

## HOW DO GERMAN CONTRACTS DO AS MUCH WITH FEWER WORDS?

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### INTRODUCTION

German business contracts are much shorter than their American counterparts. They also avoid the worst excesses of legalese that American contracts are known for. But they seem to work as well as United States contracts. We seek to understand how German business contracts could do as much with fewer words.

How well a contract works is not amenable to precise measurement. Still, characterizing German contracts and the business-contracting endeavor in Germany as working as well as their American counterparts seems reasonable as a working assumption. Certainly, there are no indications that Germany's transactional sector has systematic defects relative to that of the United States. Transaction activity is vigorous—many deals are negotiated and consummated. And, as is the case in the United States, some transactions end up being litigated in court, but most do not.

Our explanation is predicated on an account of what contracting does. Contracting aims to create a bigger transactional pie in a world where parties' incentives are misaligned and they need to coordinate

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the production of information, specify future rights, duties and procedures, and allocate risks. Addressing opportunism resulting from parties' misalignment of incentives is therefore an enormous part of the contracting endeavor. Even if the parties' incentives were perfectly aligned, they would still need to find out about one another, and create and define the subject matter of their relationship. But misaligned incentives add to the volume and urgency of what's needed: finding out about somebody else is harder if he can benefit from lying to you. And providing for future contingencies becomes more important if the other side is willing and able to take advantage of gaps in the contract to act strategically. Even if we assume a best case scenario—that each party knows, and knows that the other party knows, that the biggest pie will result if neither party acts strategically—the two parties will still expend resources, each to convince the other that it is not acting strategically, and each to become convinced that the other is not acting strategically.

The task of contracting thus has both adversarial and non-adversarial components. The German system permits considerable economies in the adversarial sphere; the economies extend to the non-adversarial sphere as well. The economies take the form of a reduction in transaction costs: transaction documents in Germany are far less custom-tailored to particular parties and their transaction than they are in the United States. But why do parties in Germany apparently think they can achieve their contracting aims with far less tailoring than is typical in the United States?

Our answer challenges an assumption made in the contracts literature: that the contracting process in the United States, with its emphasis on custom tailoring of contracts, sensibly operates to help parties get precisely the deal they want. If this assumption were accurate, that German parties tailor their contracts less than do their U.S. counterparts would be puzzling indeed. But we think much customization in the United States has a far less charitable explanation: it reflects (a) a costly attempt to constrain opportunism using contract language, and (b) a failure to create and accept “good enough” solutions to non-adversarial (and some adversarial) issues parties commonly face.

We argue that German contracting does better on both these fronts. It cuts short the costly and inefficient “arms race” in which U.S. transacting parties and their lawyers too often engage in their negotiation and drafting of contracts. It also creates and uses “good

enough” standardized solutions to common non-adversarial (and some adversarial) problems faced by transacting parties. The solutions are found in the law, in trade association forms, and in law firms’ forms, which are not uncommonly published. The two features, “stopping sooner” in the arms race and the availability and use of standardized solutions, are related. If there were more of a norm to customize contracts, the payoff to developing and using standardized solutions would be far smaller, and there would probably be far less standardization.

But we do not want to paint too rosy a picture of German contracting. First, there are costs to the foregone tailoring itself: to some extent, German parties may very well compromise in their contracts on getting (or in any event, specifying) precisely the deal they want. And the laws, norms, and institutional features that limit the payoff to contract tailoring and increase the payoff to stopping sooner impose other costs. Indeed, there are laws limiting “unfair” behavior or behavior “not in good faith.” The scope of these laws may be uncertain, and costly to assess. These laws may go too far, preventing parties who would like to do so from agreeing on a lower standard of conduct.

Second, what we characterize as German contracting may, in the not-so-distant future, become extinct. Anglo-American firms are increasingly bringing their style of practice, notably including Anglo-American style transaction documentation, to Germany.<sup>1</sup> Such firms presently dominate large cross-border transactions and are making inroads into domestic middle market transactions as well.<sup>2</sup> We have an explanation as to why what we characterize as a superior system would be supplanted by an inferior system. However, even if our explanation is correct, the ostensibly superior system can be faulted at least for its inability to resist the ostensibly inferior system. We also cannot rule out the possibility that the market is rendering its verdict. Until recently, Germany’s transacting community had been fairly

1. For instance, cross-border merger and acquisition (M & A) transactions between German and non-German parties made up approximately 50 percent of all German M & A transactions in 2000. MECKL LUCKS, INTERNATIONALE MERGERS & ACQUISITIONS, DER PROZESSORIENTIERTE ANSATZ S. 2 (2002). Such transactions use the longer Anglo-American style contract documentation rather than the shorter “German” documentation we are discussing in this Article.

2. *Id.*; see also HANDBUCH MERGERS & ACQUISITIONS S. 97–98 (Gerhard Picot ed., 2002). Indeed, a recent article attributed some responsibility for German companies’ rising costs of legal services to English law firms. See *Unternehmen prüfen Anwaltshonorare strenger*, FRANKFURTER ALLGEMEINE ZEITUNG, 26.5.2004 S. 25.

repeat and homogeneous. The arms race in customizing contract provisions may be impossible to constrain in the more diffuse transactional community that European integration and globalization are bringing about; with enough customization, the benefits to using and developing standardized provisions diminish greatly.<sup>3</sup>

Where is law in our analysis? Its role is critical, but complex. Its “traditional” role—discouraging breach and compensating the victim of a breach—may be less important than its other roles. Law may function expressively<sup>4</sup> to influence norms and practices in the transacting community; it also may provide a focal point around which parties can coordinate.<sup>5</sup>

To be sure, law’s traditional role is not unimportant in our analysis. Indeed, compared to U.S. law, German law may more cheaply yield more certain results in litigation. But in much of our explanation, law plays a more intricate and less direct role, and appropriately so, given that becoming bound under law is only one of the functions contracting serves. Indeed, no changes in law can plausibly explain the shift to Anglo-American style contracting; our account provides further evidence, if it were needed, that contracting is not in any simple way merely a creature of law.

Our account also has implications for the debates on the proper content of and role for contract law. At least where the parties are sophisticated, and equally so, and externalities are not at issue, there might seem to be a case for less law; why shouldn’t parties know better what they want than (notoriously flawed) lawmakers, especially legislators? And not just less mandatory law, but also less default law, so that parties don’t have to incur the expense of contracting around the default.<sup>6</sup> But the less law argument is seriously undermined even in this best case scenario, because the alternative is

3. Interestingly, the European community is studying the development of standardized contract terms for use throughout Europe. See [http://europa.eu.int/comm/consumers/cons\\_int/safe\\_shop/fair\\_bus\\_pract/cont\\_law/index\\_en.htm](http://europa.eu.int/comm/consumers/cons_int/safe_shop/fair_bus_pract/cont_law/index_en.htm), (last visited May 31, 2004), in which the initiative is described, and [http://europa.eu.int/comm/consumers/cons\\_int/safe\\_shop/fair\\_bus\\_pract/cont\\_law/analytical\\_en.pdf](http://europa.eu.int/comm/consumers/cons_int/safe_shop/fair_bus_pract/cont_law/analytical_en.pdf) (last visited June 1, 2004), summarizing the quite-divergent views received on the initiative.

