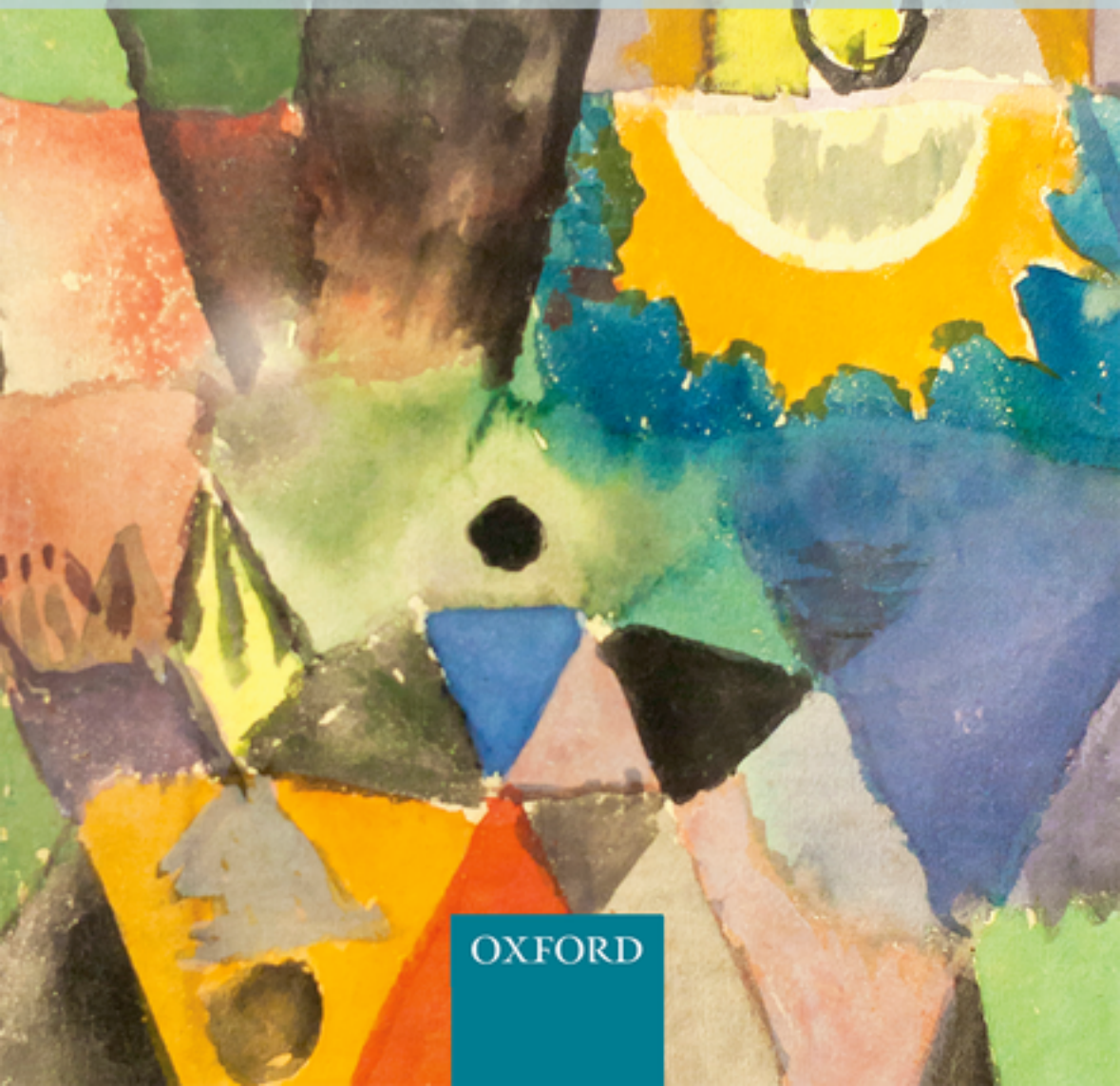
CONTRACT GOVERNANCE

Dimensions in Law & Interdisciplinary Research

EDITED BY STEFAN GRUNDMANN,
FLORIAN MÖSLEIN & KARL RIESENHUBER



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List of Abbreviations

B2B	Business-to-Business
B2C	Business-to-Consumers
B2I	Business-to-Investors
BIS	Bank of International Settlement
BLE	Behavioural Law and Economics
BVB	*Berliner Verkehrsbetriebe*
CAC	Collective Action Clauses
CCP	Central Counterparties
CCE	Central and Eastern Europe
ChFR	Charter of Fundamental Rights of the European Union
CDO	Collaterized Debt Obligation
CDS	Credit Default Swap
CFI	Court of First Instance
CISG	United Nations Convention on Contracts for the International Sale of Goods
CLE	Conventional Law and Economics
DCFR	Draft Common Frame of Reference
EBCI	European Banking Coordinative Initiative
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
ECHR	European Convention for the Protection of Human Rights and Fundamental Freedoms
EFSF	European Financial Stability Facility
EIB	European Investment Bank
ELSTAT	Hellenic Statistical Authority
ESRB	European Systemic Risk Board
HACCP	Hazard Critical Control Plan
IASB	International Accounting Standards Board (IASB)
ICANN	Internet Corporation for Assigned Names and Numbers
IFI	International Financial Institutions
IMF	International Monetary Fund
IOSCO	International Organization of Securities Committees
ISDA	International Swaps and Derivatives Association
KWL	*Kommunale Wasserwerke Leipzig*
LBSF	Lehman Brothers Special Financing Inc
LCFI	Large, Complex Financial Institution
MiFID	Markets in Financial Instruments Directive
NGO	Non Governmental Organization
OTC	Over the Counter
PoWD	Posting of Workers Directive
QIA	Qatar Investment Authority
SPV	Special Purpose Vehicle
SWF	Sovereign Wealth Fund

TEN	Techno-Economic Networks
TEU	Treaty on European Union
TFEU	Treaty on the Functioning of the European Union
TPC	Third Party Certification
TPR	Transnational Private Regulation
TUD	Transfer of Undertakings Directive
UCC	Uniform Commercial Code

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PART I

THE OVERALL ARCHITECTURE OF CONTRACT GOVERNANCE

1

Contract Governance: Dimensions in Law and Interdisciplinary Research

Stefan Grundmann, Florian Möslein, and Karl Riesenhuber

I. Introduction and Overview

This book introduces and develops contract governance as a new approach to contract theory. It thereby aims at setting an international and interdisciplinary research agenda for a modern contract law.[1] At its core, contract governance combines insights from governance research and contract theory. As an umbrella term, contract governance therefore covers various and very diverse issues of governance in contract law and contract practice—just as corporate governance does for company law and finance.

In this context, governance is defined as 'the institutional matrix within which transactions are negotiated and executed'.[2] Governance regimes are necessary where risks of opportunism occur or the interests of third parties are involved. In contracts, governance becomes relevant whenever the contractual agreement reaches beyond a mere discrete spot exchange, namely in long-term or network relations and where regulators employ the mechanism of contract to pursue regulatory goals. The latter aim can apply as well to masses of parallel spot contracts, as where, for instance, herd behaviour risks producing adverse effects. When analysing such phenomena, contract governance can obviously draw on a number of existing approaches such as institutional economics, incomplete contracts and relational contracting, networks of contracts theory, regulation theory and private ordering, elements of ordo-liberalism, and the insights of behavioural economics. Governance research may well be seen as the scientific answer to major economic or state crises—which would explain as well why conceptions of corporate and

[1] F. Möslein and K. Riesenhuber, 'Contract Governance – A Draft Research Agenda,' (2009) 5 *European Review of Contract Law* 248–89 (with differentiation of four modes of contract governance, see Section IV of this Chapter); particularly close before, namely in the English literature: J. Brownsword, *Contract Law – Themes for the 21st Century* (Oxford: Clarendon Press, 2nd edn, 2006); H. Collins, *Regulating Contracts* (Oxford: Oxford University Press, 1999).

[2] O. Williamson, 'Transaction-Cost Economics: The Governance of Contractual Relations' (1979) 22 *Journal of Law and Economics* 233–61, 239 (and see also 235: 'by governance structure I refer to the institutional framework within which the integrity of a transaction is decided.')

public governance developed earlier and why the time may now be ripe for contract governance (see Section II of this Chapter). Contract governance proposes a scientific answer that is oriented towards the long-term and is principally aimed at overcoming the isolation of these different existing approaches to contract governance and thus strengthening both their theoretical coverage and their realism.

By bringing these existing approaches together, contract governance opens up new research perspectives. More importantly, contract governance approaches contract law in its entire width. While Williamson and subsequent governance research focussed almost exclusively on long-term contracts and on organizations (corporate governance),[3] markets and exchange contracts require and depend on governance structures as well. After all, the global financial crisis has strikingly shown the third-party impact of contractual arrangements, and it has also shown that in the world of contracts, there is a high risk of mutual contagion because a modern economy is often arranged in networks. In financial markets, contractual transactions like collateralized debt obligations increasingly serve similar purposes to institutions such as credit banks, and the crisis has shown that market- and bank-based financial systems pose similar governance problems.[4] In the Markets in Financial Instruments Directive (2004) (MiFID), a parallel phenomenon, stock exchanges and its contract-based alternatives, which in fact compete with stock exchanges, had been similarly regulated already in 2004. Therefore, Part II of the present work focuses on third party impact of contracting, while Parts III and IV on the network and on the long-term character of the phenomenon of 'organization by contract'. Indeed, at a more fundamental level, exchange contracts on the one hand and long-term contracts on the other hand are not as fundamentally different as governance research hitherto seems to suggest. Both types of contracts do not pose entirely separate issues, but rather comprise part of a continuum.[5] As a consequence, contracts as organization and contracts as exchange need to be seen and analysed within a common framework. Contract governance broadens the perspective accordingly.

Contract governance therefore stands for a holistic, comprehensive approach. It does so also in some other important respects. First, the governance perspective contributes to a genuinely interdisciplinary discussion. As opposed to law and economics, the range of disciplines that 'collaborate' has greatly increased, and

[3] Williamson, n 2; K. Hopt, H. Kanda, M. Roe, E. Wymeersch, and S. Prigge (eds) *Comparative Corporate Governance – the State of the Art and Emerging Research* (Oxford: Oxford University Press, 1998); J. McCahery, P. Moerland, T. Raaijmakers, and L. Renneboog (eds) *Corporate Governance Regimes – Convergence and Diversity*, (Oxford: Oxford University Press, 2002); T. Clarke (ed) *Corporate Governance – Critical Perspectives on Business and Management* (5 vols) (London/New York: Routledge, 2005); K. Hopt, 'Comparative Corporate Governance: The State of the Art and International Regulation' (2011) 59 *American Journal of Comparative Law* 1–73.

[4] As a consequence, the regulation of shadow banking is intensively debated see, inter alia, Financial Stability Board, *Shadow Banking: Scoping the Issues* (2011); European Commission, Green Paper on Shadow Banking, COM(2012) 102 Final. On the variety of financial systems in general see F. Allen and D. Gale, *Comparing Financial Systems* (Cambridge, MA: MIT Press, 2000).

[5] See S. Grundmann, 'The Future of Contract Law' (2011) 7 *European Review of Contract Law* 490–527, esp. 523–5; S. Grundmann, F. Cafaggi, and G. Vettori (eds) *The Organisational Contract – From Exchange to Cooperation in European Contract Law* (Oxford: Hart Publishing, 2013).

these various disciplines contribute on an equal footing, gathering together into one discourse community. With this approach, under the paradigm of regulatory competition and by subjecting rule-setters themselves to a scrutiny of their incentives, questions of rule-making become paramount and turn into a genuinely 'constitutional' question.[6] Beyond institutional economics, governance research includes various different perspectives: law and legal practice, sociology, psychology, and other behavioural sciences. In addition, if mutual consent is an alternative instrument of governance, it is paramount to take insights from contract theory and contract law into account. This broader interdisciplinary approach is what the book aims to illustrate in its overall arrangement. Secondly, contract governance takes a broader range of rule- and decision-makers into account. In addition to hierarchies, mutual and consensual forms of coordination and decision-making come to the fore. Part VI of the present work is devoted to this perspective. One of the central issues in governance theory is the interplay between external and internal impacts on decision-making in institutions (state or corporation)[7] and the analysis of 'weak spots' within a scheme of collaboration, which is where governance arrangements are required.[8] As in corporate governance, we can therefore distinguish external and internal mechanisms of governance, and as in general governance theory, the relevant structures include, but are not limited to, legal mechanisms. As a consequence, the substantive focus of contract governance is inherently broad, taking into account the different levels of rule-making, the different standard-setters, and the different rule-setting schemes and procedures. Finally, and as a consequence of the foregoing, contract governance takes advantage of broader circles of discussion. As in corporate governance, the discussion is not only interdisciplinary, but genuinely international, starting from an analysis of issues and considering solutions in national law or contractual practice as competing models. Moreover, contract governance links the classical contract law debate with modern regulation theory. Summarizing all this, contract governance research is holistic by nature with respect to disciplines, with respect to the discussion of standard setters, with respect to the discussion circles involved—contract law, market regulation, parallels in corporate law—and truly international.

