered more relevant in the consumer context- to be informed and to read the contract terms that will govern the transaction as a result of the binding force of the agreed contract. Art. II.-3:105, on formation of contract by electronic means, imposes upon businesses the duty to supply to the other party, before that party consents to an offer or makes an offer, with the contract terms in textual form. In turn, Art. II.-9:103, on terms not individually negotiated, make those terms enforceable against the non-drafting party –the consumer, always, but also a business party eventually- if the latter party was aware of them or if the drafter took steps to draw attention to the contract terms before or when the contract was concluded.

There is evidence of various sorts that consumers, in e-transactions and in other forms of contracting relying on standard form terms governing the transaction, do not commonly read the contract terms before entering into the contract, do not have the capacity, or the willingness, to read and understand the implications of standard contract terms, and do not value the opportunity to read the terms prior to contract, nor they value typically the more advantageous contract terms they may hypothetically be able to find if they read standard contract terms in advance and shop around for more favorable ones.33 Moreover, there is also evidence that the

---

32 For instance, the recent Directive 2008/48/EC, on credit agreements for consumers does not foresee such kind of information on average use –e.g. of credit card borrowing, of penalties incurred for late payment, and so forth– much less on past use by the individual consumer affected. In the US, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 forces lenders to personally inform consumers how much increased interest they would pay, and how much longer would it take to repay the debt if they choose the minimum monthly payment. It is true, however, than the 2008 Directive improves upon Directive 87/102/EEC (the old consumer credit Directive) on other features that empirical literature has highlighted, such as interest for payable for late payments, or penalties for default.

33 See, for a summary of evidence of consumers not reading the terms, HILLMAN/RACHLINSKI (2002, p. 429); HILLMAN (2007, p. 83). For an excellent discussion of the factors that make reading the standard terms an unattractive –and hopeless- course of action for consumers, see BEN-SHAHAR (2008, p. 7). On the potential valuation of consumers of the opportunity to read and of favorable terms in the set of standard terms, using a large sample of real-world contracts (End User License Agreements in online transactions on software products), it has been found that the absence of presumptively unfavorable –for the consumer, that is, pro-seller- choice of Law and choice of forum clauses does not affect the price consumers pay for the goods: MAROTTA-WURGLER (2007, p. 45). Additionally, this study does not reveal any statistically significant different between consumers and business buyers of the same software goods. Using the same database of online software contracts, and after constructing a comprehensive index of the “quality” in terms of consumer friendliness of the set of standard terms (covering aspects as the acceptance of the license, the scope of the license, the transfer of the license, warranties and warranty disclaimers, limitations of liabilities, maintenance and support, and conflict resolution) it has been found that there is no evidence that consumers of a given type of product are willing to pay higher prices in order to get more favorable contract terms of a standard nature: MAROTTA-WURGLER (2005, p. 45).
opportunity to read the standard terms before signing the contract does not change the substantive content of the contract terms, as the rights and obligations of consumers go: an empirical analysis of more than 500 types of contracts –online software transactions- does not show that the standard terms that were not made available to the consumer prior to the transaction, but sent together with the good to the consumer after the contract was binding were any worse, in terms of consumer friendliness across all dimensions of the transaction, than the standard terms that were made available to the consumers prior to the purchase decision. It is the size of the firm and the number of years the seller has been in operation what seem to drive the main influences upon the quality of the standard terms.

So the available empirical evidence does not seem to give a clear indication that imposing duties to disclose standard contract terms and providing consumers with opportunities to read them –as proposed in the model rules of the DCFR- actually improve the material situation of consumers in terms of the welfare they obtain from the transaction.

3. Empirical evidence on long-term distribution contracts

The relative disregard of the DCFR for empirical evidence on contracting and Contract Law in the real world –beyond the legal-comparative study of EU and Member States’ Law- also extends the realm of consumer behavior and contracting. The area of distribution contracts in the economic sense of the term –commercial agency, franchising, distributorship contracts- also reveals the existence of missing empirical links in the DCFR.

Economic theory has for some time already cogently argued the crucial consideration of long-term distribution contract as essentially incomplete nature of long- contracts, and the primary relevance of unverifiable –to an outside adjudicator as a Court and arbitrator- breach of

23). As with the study previously cited on dispute resolution clauses, a third related study (MAROTTA-WURGLER, 2005, p. 23) shows no perceptible difference in the overall buyer-friendliness of the terms between consumer and business buyers, nor between products typically oriented to consumers and more business-like types of products.