4. Some of the most interesting work on the expressive function of law has been done by Richard McAdams. See, e.g., Richard H. McAdams, *A Focal Point Theory of Expressive Law*, 86 VA. L. REV. 1649 (2000) [hereinafter *Focal Point Theory*]; Richard H. McAdams, *An Attitudinal Theory of Expressive Law*, 79 OR. L. REV. 339 (2000).

5. McAdams, *Focal Point Theory*, *supra* note 4, at 1651; see also Robert E. Scott, *Rethinking the Default Rule Project*, 6 VA. J. 84, 91–93 (2003).

6. The “less law” position is forcefully argued in a recent article by Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 540 (2003).

not nearly as nirvana-esq as is implicitly assumed. As Professor Hill has argued in *Why Contracts Are Written in "Legalese,"*<sup>7</sup> the complex business contracts U.S. parties, aided by their smart lawyers, enter into are second-best products hobbled by their lineage and the agency costs and behavioral foibles of many of the participants involved in the process. To appraise what, and how much, contract law there should be, flawed legislators using a flawed lawmaking process should be compared with flawed private individuals using a flawed contracting process. Our analysis, and King's experience, suggests that at least in the circumstances that pertain in Germany, more law can felicitously combine with a norm of limiting customization—of "stopping sooner"—to produce contracts that serve the parties' interests as well as U.S. contracts do, with fewer words and, presumably, lower transaction costs.

This Article proceeds as follows. Section I compares German and U.S. contracts. The contracts our arguments cover are complex business contracts such as merger and acquisition agreements, financing agreements and many other types of negotiated commercial agreements between sophisticated commercial parties. We exclude cross-border contracts, since, as noted above, these are increasingly drafted and negotiated by Anglo-American law firms.

Section II presents our explanation of how German contracts do as much with fewer words. The benefits, in the form of transaction cost savings resulting from the German system, are obvious. The key to our argument is that the associated costs are far smaller than they might initially seem—that parties can customize quite a bit less without significantly (or commensurately) compromising their ability to get the deal they want. We show how German law, institutions, practices, and norms permit German contracting to do as much with fewer words.

## I. THE CONTRACTS

To best articulate our point, we provide a stylized contrast between U.S. (and, more broadly, Anglo-American) and German complex business contracts. For ease of exposition, our paradigm is of acquisition agreements.

7. See Claire A. Hill, *Why Contracts are Written in "Legalese,"* 77 CHI.-KENT L. REV. 59, 75–81 (2001) [hereinafter *Legalese*].

Our stylized picture of U.S. complex business contracts is as follows:

- They are very long: a prominent corporate lawyer refers to “three pound acquisition agreement[s].”<sup>8</sup>
- There is a great deal of explanation, qualification, and limitation in the language.
- There is a great deal of “legalese.”
- The legalese is similar from agreement to agreement, but not exactly the same.
- More broadly, contracts of a particular type of transaction are similar in general coverage, but the specific language varies considerably from contract to contract.<sup>9</sup>
- The initial drafts are relatively divergent, with, for instance, the buyer wanting extensive representations and the seller wanting to give many fewer, and highly qualified, representations; after a long series of negotiations, the parties end up in the middle.<sup>10</sup>

By contrast, our picture of German contracts is as follows:

- The agreements are much “lighter”—by some accounts, German agreements are one-half or two-thirds the size of otherwise comparable U.S. agreements.<sup>11</sup>

8. JAMES C. FREUND, ANATOMY OF A MERGER: STRATEGIES AND TECHNIQUES FOR NEGOTIATING CORPORATE ACQUISITIONS 233 (1975).

9. Note, though, that a law firm or a client (for instance, a bank) may develop a form for one particular type of transaction, and abide by that form very closely in subsequent transactions. A colloquial expression sometimes used for a series of financing transactions done using very similar documentation is “cookie cutter.”

10. This description is of traditionally negotiated transactions. Companies sometimes try to sell themselves by auctioning themselves off with a prepared set of documents; such documents, not surprisingly, don’t take nearly as extreme a starting position as do the first drafts in traditionally negotiated transactions.

11. These are estimates given by various practitioners with whom Hill discussed this matter. King’s assessment is that Anglo-American forms are at least twice as long as the German forms. His assessment is based not only on his practice experience, but also on his review of all the major German form books for share and asset purchase agreements. Indeed, the form book published in 1995 by the largest legal publisher in Germany contains a draft stock purchase agreement that is four pages long. See Beck’sches Formularbuch zum Bürgerlichen, HANDELS- UND WIRTSCHAFTSRECHT 82-6 (Unternehmenskauf bei Erwerb von Anteilen 6 Aufl. 1995). By contrast, in that same year the American Bar Association’s Model Stock Purchase Agreement was published; that agreement is more than ten times longer. See ABA MODEL STOCK PURCHASE AGREEMENT WITH COMMENTARY (ABA Committee on Negotiated Acquisitions 1995). Professor Thomas Lundmark also notes that German contracts tend to be much shorter. See Thomas Lundmark, *Verbose Contracts*, 49 AM. J. COMP. L. 121, 129 (2001).

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- There is much less explanation, qualification, and limitation in the language.
- There is much less legalese.
- The legalese is almost identical from contract to contract.
- Many provisions are quite similar from contract to contract.
- The initial drafts are far closer to one another than are the U.S. drafts, with the parties ending up far closer to their starting positions.

Contrast these two standard forms of a forum selection clause:

- American Clause: *The exclusive forum for the resolution of any dispute under or arising out of this agreement shall be the courts of general jurisdiction of \_\_\_ and both parties submit to the jurisdiction of such courts. The parties waive all objections to such forum based on forum non conveniens.*
- German Clause: *Ausschließlicher Gerichtsstand ist \_\_\_.*

Contrast these two boilerplate phrases:

- American clause: *including but not limited to.*
- German Clause: *insbesondere.*

Contrast these two clauses on scope of agency:

- English Clause: *The [Agent] agrees that the [Principal] shall at its sole discretion be able to accept or reject any order obtained by the [Agent] for any reason including poor credit rating of the client, bad payment record, unavailability of materials or textiles, [and] conflict of interest with existing clients. The [Agent] shall not be entitled to receive any payment for any order so rejected.<sup>12</sup>*
- German Clause: *Es steht dem Unternehmer frei, ein vom Handelsvertreter vermitteltes Geschäft anzuschließen oder abzulehnen.<sup>13</sup>*

Contrast these two portions of a granting clause:

- American clause: *\_\_ does hereby grant, bargain, sell, assign, transfer, convey, pledge and confirm, unto Indenture*

12. DEBORAH FOSBROOK & ADRIAN C. LANG, THE A-Z OF CONTRACT CLAUSES A.013 (2003).

13. From Art. III Nr. 1 of the standard contract form for sales agency agreements of the VDMA, a prominent German trade organization in the machine tool industry, as reprinted in Hopt, Vertrags- und Formularbuch I.G.2 (2. Aufl. 2000).