[6] On the limited scope of traditional government (and regulation) in a globalized world, see J. Rosenau and E. -O. Czempiel, *Governance without Government: Order and Change in World Politics* (Cambridge: Cambridge University Press, 1992).

[7] This aspect is broadly taken up in this book in Part II. Ground-breaking in this respect is A. O. Hirshman, *Exit, Voice and Loyalty – Responses to Decline in Firms, Organizations, and States*, (Cambridge, MA: Harvard University Press, 1974); then J. E. Parkinson, *Corporate Power and Responsibility* (Oxford: Clarendon Press, 1995) 178–99; W. Ebke, '*Unternehmenskontrolle durch Gesellschafter und Markt*' in O. Sandrock and W. Jaeger (eds) *Internationale Unternehmenskontrolle und Unternehmenskultur* (Tübingen: Mohr Siebeck, 1994) 7–35, 27; see also n 17.

[8] This aspect is broadly taken up in this book in Part IV. Vulnerability (and a need for governance schemes) is seen if future developments are unforeseeable, but investments specific to this relationship (and not easily to be re-used elsewhere) are made (creating the risk of sunk cost if the relationship is terminated or if the other side devaluates it by behaving opportunistically [moral hazard]), see Williamson, n 2, 233–61; O. Williamson, *Markets and Hierarchies – Analysis and Antitrust Implications* (New York/London: Free Press, 1975) *et passim*; O. Williamson, *The Economic Institutions of Capitalism* (New York: Free Press, 1985) 56–67.

The added value of contract governance, however, is not restricted to broadening the perspective. On the contrary, its broader perspective raises a whole range of new and innovative research questions. Not only are old questions often approached differently, but completely new ones become visible. For example, where the question is whether there is an alternative to mandatory regimes even where mandatory protection is desired, contractual and legal regimes of codetermination and workers representation can be compared and analysed. Such analysis promises to show less intrusive means of regulation.[9] More generally, contract governance challenges the mandatory character of rules by understanding legal and contractual provisions as alternative possibilities of rule-making. Moreover, with its focus on external effects contract governance sheds new light on the market dimension of contracts, for example, with regard to the systemic effects of credit agreements. This approach diverges fundamentally from the very broadly accepted view of contract as producing effects exclusively or at least mostly amongst the parties alone. Conversely, a contract governance perspective proposes to study third party effects of, and on, contracts, positive and negative, in a systematic way, and not only with respect to contractual networks.

The present work approaches issues of contract governance by focusing on particular sets of such real world problems from the perspectives of various disciplines. On this basis, the book proposes to show two advantages of contract governance in more detail: (i) how a governance perspective leads to different and new questions, a good number of which seem to have been neglected in traditional contract law scholarship, and (ii) how these questions are dealt with in a different manner and style. We submit that a governance perspective helps to formulate questions more precisely and to discuss them more thoroughly, with a richer set of tools and possible outcomes.

This book addresses issues of contract governance in four areas:

(1) Contract and third parties: how should the legal framework for the drafting of contracts deal with the problem that different contract solutions have different impacts on third parties and third parties exert their influence on contract solutions? What are the biological, behavioural, and social science models behind this mutual impact (Part II)?

(2) Contracts and networks: how should the regime driving contract practice deal with the problem that contracts are often part of a larger network of relationships, which are both individual contracts and at the same time interdependent? What are the sociological and economic models behind such hybrids (Part III)?

(3) Contracts as organization: how should the regime driving contract practice deal with the problem that contracts, beyond individual exchange (as in the typical sales contract) may also have an 'organizational' function in that they may, and in modern market economies very often do, constitute the

[9] In a similar vein, see I. Ayres, 'Menus Matter', *University of Chicago Law Review* 73 (2006) 3, 4 (with the general goal 'to change the world with less intrusive interventions).

basis of (long-term) collaboration? What are the behavioural, sociological, and economic models behind such schemes of collaboration (Part IV)? All these topics are rather marginal in traditional contract law thinking—but not in current practice.

(4) Part V of this book concentrates on rule-setting as such, namely on (i) contract law and regulation and (ii) on contract law and contract drafting.

Before addressing these specific issues of contract governance, this Chapter addresses three cross-sectional themes, relevant for contract governance more generally and recurrent in the subsequent chapters:

(1) the relationship between the established fields of corporate governance and public governance and the emerging field of contract governance research (Part II);

(2) the issue of levels and of regulation (Part III); and

(3) questions of interdisciplinary discourse (Part IV).

Despite the cross-sectional character of this Chapter, Sections II and III already address the four topics which form the parts of this book: third party impacts, networks, the long-term character of contracts (Part II), and the issue of rule-setting (Part III).

II. Governance of Hierarchies and Governance of Market Relationships

1. Common ground between the governance perspectives

a. From public and corporate governance to contract governance

While governance research has developed richly since the 1970s in the areas of public governance and corporate governance where hierarchies and organizations are concerned, there has not been a similar development in the area of contracts where markets and cooperation are concerned. This is all the more astonishing as governance research is so strongly focused on the search for solutions to which all affected parties could have consented and on arrangements installed by the private actors themselves.

Hierarchies, of course, use state and supranational entities as paradigms. Indeed, the most prominent branch, based on general governance research,[10] can be found in public governance. The term is highly heterogeneous, but in certain parts also closely linked both to contract and to corporate governance. Public governance

[10] M. Bevir (ed) *The SAGE Handbook of Governance* (London: Sage, 2010); R. v. Lüde, D. Moldt and R. Valk (eds) *Selbstorganisation und Governance in Künstlichen und Sozialen Systemen* (Münster: Lit, 2009); G. F. Schuppert, *Alles Governance oder was?* (Baden-Baden: Nomos, 2011).

can be conceived mainly as governance of states.[11] It is then mainly about the allocation and balance of public power. This involves important questions which are also relevant in other hierarchies, including the corporations, and which are therefore less telling for contract governance than corporate governance. Public governance can also be conceived as encompassing all mechanisms by which public law, namely administrative functions, are enhanced by consensus-based mechanisms, thus furthering co-operation between private actors and the public authority or among different public authorities in the search for solutions.[12] This line of governance research has much in common with contract governance, namely the interplay between consensus-based design and the importance of the dimension of public good. In fact, while public governance would seem to be clearly focused on public good(s) in the typical case, it is exactly this interplay between consensus-based design and the dimension of public good that is also important for contract governance (and other branches of governance research in private law areas). As the remainder of this Chapter, and also the following chapters, illustrate one core aspect of governance research involves considering the private law side of contract design and the public regulation side as interdependent. This encompasses, in particular, private contract design *and* market stability; individual *and* institutional functions. The most important remaining difference might be that in contract and corporate governance, the aspect of public good is one of keeping intact a basically market-driven mechanism which is used for finding solutions while in public governance the solution is not seen as one driven mainly by market mechanisms, but rather by (re-)distribution or adjudication, which in turn promotes the public good. The same issue can, of course, be seen as belonging rather to one area in one country and to another in the other one, as the example of the organization of universities illustrates.

On the private law side, one reason for the dominance of the corporation (hierarchy) in governance research may be that the most important economic crises in the G7, G8, and then G20 states centred around issues of the 'firm' and

[11] This strand of research owes a lot to the 'crisis' of globalization and the post Cold War period both leading to an increase in comparison between countries. See on these issues, for instance, K. Dingwerth and P. Pattberg, 'Global Governance as a Perspective on World Politics' (2006) 12 *Global Governance* 185–203; U. Brand, 'Order and Regulation: Global Governance as a Hegemonic Discourse of International Politics?' (2005) 12 *Review of International Political Economy* 155–76; J. Bolton, 'Should We Take Global Governance Seriously?' (2000) 1 *Chicago Journal of International Law* 205–22; M. Shapiro, 'Administrative Law Unbounded: Reflections on Government and Governance' (2001) 8 *Indiana Journal of Global Legal Studies* 369–77; O. J. Sending and I. B. Neumann, 'Governance to Governmentality: Analyzing NGOs, States, and Power' (2006) 50 *International Studies Quarterly* 651–72; ground-breaking in this respect is J. Rosenau and E. -O. Czempiel (eds) *Governance without Government: Order and Change in World Politics* (Cambridge, Mass: Harvard University Press, 1992).

[12] J. Freeman and M. Minow, *Government by Contract: Outsourcing and American Democracy* (Cambridge, Mass: Harvard University Press, 2009); P. Zumbansen, 'The Law of Society: Governance Through Contract' (2007) 14 *Indiana Journal of Global Legal Studies* 191–233 (and further contributions to the symposium 'Governing Contracts: Public and Private Perspectives', published in the same issue); A. Habel, Contract Governance – *eine Verfassungsrechtliche und Rechtsdogmatische Analyse zu Vertraglichen und Vertragsrechtlichen Regelungsstrukturen in Belangen des Gemeinwohls* (Baden-Baden: Nomos Verlagsgesellschaft, 2012).

thus company law. This may not be true of the Japanese and then Asian crises 1991/1992 and 1997/1998,[13] but it was true of the crises in the UK and in the US (and also some other European countries) which have been the focus of much of the scholarly debates. These have concerned issues of control in companies (UK Cadbury Report and Code of Best Practice, now Corporate Governance Code)[14] and in the area of annual accounts, responsibility within the company and their auditing in particular (Enron, Worldcom, Sarbanes Oxley Act).[15] Some of the problems were mainly related to capital markets, but capital market law, despite its strong links to markets and contracts, can be seen as having an equally strong relationship with company law.[16] In other words, company law research and accounting law considerations strongly integrate capital market law problems.

On the private law side, these circumstances may explain why corporate governance research developed so strongly while contract governance did not. The distinction is not, however, justified in substance. This development is largely due to historic coincidence—crises, but also certain features in the scientific

[13] These were genuine bubbles. They were, however, distinct from the financial crisis in 2007/2008/2009 in that while also, then, over-investment in real estate markets was involved, poor contract law design played no role. See for the Japanese and Asian crises: N. Roubini and B. Setser, *Bailouts or Bail-ins? Responding to Financial Crises in Emerging Economies* (Washington DC: Institute for International Economics, 2004); G. Corsetti, P. Pesenti, and N. Roubini, 'Paper Tigers? A Model of the Asian Crisis' (1999) 43 *European Economic Review* 1211–36; G. Corsetti, P. Pesenti, and N. Roubini, 'What Caused the Asian Currency and Financial Crises?' (1999) 11 *Japan and the World Economy* 305–73; G. Kaufman, T. Krueger, and W. Hunter. *The Asian Financial Crisis: Origins, Implications and Solutions* (Boston: Kluwer Academic, 1999); M. Pohlmann, '*Die Entwicklung des Kapitalismus in Ostasien und die Lehren aus der Asiatischen Finanzkrise*' (2004) 32 *Leviathan* 360–81.

[14] Cadbury Committee, *The Financial Aspects of Corporate Governance* (London: Gee Publishing, 1992); Greenbury Committee, *Directors' Remuneration*, (London: Gee Publishing, 1995); Hampel Committee on Corporate Governance, *Final Report* (London: Gee Publishing, 1998) (all available at <http://www.ecgi.org/codes/>). London Stock Exchange Committee on Corporate Governance, *The Combined Code: Principles of Good Governance and Code of Best Practice* (1998 and 2000) (available at <http://www.ecgi.org/codes/documents/combined_code.pdf>). Now Corporate Governance Code (available at <http://frc.org.uk/corporate/ukcgcode.cfm>).

[15] The Sarbanes-Oxley Act of 2002 (available at <http://www.soxlaw.com>); on the Act see: J. Chung, J. Farrar, P. Puri, and L. Thome, 'Auditor Liability to Third Parties after Sarbanes-Oxley: An International Comparison of Regulatory and Legal Reforms' (2010) 19 *Journal of International Accounting, Auditing and Taxation* 66–78; H. -J. Hellwig, 'The US Concept of Corporate Governance under the Sarbanes-Oxley Act of 2002 and Its Effects in Europe' (2007) 4 *European Company and Financial Law Review* 417–33; also F. Frugier, *Die Einrichtung Moderner Interner Kontrollsysteme in Unternehmen mit US-amerikanischem Listing. Politische und Betriebliche Rahmenbedingungen und Besonderheiten der Umsetzung des Sarbanes Oxley Act in Deutschland* (Hamburg: Diplomica Verlag, 2009).