34 Two relevant decisions by the Federal US Court of Appeals, 7th Circuit (ProCD v. Zeidenberg, and Hill v. Gateway 2000) confirmed the validity and binding effect of the terms in these transactions, commonly known as “Pay Now, Terms Later”, or rolling contracts.


36 See, MAROTTA-WURGLER (2005, p. 22). The market structure (whether there is less or more competition in the relevant product market does not seem to play a role either in the forces leading to more or less consumer-friendliness of the standard terms: MAROTTA-WURGLER (2005, p. 29).

37 See, WILHEMSSON/TWIGG-FLESNER (2006). Some even argue that concentrating effort on disclosure duties may actually be harmful for consumers, if these “procedural” sorts of protections associated with the opportunity to read are negatively correlated with the willingness of Courts to strike down individual clauses –and not the entire set of standard terms- for substantive reasons, or adopt more effective means to prevent those clauses that are actually detrimental to consumer welfare: HILLMAN (2007, p. 89); BEN-SHAHAR (2008, p. 25).

contractual duties by the distributor. In this setting, the open-ended character of the relationship, and the disciplining force of termination by the principal gain remarkable salience. The preservation of the conditions for relatively unconstrained –by legal requirements concerning good cause, or the imposition of compensation ex post–exercise of termination at will in long-term distribution contracts thus seem, from an economic perspective, important elements of an efficient legal regime of this area of contracting that, it should be kept in mind, is an area of B2B transactions.

This view seems to be supported by the available empirical evidence on the effects upon the behavior of the contracting parties of the legal rules that restrict or impose legal conditions to terminate the contract on the initiative of the principal or manufacturer. This evidence refers to franchising, but there does not seem to be a powerful reason to doubt that the main findings would not be applicable to other contractual arrangements in distribution chains sharing similar issues of controlling opportunism by distributor (and, as we will see in a moment, also by manufacturer).

The first and best-known piece of this empirical evidence concerning termination of long-term distribution contracts is that by Brickley, Dark, and Weisbach. They hypothesize that laws restricting franchisor termination rights will lead to less franchising. The reason lying in the fact that, for instance, cheating franchisees receive compensation after the franchisor terminates, the benefits from cheating increase, and thus the amount of breach. This would lead to less profitable franchising, making other arrangements (such as the franchisor directly running the units) more profitable by comparison. Interestingly, because franchisees are assumed to be able to generate higher revenue in the operation of units than are franchisors themselves, the reduction of franchised units also leads to an aggregate reduction of units: While the franchisor will now – after laws restricting termination– find profitable to run some of the units it would have franchised were it able to commit the franchisee not to cheat, there will be some marginal units that are no longer profitable to run or to franchise.

Brickley, Dark, and Weisbach also consider that unconstrained termination can be used by the franchisor not only to discipline non-cooperative behavior by franchisees, but also to exploit and abuse franchisees and try to own (and thus, not share the profit with the franchisee) those units, that through franchisee’s sales effort, or through franchisee’s market discovery, turn out to be particularly profitable. But if this is the case, and franchisees use their termination rights to


40 The reason for this, lies in the fact that the studies are based on the US experience, where State legislation interfering with termination at will has concentrated on franchise contracts. Moreover, it seems that franchise plays a somewhat larger role in US distribution compared with the European context.


42 Both explanations for termination by the franchisor (or by the manufacturer, or principal, more generally), the benevolent –discipline on non-verifiable breach by the other party- and the sinister (expropriation of value from specific investments by the “weaker” party) are consistent with the brute factual observation that it is principals,
expropriate franchisees of their specific investments, and franchisees do not correctly estimate the expected cost of this opportunistic behavior on the part of franchisors, there will be too much franchising as some franchisees pay—as franchise fee—above their true reservation prices for their units. Laws restricting termination by franchisors would also decrease franchising in this scenario.