*Trustee, its successors and assigns, for the security and benefit of the Indenture Trustee, for itself, and for the Holders from time to time a security interest in and lien on, all estate, right, title and interest of \_\_in, to and under the following described property, agreements, rights, interests and privileges, whether now owned or hereafter acquired, arising or existing (which collectively . . . , are herein called the “\_\_ Trustee Indenture Estate”).*<sup>14</sup>

- **German Clause:** *Der Sicherungsgeber übereignet der Bank hiermit den gesamten jeweiligen Bestand an\_\_ der sich in\_\_\_\_\_befindet und in Zukunft dorthin verbracht wird.*<sup>15</sup>

The German contracts we are describing are solely domestic contracts.<sup>16</sup> Such contracts tend to be within the middle market.<sup>17</sup> Larger dollar (euro) amount contracts typically involve more than one jurisdiction, are frequently governed by foreign (non-German) law, and are frequently drafted and negotiated by one of the five London-based law firms that form the “magic circle.” These firms are among

14. Adapted from Trust Indenture and Securities Agreement dated as of December 15, 1999 among First Securities Trust Company of Nevada not in its individual capacity except as otherwise expressly provided herein, but solely as Nonaffiliated Partner Trustee under the Trust Agreement dated as of December 15, 1999 with Beneficiaries, BJ Services Equipment II, L.P., a Delaware Limited Partnership and State Street Bank and Trust Company, as Indenture Trustee, available at <http://contracts.corporate.findlaw.com/agreements/bjservices/trustindenture.html> (last visited May 6, 2004).

15. Graf von Westfalen, *Sicherungsübereignungsvertrag mit Anschlusszession* § 1, *Münchener Vertragshandbuch* Bd. 3 *Wirtschaftsrecht* II, 5. Aufl. 2004.

16. While we don't think that the fact that we are comparing U.S. complex business contracts, whether they be middle market or larger, with German middle market contracts, affects our analysis generally, it does in one respect: in the United States, once contracts become small enough, parties—especially those using lawyers specializing in smaller transactions, or indeed, general practitioners not specializing in transactions at all—might to some extent veer towards the German norm of stopping sooner, on the theory that the stakes are too small to warrant costs of “getting it exactly right.” But our (U.S.) practice experience suggests that it's hard for lawyers who typically are involved in larger-stakes transactions to stop sooner notwithstanding the smaller dollars involved.

17. For our purposes, middle market includes, roughly, the larger enterprises referred to by the European Union definition of small to medium enterprises (usually abbreviated in English “SME,” in German “KMU,” and in French “PME”): enterprises with fewer than 250 employees, turnover not exceeding €50 million, and total assets not exceeding €43 million. (Small enterprises are defined as having fewer than fifty employees and a balance sheet total of under €10 million.) See *Commission Recommendation*, Annex I. Art 2(1) & 2 (preliminary draft), available at [http://europa.eu.int/comm/enterprise/consultations/sme\\_definition/consultation2/153\\_sme\\_definition\\_25\\_6\\_2002\\_pp1\\_11\\_en.pdf](http://europa.eu.int/comm/enterprise/consultations/sme_definition/consultation2/153_sme_definition_25_6_2002_pp1_11_en.pdf) (June 25, 2002).



the largest law firms in the world, with offices in many cities in Europe (including cities in Germany) and elsewhere.<sup>18</sup>

While our focus is principally on comparing German contracts with U.S. contracts, much of what we say is applicable more broadly to civil law contracts versus contracts from common-law regimes with heavy Anglo-American legal influence. One anecdote, comparing Belgium with the U.S., is told by Georges A. van Hecke.<sup>19</sup> Van Hecke recites an incident that occurred in 1962. An American company and a Belgian company wanted to engage in a share-exchange transaction. The American party sent a draft of 10,000 words. The Belgians refused to continue with the transaction, apparently because they were shocked by the length of the draft contract. They agreed to continue so long as they were allowed to supply the next draft of the contract. Their draft was 1,400 words, and was “found by the American party to include all the substance that was really needed.”<sup>20</sup> The contract was signed and performed to all parties’ satisfaction.

## II. OUR EXPLANATION

### A. Introduction and Theory

The ultimate function of contracting is, of course, to create the largest possible transactional “pie.” To understand how contracting serves this function, we must understand what might otherwise decrease the size of the pie. Parties’ propensity for opportunism—acting in their own interest and contrary to the interests of their contracting partner—can decrease the size of the pie.<sup>21</sup> Parties use contracting to constrain each other’s opportunism, marshalling both legal and extra-legal forces. A party binds itself to act in the other party’s interest in ways specified in the agreement: to tell the truth about the present,

18. See, e.g., Friedrich Graf von Westphalen, *Von den Vorzügen des deutschen Rechts gegenüber anglo-amerikanischen Vertragsmustern*, 102 ZVGLRWISS 53 (2003). We gloss over the differences between U.S. and English practice here, since, in salient respects, the two types of practices are the same.

19. Georges A. van Hecke, *A Civilian Looks at the Common-Law Lawyer*, in INTERNATIONAL CONTRACTS: CHOICE OF LAW AND LANGUAGE 5, 10 (Willis L. M. Reese ed., 1962).

20. *Id.* Van Hecke’s story is also recounted in John H. Langbein, *Comparative Civil Procedure and the Style of Complex Contracts*, 35 AM. J. COMP. L. 381, 381 (1987) [hereinafter *Complex Contracts*].

21. The classic statement of the problem is of course George A. Akerlof’s, in *The Market for “Lemons:” Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970).

and act in agreed-upon ways in the future. But even if parties' interests were (and were expected to remain) perfectly aligned, they would still enter into contracts to reduce non-adversarial transaction costs. Parties use contracting to arrange for and coordinate the acquisition and conveyance of information and the performance of particular tasks, as well as to allocate risks of events that neither is in a position to control. The contracting process thus aims to reduce opportunism (an adversarial transaction cost) as well as non-adversarial transaction costs.<sup>22</sup> The more cheaply it can do so, the better. The contracting process also provides an opportunity for the parties to come to know one another and their own and the other party's expectations about the relationship; indeed, at the outset, if they have not transacted with each other before, they are appraising whether they want to have a relationship at all.<sup>23</sup>

In the United States, contract drafting and negotiation is far more about addressing opportunism than is contract drafting and negotiation in Germany. The use of contract drafting and negotiation to constrain opportunism is very costly, as we will argue in Part II.B below, resembling an arms race in which each party has to make considerable expenditures simply to keep up with the other. German attempts to constrain opportunism are less costly because German parties and their lawyers abide by a norm<sup>24</sup> to stop the arms race far sooner. Moreover, as we will argue in Part II.C below, Germany does better than does the United States in helping parties deal with common contracting issues by providing standardized "good enough" solutions; overall transaction costs of contracting are thereby reduced.