[16] 'Final Report of the Committee of Wise Men on the Regulation of European Securities Markets of 15 February 2001', Annex 5, 12, 20ff ('Lamfalussy Report'); P. Mülbert, *Aktiengesellschaft, Unternehmensgruppe und Kapitalmarkt – Die Aktionärsrechte bei Bildung und Umbildung einer Unternehmensgruppe zwischen Verbands – und Anlegerschutzrecht* (München: Beck, 1995); F. Möslein, *Grenzen unternehmerischer Leitungsmacht im markoffenen Verband* (Berlin/New York: de Gruyter, 2007); S. Kalss, *Anlegerinteressen – der Anleger im Handlungsdreieck von Vertrag, Verband, und Markt* (Vienna: Springer, 2001); E. Wymeersch, 'Factors and Trends of Change in Company Law' (2001) 2 *International and Comparative Company Law Review* 481–501, 484ff; and also, S. Grundmann, *European Company Law – Organization, Finance and Capital Markets* (Antwerp: Intersentia, 2nd edn, 2012) § 1 paras 5ff, § 30, and § 37 paras 36–41.

communities dealing with the respective areas (see Section II(2) later in this Chapter).

In fact, contract and company ('market and firm') can be viewed as the two basic—and often alternative—instruments of economic planning and arrangements. Contract and corporation are the two elementary areas where economic players are invited to create their own designs via party autonomy, and conversely, they are also the two core areas where business regulation sets limits to (and thereby also additionally empowers) the use of individual autonomy (*privatautonomie*) and freedom of contract:[17] The dominant form of regulation with respect to competition is antitrust law. Antitrust law has two main branches, control of cartels and merger control, i.e. contracts and companies. The dominant form of regulation of information problems and asymmetries are again clearly related to firm and market and have been developed because of this source of market failure. This is, on the one hand, capital market and accounting law in the area of company law (firms) and, on the other hand, consumer law with its information model in the area of contract law (markets).[18] Both waves of regulation—and their imposition worldwide—follow important developments in economic theory with respect to the effects of competitive markets in the 1930s through to the 1950s (highly influential for Europe is the Freiburg School) and with respect to information economics in the 1960s and 1970s (from Stigler through to Akerlof and Spence).[19] It would seem highly plausible that the idea of governance that has been considered in long-term relationships (and often in networks), i.e. in 'organization contracts' or schemes, developed in the 1970s and 1980s,[20] should and will follow the same path. In summary, both corporate and contract governance, are equally about individual, private party-driven design, *and* market regulation or, more generally, stability of organization forms and institutions.

[17] For more detail on the following see S. Grundmann, 'On the Unity of Private Law – From a Formal to a Substance Based Concept of Private Law' (2010) *European Review of Private Law* 1055–78, 1057–9, and 1063–6.

[18] On information problems see, for the law of contracts, H. Fleischer, *Informationsasymmetrie im Vertragsrecht* (Tübingen: Mohr Siebeck, 2001); S. Grundmann, 'Information, Party Autonomy and Economic Agents in European Contract Law' (2002) 39 *CMLR* 269–93; for company law see S. Grundmann, '*Information und ihre Grenzen im Europäischen und Neuen Englischen Gesellschaftsrecht*' in U.H. Schneider, P. Hommelhoff, and K. Schmidt (eds) *Festschrift Lutter* (Köln: Otto Schmidt, 2000) 61–82; U. Grohmann, *Das Informationsmodell im Europäischen Gesellschaftsrecht* (Berlin: de Gruyter, 2006); H. Merkt, *Unternehmenspublizität – Offenlegung von Unternehmensdaten als Korrelat der Marktteilnahme* (Tübingen: Mohr Siebeck, 2001); S. Grundmann, W. Kerber, and S. Weatherill (eds) *Party Autonomy and the Role of Information in the Internal Market* (Berlin: de Gruyter, 2001).

[19] G. Akerlof, 'The Market for 'Lemons': Quality Uncertainty and the Market Mechanism' (1970) 84 *Quarterly Journal of Economics* 488–500; A. M. Spence, *Market Signalling – Information Transfer in Hiring and Related Screening Processes* (Cambridge, Mass: Harvard University Press, 1974); G. Stigler, 'The Economics of Information' (1961) 3 *Journal of Political Economy* 213–25; today, for instance, see W. Magat, 'Information Regulation' in P. Newmann (ed) *The New Palgrave Dictionary of Economics,* vol 2 (London: Macmillan, 2002) 307–10; and also Grundmann, Kerber, and Weatherill, n 18.

[20] See n 2.

b. Three common paradigmatic questions between corporate and contract governance

The parallels between firm and market do, however, not end at this rather abstract level. These are not only the two areas where party autonomy is paramount and perhaps the most developed and where certainly limits to and regulation of party autonomy are the most extensive and prominent. On the contrary, much more specific and nevertheless paradigmatic questions can be asked about both areas in a similar way, though hitherto such questions have been mostly directed toward corporate governance. The three fields of questions focussed in the present book illustrate the point. First, there is the relationship of the firm or the contract to third parties who are not part of the company or a party to the contract, respectively, but who are nevertheless affected by it or who can influence the relationship, be it negatively or positively. Secondly, the question cab be posed of how can the relationships between a multitude of persons concerned be conceived—namely where such a multitude exists also in the setting of contracts—and how does the 'constitution' of these relationships influence the rights and duties and the governance arrangements in the overall design. This is the question of networks of contracts and relationships within (contractual und company) arrangements. A third question is about the duration of the relationship and its effects on the problems to be solved between all parties concerned. Arguably, the issues raised by long-term contractual relations are more similar to those of companies than to those of spot contracts, a proximity that would imply that one large part of contract law is closer to company law in its main problems than to the other, an important dividing line. Let us consider these three questions in more detail.

(1) Internal and external perspectives

The first question is about the *internal and external perspectives*. For corporate governance, it is evident and perhaps also the starting-point that instruments of internal and external governance are distinguished from one another and that their interplay is paramount.[21] Thus, shareholder influence within the organization, namely in the general assembly (voice), is distinguished from shareholder influence outside the company's organization, namely the influence they exercise via purchase and sale (exit; Wall Street Rule). Both dimensions are often intimately linked. Takeover law is paradigmatic for the interplay: the takeover bid to shareholders on capital markets, offering to buy their shares (exit, external governance) typically leads to a restructuring of the board as the core decision-making body within the company (internal governance).

A similar interplay of internal and external forces can be seen with respect to questions of the remuneration of management. From a legal perspective, the position of management has a company law dimension (position on the board) and a contract law dimension (contract for services for remuneration).

[21] On the combination of internal and external governance, see n 7. For all this and the examples given (also takeover law) see also Grundmann, n 16, §§ 14 and 30.

Functionally, however, both dimensions are intimately linked which is already evidenced by the fact that remuneration has increasingly become the object of a complicated decision-making process within the company. Since the financial crisis, the relevance of remuneration for the economy as a whole, in particular, has been intensely discussed—on the grounds of its potential third-party effects (see Section II of this Chapter). This last example also shows how important the third party perspective is in the contract law context. Contract arrangements have just as much potential for negative external effects as remuneration schemes. In fact, the financial crisis is paradigmatic for a whole range of adverse external (third-party) effects that contracts may have. Nevertheless, third-party effects are only a minor research topic in traditional contract law doctrine, typically seen as being unworthy of systematic inquiry. The issue of third party-effects may, for example, shed a new light on the controversial (contractual) duty of responsible lending. The question is whether this aspect matters when the design of contract law is at stake, and whether there has to be a governance framework beyond the two parties. Similarly, securitization and the passing on of risks inherent in credit contracts via special purpose vehicles gives the incentives and the legal instruments to the first lender (creditor) to multiply the risks he can take. Moreover, is the design not such that redress to the first creditor (bank) who is the initiator of the product is interrupted while, in the area of sales of goods, Article 4 of the EC Sales Directive of 1999 had introduced a right to redress which the parties were not allowed to interrupt—not even within the B2B distribution chain? In a third step, it is clear that also a credit rating which is erroneously optimistic or disregards systemic risk can hurt not only the partner who contracted for the rating, but third (or fourth, fifth, . . .) parties as well—all this in a context where rating firms were subject to (usually undisclosed) massive conflicts of interests. Finally, how can the legal arrangement capture the phenomenon that parallel investment behaviour (herd behaviour) may transform individual risks into systemic risks, i.e. understand the phenomenon and develop a legal concept for it on the basis of (interdisciplinary) strands of theory? When is herding problematic, even though often it is seen as having positive effects?

Thus *negative* effects of contract drafting on third parties would seem to be a major issue of concern. At least four distinct forms can be identified in the chain of causation in the financial crisis—each of them interesting in and of itself but not discussed in depth in contract law scholarship: responsible lending; passing on of risks without retaining at least some responsibility; mixing of risks and thus inherently obscuring information; and credit rating under the influence of conflict of interests. All these have to do with the limits set by contract law, but influence market stability as well. Hence the question: can contract theory be amended so as to take the issue of market stability into consideration? A general reference to tort law has proved to be much less nuanced, insensitive to the problem that, in many cases, there is some kind of 'implied promise' involved between 'tortfeasor' and 'victim'. Conversely, for the corporate governance debate—as previously in company law with its focus on creditor protection—adverse effects on third parties are a major research topic. The corporate governance debate indicates that

the full picture is worth discussing, with three more dimensions: *positive* effects of contracts on third parties as well as negative, or positive, influence *from third parties* on contracts. Again, the idea that even positive impact from third parties is worth being analyzed becomes evident when turning to corporate governance: of course, the positive effect which (potential) bidders in takeovers may have for disciplining management (already *ex ante*), is a major issue in the corporate governance debate. Likewise, could it not be that someday third parties—offering, for instance, ratings on fair behaviour—become a major factor in, say, markets characterized by long-term relationships, for instance franchise relationships?[22] Thus four dimensions of effects really have to be distinguished: contracts on third parties and third parties on contracts, both positive and negative. All four dimensions would have to be considered from a traditional private law perspective, from a regulatory perspective (antitrust law being, of course, about negative effects of certain contracts, i.e. cartels), and in the private drafting process as such. In all dimensions, the legal framework can help to improve the outcomes, as evidenced, for instance, in the area of ratings. A contract governance approach would favour analysing the question in all three perspectives jointly—contract law, regulation, and the forces present in the drafting process. It would have to be asked at which level it is best to regulate and by which instrument. The financial crisis amply proved that legal and economic sciences are in crisis as well, namely with respect to seeing contracts too much in isolation from the world around. The disregard of third party relationships has a long-standing tradition—one major example being that fiduciary ('trust') relationships have not been conceived as contractual (having third party effects), but only as quasi-proprietary rights and effects.[23]

In the present work, the external effects of contract—namely in situations of herding, as in the financial crisis—are discussed from various perspectives: from a biological/psychological perspective and from an economic perspective as well as from a legal perspective (in most cases with comments from other disciplines). Particular emphasis is placed on the contractual reconstruction of how potentially to internalize costs of external effects.[24] In his contribution to this book, Micklitz starts out from the traditional teaching that external effects are to be caught by tort law only (which does not pay particular attention to the pre-existing relationships between all affected parties). Micklitz then asks how a liability regime could be reconstructed on a contractual basis, rendering parties to the contract liable to third parties, based on the assumption that there are networks of contractual relationships by which also those causing the external effects and those suffering the

[22] See, for instance, S. Grundmann and M. Renner, '*Vertrag und Dritter*' (2013) *Juristenzeitung* 379–89.

[23] See S. Grundmann, 'Trust and Treuhand at the End of the 20th Century – Key Problems and Shift of Interests' (1999) 47 *American Journal of Comparative Law* 401–28, 403–12; more extensively (mainly on the German development) see S. Grundmann, *Der Treuhandvertrag – Insbesondere die Werbende Treuhand* (München: C. H. Beck, 1997) §§ 7 and 8.

[24] See contributions by T. Kameda and colleagues and P. Zumbansen (Chapter 2 and accompanying comment), by B. Frey and R. Cueni and by G. Teubner (Chapter 3 and accompanying comment), and by H.-W. Micklitz (Chapter 4). See also Section IV(3)(1) of this Chapter.

losses are linked at least indirectly (via a chain). This is the basis for asking how implied contractual arrangements between all parties affected could be conceived and how incomplete contracts could be reconstructed so as to reach commitments across the networks of contracts via presumed consensus.