**Brickley, Dark, and Weisbach,** however, rule out this second possibility by focusing their empirical analysis on differences across industries. Specifically, they argue that if termination primarily serves to discipline franchisee’s non-cooperative behavior, the effect of termination laws on the rate of franchising will be most pronounced in industries with mostly non-repeat business. In areas or sectors with significant repeat business, disciplining franchisees is less important, since the self-enforcement mechanisms induce better behavior from the franchisee: Otherwise, it will lose its repeat business and suffer a large revenue loss. In industries without much repeat business, there is less potential for self-enforcement, making termination more important as a policing tool. On the other hand, if termination clauses primarily allow the franchisor to exploit the franchisee, no such cross-industry relation would appear, and no systematic difference in the change in franchising across industries would be found. **Brickley, Dark, and Weisbach** data show that the effect of legislation conditioning termination of franchise agreements is greater (and, in statistical terms, significantly so) in industries they classify as particularly subject to non-repeat customers (restaurants, hotels, and auto rental agencies) as compared to the effect in other sectors.

**Beales and Muris,** in turn, look at whether data on franchise terminations and non-renewals support the efficiency or opportunistic explanation for terminations. What they label an efficient termination is the one in which the franchisor detects breach of quality provision duties by franchisee. They define opportunistic termination as any non-efficient termination, presumably for the exploitative reasons mentioned earlier. They have data on terminations (by both franchisor and franchisee) in thirteen industries over eight years. Their independent variables include: growth in number of outlets (which should increase breach); growth in sales per outlet (should decrease breach); and, proxies for appropriable rent (should increase opportunistic terminations). Their results do not support or reject the opportunism hypothesis — the estimated coefficients are often of the wrong sign or are statistically insignificant. They do obtain, however, a robust, significant, and negative coefficient on the “growth in outlets” variable. This is likely to imply if opportunism or expropriation by the franchisor is a factor, it is watered down by the franchisor’s interest in keeping a reputation in order to attract additional good franchisees.

---

and not the other parties, who typically terminate the relationship. In a Spanish survey carried out by a business daily newspaper (Expansión, 9 December 1996), in 88% of the cases termination is decided by the principal, in 8% by the distributor, and in 4% it is a joint decision (I have taken these figures from **Paz-Ares, 2003**, p. 32). Also, a look at litigated cases points in the direction of the principal or manufacturer being the party behind most disputed cases of termination. In view of this, it seems that we need some more elaborated empirical analysis to test which theoretical explanation is empirically corroborated by facts.

**43 See, Beales III/Muris (1995, p. 157).**
InDret 1/2009  Fernando Gómez Pomar

Williams also looks at termination rates of franchise contracts, in a sample of over 1,000 contracts over a 4-year period, and finds that there is no evidence of termination being influenced relevantly by a scheme by the franchisor to appropriate for himself those units, that through franchisee’s sales effort, or other reasons, turned out to be particularly profitable. In fact, it seems that the desire to transfer the unit—very often, by the franchisee herself—and to end those units that were underperforming—due to inadequate franchisee’s performance or to a disadvantaged location—are the main driving factors explaining termination rates.

Klick, Kobayashi and Ribstein also use data on franchising chains to test the relative importance for termination of the disciplining or the expropriation story. They use state laws limiting franchisor termination rights to identify the effect of termination at will on both the choice to franchise and on franchisor expansion generally. In their first set of empirical tests, they use firm-level data on franchising in the fast food industry, and their regressions show that constraining termination leads to a reduction in franchising, and to a smaller increase in franchisor-operated units. Their second set tries to connect the changes in laws conditioning termination with state employment in industries characterized by a high degree of franchising. There they find that restrictions on termination at will are correlated with a decrease in the franchised industries’ employment rates relative to employment rates in industries with little franchising. Both sets of tests, thus, tend to give support to the view that the disciplining effect of termination on franchisee’s non-cooperative behavior seems to outweigh, in their empirical relevance, the opportunities for franchisor abuse and expropriation of value that termination at will may allow.

LaFontaine and Shaw, in turn, try to determine whether data may sustain an implication from the idea that franchisor’s opportunism is an important factor behind the rate of termination. If this were true, they claim, and franchisors were disproportionately acquiring, through undue termination, those franchise units that were more profitable, one would expect that more established franchising chains would end up showing more company ownership (franchisor’s ownership) over time. Their data are not consistent with that prediction.

Brickley, Misra, and Van Horn have looked not at the legal provisions concerning termination of franchise contracts, but at whether an “exploitation” theory of franchising (powerful franchisors are able to impose contract terms on weaker franchisees) is confirmed by empirical data. They concentrate on clauses regulating contract duration, as these are typically crucial on the chances that the franchisees recover the relation-specific investments (those that loose all, or a substantial fraction of value outside the contract) made in contemplation of the contract being in place for some period of time. Specific investments make the franchisee vulnerable, because the termination of the contract will not allow the franchisee to recover the

44 See, Williams (1996).
45 See, Klick/Kobayashi/Ribstein (2007).
46 See, LaFontaine/Shaw (2005, p. 131).
specific –and thus non-salvageable- investment. The longer the contract term, the higher the chances of complete recovery of investment by the franchisee will be.