22. These have attracted much less attention in the literature. A notable exception is Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 *YALE L.J.* 239, 296-98 (1984) (describing how an "earn-out" provision in an acquisition agreement is a low-cost solution to the difficulties of valuing a future earnings stream). In most instances adversarial and non-adversarial components are both present.

23. The extent to which contracting is about parties' defining and establishing their relationship is traditionally given short shrift in the literature. Hill discusses this matter in Claire A. Hill, *A Comment on Language and Norms in Complex Business Contracting*, 77 *CHI.-KENT L. REV.* 29, 31-32 (2001) [hereinafter *Language and Norms*]. Where the transacting community is less repeat and less homogeneous than it is in Germany, as it is in the United States, the more protracted process may be quite valuable, since parties have a great deal to learn about one another. In Germany, where thus far it's been more the particular transactional relationship that needs defining than the parties needing to know one another, a less protracted process may be cost-effective. King is less inclined than Hill to think a U.S.-style protracted negotiation process will have additional value relative to the German process even in the U.S.; he thinks that a larger proportion of the process consists of an arms race than Hill does.

24. There is no agreed-upon definition of norms. A useful discussion of norms in law and economics is Richard H. McAdams & Eric Rasmusen, *Norms in Law and Economics*, in *HANDBOOK OF LAW AND ECONOMICS* (Polinsky & Shavell eds., forthcoming 2005).

## B. Opportunism

### 1. The Norm of “Stopping Sooner”

Constraining opportunism through contract drafting and negotiation means constantly being on the lookout for strategic handles or ambiguities that the other party might exploit, and making sure to address them. The effect on contract documentation is cumulative: Parties in the U.S. start with “forms” that are already quite cluttered with language from previous deals in which the forms were used, and clutter them further.<sup>25</sup> Nobody will have the incentive to truncate, weeding out what’s unlikely or just unnecessarily convoluted. Indeed, on the contrary, everybody (the people constituting the client firm and the law firm, at both the lower and higher levels, and the firms themselves) will have the incentive to keep what there is and add whatever they can think of that might go wrong or might expressly rebut some possible misreading of the contract language.

Some of the costs of prolix U.S.-style contracts are obvious. Each party busily searches for strategic handles that the other party may have provided for, knowing that it can’t be assured of finding all of them, and knowing, too, that it can’t completely prevent the other party from using the contract, and legal process, strategically. The search isn’t just confined to discrete areas: everything potentially could be a strategic handle. And each party needs to expend costs to convince the other party that it is not using strategic handles itself. The more “substantive” the provision at issue, the more potent are arguments that strategic handles might remain and must be detected and definitively rebutted. But even as to common definitions and logistical and other coordination-type provisions, there are many variants and each party (or her lawyer) will often prefer her own, if only because she’s more familiar with it—and is sure it doesn’t contain any strategic handles she doesn’t know about.

A few costs bear stressing. Consider the costs associated with addressing contingencies. There is a great deal of emphasis on addressing even remote contingencies, in significant part for fear that should the contingencies arise and there be no contractual specifica-

25. Hill discusses this topic in *Legalese*, *supra* note 7, at 73–74, 80–81. Among the “clutter” are the long litanies of examples (“including but not limited to . . .”) that elaborate on the contract’s general terms and statements. In Germany, by contrast, only the general statements are used, without the litany of examples. See Picot, *supra* note 2.

tion of rights and duties, parties might act strategically. Parties spend a great deal of time anticipating and providing for contingencies that won't occur. Standard economic theory suggests that contingencies will be addressed if the cost of not having addressed them (that is, the probability that they'll occur multiplied by the cost of not having addressed them should they occur) exceeds the cost of addressing them.<sup>26</sup> In a world where ubiquitous opportunism is the working assumption, this condition will very often be met—and we can expect a great deal of costly contingency planning.

Moreover, it's not as though the only costs of thinking about contingencies are the structuring costs of considering possible contractual solutions. There are also the costs to the parties' relationship. The lawyer raises the possibility of some bad event; what one party says about how she'd react to the event may damage the relationship even if the event never occurs and even if the party would not have reacted in the way she described. The dynamic is particularly familiar to lawyers involved in negotiating the formation of small businesses, but is also present to some degree even for the largest businesses.<sup>27</sup>

Furthermore, recall that the subject matter of the contracts at issue is complex and singular. Planning for contingencies is likely to be far less satisfactory than it is in a simple purchase of commodities, for instance, where what can go wrong is well understood, and there are a well-specified set of contract solutions. By contrast, in the types of transactions at issue in this Article, it is far harder to classify what can go wrong in a manner that would dictate one or even a specified set of solutions. If opportunism weren't at issue, the parties might find agreement on process or even an agreement to agree preferable.<sup>28</sup> But

26. Note the heroic assumption that all of these numbers can be estimated within a tractable range.

27. We don't want to make too much of this point, though. If, in the United States, it's the norm to raise a certain number of points of this sort, a party may signal institutional competence by doing so and a susceptibility to being taken advantage of if she doesn't.

28. While, as a matter of black letter law in the United States, "agreements to agree" are unenforceable, courts strive to "construct an enforceable contract out of whatever raw materials or intention the parties have made available." "While the [U.S.] courts will not enforce a mere 'agreement to agree,' there is a tendency . . . to find an understanding by reasonable reference to custom or to the parties' previous conduct." MARVIN A. CHIRLSTEIN, *CONCEPTS AND CASE ANALYSIS IN THE LAW OF CONTRACTS*, 87–88 (4th ed. 2001). U.S. parties might even include in their contracts a provision they thought might be unenforceable as an agreement to agree if they thought the contingency at issue might arise when reputational and relational constraints would provide any needed enforcement, and the costs of making the provision enforceable at law would exceed the incremental benefits.

German law is similar to U.S. law, albeit a bit more permissive in enforcing agreements to agree. An agreement to agree will be enforceable (*Vorvertrag*) if there's an appropriate and

fear of opportunism may lead parties to prefer a solution specified *ex ante* notwithstanding that they can predict that the optimal solution *ex post* might be quite different. A response might be that if there is a preferable solution *ex post*, the parties should agree to use it, notwithstanding the *ex ante* agreement. Perhaps—but even then, the (not inconsiderable) costs of coming up with the *ex ante* solution will have been incurred.