(2) Networks of contracts

The second issue is that of *networks of contracts* ('nexus of contracts')—a concept found both in contract and in company law. In company law, the concept of a nexus of contracts is primarily employed to illustrate how each shareholder—and potentially also stakeholder—or any other player, for instance a manager, has individual incentives, but also rights and duties towards others. Thus, the concept is a perfect image of methodological as well as normative individualism.[25] Based on this concept, it is easy to explain why the legal personality of the company as such does not prevent the existence of direct duties and rights between the different members.[26] The concept of nexus of contracts, however, does not cogently explain whether all members have contractual relationships with all others individually (multi-facetted network) or rather with the company which administers the rights of all the other members in this respect (star-shaped form of nexus). The basic assumption of most laws would seem to be, however, that each member has the right to keep the 'same' proportional share in the profits (and, as a starting-point, also share in the decision-making power) and that each (other) member has the duty to respect this principle and not to gain hidden additional profits. The nexus of contracts is more heterogeneous and complex if stakeholders are included. Whether this is to be assumed is, of course, one of the core divergences which can be sensed in the corporate governance debate in different parts of the world, namely between Europe and the United States.[27]

[25] Path-breaking for the theory of a '*nexus of contracts*', see A. Alchian and H. Demsetz, 'Production, Information Costs, and Business Organization' (1972) 72 *The American Economic Review* 777–95; R. Coase, 'The Nature of the Firm' (1937) 4 *Economica* 386–405; S. Cheung, 'The Contractual Nature of the Firm' (1963) 26 *The Journal of Law and Economics* 1–21; M. Jensen and W. Meckling, 'Theory of the Firm – Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305–60; W. A. Klein, 'The Modern Business Organization – Bargaining under Constraints' (1982) 91 *The Yale Law Journal* 1521–64; O. Williamson, 'Corporate Governance' (1984) 93 *The Yale Law Journal* 1196–230.

[26] In this respect, it is an interesting development, for instance, that under the German Law on the Plc, in particular situations a fiduciary duty may even be owed by small shareholders to large shareholders: see mainly *Bundesgerichtsho—Official Reports: BGHZ* 103, 184, 194 (Linotype); case law of long standing tradition today, see for instance *BGHZ* 129, 136, 142–4 (Girmes) (also small investors); *BGHZ* 142, 167, 169ff (Hilgers).

[27] For an increasing trend towards stakeholderism recently, see R. E. Freeman, 'A Stakeholder Theory of the Modern Corporation' in L. Hartman (ed) *Perspectives in Business Ethics* (New York: McGraw-Hill, 3rd edn, 2004) 112–22; A. Keay, 'Moving Towards Stakeholderism? Constituency Statutes, Enlightened Shareholder Value, and More: Much Ado About Little?' (2011) 22 *European Business Law Review* 1–49; A. Keay, 'Shareholder Primacy in Corporate Law: Can it Survive? Should it Survive?' (2010) 7 *European Company and Financial Law Review* 369–413; or, describing more objectively the main stream in the different countries, see *Modern Company Law – For a Competitive Economy – The Strategic Framework – A Consultation Document from the Company Law Review Steering Group* (London, February 1999) 37–51 (available at <http://www.bis.gov.uk/>); K. Hopt, 'Common Principles of Corporate Governance in Europe?' in B. Markesinis (ed)

In contract law, the contractual relationships integrated into a network are manifold as well. Think, for example, of networks of suppliers, distribution chains, or in networks of payment systems or syndicated loans, all these constituting in some sense the backbone of the market economy. While all parties have a 'shared' interest in the existence and success of these networks, the jointly pursued purpose—with a pooling of inputs—and the common legal basis—a charter or articles of association—are less clearly defined. The core question is which modifications to general contract law are required to take account of the intended interrelation or network structure of the various contracts. Different legal instruments may come into play. So, for example, the remedies of the parties to the various contracts in a chain may be aligned, or a direct claim within a chain- or network-relation could be allowed—in modification of the general principle of privity. In both instances, general contract law is modified because of the existence of a network.[28]

Those inquiries dealing specifically with networks of contracts unanimously favour some kind of modification of general contract law. The (fairly recent) right to redress in the distribution chain provided for in Article 4 of the EC Sales Directive seems to indicate that legislatures (both on the Union and Member State level) in principle concur. What is disputed, though, is whether direct claims should be the rule or the exception or, conversely, a mere modification within the single contractual link. While important questions may have to be solved in different ways in contract and company law—for instance sharing of profits as the core principle in company law and split accounts, costs and income in the network of contracts—all core questions have to be asked in a very similar way both in company law and in the (network of) contracts setting: whether an added

The Clifford Chance Millenium Lectures – The Coming Together of the Common Law and the Civil Law (Oxford: Hart Publishing, 2000) 105–32, 118ff; comparative law survey in E. Wymeersch, 'A Status Report on Corporate Governance Rules and Practices in Some Continental European States' in K. Hopt, H. Kanda, M. Roe, E. Wymeersch, and S. Prigge (eds) *Comparative Corporate Governance – the State of the Art and Emerging Research* (Oxford: Oxford University Press, 1998) 1045–199, 1079–87 (recognizing consensus in that there should be scrutiny always only when clearly defined procedures have been violated). Even in the US, in principle, stakeholder interests may at least be taken into account: ground-breaking on this is *Shlensky v. Wrigley* 237 N.E.2d 776, 778–80 (Ill App Ct, 1968).

[28] See also, for the different opinions referred to in the text, M. Amstutz, '*Vertragskollisionen: Fragmente für eine Lehre von der Vertragsverbindung*' in H. Honsel, W. Portmann, R. Zäch, and D. Zobl (eds) *Festschrift für Heinz Rey* (Zürich: Schulthess, 2003) 161–76, 168–70; F. Cafaggi, 'Contractual Networks and the Small Business Act – Towards European Principles?' (2008) 4 *European Review of Contract Law* 493–539; S. Grundmann, 'Contractual Networks in German Private Law' in F. Cafaggi (ed) *Contractual Networks, Inter-Firm Cooperation and Economic Growth* (Cheltenham: Edward Elgar Publishing, 2011) 111–62, 126–42; G. Teubner, *Netzwerk als Vertragsverbund - Virtuelle Unternehmen, Franchising, Just-in-time aus Sozialwissenschaftlicher und Juristischer Sicht* (Baden-Baden: Nomos, 2004) 25–8, 141–3, 161ff, *et passim*; M. Wellenhofer, '*Drittwirkung von Schutzpflichten im Netz*' (2006) *Kritische Vierteljahresschrift* 187–207, 192, 194, 196ff, *et passim*; the discussion started with W. Möschel, '*Dogmatische Strukturen des Bargeldlosen Zahlungsverkehrs*' (1986) 186 *Archiv für die Civilistische Praxis* 187–212; M. Rohe, *Netzverträge – Rechtsprobleme Komplexer Vertragsverbindungen* (Tübingen: Mohr-Siebeck, 1998).

income which the network creates or added costs which it incurs should be shared by all; which decision mechanisms should apply (majority, unanimity/consensus); and which management powers should be delegated to one core decision body (such as the franchisor or the board) and which should be direct claims between the members. One thing is clear though: in each setting, party autonomy permit to a large extent the mimicking of the default rules of the other setting (in the charter or in the contract provisions).

In the present work, networks (of contracts) are also discussed from various perspectives: law, economics, and sociology.[29] Again, many issues are inspired by the financial crisis. Gilson, Sabel, and Scott, for developing legal concepts in this context, focus on network arrangements between entrepreneurial innovation and the finance and other contracts needed for carrying this innovation to an end. They conclude that traditional contract law (namely US case law) is not well suited to cope with the governance of these contracts characterized by (highly unforeseeable, incalculable, yet innovative) situations of uncertainty and propose a more flexible system of networks of contracts ('braided contracts'). Also chapters primarily focusing on third party effects—namely those by Frey and Cueni and by Teubner—cannot disregard network effects.

(3) Long-term relationships

A third set of questions is related to the long-term nature of the relationship—evident in the company law setting, but characteristic as well of many contractual relationships, namely those of organizational character. Two approaches are central—the theory of relational contracts[30] and—in fact—general governance research as initiated by Williamson.[31] Both approaches depart from a common starting point: the uncertainty of future developments and needs raises specific problems which fundamentally diverge from those posed by spot contracts. The

[29] See contributions by R. Gilson, C. Sabel, and R. Scott and by G. Hertig (Chapter 5 and accompanying comment) (the former also published in The Kauffman Task Force on Law, Innovation, and Growth, *Rules for Growth: Promoting Innovation and Growth Through Legal Reform* (Kansas City, Mo.: Kauffman, 2011); by R. Swedberg and by M. Amstutz (Chapter 6 and accompanying comment); and by M. Klausner (Chapter 7). See also Section IV(3)(a).

[30] S. Macaulay, 'Non-Contractual Relations in Business – a Preliminary Study' (1963) 28 *American Sociological Review* 55–67; I. R. MacNeil. 'The Many Futures of Contracts' (1974) 47 *Southern California Law Review* 691–816; O. Williamson, 'Markets and Hierarchies – Some Elementary Considerations' (1973) 63 *American Economic Review, Papers and Proceedings* 316–25; and also n 31; then V. Goldberg, 'Relational Exchange – Economic and Complex Contracts' (1980) 23 *American Behavioural Scientist* 337–52; B. Klein, R. G. Crawford, and A. Alchian, 'Vertical Integration, Appropriable Rents, and the Competitive Contracting Process' (1978) 28 *Journal of Law and Economics* 297–326. In German literature, the parallel discussion has taken place very early under the heading of 'long-term obligation' (*dauerschuldverhältnis*), see summary by M. Martinek in *Staudinger Commentary*, vol II (Berlin: de Gruyter, 14th edn, 2006) 'Introduction to §§ 662 et seq.' paras 68–88.

[31] O. Williamson, 'Transaction-Cost Economics: The Governance of Contractual Relations' (1979) 22 *Journal of Law and Economics* 233–61; Williamson, *The Economic Institutions of Capitalism,* n 8, 43–63, 68–84; for a combination of contract law and company law in this respect see Möslein and Riesenhuber, n 1, 248, 251–60.

parties to spot contracts are mainly confronted with the uncertainty of whether the other party will perform. Consequently, the parties' obligations can be described in a fairly complete way. A so-called complete contract, i.e. a contract regulating all potential developments, is more easily conceivable. For long-term relationships, on the other hand, a precise and exhaustive description of the core obligations is impossible, long-term contracts are inherently incomplete. This is the source of a particular set of risks of opportunism. More often than not, long-term relationships require high investments from one party or both and may thus lead to a hold-up situation where one partner can take advantage of the other partner's sunk costs (or relation-specific investment), for instance, by demanding changes in the arrangement or by asking the other party to accept certain breaches.[32] Conversely, there may also be a danger of holding the other partner too strictly to the agreement—for instance with respect to the conditions of termination of labour contracts or credit contracts or also partnership agreements. A termination regime which is too protective increases this danger.

Given the inherent incompleteness of long-term contracts, adjustment mechanisms are required. Various different instruments are at the parties' disposal, and choice of the right one is a core governance issue. In all cases, procedure becomes paramount. Agency is a core instrument in this context—the basic model of a duty to decide in the interest solely of the principal which also applies in company law. This basic model reveals far-reaching similarities in the treatment of a contractual and corporate long-term relationship. The board's fiduciary duty to further the interests of the company/shareholders is particularly prominent. It has been discussed extensively in the company context but much less in the context of contractual long-term relationships, even though the underlying questions are largely identical. In other words, the principal-agent theory which deals in particular with the question of how actions have to be taken in the interest of another person (or pool)[33] should be seen as a theory of company *and* contract law. With respect to risks (and chances) resulting from the long-term duration of the relationship, the similarities between the contractual and the corporate setting are particularly evident and striking. The examples discussed in this context can equally be formulated as those of contract law. Take, for instance, the 'Alaska Packers Case'[34]—like in Williamson's example, this case involved a workforce hired for a place in Alaska—which raised the issue of how proprietary rights and

[32] On this form of opportunism see references in n 6.

[33] Path-breaking in this regard, see M. Jensen and W. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305–60; M. Jensen and W. Meckling, 'Separation of Ownership and Control' (1983) 26 *Journal of Law and Economics* 301–25; today M. Roe, *Strong Managers and Weak Owners – The Political Roots of American Corporate Finance* (Princeton, NJ: Princeton University Press, 1994); A. Shleifer and R.W. Vishny, 'A Survey of Corporate Governance' (1997) 52 *Journal of Finance* 737–83; good description also in M. Ruffner, *Die ökonomischen Grundlagen eines Rechts der Publikumsgesellschaft – ein Beitrag zur Theorie der Corporate Governance* (Zurich: Schulthess, 2000) 131ff. For these questions from a strictly contract related perspective see U. Schweizer, *Vertragstheorie*, (Tübingen: Mohr Siebeck, 1999) 33–85, 230–38.

[34] *Alaska Packers' Association v. Domenico*, 117 F. 99 (9th. Cir., 1902).

investment in housing, as well in the local retail store, should be arranged. The model of low search costs and high agency costs[35] is well adapted both to the company law setting and to long-term contractual relationships—more or less depending on the degree of stabilization, for instance via termination prerequisites. It is always the legal shaping of the relationship—in the company law setting *or* in a contractual setting—which makes it adopt more of one characteristic than another, but the particular mix can be largely identical in contractual long-term relationships and in partnerships/companies with respect to termination prerequisites; the important question of compensation; inspection rights into the other actor's actions; and decision-making rights.