Using a large sample of franchising firms, they analyze the effects on contract duration clauses of several factors: the number of years the franchisor has been in operation; the number of sites comprised within the franchising network –that is, the size of the franchisor; the average total initial investment of a franchisee entering the franchise network; the number of weeks of off-site training of franchisee’s personnel. The first two factors relate to the power, experience and contractual strength of the franchisor, the second two are good proxies of the level of specific investments made by the franchisee. If the exploited franchisee view were correct, we would expect that the bigger, more sophisticated the franchisor, the more exploitative the contract terms, here, the shorter the contract duration, will be. Again, if the naïve franchisee image were true, the level of specific investments would not raise contract duration, given that the exploitative franchisors would try to appropriate the value of the non-amortized specific investments incurred by the franchisee. Empirical results show that the four factors are positively and significantly correlated with the length of the contract term: Both the level of the investments by the franchisee, and the size and the experience of the franchisor tend to increase, contract duration, contrary to what the “exploitation” hypothesis would predict. And these results hold with and without taking into account the fixed effects of the particular industry in which the franchisor operates. There seems to be, therefore, evidence indicating that franchisors are responsive to the level of specific investments by franchisees, and they are more responsive the bigger, and better established they are. These results would provide indirect evidence that the threat posed by opportunistic and exploitative behavior on the part of franchisors does not seem to be a particularly worrying problem in reality, or at least, to be sufficiently secondary not to show in the data.

There is also a striking feature arising from some results in the empirical studies just summarized. It is the observation that legislation restricting termination at will increases, rather than decreases, the number of terminations, that is, that when the law sets some conditions –financial compensation or showing good cause for termination- for terminating a franchise contract, franchisors terminate more often, and not less, as could intuitively be expected.

The explanation that has been forwarded by some commentators for this counterintuitive empirical finding runs along the following lines: unconstrained termination at will induces franchisors to be more forgiving of minor –even if verifiable- instances of breach by the franchisor.

---

48 See, BLAIR/LAFONTAINE (2005, pp. 259-260), who also find that larger franchisors tend to offer longer contracts on average, than smaller ones.

49 It is true, however, that BRICKLEY and his co-authors also find a positive effect of legal restrictions on franchise termination (in the state where the franchisor has its headquarters) on contract duration clauses: BRICKLEY/MEHRA/VAN HORN (2006, p. 185). They hypothesize that this effect is due to the increased bargaining power such legislation gives franchisees upon termination of the contract, thus reducing the value of short term contracts for the franchisor.

franchisee. To be forgiving at the beginning is not too costly for the franchisor, given that he always retains the ability to terminate without any restriction, financial or otherwise, as soon as he observes that his benevolence has not been repaid with cooperative behavior on the part of the franchisee. On the contrary, if the decision to terminate is legally constrained, the franchisor will terminate at the first occasion in which he can legally and costlessly –in terms of severance or compensation payment to the franchisee- do so. The franchisor (or the principal, more generally) will not be inclined to act forgivingly of a first minor breach if there is sufficient evidence to show that termination would be deemed an acceptable punishment of franchisee’s breach. This would lead, then, to more terminations, rather than less, following legislation that makes termination more difficult and/or costly for the franchisor.

In sum, the empirical evidence on long-term distribution contracts clearly indicates that one should be, at least prima facie, skeptical towards rules that interfere in those extended incomplete commercial relationships in order to restrict the ability of principals to use termination of the distribution contract as an effective means to improve the efficiency of performance of agents, franchisees and other firms down the distribution chain in other comparable arrangements in the contract networks that in the end bring goods and services to consumers.

Turning to the DCFR, one could legitimately ask whether this considerable amount of empirical knowledge about the effects on real-world distribution markets of the rules of Contract Law that govern those relationships had been duly taken into consideration –which is, no doubt, different than full and unconditional acceptance of its implications- in the proposed model rules in the DCFR. If one looks at the latter rules, the answer can hardly be in the affirmative.