There is another cost to contracting focused on constraining opportunism. Parties spend a great deal of time establishing specific prohibitions, again in significant part because they fear that the other party will take advantage of whatever latitude it is given. The intimation of a very specific prohibition is that what is not prohibited is permitted. If the subject had never been broached, a general prohibition, or perhaps no prohibition, might have invoked a norm with greater breadth than the breadth of the specific contractual prohibition. Extra-legal sanctions would attach to breaching the norm; a party might be more broadly constrained by the general prohibition (or no prohibition) and the norm than by the specific contractual prohibition. Consider a prohibition against related party transactions. If a dollar minimum is given, the intimation is clearly that transactions below that dollar amount are permitted. With a general prohibition, or perhaps no prohibition at all, the norm might be to avoid any such transactions, or at least many more of them. To overstate a bit, specificity in a contract provision may be an invitation to honor the fact but violate the spirit.<sup>29</sup>

defensible way to find enough to enforce; if not, it may be an unenforceable expression of intent (German: *Absichtserklärung*). See Palandt / Heichrichs, Rn. 19 zu § 145 BGB.

29. Relatedly, consider the U.S. practice in many types of agreements to (a) have specific (one could say “narrow”) factual disclosures made by each party as negotiated for by the other, and (b) not have a residual representation that, in effect, a party has told the other party what the other party would (reasonably) want to know. The potential for strategic behavior in making only the “narrow” disclosure is clear; an excellent analogy is the U.S. accounting profession’s ability to certify as accurate financial statements that abide by the applicable rules even though the spirit of the rules is arguably being violated, as was the case in Enron. To be fair, in the context of U.S. contracts, common law doctrines might permit recovery for “narrow” disclosure that turns out to omit material information. But sophisticated commercial parties dealing with one another do not take much comfort in a court’s giving them more protection than they expressly bargained for. And they are reasonable in so doing, especially since courts might very well expect them to be able to look after themselves.

Note, too, that the argument used *against* including a residual representation also turns on the potential for strategic behavior. The party asked to give the representation responds that she doesn’t know what the other party would want to know, and that giving the representation would give the other party an open-ended invitation to claim breach—there will surely be something the other party can claim she would (reasonably) have wanted to know that wasn’t disclosed.

It is therefore quite costly to deal with opportunism through the contract drafting and negotiation process. Why are parties in the U.S. incurring these costs? In our view, parties have gotten locked into an arms race in which each seeks to ferret out the other's possible strategic handles at every turn. The result is U.S.-style extensive custom tailoring of contracts. The participants in the process either believe, or persuade themselves to believe, that "every semicolon matters." The agents involved—the lawyers, answering to their clients, the people representing the clients answering to their seniors—will err on the side of more custom tailoring. Abiding by the norm will never engender criticism,<sup>30</sup> but if there should be a dispute over the contract language later on, not having abided by the norm may very well be punished: could more care have clarified the language sufficiently to avoid the dispute (or to easily prevail at litigation)?

This horror scenario looms large even though the main period with which contracting parties are concerned is the period in which they are getting along and have no need to resort to legal enforcement. During this period, the parties may routinely waive strict adherence to the contract; they may not even consult the contract at all. It is only if the relationship begins to sour—when litigation either is occurring or contemplated—that the actual words of their contract take on paramount importance.<sup>31</sup> And even then, the chance that the actual words will make as great a difference as getting it "exactly right" costs is small. This is particularly true in the United States, where the results of litigation are quite uncertain. Even in Germany, where, as we discuss in Parts II.B.2 and II.C.3 below, the results of litigation may be more certain, the computation should come out the same way, just because of the high costs of customization. And this is so even without discounting for the low probability of litigation. The customization expenditure must be weighed against the expected likelihood that the matter would have to be resolved in litigation, as well as the incremental value of the court's interpretation of the customized provision over the court's interpretation of a less customized provision; the computation should often argue against customization. Parties in the U.S. would be better off if they could agree to stop the arms race sooner. But such an agreement is difficult to make and

30. Hill makes this point in *Legalese*, *supra* note 7, at 68, n. 21.

31. See Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 MICH. L. REV. 1724 (2001) [hereinafter *Creating Cooperation*], at 1743–44.

enforce, especially when the arms race has been the reigning *modus operandi*. And, in what is in part an agency cost dynamic, no one involved in the process can afford to take a chance on unilaterally “laying down her arms” in the hope and expectation that the other party will do the same.

In Germany, the norm is to “stop sooner” in the customization process. A lawyer in Germany attempting U.S.-style negotiating has thus far seemed overly aggressive, lacking in institutional competence, or both. By contrast, a lawyer in the United States is seen as lacking zeal or institutional competence or both if she does *not* negotiate “every” term aggressively. Lest one think that a simple story of differing lawyers’ incentives explains the contrasting styles of drafting and negotiation, it should be noted that in both Germany and the United States, transaction lawyers are compensated roughly in the same manner—the hours spent are multiplied by the lawyer’s hourly rate.<sup>32</sup> There doesn’t seem to be any obvious reason why German lawyers have less of an incentive to spend time negotiating and revising contract documentation than do U.S. lawyers. One could say that in the United States, U.S.-style zeal is rewarded with professional advancement—partners who observe a junior lawyer being zealous in this manner are impressed, and clients are, if not impressed, at least not depressed. In Germany, the same conduct might not be rewarded. But what would account for this difference?

As we discuss in Part II.B.3 below, the German transacting community has thus far been relatively homogeneous and repeat. Such a community may encourage the development and effective enforcement of a norm to “stop sooner.” Indeed, enforcement is key: Once one party stops abiding by the norm and begins pushing for customization, the other party will almost certainly do so as well. [Deviations can readily be punished.](#)

Our recourse to norms might seem wholly unsatisfactory. On what authority do we claim that the German norm of stopping sooner exists? Our evidence is admittedly anecdotal—but so is evidence for the presumably uncontroversial proposition that U.S.-style negotiating is what it is.<sup>33</sup>

32. NIGEL G. FOSTER & SATISH SULE, *GERMAN LEGAL SYSTEM & LAWS* 98 (3d ed. 2002); Lawrence W. Schonbrun, *Attorney Billing Practices in Germany: An American Perspective*, 19 INT’L LEGAL PRAC. 120, 121 (1994).