In the present work, the long-term dimensions of contracts—namely fairness, reciprocity, and opportunistic behaviour—are again discussed from various perspectives. In other words, it investigates schemes of behaviour and then looks at these from an economic and from a legal perspective.[36] In two case studies, Klausner develops the parallels between corporate and long-term (contractual) relationships, emphasizing their similarity as well as key distinctions. For long-term contracts, integration (pooling) of efforts and assets does not go as far leading to a situation where some problems are less pronounced (some players' apathy), others more pronounced (hold-up situations), and many are very similar. The chapter focusses on governance mechanisms in long-term contractual relationships which can cope with, or minimize, the problems resulting from hold-up situations and moral hazard. Gillette, in his contribution, concentrates on opportunistic behaviour devaluating firm- or relation-specific investments made by the other side or other parties[37]. Starting out with an analysis of legal rules aimed at preventing opportunism and thereby encouraging relation-specific behaviour, Gillette—very much in line with what Williamson assumed—reaches the conclusion that such legal rules may not always achieve this goal. Judge-made rules, in particular, imposed *ex post,* may prove ill-informed or overprotective and thus provide room for opportunistic manoeuvre. This scepticism about rules is not completely shared by Schweizer who, while agreeing in principle, nevertheless sees a much more prominent role at least for default rules. The core of Gillette's contribution is then about how parties can design their own arrangements to protect relation-specific investment. With regard to US law, Gillette concludes that courts too often adversely interfere with contractual arrangements of the parties. At least in a commercial setting, he argues, (virtually unlimited) deference to contractual governance schemes would be preferable.

[35] Jensen and Meckling, n 33.

[36] See contributions by S. Magen and by G. -P. Calliess (Chapter 8 and accompanying comment) by B. Defains and D. Demougin and by F. Gomez (Chapter 9 and accompanying comment), and by C. Gillette and U. Schweizer (Chapter 10 and accompanying comment). See also Section IV(3)(a).

[37] See n 6.

2. Is contract governance needed in addition to corporate governance?

If governance research seems to be particularly promising where contracts lead to relations which have a structure similar to that of a company, is not contract governance simply a plea for extending corporate governance? Could not corporate governance integrate the aspects of contract law? What is the added value of a genuinely contract- and market transaction-centred governance discussion?[38]

First, the recent discussion of the financial crisis indicates that such an 'inclusive' approach would tend to disregard at least a good part of the important problems if, in a particular setting or crisis, the problems are mainly contract- or contract law-related. Secondly, a governance research agenda is important for contract and market transactions in order to fully profit from all the highly important tools and the changes in approach which a governance discussion brings about. The two-fold answer would then be that without contract governance, the discussion is too focused on the paradigm of the firm (disregarding the market), and without contract governance, all the changes in approach discussed are not fully exploited for contract law and in its market context.

a. Corporate governance not reaching deep enough into markets

Corporate governance covers a lot of material, but it does not reach deep enough into market transactions and contractual questions. Looking at how the financial crisis was dealt with would seem to be a good example. Again, market mechanisms (including contract drafting), default rules, and the mandatory framework have to be seen as different aspects of *one* overall governance scheme, taking into account its legal and interdisciplinary perspectives and paying particular attention to the (transnational) rule-setting scenarios.

For the regulatory framework in particular, it becomes evident that the focus is too narrow. One focus was on prudential supervision—and rightly so.[39] Reforms

[38] On these questions, see K. Riesenhuber, 'A Need for Contract Governance?' in S. Grundmann and Y. Atamer (eds) *Financial Services, Financial Crisis and General European Contract Law – Failure and Challenges of Contracting* (Alphen: Kluwer International, 2011) 61–83.

[39] See, for instance, Directive 2009/111/EC of the European Parliament and of the Council Amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management (OJ 2009 L 302/97); on this regime see, e.g., G. Spindler, '*Finanzkrise und Wirtschaftsrecht*' (2010) *Aktiengesellschaft* 601–17, 606ff; broader surveys, also on the lacunae leading to the crisis in V. Acharya and P. Schnabel, 'How Banks Played the Leverage Game' in V. Acharya and M. Richardson (eds) *Restoring Financial Stability – How to Repair a Failed System* (Hoboken: John Wiley & Sons, 2009) 83–100, 86–98; W. Heun, '*Der Staat und die Finanzkrise*' (2010) *Juristenzeitung* 53–62, 57ff and 61ff; see also Directive 2010/76/EU of the European Parliament and of the Council Amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies (OJ 2010 L 329/3) and n 41. The largest lacuna would still seem to be that there are important professional players active on credit markets who are not or only scarcely covered by the supervisory scheme.

dealt with (i) an increase in own funds, (ii) the question of how all institutions and tools which provide credit can be integrated into the supervisory regime, with extended supervision on a consolidated basis (also covering risks transferred to SPVs and short term guarantees provided for other group members), and (iii) supervision of market risks which can provoke problems similar to those resulting from the 'traditional' risk of non-diversification ('agglutination risks').

Beyond prudential supervision, however, the reform discussion focused on one 'private law' topic only: remuneration of management.[40] This is certainly important and may even constitute a 'systemic' issue. If one considers the EU level though, binding legislation has been enacted in a sector-specific way only.[41] The question why this particular issue attracted more legislative and academic attention than any other private law issue can probably best answered by referring to the fact that there had been a debate about remuneration before in the corporate governance discussion.[42] In any case, not only could the remuneration issue have been considered *also* as a contractual one—certainly on the level of the brokers, but also on the level of management, as rooted in the contract between management and firm—but moreover this issue by no means exhausts the private law defects which lead up to the crisis. In fact, there are some issues which are clearly firm-related, others which are clearly market-related, and still others relating to both firm and market, such as takeovers and remuneration. Contract governance *and* corporate governance, not one *or* the other, would seem to be the approach needed. And given that corporate governance is already so well developed, a crisis like the financial crisis which is now mainly related to deficits in the drafting of contracts is helpful in highlighting this rather obvious statement.

[40] On this issue and the reform steps see: S. Bhagat and R. Romano, 'Reforming Executive Compensation: Simplicity, Transparency and Committing to the Long-term' (2010) 7 *European Company and Financial Law Review* 273–96; G. Ferrarini, N. Moloney, and M.-C. Ungureanu, 'Executive Remuneration in Crisis: A Critical Assessment of Reforms in Europe' (2010) 10 *Journal of Corporate Law Studies* 73–118; Y. Hausmann and E. Bechtold-Orthi, 'Changing Remuneration Systems in Europe and the United States – A Legal Analysis of Recent Developments in the Wake of the Financial Crisis' (2010) 11 *European Business Organisation Law Review* 19–229. The dimension of the issue is, however, disputed, see, for instance, G. L. Clementi, Th. Cooley, M. Richardson, and I. Walter: 'Rethinking Compensation in Financial Firms' in V. Acharya and M. Richardson (eds) *Restoring Financial Stability – How to Repair a Failed System* (Hoboken: John Wiley & Sons, 2009) 197–214; Heun, n 39, 53, 60.

[41] Directive 2010/76/EU; on this directive see n 39; for all listed companies, only recommendations have been enacted: Commission Recommendation 2009/385/EC complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies (K(2009) 3177, OJ 2009 L 120/28) and Commission Recommendation 2009/384/EC on remuneration policies in the financial sector (K(2009) 3159, OJ 2009 L 120/22); on these recommendations see n 3 (namely Hopt (2011) 1, 40–2).

[42] See, for instance, G. Ferrarini and N. Moloney, 'Executive Remuneration and Corporate Governance in the EU: Convergence, Divergence and Reform Perspectives' (2004) 1 *European Company and Financial Law Review* 251–339; and first, in the UK in 1995, the Greenbury Committee, *Directors' Remuneration*, n 14 (disclosure of remuneration and recommendation of an independent committee); and those named in nn 40 and 41. Quite lucidly in the sense that corporate *and* contract governance should be seen in conjunction in such cases: K. Riesenhuber, n 38, 64–77.

There are many other issues which would have deserved just as much, perhaps even more attention with respect to the repercussions on the overall system. For instance, would not a duty of responsible lending—as discussed in the legislative history of the consolidated EC Consumer Credit Directive—[43] have prevented a consistent practice of issuing loans which were given to debtors who systematically did not even have the funds to afford the repayments out of their own income? Would not a mandatory redress rule or scheme—leading from any purchaser of a defective financial product up to the initiator—have prevented initiators from making such loans and then completely selling them off? Did not the lack of such a scheme of redress dramatically reduce the incentive to care about the creditworthiness of the debtors? This is not an abstract question either, given that such a mandatory redress rule does exist in Article 4 of the EC Sales Directive with respect to goods.[44] It can be argued that such a redress rule is at least as appropriate for financial products. And finally, would not a mandatory disclosure rule—at least for all substantial conflicts of interest (like in Article 18 of MiFID)—have prevented rating agencies from structuring toxic bonds and at the same time rating them very positively (without such disclosure)?

Three main contract law factors constituting the chain which led to the financial crisis—sub-prime lending, a complete passing on of risks in distribution chains, and rating under conflicts of interest—were largely left undiscussed in the corporate governance dialogue—as well as in traditional contract law. A contract governance discussion would have been needed for this purpose. These aspects have, of course, been discussed as issues of regulation and prudential supervision. A governance approach would, however, have added the view that regulation and prudential supervision should not be seen in isolation, but in conjunction with their 'private law' side, i.e. the tools of contract law, on which the schemes were based. Thus, with respect to 'the market', private law and supervision were not seen together, as alternatives and mutually reinforcing each other. Such a holistic approach would, however, be needed also for market phenomena and also in a rule-setting perspective. It would indeed be helpful to ask—taking all alternatives into consideration!—which level(s) and which substantive remedy to choose or whether the cumulation of different remedies or levels would be preferable, considering moreover how parties will probably respond to the alternative legal settings.

[43] Arts 8–9 of the Proposal for a Directive of the European Parliament and of the Council on the Harmonization of the Laws, Regulations and Administrative Provisions of the Member States Concerning Credit for Consumers, COM(2002) 443 final; then Directive 2008/48/EC of the European Parliament and of the Council on Credit Agreements for Consumers and Repealing Council Directive 87/102/EEC (OJ 1987 L 133/66). See, for instance, Y. Atamer, 'Duty of Responsible Lending – Should the European Union Take Action?' in S. Grundmann and Y. Atamer (eds) *Financial Services, Financial Crisis and General European Contract Law – Failure and Challenges of Contracting* (Alphen: Kluwer International, 2011) 179–202 (favouring strong paternalism); C. Sunstein, 'Boundedly Rational Borrowing' (2006) 73 *University of Chicago Law Review* 249–70 (favouring weak paternalism).

[44] See Art 4 of Directive 1999/44/EC of the European Parliament and of the Council of 25 May 1999 on certain aspects of the sale of consumer goods and associated guarantees (OJ 1999 L 171/12); on redress, see, i.e.: M. Bridge, C.M. Bianca, and S. Grundmann (eds) *EU Sales Directive – Commentary* (Antwerp/Oxford: Intersentia, 2002) Art 4, paras 12–36.

For 'the firm', i.e. for company law, such a discussion in mutual isolation—of the law of organization and of regulation—would not have happened to the same extent, and the corporate governance discussion helped in developing this more integrated perspective.

The discussion that has been summarized in the preceding paragraphs would seem to indicate that a corporate governance discussion does not reach deep enough into the market side of the question if the problem is genuinely contractual and that it cannot help contract law to develop the vision that indeed contract law tools and regulatory tools—from prudential supervision or investor protection—are to be seen as alternatives: both are capable of improving market structures and of contributing to their stability. As a matter of fact, it seems even peculiar that governance research did not first start in contract law. This is not only the area that is seen as the paradigm of any consensus-based method of problem solving and the 'first' area in traditional private law doctrine in most countries, but Williamson, when he coined the concept and also the term, took his examples mainly from this area.[45] Theoretically, the development could have been just the other way around.

b. Contract law in need of a governance approach

If the first strand of the answer is mainly about the fact that corporate governance does not reach deep enough into market phenomena, the second strand is more about the status of contract law as such: to develop the potential of governance as a tool may well contribute to the modernity (also) of contract law. Contract governance studies can indeed be seen as a particular way to contribute to the modernization of contract law studies.