The DCFR seems to have been drafted with more than one eye on the regime introduced for commercial agents by the Commercial Agency Directive, even if the proposed model rules –it must be acknowledged- do indeed simplify and clarify the complicated regime contained in Directive 86/653/EEC. As a general rule for long-term distribution contracts (encompassing not just commercial agency, but also franchising and distribution, the DCFR foresees several important conditions and legal duties that restrict the disciplining use of termination by principals and manufacturers along distribution networks51.

Firstly, the DCFR (Art. IV.E.2:303, probably inspired by the general principle in art. 17.2.c) of the Commercial Agency Directive) imposes a general –for all kinds of contractual arrangements- duty to pay damages for termination with inadequate notice, trying to ensure that the agent obtains the benefit he or she would have enjoyed, had the notice period been complied with, and using the average benefit of the previous three years as the benchmark to assess that benefit.

Secondly, Art. IV.E.2:305, contemplates and indemnity for goodwill broadly corresponding, though not in its details, with art. 17.2 a) of the Commercial Agency Directive. This later indemnity is not mandatory –except for commercial agency, under the complex regime proposed in IV.E.3:312, in turn inspired by art. 17.2.b) of said Directive- but it would, unless otherwise

agreed by the parties, be applicable also in favor of the agent, franchisee or distributor party who had breached the contract, even fundamentally.

Moreover, Art. IV.E.2:304 prohibits all clauses that allow one party to terminate for instances of breach of the other party that are not cases of fundamental breach, thus making impossible to use termination as an effective tool to sanction instances of non-verifiable breach, a common occurrence in long-term, incomplete, and poorly specified contractual relationships as the ones prevailing in the field of distribution.

These solutions contained in the proposed model rules, all to the effect of restricting termination by the principal in this field of contracting -which, it must be again emphasized, is not B2C, but B2B- seem difficult to reconcile with the important empirical evidence concerning the real-world consequences of legal restrictions to termination in distribution networks, evidence that strongly points at the efficiency costs -also to the detriment of distributors and potential distributors- that may ensue from such legal restrictions. A closer look at this evidence would have suggested, probably, a more parsimonious view of the beneficial effects of ad-hoc contract specific rules that in a commercial setting try from the start to favor one of the contracting parties. At a minimum, a more detailed consideration of the available empirical knowledge about this area of contracting would have advised a less deferential attitude towards the highly controversial solutions contained in the Commercial Agency Directive, and a critical stance with regard to its expansion to other contractual arrangements in distribution chains.

4. Conclusion

In general, the Law, both as an academic endeavor and as social institution to influence human and social conduct, concerns the real world: real world human beings, situations and phenomena. This is, of course, not less true of Contract Law, quite the opposite. With all due respect towards purely theoretical and normative analysis -that are by all means necessary to the Law as an intellectual discipline, but also to legal systems- this places empirical knowledge at the forefront of legal interest.

In this paper, I have tried to show how the important task accomplished by the DCFR has not made use of the entire range of empirical knowledge that was at disposal for such an important enterprise. Beyond the empirical evidence on what are the rules in place in EU Law, and in the legal systems of the Member States, there is a large and rich amount of empirical knowledge developed using widely accepted techniques in the social sciences (experimental and statistical, but also qualitative), on data reflecting the real-world contracting behavior of real-world people.

I have illustrated this general point about the use of empirical evidence in the DCFR with two specific applications that affect two different areas of contracting that lie within the scope of the DCFR: consumer behavior and contracting, on the one side, and long-term distribution contracts, on the other. In both areas, the use of existing empirical knowledge of its subject matter is far
from optimal. The fact is, though, that to be able to understand and to anticipate, however
imperfectly, the potential effects that by legal rules will have on the functioning of markets for
goods and services and on the behavior of contracting parties, one needs empirical information.
Our current level of knowledge is, for sure, far away from being comprehensive and perfect. But
it seems preferable, both in epistemological terms, and for policy-making, to use imperfect data
and knowledge, than no data at all.

5. References


Consumers Choose the Right Credit Contracts?”, Working Paper, Federal Reserve Bank of

Paper Series, New York University School of Law, NYU Center for Law and Economics, WP no.

749-802.


Economy, vol. 112, no. 4, pp. 848-886.


Roger BLAIR / Francine LAFONTAINE (2005), The Economics of Franchising, Cambridge University

James BRICKLEY / Frederick DARK / Michael WEISBACH (1991), “The Economic Effects of Franchise