33. Certainly, the popular press offers considerable, albeit anecdotal, support for this characterization. See, e.g., James Baxter, *Insolvency: On the Bandwagon*, LEGAL WEEK, Jan. 22,

## 2. The Role Of Civil Procedure

Differences in the two countries' civil procedure probably play a role. In the United States, each party presumes, correctly, that the other party can cause it considerable difficulties by advancing a strategic misinterpretation of a contract provision. A party advancing such a misinterpretation might prevail in court. Or, even if the party did not prevail, it might nevertheless be able to impose considerable costs on the other party, at the pre-trial stage (by, for instance, requiring it to respond to multiple motions or make its officers available for extensive discovery and depositions) and at the trial stage if the case were not earlier dismissed. Strategic misinterpretation thus can be a worthwhile strategy.<sup>34</sup>

German civil procedure may limit the extent to which strategic misinterpretation is a worthwhile strategy. Limits on pre-trial discovery<sup>35</sup> and motion practice, as well as the "loser pays" rule, vastly constrict a party's ability to use litigation to impose costs on the other party.<sup>36</sup> Moreover, the judicial panel trying the case controls much

2004 (referring to "highly aggressive U.S.-style negotiating."); see also Langbein, *Complex Contracts*, *supra* note 19, at 383.

34. The computation that the strategy is worthwhile in a particular instance will necessarily take into account any expected reputational costs, especially if it's hard to advance the misinterpretation as legitimate; the possibility of such costs constrains use of the strategy in some instances.

35. Note, however, that by introducing Section 142 ZPO in the code of civil procedure, the German Parliament has taken a small step towards American-style discovery. See, e.g., Joachim Zekol, *Die Pflicht zur Vorlage von Urkunden im Zivilprozess—Amerikanische Verhältnisse in Deutschland?*, 43 NJW 3129 (2002). This Section allows the court to order third parties to produce relevant documents, so long as the burden on the third parties is not "excessive" and other conditions are met. In Sections 137 IV; 141 I S. 1; 278 II 2, 3; 287 I, S. 3; 445 ff; 613 I 1 ZPO, the new ZPO departs from previous practice wherein parties couldn't normally prove their cases through their own testimony. The new ZPO accords more of a role to testimony of parties, although parties still do not have the same status as regular witnesses. This also brings the German Civil Procedure a small step closer to the American practice. Dagmar Coester-Waltjen, *Parteiaussage und Parteivernehmung am Ende des 20. Jahrhunderts*, ZJP 2000, 269 (278 ff).

36. The general rule in Germany for costs in Section 91 Abs. 1 Satz 2 ZPO is that a loser pays the costs in the proceeding, which include attorneys' fees at the rates governed by the applicable statute. A full comparative account of how the U.S. rule versus the "loser pays" rule affects contracting parties' incentives in writing contracts and in litigating is beyond the scope of this Article.



more of the proceedings than would an American judge:<sup>37</sup> the panel conducts fact-finding in a far more informal and less costly process.<sup>38</sup>

The German system gives judges a great deal of power. It therefore ought to have good ways of assuring judicial quality. And, we think, it does. German judges are neither elected nor appointed in a political process. Rather, they are selected on the basis of law school success. The selection usually occurs immediately after law school, and is followed by specialized judicial training. Career advancement in the judiciary turns largely on the results of peer review.<sup>39</sup>

In most litigated complex contract cases,<sup>40</sup> disputes will be heard by a commercial panel<sup>41</sup> consisting of a professional judge and two business-people.<sup>42</sup> The two people are appointed on the recommendation of the local chamber of commerce.<sup>43</sup> The lay judges have to meet certain minimum statutory qualifications as to their business experience and position.<sup>44</sup> Should a litigant wish to appeal, a higher court, whose members are likely to be specialized in commercial matters and to have advanced based on merit, will review the lower court

37. In Germany, the cases at issue are always tried by judges; there is no provision for jury trials of such cases. Rolf Stürner, *Why are Europeans Afraid to Litigate in the United States?*, 45 CONFERNEZE E SEMINARE 5 (Roma 2001). In the United States, jury trials for such cases are permitted, but are exceedingly rare.

38. In Continental litigation, the judge is the one who takes evidence, summons and examines witnesses and parties, and reviews the evidence. See John H. Langbein, *The German Advantage in Civil Procedure*, 52 U. CHI. L. REV. 823, 826–28 (1985) [hereinafter, *The German Advantage*]. It should be noted that Langbein's article, which presents a highly positive view of German civil procedure, provoked a strong critique by Ronald J. Allen et al., *The German Advantage in Civil Procedure: A Plea for More Details and Fewer Generalities in Comparative Scholarship*, 82 NW. U. L. REV. 705 (1988); Samuel R. Gross, *The American Advantage: The Value of Inefficient Litigation*, 85 MICH. L. REV. 734 (1987); and John Reitz, *Why We Probably Cannot Adopt the German Advantage in Civil Procedure*, 75 IOWA L. REV. 987 (1990). Allen et al.'s critique provoked a response by Langbein, John H. Langbein, *Trashing the German Advantage*, 82 NW. U. L. REV. 763 (1988) [hereinafter, *Trashing the German Advantage*]; to which Allen et al. also responded. Ronald J. Allen, *Idealization & Caricature in Comparative Scholarship*, 82 NW. U. L. REV. 785 (1988). Overall, King's experience is more in accord with Langbein's view than Allen's.

39. See *The German Advantage*, *supra* note 35, at 850. Of course, peer review is not perfect; still, King's experience is that judges who advance tend to be of high quality. Langbein also thinks very highly of German judges. See *id.* at 862.

40. As is the case for U.S. parties, parties to German contracts sometimes agree to arbitration. Arbitration costs are, of course, far lower than litigation costs.

41. *Kammer für Handelssachen*. See § 394 ZPO; §§ 95 ff GVG.

42. Certain "legal" decisions (such as those concerning jurisdiction, default judgments, posting of bonds, calculation of court costs and attorneys' fees) have to be made by the professional judge. § 349 ZPO. However, most matters are decided by a majority of the judges.

43. Membership in the Chambers of Commerce is mandatory for most German companies. German law delegates a number of functions to the Chambers of Commerce, including the appointment of lay judges to commercial panels.

44. See § 109 GVG as to minimum age and other qualifications.

decision.<sup>45</sup> Thus, a judicial panel hearing a commercial dispute is very likely to have expertise in commercial matters.<sup>46</sup>

We must consider a counter-argument to our position: two adversarial fact-finders, such as we have in the United States, will have a stronger incentive to flesh out the facts of a case than will the judges on a German court.<sup>47</sup> The adversarial fact-finders in the United States have extensive pre-trial discovery<sup>48</sup> at their disposal as well; they don't just have more "will," but also a better way, to ferret out "the truth." While we think this objection has merit in general terms, we think that in the context with which we are concerned, litigation between commercially sophisticated parties in a complex transaction, a well-selected and well-trained judge with experience in cases involving complex transactions, together with two lay judges who have business experience, should be able to ferret out facts effectively and in any event, should not systematically disadvantage the plaintiff or defendant. Certainly, this is King's experience. Indeed, more broadly, we think the overall picture we have painted, in which strategic misuse of litigation is less of a concern in Germany than in the United States, accords with the anecdotal sense of a great many practitioners in a position to compare the two systems. Effort spent putting or leaving strategic handles in a contract may simply have less of a payoff in Germany than it does in the United States. Accordingly, each party should spend fewer resources to that end, and should spend fewer resources trying to detect the other party's efforts to that end.