To this end, the three more concrete issues can be considered which form the core of the present work—contract and third party, contract and network, contract and long-term duration. This will be done in more detail later, but some comments are helpful here. An important aspect of modernization would be that of developing a more integrated view of regulation and private law in market transactions. This integrated view would seem to be indicated by the characteristics of substantive law *and* to correlate with recent trends, but it is still far from being mainstream in a contract law setting (or at least much less so than in company law). A first consideration would be that regulation can not be seen only as a limit to freedom of contract, but also as restoring the actual foundations—the prerequisites—for a meaningful exercise of party autonomy, thus contributing to rather than restraining it.[46] Antitrust would then mainly be about restoring real freedom of choice and negotiation to the other side of the market, and consumer

[45] See n 2.

[46] Ground-breaking in this regard, see F. Böhm, '*Privatrechtsgesellschaft und Marktwirtschaft*' (1966) 17 *Jahrbuch für die Ordnung von Wirtschaft und Gesellschaft (ORDO)* 75–151, esp. 85, 88, 138; W. Eucken, *Grundsätze der Wirtschaftspolitik* (Tübingen: Mohr Siebeck, 6th edn, 1990; 1st edn, 1952) esp. 241–50 *et passim*; see only D. Kennedy, 'A Transnational Genealogy of Proportionality in Private Law' in R. Brownsword, H. Micklitz, L. Niglia, and S. Weatherill (eds) *The Foundations of European Private Law* (Oxford: Hart Publishing, 2011) 185–220.

law would primarily be about allowing an informed choice and negotiation by those contract partners who typically suffer from information problems and asymmetries, etc.

A second consideration would be that regulation and traditional private—in this context—contract law are furthering one common goal, i.e. free and informed choice in the process of formation of contract, but that they do so by focusing on different ways of cure, raising also different problems of proof, etc. One is looking at the overall market structure, the other at the individual position of (proprietary) rights of the parties but, by doing so, this, indirectly, also furthers overall market functions.[47] Thus, regulation in antitrust law requires consideration of the relevant market and that for a good part of this market competition no longer properly works. On the side of regulation, no actual damage has to be proven. If, however, actual damage can be proven, the more recent trends show that there is no reason not to provide also compensation rights for private parties and even encourage action.[48] On the other hand, in contract law settings, the effect on the whole of the market (structure) is not needed; it is not a core category in contract law, but rather actual loss (and lost gains). Third party behaviour may therefore be prohibited because it caused loss—destroying, for instance, a relation-specific investment—even if it did not reach the level of cartelization of whole markets. However, it may again be an argument to prohibit practices by third parties more easily if, in addition, they affect the market structure. Market regulation and contract law could then be considered to constitute what has been called in the German literature (with respect to public law and private law more generally) 'mutually supplementary orders' (*gegenseitige auffangordnungen*).[49]

The third consideration would be that the first steps to close the gap between private law (contract) remedies and market regulation have already been taken.

[47] Particularly striking is the parallelism in capital market law between the scope of protecting individual investors and the scope of protecting the market: see, for instance, very explicit Recitals 2, 5, 17, 31, 34, and 44 of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EC (OJ 2004 L 145/)—the basic Act on securities' exchange in Europe; or, from literature, N. Moloney, *EC Securities Regulation* (Oxford: Oxford University Press, 2nd edn, 2008) 564–71; Grundmann, n 16, § 19 paras 15–17; ground-breaking for Germany (which was late in its development) is K. Hopt, *Kapitalanlegerschutz im Recht der Banken* (Munich: C.H. Beck, 1975) 51ff, 334–7.

[48] White Paper on Damages for Breach of Competition Law, COM(2008) 165 (considering also remedies such as collective actions); on this development see J. Basedow, 'Incentives and Disincentives for the Private Enforcement of EC Competition Law' in T. Egers, C. Ott, J. Bigus, and G. von Wangenheim (eds) *Internationalisierung des Rechts und seine ökonomische Analyse Festschrift für Hans-Bernd Schäfer zum 65. Geburtstag* (Wiesbaden: Gabler, 2008) 499–508; G. Wagner, 'Should Private Enforcement of Competition Law be Strengthened?' in D. Schmittchen and M. Albert (eds) *The More Economic Approach to European Competition Law* (Tübingen: Mohr Siebeck, 2007) 115–29; for the latest developments see V. Pinotti and D. Stepina, 'Antitrust Class Actions in the European Union: Latest Developments and the Need for a Uniform Regime' (2011) 2 *Journal of European Competition Law and Practice* 24–33.

[49] W. Hoffmann-Riem and E. Schmidt-Aßmann (eds) *Öffentliches Recht und Privatrecht als Wechselseitige Auffangordnungen* (Baden-Baden: Nomos, 1996); Grundmann and Renner, n 22.

With respect to the prime field of regulation, i.e. antitrust law, there is already a discussion and even a legislative procedure leading to a particular private law action for damages. It would be desirable to evaluate this trend and inquire more into the general repercussions such a trend may have. For example, what should be the private law actions for violation of regulation (including punitive damages), and what regulatory dimensions can influence interpretation of private law norms and concepts?

For a fourth consideration, one could refer to the old dispute on the nature of default rules: whether they should (primarily) aim at mimicking the assumed will of (the majority of) typical parties or at finding the equilibrium between the interests which the legislature sees as adequate for overall society, taking into account, of course, the preferences of the parties as well.[50] In fact, the result reached in a concrete contract can be seen not only as the result of a (bipolar) negotiation process between the parties, but also as a (triangular) process between the legislature as the author of the default rule and both parties.[51] Contract law and regulation thus have a common goal but with differing approaches, different rule setters, different ways of imposing the standard, different levels at which the rules can be situated. Considering the interplay described and doing so from manifold perspectives as described—taking it as one mega-theme of contract law—would constitute a core feature in a contract governance debate to come. All this shows again that contract governance—just like corporate governance—is just as much about individual, private party driven design as it is about market regulation and stability or more generally, stability of organization forms and institutions.[52]

The plea for a more integrated view of contract drafting, default rules, and market regulation exemplified by these four considerations is, however, at odds with powerful structural characteristics of contract law legislation and scholarship as they currently exist. A contract governance approach may also have been and may still be particularly difficult—and at the same time particularly needed—because of a marked heterogeneity in the subject matter and in the discussion and decision platforms. This is a consideration about the 'contract law community'. First, the legislature would seem to be less 'homogeneous' in contract law than in company (and capital market) law. In the EU scenario, one Directorate General is responsible for company and capital market law, while for contract law several Directorates General are competent with fundamentally diverging 'philosophies', on the side of B2C contracts DG Sanco (with interests also in general contract law), on the side of B2B contracts DG Internal Market (lately also, for

[50] See n 128 and n 150 on the one hand and n 129 on the other.

[51] F. Möslein, *Dispositives Recht – Zwecke, Strukturen und Methoden* (Tübingen: Mohr Siebeck, 2011) esp. 129–50; F. Möslein, 'Governance by Default' in S. Grundmann, B. Haar, H. Merkt, *et al* (eds) *Festschrift für Klaus J. Hopt zum 70. Geburtstag am 24. August 2010* (Berlin: deGruyter, 2010) 2861–80; in a similar vein, see J.-H. Binder, *Regulierungsinstrumente und Regulierungsstrategien im Kapitalgesellschaftsrecht* (Tübingen: Mohr Siebeck, 2012).

[52] In some more detail (with respect to governance taxation) see F. Möslein, '*Steuerrecht und Marktstabilität*' (2012) *Juristenzeitung* 243.

all contracts, DG Justice). In the US, capital markets are mainly regulated under federal law with a strong supervisory and regulatory commission, the SEC, and company law is dominated by one trend setter (Delaware), whereas in contract law, competences are scattered among the states—with the important exception of the Uniform Commercial Code.

Similarly, the scientific community would seem to be less homogeneous in the contract law area, with a split between the '*Civilisti*' and '*Commercialisti*' (which, despite the Italian terminology, is a split which describes the status quo at least in most of the EU), the former primarily 'responsible' for contract law, but mostly neglecting important parts such as financial services (or other commercial) contracts and even more so regulation of markets, the latter often less integrated into the discourse community in core civil law. Within civil law, contract law is, moreover, typically combined with other civil law areas such as torts (thus forming the paradigm of a law of 'obligations'), property or family law, rather than with other modes of shaping economic transactions via party autonomy, namely with company law. There are few typical common discussion platforms between 'contract/market' and 'firm' and not even between 'contract' and 'market'. The same could be said of the courts. There would seem to be more of a trend to have only one leading court competent in company law, a court which guides and accompanies the discussion, which is certainly the case in the US with the Delaware Supreme Court, but also in some EU Member States like Germany and (at least in Germany) also very meaningful joint platforms between practice and academia. The same is more difficult to find for contract law and market regulation. Whereas company law—with its organizational and capital market aspects—is mostly discussed by the same circles of scholars and practitioners, the same is much less true of contract law—with respect to the contractual basis and the regulation affecting it. This status quo may also be influenced to a certain extent by the high heterogeneity of contract types, a consequence of its high degree of flexibility. While companies, associations, and partnerships all share a common aim, contract can be the basis of highly antagonistic and on-the-spot exchange, but also of very intense and long-term cooperation. Certainly, contract governance would need to aim at bridging gaps where they hinder the discussion needed. Contract governance discussion could act as a catalyst when developing a common methodological framework for this large variety of phenomena, which are currently still viewed as being too heterogeneous for such a joint discourse. Even better, a genuine contract governance discussion would probably not fail to develop the links to corporate governance—because they are twins in problems, party autonomy and its regulation, and they can be twins in their modes of discussion.

In fact, there is a continuum from the company law setting to the long-term contractual setting to the more short-term and spot contract setting, but also from market regulation to mandatory contract law to default rules in contract law. And seeing more of a continuum here would be one core challenge, but would as well be typical for a contract governance approach.

III. Multi-level Regulatory Perspectives

1. Levels of regulation

If, following Williamson, governance is defined as 'the institutional matrix within which transactions are negotiated and executed',[53] the issue of the levels of regulation is at the heart of governance in general and of contract governance in particular.[54] The example of the employment relation is a particularly suitable example to illustrate the issue from a legal perspective.

2. Levels of contract governance: employment as an example

If we look at private governance by the parties, there is, first of all, the employment contract. Yet, it is a characteristic of the employment contract as a long-term relation that not all the details of the mutual obligations can be spelled out at the beginning.[55] Some aspects have to be left to renegotiation, but the central contractual instrument of adaptation is the employer's managerial authority. In addition, there are other mechanisms in the vicinity of the managerial authority. Many aspects of work are determined by practice, custom or usage. An established usage may under certain conditions gain the quality of an enforceable promise. Other aspects are governed by autonomous agreement of a group of employees. Yet other aspects may be determined by standard terms or work rules.

At another level of autonomous governance, collective agreements govern the workplace. They are subdivided into different levels as well: some with nation-wide or industry-wide effect, others with effect for a company or a plant or shop-floor. They may be concluded by unions or by employees' representatives of smaller units on the one hand and individual employers or their associations on the other.

[53] See n 2.

[54] See, e.g. H. Fleischer, 'Corporate Governance in *Europa als Mehrebenensystem*' (2012) *ZGR* 160–96; S. Grundmann and W. Kerber, 'European System of Contract Laws – A Map for Combining the Advantages of Centralised and Decentralised Rule-making' in S. Grundmann and J. Stuyck, *An Academic Greenpaper on European Contract Law* (The Hague: Kluwer International, 2002) 295–342; in S. Grundmann and J. Stuyck, 'An Optional European Contract Law Code – Advantages and Disadvantages' (2005) *European Journal of Law and Economics* 21, 215–36; See also Möslein and Riesenhuber, n 1, 248–89. With some adaptations also G. F. Schuppert, 'Contract Governance – *Vorüberlegungen zur Strukturierung einer Neuen Forschungsperspektive*' in S. Grundmann, M. Kloepfer, C. Paulus, and G. Werle (eds) *Festschrift 200 Jahre Juristische Fakultät der Humboldt-Universität zu Berlin: Geschichte, Gegenwart und Zukunft* (Berlin/New York: de Gruyter, 2010) 1333–59, esp at 1340–7. For a different approach of *levels of social analysis,* see O. Williamson, 'The New Institutional Economics: Taking Stock, Looking Ahead' (2000) 38 *Journal of Economic Literature* 595, 596ff.

[55] See the discussion earlier at Section II(1)(b)(3). See also, e.g., H. Collins, *Employment Law* (Oxford: Oxford University Press, 2nd edn, 2010) 6ff; see also H. Collins, 'Legal Regulation of Dependent Entrepreneurs' (1996) 152 *Journal of Institutional and Theoretical Economics* 263–70; A.-S. Vandenberghe, 'Employment Contracts' in K. G. Dau-Schmidt, S. D. Harris, and O. Lobel (eds) *Labor and Employment Law and Economics* (Cheltenham, Edward Elgar Publishing, 2009) 62ff; Williamson, n 6, 218ff ('The employment relationship is, by design, an incomplete form of contracting.').

Collective agreements can in principle be considered as part of private governance. Yet, they may serve as an instrument of public governance, too. With a view to established practice in some Member States, EU law provides for the possibility that directives in the area of social policy may be implemented by collective agreement (Article 153(3) of the Treaty on the Functioning of the European Union (TFEU)). Anti-discrimination directives encourage the social partners to adopt anti-discrimination programmes complementing public regulation (see, for example, Article 21 of Directive 2006/54/EC).

If we focus on public governance (in the sense of public ordering), again we find a multi-layered system. The regulatory cooperation of the EU and the Member States has already been indicated, as has the regulatory cooperation between public authorities and the social partners (on various levels). Regulation may take the form of substantive or procedural rules for the individual employment contract or relationship. It may also take the form of substantive or procedural rules for collective agreements. The EU's 'social dialogue' procedure of Articles 154 and 155 of the TFEU is an example of an intricate mixture of public and private governance.[56] Management and labour, the social partners, are involved in the legislative process from the beginning. They are being consulted on whether there is a need for EU legislation and on the form it should take; and they may request to be given an opportunity to regulate the issue by way of a collective agreement ('framework agreement') which then may be implemented by a Union legislative act. (This is an instance of 'bargaining in the shadow of the law'—or a 'regulatory threat'—and thus a private-public governance- and ordering-mix.)[57]

At another level, issues of constitutional law, fundamental rights in particular, come into play. There are, of course, many established issues such as the prohibition of slavery and forced work or the protection of collective action as a fundamental right. Recent years have evidenced an increasing sensitivity—or sometimes inventory spirit—for issues of fundamental rights. An (in)famous example is, of course, the invention of a fundamental right against age discrimination in the Court of Justice's *Mangold* decision.[58] The long list of 'fundamental social rights' included in the 'solidarity' chapter of the EU's Charter of Fundamental Rights (ChFR)[59] has raised expectations—although the vague and deferential wording (in itself an example of multi-level governance) of almost all of the 'social rights' confirms their limited reach.[60]

[56] For a survey see K. Riesenhuber, *Europäisches Arbeitsrecht* (Heidelberg: C. F. Müller, 2009) § 4 paras 26ff.

[57] See also K. Riesenhuber, '*Schatten des Rechts*' in S. Grundmann, P.O. Mülbert, and M. Roth (eds) *Festschrift für Klaus J. Hopt* (Berlin: de Gruyter, 2010) 1225–43.

[58] ECJ Case C-144/04 *Mangold* [2005] ECR I-9981. See also K. Riesenhuber, 'Case Note: ECJ of 22 November 2005—Case C-144/04—Mangold' (2007) 3 *European Review of Contract Law* 62–71.

[59] Charter of Fundamental Rights of the European Union, reproduced in OJ 2010 C 83/389.

[60] See, e.g., Case C-323/08 *Rodríguez Mayor* [2009] ECR I-11621 paras 58ff (concerning Art 30 ChFR).

3. Aspects of contract governance

Levels of governance raise a multitude of—often conflicting—issues. The large number and disparity of issues leads to the question of meta-governance: how can conflicting governance issues be resolved? We will briefly address this latter issue in Section IV.

a. Coherence

The multi-faceted and multi-layered governance structures in the area of employment law lead to the problem of maintaining coherence. Means to this end may be a clear demarcation of the various levels, for example by supremacy or conflict rules or—for the overall body of law at transcending levels—a pre-structuring in substance by principles.

In this work, Hugh Collins' contribution gives an illustration of the issues involved from another field. If courts from different jurisdictions decide differently on the recognition of a charge over property by way of security for a loan, this may be considered an issue of horizontal levels. As Collins suggests, the issue may also be discussed as a matter of 'global law', i.e. a level on the vertical scale. Such global law can, in this instance, however only be found in the 'law' that the parties created, a *lex mercatoria*. And while such *lex mercatoria* may claim a higher position in terms of its geographic scope of application, national conflict laws (and thereby also national and supra-national substantive laws) assume a higher position in the hierarchy of norms and—certainly traditionally—refuse recognition of such 'private laws' or, in any case, do not without reservation allow their derogation of mandatory national provisions.[61] The governance response to the issue may be different, depending on how we view the reliability and responsibility of the parties concerned, resulting externalities and other public policy issues that public regulation is intended to accommodate.[62]

b. Fundamental rights

Among the principles for the demarcation of different levels of governance, fundamental rights may be particularly prominent and high up in the hierarchy. There are fundamental rights of various actors to be taken into consideration. At the outset, the individual liberty—freedom of contract—of the contracting parties is concerned.[63] Individual liberty is not only a fundamental right in itself

[61] See Recitals 13ff Rome I-Convention. For the discussion in the EU see C. -W. Canaris, '*Die Stellung der 'UNIDROIT-Principles' und der 'Principles of European Contract Law' im System der Rechtsquellen*' in J. Basedow (ed) *Europäische Vertragsrechtsvereinheitlichung und deutsches Recht* (Tübingen: Mohr Siebeck, 2000) 5–31; S. Grundmann, 'General Principles of Private Law and *Ius Commune Modernum* as Applicable Law?' in T. Baum and K. J. Hopt (eds) *Corporations, Capital Markets and Business in the Law* – Liber Amicorum *Richard M. Buxbaum* (Den Haag/London/Boston: Kluwer Law International, 2000) 213–34.

[62] See the different approaches by H. Collins and H. Eidenmüller (Chapter 12 and accompanying comment).

[63] See, e.g., R. A. Epstein, 'In Defense of the Contract at Will' (1984) 51 *University of Chicago Law Review* 957–82.

but a fundamental right that is reinforced by every individual's right to respect for his dignity. Focused on regulation, governance theory always has to assure that it respects individual liberty instead of only using individual contract to a regulatory end.

Employers and employees enjoy freedom of association. The more recent collections of fundamental rights grant employees as a group (or as a collective) rights such as the right to information and consultation (Article 27 of the ChFR). Workers and employers and their organizations have a fundamental right to negotiate and conclude collective agreements and, in cases of conflict, take collective action (Article 28 of the ChFR).

While the state or other public entities (such as the EU) do not as such enjoy fundamental rights, they may rely on the fundamental rights of, for example, employees to justify intervention. Indeed, they may be under an obligation to intervene in order to protect the fundamental rights of individuals or groups.[64] Thus, for example, the Union or Member States may justify protection against unjustified dismissal under Article 30 of the ChFR (although, of course, the provision does not in a strict sense mandate regulation and does not constitute a competence basis).

c. Subsidiarity

Conversely, the principle of subsidiarity may be seen as a conflicts rule, albeit a hidden rule, arranging for interplay between the levels:[65]

> Under the principle of subsidiarity . . . the Union shall act only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States, either at central level or at regional and local level, but can rather, by reason of the scale or effects of the proposed action, be better achieved at Union level.[66]

While the principle is here spelled out with regard to the vertical division of powers between the Union and the Member States, it may also apply as between public and private entities and as between (private) organizations and individuals, for example Unions and workers. Closely related to issues of fundamental rights—freedom of contract in particular—it provides for a presumption of competence of the smaller entity. Also fundamental freedoms may be seen as rules prescribing subsidiarity of state action as against action taken by private law subjects, thus prescribing subsidiarity for Member States and subjecting them to an outside scrutiny in this respect (by the European Court of Justice).[67]

[64] See the seminal decision in Case C-265/95 *Commission v. France* [1997] ECR I-6959. For the theoretical framework see C. -W. Canaris, *Grundrechte und Privatrecht* (Berlin/New York: de Gruyter, 1999) (with a hint at the 'internationality' of the issue at 10ff); C. -W. Canaris, '*Grundrechte und Privatrecht*' (1984) 184 *Archiv für die ivilistische Praxis* 201–46.

[65] In a governance context, see recently Fleischer, n 54, 160, 168ff.

[66] Art 5(3) TEU. For a recent (and critical) discussion see Möslein, n 51, 77ff.

[67] See in more detail and with references from the ECJ case law: S. Grundmann, 'The Concept of the Private Law Society after 50 Years of European and European Business Law' (2008) *European Review of Private Law* 553–81, esp at 558–67.

d. Public and private levels

The issues of fundamental rights on the one hand and subsidiarity on the other also lead to the public-private divide. Subsidiarity, individual autonomy (*privatautonomie*) and freedom of contract can be construed as value judgments in favour of private governance as opposed to public governance and ordering. And indeed, recent years have evidenced a move to private governance also in the area of employment law.

Employee participation in the European Company (*Societas Europaea*) is a prominent example where mandatory public regulation (public governance and ordering) has been superseded by a system of contract governance. For no less than 30 years, repeated and creative attempts of the Member States to agree on a substantive regulation of employee participation in the European Company failed. The breakthrough came with a shift from the substantive approach to a procedural approach of regulation. Instead of providing a one-size-fits-all solution, the legislator opted for a negotiation model pursuant to which employee participation is to be determined, in principle, by way of agreement between the employer-side and the employee-side. The agreement is being negotiated by the representatives of the participating companies and a 'special negotiating body', formed specifically for the purpose of representing the employees—their number and their distribution over Member States—of the participating companies.[68] (Note, incidentally, how the creation of the special negotiating body as well as the determination of the representation on the employer side again raises issues of governance.)[69] The parties can determine employee participation according to their interests and needs—a custom-tailored solution. If they do not reach agreement within the prescribed period of negotiation, the fall-back solution annexed to the Directive applies. The system is mixed with a few mandatory elements with regard to the substance of regulation, a mandatory procedural framework, and considerable room for freedom of contract. The freedom to determine the employee participation is combined, though, with elements of incentives and 'nudges' as they result from the fall-back solution.

The same structure was subsequently employed for the European Cooperative Company (*Societas Cooperativa Privata*) and cross-border mergers. It is also the model discussed for cross-border transfer of the company seat and for the European Private Company (*Societas Privata Europaea*). Contract governance serves various purposes here. It gives back responsibility to the parties concerned, thus at the same time alleviating the legislature of a burden, re-empowering private parties, and providing for additional legitimacy of the employee involvement regimes

[68] For a survey see, e.g., Riesenhuber, n 56, § 29 paras 31ff.

[69] C. Windbichler, '*Der Gordische Mitbestimmungsknoten und das Vereinbarungsschwert – Regulierung durch Selbstregulierung*?' in U. Jürgens, D. Sadowski, G. F. Schuppert, and M. Weiss (eds) *Perspektiven der Corporate Governance – Bestimmungsfaktoren unternehmerischer Entscheidungsprozesse und Mitwirkung der Arbeitnehmer* (Baden-Baden: Nomos, 2007) 282, 291–3.

ultimately installed. Indeed, the negotiation model takes the idea of employee involvement a consequential step further than mandatory models. Negotiated employee participation promises to be better suited to the needs of management and labour in the individual firm. At the same time, procedural safeguards take account of the specific needs of the parties.

In this work, Pistor discusses how switching from hierarchical and coercive forms of governance in the area of global finance to 'inclusive, horizontal, cooperative' forms of governance—i.e. forms of contract governance—may contribute to improving existing structures. She uses the example of the European Banking Coordinative Initiative (EBCI) as a 'full-fledged contractual governance regime'. Drawing on organizational theory, Pistor suggests that the predominant circumstances of uncertainty make contractual governance regimes superior in the financial markets. She expounds in more detail on the central elements—inclusiveness, horizontality, and cooperation—that characterize this model of governance.[70]

e. Democracy and representation

Where collectives make rules, this may raise specific questions of legitimacy: democracy, self-determination, and representation. This issue is of considerable relevance also with regard to contract governance. Private rule-making in particular raises intricate issues of legitimacy.[71]

A good (and still virulent) example is participation of the social partners—management and labour—in EU legislation under the social dialogue-procedures of Articles 153 and 154 of the TFEU discussed earlier.[72] Originally, Parliament was not institutionally involved in this form of rule-making at all. Article 155(2)(1) of the TFEU now provides for a right to be informed. Legislation adopted in the social dialogue-procedure cannot draw democratic legitimacy from the European Parliament. The Court of First Instance (CFI) emphasized the necessity for the organizations involved to be representative for their constituents.[73]

Another example is the posting of workers. Posting of workers raises intricate issues of legitimacy and representation on the horizontal level of the various Member States. For the posted employees who, purportedly, are to be protected by the application of the employee protection laws of the host Member State do not have a voice in the making of these laws or in the determination whether and in how far they should apply to them.[74]

[70] See Chapter 13. The mechanisms as such may, of course, not all be new and can be related back to general governance discussion: see comment accompanying Chapter 13.

[71] See in detail G. Bachmann, *Private Ordnung* (Tübingen: Mohr Siebeck, 2006) 159–226.

[72] See n 56.

[73] Case T-135/96 *UEAPME v. Council* [1998] ECR II-2335, paras 88–90.