There may also be fewer possible strategic misinterpretations that a party can advance. Because German contracts avoid the U.S.-style cumulation that results in significant part from the "arms race" we described above, the contracts may simply be easier to interpret.<sup>49</sup>

45. See *Complex Contracts*, *supra* note 19, at 387.

46. In this regard, consider the widely-acknowledged benefits in the U.S. to litigating complex corporate law matters in the courts with the most expertise and experience in corporate law, the Delaware courts, rather than in courts of other states. Indeed, both the authors can attest to the fact that every lawyer, when asked by a client "Why are we incorporating in Delaware?" includes in the list of reasons that Delaware courts are more experienced in corporate law.

47. Allen et al., *supra* note 35, at 710-11.

48. Schütze, *Zum Stand des deutsch-amerikanischen Justizkonfliktes*, RIW 2004, 162, 163.

49. Consider, for instance, the many provisions in U.S. contracts that contain difficult and tortured clauses qualifying the provisions' applicability ("anything in the foregoing to the contrary notwithstanding . . ." or "the foregoing shall not be deemed to include . . .") Consider, too, the provisions containing long litanies of examples mentioned in note 24, *supra*. These types of provisions reflect in significant part the cumulative effect of the arms race. And it's not just strategic misinterpretation that parties may need to worry less about. It may be possible for

### 3. The Role of Extra-Legal Forces

We argued above that German parties don't seek to constrain opportunism as much by contract language as do U.S. parties. We discussed two reasons: the norm to "stop sooner" in customizing contracts, and various features of German civil procedure. Another possible reason is that extra-legal forces might be more effective at constraining opportunism than they are in the U.S.

Our account is familiar from the norms literature and, in particular, the work of Lisa Bernstein.<sup>50</sup> Germany's business community is small compared to the business community of the United States. Many industries are concentrated in particular regions;<sup>51</sup> transactions have typically taken place among those in the same industries. Trade associations exist in many industries, and are more important than their counterparts in the United States.<sup>52</sup> Acquisitions by firms from outside the close community—for instance, by private equity firms—have, until recently, been relatively rare.<sup>53</sup>

parties to worry less about even benign misinterpretations. German grammar is helpful in this regard. In German, referents are clearer; the grammar makes it more likely that a given phrase will have only one unambiguous reading. For instance, German has three genders to refer to things that are not natural persons. In a sentence referring to the target entity (*das Unternehmen* = neuter), a trade union (*die Gewerkschaft* = feminine) and the workers council (*der Betriebsrat* = masculine), it is possible in German to unambiguously determine the reference just by prepositions and endings. In English, all three would have the same reference (it). Provisions intended to constrain possible misinterpretations of other provisions are therefore less likely to be needed.

50. See, e.g., *Creating Cooperation*, *supra* note 29; Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992); Lisa Bernstein, *The Questionable Basis of Article 2's Incorporation Strategy: A Preliminary Study*, 66 U. CHI. L. REV. 710 (1999).

51. For instance, most of the roller bearing industry manufacturers are located in Schweinfurt, a small town between Nürnberg and Frankfurt. The world's precision surgical instrument industry—aside from certain low priced manufacturers in Pakistan—is located in and around Tuttlingen, a small town an hour south of Stuttgart. King was on a plane seated next to an executive of a large American health products company that distributes surgical instruments. When asked what he did when he was in Germany, the executive reported that he spent all his time in and around Tuttlingen and knew not only every restaurant in the vicinity but the name of the cooks.

52. See, e.g., *Allgemeine Lieferungs- und Zahlungsbedingungen der WSM-Industrie für Industriegeschäfte mit dem Ausland* (Trade Association of the Steel and Metalworking Industry), available at <http://www.wsm-net.de/wsmagbah.doc> (Apr. 2002); Banken- und Sparkassen-AGBs (GT&C of banks and savings banks), die AGBs der Treuhandanstalt und die VDMA-Bedingungen, *reprinted in* Friedrich Graf von Westphalen, *Vertragsrecht und AGB-Klauselwerke*.

53. Constantin Christofidis & Olivier Debande, *Financing Innovative Firms Through Venture Capital*, available at [http://www.gfgnet.com/files/Financing\\_Innovative\\_Firms\\_Through\\_VC.pdf](http://www.gfgnet.com/files/Financing_Innovative_Firms_Through_VC.pdf) (Feb. 2001) (last visited May 20, 2004) discusses how European venture capital activity began a long time after U.S. activity. The article notes that it has recently been

More broadly, German contracting nowadays resembles in some respects U.S. contracting in the early 1980s and before, when people involved in complex business transactions, including both parties and their lawyers, were in more repeat and homogeneous communities.<sup>54</sup> Parties engage in transactions within the same communities, using the same law firms. Furthermore, the few big banks in Germany have considerable equity stakes in many companies.<sup>55</sup> It is not unusual to find a bank involved in both sides of a transaction.<sup>56</sup> For all these reasons, it might thus have been possible to achieve consensus as to norms of good behavior, and develop good mechanisms for detecting and punishing deviations from the norms. The U.S. complex business transacting community also has norms of good behavior and mechanisms for detecting and punishing deviations, but these may not work quite as well as they do in Germany because the U.S. community is less homogeneous and less repeat than the German community.<sup>57</sup> Parties in Germany therefore might have more effective alternate means of constraining opportunism than do parties in the United States, and might not need to rely as much on the legal enforcement of contract terms (and the threat thereof) as do their U.S. counterparts.

#### 4. The Role of Substantive Law: Good Faith

Also relevant to our account is that German substantive law imposes considerably stronger obligations of good faith than does U.S.

rapidly increasing but that German has “lagged” behind other countries that have more of an “equity market culture.”

54. Certainly, this was King’s and Hill’s experience regarding U.S. practice in the 1980s, and it is King’s experience regarding German practice now. For a discussion of current German legal culture, see Erhard Blankenburg, *Patterns of Legal Culture: The Netherlands Compared to Neighboring Germany*, 46 AM. J. COMP. L. 1 (1998).

55. See MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 171–77 (1994).

56. This state of affairs may be changing; equity in German firms is increasingly owned by capital markets investors rather than banks. See Eric Nowak, *Recent Developments in German Capital Markets and Corporate Governance*, 14 J. APPL. CORP. FIN. 35 (2001); Erik Theissen, *Organized Equity Markets in Germany*, CFS Working Paper No. 2003/17 (March 2003), available at <http://ssrn.com/abstract=427020>. This change is being accelerated by the capital adequacy rules to be imposed by the New Basel Capital Accord, available at <http://www.bis.org/bcbs/cp3full.pdf> (last visited May 31, 2004). The Accord effectively will discourage banks from holding significant equity interests in industrial companies. All of this being said, at present, German banks continue to hold significant equity interests in companies of all types.