[74] A. R. Ganesh, 'Appointing Foxes to Guard Henhouses: The European Posted Workers' Directive' (2008) 15 *Columbia Journal of European Law* 123–42.

f. Competition and cartelization

Uniform rules at one level exclude competition at the lower levels.[75] The cartelization of employees in unions was generally accepted in the latter half of the 19th century.[76] On the EU-level, the Court in its *Albany* decision accepted that agreements concluded in the context of collective negotiations between management and labour in pursuit of social policy objectives are not covered by Article 101(1) of the TFEU.[77] This does not exclude the possibility, however, that under fundamental freedoms, standard-setting that covers activities nationwide or even beyond is or might be scrutinized and struck down if amounting to an impediment.[78]

Harmonization of laws of the Member States eliminates competition. Yet social policy legislation of the EU is (at least in principle) limited to minimum standards (Article 153(4) of the TFEU) and some areas, pay in particular, are exempted from EU legislation. Intra-Member State competition is strong where free movement of goods is concerned. Competition on the basis of employment standards is restricted though where free movement of services is concerned. In *Rush Portuguesa,* the Court accepted that:

> Community law does not preclude Member States from extending their legislation, or collective labour agreements entered into by both sides of industry, to any person who is employed, even temporarily, within their territory, no matter in which country the employer is established.[79]

While subsequent decisions have spelled out certain limits to a duplication of standards of employee protection, these limits are rather broad. They do not even coincide with the Union standards of protection. Thus, while EU law provides that every worker is entitled to four weeks of paid annual leave, the Court has accepted that the host Member States may extend this entitlement—in this case six weeks—for posted workers.[80]

The Posting of Workers Directive (PoWD) responds to this judgment with an attempt to coordinate national posting of workers laws and make their operation transparent.

[75] For a comprehensive discussion of issues of the employment market and competition from a legal perspective, see V. Rieble, *Arbeitsmarkt und Wettbewerb Der Schutz von Vertrags- und Wettbewerbsfreiheit im Arbeitsrecht* (Berlin: Springer, 1996).

[76] See, e.g., S. Deakin and G. Morris, *Labour Law* (Oxford: Hart Publishing, 5th edn, 2009) paras 1.4ff; W. Zöllner, K. -G. Loritz, and C. W. Hergenröder, *Arbeitsrecht* (Munich: C. H. Beck, 6th edn, 2008) 22ff.

[77] Case C-67/96 *Albany* [1999] ECR I-5751 paras 52–9.

[78] Case 36/74 *Walrave* [1974] ECR 1405, 1419ff; Case C-415/93 *Bosman* [1995] ECR I-4921, 5065–7; and similar Case 155/73 *Sacchi* [1974] ECR 409, 431ff; Case 13/76 *Doná* [1976] ECR 1333, 1340ff; and Case 90/76 *van Ameyde* [1977] ECR 1091, 1127ff.

[79] Case C-113/89 *Rush Portuguesa* [1990] ECR I-1417 para. 18; to the same effect already Joined Case 62 and 63/81 *Seco* [1980] ECR 223 para. 14; and subsequently Case C-43/93 Vander Elst [1994] ECR I-3803 para. 23; Case C-272/94 *Guiot* [1996] ECR I-1905.

[80] Joined Cases C-49/98, C-50/98, C-52/98 to C-54/98 and C-6898 to C-71/98 *Finalarte* [2001] ECR I-8731 paras 57ff.0

g. Functions of workers' representation

If we look at workers' representatives, they may serve various functions. Much of the debate focuses on 'participation', 'representation', and 'industrial democracy'.[81] Indeed, this relates back to the issues discussed earlier.[82] Representation and voice are all the more important where decisions affect a person directly and where the exit option may be restricted. It is quite another issue, of course, whether the respective rights should be mandated by law or left to individual agreement. Let us briefly consider two other aspects: information and adaptation.

In various instances, workers' representatives mediate information.[83] Take the example of the Transfer of Undertakings Directive (TUD). Article 7 of the TUD requires the employers, both transferor and transferee, to provide the representatives of their workers with detailed information about the transfer. The information is certainly too detailed for the rank and file employee. The workers' representatives serve as information intermediaries. While the information is detailed, channelling it through the workers' representatives alleviates the burden of providing it for the employer. The workers' representatives will usually be especially experienced and often specifically trained in handling such information. They will thus be in a position to ask (the right) questions and make additional suggestions. They thus serve similar functions as information intermediaries do more generally, for instance accountants or rating firms whose roles for corporate governance are currently debated.[84] And again, as there is usually only one workers' representation forum, channelling information thus alleviates the burden that comes along with information for employers.

As a long-term relationship, the employment contract requires adaptation over time.[85] Employee representation and the system of collective bargaining can serve as adaptation mechanisms. This is particularly obvious for collective bargaining over wages. But it also applies with regard to employees' representatives at the plant level and their rights to information, consultation, or co-determination with regard to issues of the workplace. As Windbichler puts it '[c]ollective agreements and codetermination at the shop-floor level serve as tools for the necessary redefinition of rights and obligations over time, i.e., they are part of a sophisticated contract governance system.'[86] Other contracts, long-term contracts in

[81] F. Gamillscheg, *Kollektives Arbeitsrecht vol. II – Betriebsverfassung* (Munich: C. H. Beck, 2008) 22ff, 42ff; Zöllner, Loritz and Hergenröder, n 76, 455ff.

[82] See Section III(2)(d).

[83] K. Riesenhuber, '*Arbeitnehmerschutz durch Information beim Betriebsübergang*' in R. Krause, W. Veelken, and K. Vieweg (eds) *Recht der Wirtschaft und der Arbeit in Europa - Gedächtnisschrift for Wolfgang Blomeyer* (Berlin: Duncker & Humblot, 2004) 195-215; K. Riesenhuber, '*Informationspflichten beim Betriebsübergang*' (2004) *Recht der Arbeit* 340–52.

[84] See survey and references in S. Grundmann, n 12, § 14, paras 43–5, 50–3.

[85] See Section III(2).

[86] C Windbichler, 'Cheers and Boos for Employee Involvement: Co-Determination as Corporate Governance Conundrum' (2005) 6 *European Business Organisation Law Review* 6 507–37; C Windbichler, '*Betriebliche Mitbestimmung als Institutionalisierte Vertragshilfe*' in M. Lieb, U. Noack, and H. P. Westermann (eds) *Festschrift for Wolfgang Zöllner* (Köln/Berlin/Bonn/München: Carl Heymanns, 1999) 999–1009; Rieble, n 75, paras 1418ff.

particular, involve similarly intricate governance arrangements, for example franchise agreements.

h. Principal and agent

Levels of contract governance may also be analysed in terms of principle and agent.[87] If we consider issues of employment law with a view to employee protection, who is the best agent of the employee's interests?

This could initially be the employee himself. The concern here is that he may not be in a position to adequately pursue his interest in the market. Yet, this requires more detailed analysis.[88] Secondly, the employer may function as the employee's agent. While certainly the employer pursues his own interest and while, undeniably, there are numerous examples of the worst forms of exploitation there are, in a working market environment, also elements that induce or even force the employer to take the employees' interests into account. Thus, the employer constantly needs to attract employees and thus has to be interested in establishing a good reputation. Again, as the employer cannot control every aspect of his employees' work (thus being potentially exposed to employee-opportunism), he may use remuneration as an incentive to reduce this risk.

Let us pursue the example of employee remuneration that we have already encountered earlier a little further.[89] Following the financial crisis, remuneration has often been discussed as an issue of corporate governance. Indeed, it undeniably is an issue of corporate governance where (a) the manager's remuneration is concerned or (b) remuneration (*boni*) is used as an incentive mechanism for employees whose work is essential (or whose misbehaviour may be fatal) for the company. Yet, remuneration may also be a pure issue of contract governance. So, for example, Akerlof has advanced the thesis that employers pay more than just market-clearing wages so as to induce their employees to excel in their work (as a 'counter-gift').[90] Indeed, subsequent laboratory studies seem to support this

[87] V. P. Goldberg, 'Regulation and Administered Contracts' (1976) 7 *Bell Journal of Economics* 426, 429ff *et passim;* C. Gillette, 'Rolling Contracts as an Agency Problem' (2004) *Wisconsin Law Review* 679–722.

[88] See R. A. Epstein, 'In Defense of the Contract at Will' (1984) 51 *University of Chicago Law Review* 957–82; E. Picker, '*Das Arbeitsrecht zwischen Marktgesetz und Machtansprüchen – Zur Kritik und Korrektur gesetzlicher, "richterrechtlicher" und korporativer Fehlentwicklungen am Beispiel von Betriebsverfassungs-, Kündigungs- und Tarifvertragsrecht*' (2005) *Zeitschrift für Arbeitsrecht* 353–90 on the one hand; P. C. Weiler, *Governing the Workplace – The Future of Labor and Employment Law* (Cambridge, Mass: Harvard University Press, 1990) on the other.

[89] See also K. Riesenhuber, '*Vergütungssysteme unter dem Blick von Governance und Compliance*' in V. Rieble, A. Junker, and R. Giesen (eds) *Finanzkriseninduzierte Vergütungsregulierung und arbeitsrechtliche Entgeltsysteme* (München: Zentrum für Arbeitsbeziehungen und Arbeitsrecht (ZAAR), 2011) 133ff.

[90] G. A. Akerlof, 'Labor Contracts as Partial Gift Exchange' (1982) 97 *Quarterly Journal of Economics* 543–69. See also C Windbichler, '*Das Arbeitsverhältnis als Austausch und "Geschenkverhältnis"*' in H. Hirte, K. Frey, and R. Wank, *Festschrift for Herbert Wiedemann* (Munich: C. H. Beck, 2002) 673–83.

theory.[91] However, more recent empirical research casts doubt on these findings. It appears that above-market remuneration merely works as a short-term incentive.[92] Governance needs to rely on interdisciplinary research, yet, the issues involved may be complex and difficult to prove or falsify.

Then there are collectives on the employee side. Unions and employees' representatives in the firm recommend themselves as agents with their market power derived from the concentration of individual interests and cartelization. Their deficiencies as agent for the individual employee result from the standardization of solutions they offer—by which, on the other hand, they also may mediate between heterogeneous employees' interests—[93] and from the focus on the interests of those whom they represent. The standardization is likely to be over- or under-inclusive, depending on the individual interests and the individual 'strength' or market power. In any event, (mandatory) collective regulation is by definition heteronomous, thus infringing with the individual's self-determination.[94] A focus on, usually, those who are currently employed will often go at the expense of the unemployed. Or, conversely, taking into account of the labour market at large (including the unemployed) may go beyond the unions' mandate.

Legislators and courts, too, have their deficits as agents of the employees. Again, employment protection is put in place for those who are employed and not for the unemployed. Protection of the employed makes entry into employment more difficult for the unemployed. Where courts view themselves as adjudicators who follow the mandate of the law, they will (inevitably) reinforce the same tendency.

i. Substantive and procedural regulation

While substantive rules provide for regulation on a given level, procedural rules do so to a lesser extent, providing only for a framework within which collectives or individuals may make their own rules.[95] The framework may be more or less

[91] E. Fehr, G Kirchsteiger, and A. Riedl, 'Does Fairness Prevent Market Clearing? An Experimental Investigation' (1993) 108 *Quarterly Journal of Economics* 437–60.

[92] U. Gneezy and J. A. List, 'Putting Behavioral Economics to Work: Testing for Gift Exchange in Labor Markets Using Field Experiments' (2006) 74 *Econometrica* 1365–84.

[93] A parallel function of mediator is attributed to the (supervisory) board: see, for instance, the description by P. Davies, 'Board Structure in the UK and Germany: Convergence or Continuing Divergence?' (2000) 4 *International and Comparative Corporate Law Journal* 435–6, 450–5; E.-J. Mestmäcker, *Verwaltung, Konzerngewalt und Rechte der Aktionäre—eine Rechtsvergleichende Untersuchung nach Deutschem Aktienrecht und dem Recht der Corporations in den Vereinigten Staaten*, (Karlsruhe: C.F. Müller, 1958) 81ff; C. Steinbeck, *Überwachungspflicht und Einwirkungsmöglichkeiten des Aufsichtsrats in der Aktiengesellschaft* (Berlin: Dunker & Humblot, 1992) 45–54; this is common ground in comparative law (even if the board member represents a certain group of shareholders or even employees and has been nominated by that group): Wymeersch, n 27, 1079, 1091, 1132ff.

[94] Picker, n 88, 353, 359ff.

[95] For a discussion of different regulatory approaches, see Collins (2010) n 55, 27ff. On 'proceduralization', also discussing the impact of procedural rules on substance, see J.-H. Binder, '*Prozeduralisierung und* Corporate Governance' (2007) *Zeitschrift für Unternehmens- und Gesellschaftsrecht (ZGR)* 745–88.