57. One of us has discussed the heterogeneity of the U.S. complex transacting community. See Hill, *Language and Norms*, *supra* note 22, at 34.

law.<sup>58</sup> Some of these obligations can be contracted around by the parties, but some cannot. The original source of these obligations is Section 242 of the German Civil Code (BGB),<sup>59</sup> a section that courts have interpreted exceedingly broadly. But many of these obligations have been codified in separate sections of the law.<sup>60</sup>

In their treatise *GOOD FAITH IN EUROPEAN CONTRACT LAW*, Whittaker and Zimmermann describe the coverage and operation of Section 242:

Thus, it is generally recognized today that § 242 BGB operates . . . so as to supplement the law. . . . It specifies the way in which contractual performance has to be rendered and it gives rise to a host of ancillary, or supplementary, duties that may arise under a contract: duties of information, documentation, co-operation, protection, disclosure, etc. These duties can also apply in the precontractual situation and they may extend after the contract has been performed. . . . In the second place, § 242 BGB serves to limit the exercise of contractual rights. . . . Thus, for instance, going against one's own previous conduct . . . is frowned upon and so is relying upon a right which has been dishonestly acquired . . . demanding something that has to be given back immediately, . . . proceeding ruthlessly and without due consideration to the reasonable interests of the other party, . . . or reacting in a way which must be considered as excessive when compared with the event occasioning the reaction. . . . Lapse of time may also lead to a loss of right even before the relevant period of prescription has expired. . . . Finally, and most problematically, § 242 BGB has also been used to interfere in contractual relations in order to avoid grave injustice.<sup>61</sup>

58. See generally SIMON WHITTAKER & REINHARD ZIMMERMANN, *GOOD FAITH IN EUROPEAN CONTRACT LAW* (2000).

59. For a general discussion of Section 242, see *id.* at 18–32; see also Canaris, Claus-Wilhelm, *Wandlungen des Schuldrechts – Tendenzen zu seiner „Materialisierung“*, *AcP* 2000, 273. Notwithstanding the conventional credo that civil law systems lack any role for precedent, the jurisprudence of Section 242 has developed in a common-law like manner. Indeed, more broadly, the idea that civil law systems lack any role for precedent is, according to commentators, overstated. See UGO MATTEI, *COMPARATIVE LAW AND ECONOMICS* 84 (1997); see also WHITTAKER & ZIMMERMANN, *supra* note 59, at 23 (“[I]t must be noted that German lawyers have become accustomed to thick layers of case law emerging from the interstices of their Code and . . . they have learn[ed] to cope with this phenomenon.”). Moreover, doctrines developed in civil law courts are sometimes codified.

60. There are other general statutes: Section 157 BGB, which provides that the interpretation of contracts be “governed by the precepts of good faith,” and Section 138 I BGB, a provision “with an ancient pedigree” that is “much stricter than § 242 BGB” and has been the basis for “a number of startling developments over the last couple of years.” WHITTAKER & ZIMMERMANN, *supra* note 55, at 29.

61. WHITTAKER & ZIMMERMANN, *supra* note 55, at 24–25. Whittaker & Zimmermann characterize the quoted portion as a rough survey of “how the requirements of § 242 BGB have been specified over the years.” *Id.* at 26.

An important application of Section 242 BGB that has been codified is Section 9 of the Standard Contract Terms Act of 1976 (“Section 9”). Section 9 makes invalid any term to which specific attention has not been drawn (a “general term and condition”)<sup>62</sup> that constitutes “unfair surprise”<sup>63</sup> or is “unfairly detrimental” to the non-drafting party.<sup>64</sup> The applicability of Section 9 cannot be waived.<sup>65</sup>

Another important application of Section 242 BGB that has been codified is “*culpa in contrahendo* (“*cic*”).”<sup>66</sup> *Cic* is, for our purposes, principally a duty to act in good faith during negotiation of the contract, and a warranty given by sellers in acquisitions. *Cic* might render a seller liable for “insufficient” disclosures to a buyer when U.S. law would have given the buyer no recourse. *Cic* can, and sometimes is, waived.<sup>67</sup>

62. Pursuant to § 305 Abs. 1 Satz 1 BGB, the heightened scrutiny applies to clauses which are intended to be used in a number of contracts. It is not necessary that the same party intends to use the clause again; using a clause from a form (such as the forms of acquisition agreements of law firms) puts the clause within the purview of § 305 c BGB. See Palandt/Heinrichs, Rn. 9 zu § 305 BGB. Interestingly, in a recent decision suggesting that judges may be eager to interpret Section 9 expansively, the BGH (the highest German court for civil cases) held that parties were subject to Section 9 if they adopt part, but not all, of the VOB-B, a commonly used statutory standard form for construction contracts.

Note that Section 9 is to some extent comparable to UCC §2-207 (2)(b), which provides that a term included in an acceptance doesn't become part of the parties' contract if it materially alters the contract. The coverage of the U.C.C. provision is, of course, far more limited than that of the German provision, insofar as it applies only to sales of goods between merchants.

63. § 305 c BGB.

64. § 307 Abs. 1 BGB. Section 305 Abs. 2 BGB defines “unfairly detrimental” by reference to the basic principles of statutory law.

65. § 306 a BGB.

66. Effective as of January 1, 2002, the doctrine of *cic* was codified in § 311 Abs. 2 BGB. For an extensive discussion of the doctrine, see HAN BUCHTA REHM, AUFKLÄRUNGSPFLICHTEN IM VERTRAGSRECHT (2003). For a discussion of how the doctrine applies in the context of negotiations concerning mergers and acquisitions, see HANS-JOACHIM HOLZAPFEL & REINHARD PÖLLATH, UNTERNEHMENSKAUF IN RECHT UND PRAXIS, Rn. 492-438 (11 Aufl. 2003).

67. In one case in which *cic* was not waived, the BGH found a seller of a computer company liable for failing to disclose that shortly before the transaction closed, contracts representing 40 percent of the sales of the company had been terminated. BGH NJW 1995, 1549f. The BGH has likewise held a party liable in *culpa in contrahendo* when the party noticed that the other party had made an error in calculation and didn't inform the other party. BGH NJW 1980, 180 (dictum). Similarly, a seller of a scaffolding business which excluded all warranties but did not expressly exclude liability for negotiation in good faith (*culpa in contrahendo*) was held liable in *culpa in contrahendo* for having negotiated the purchase price on the basis of financial statements that negligently overstated the scaffolding owned by the company. The court noted that since 70 percent of the scaffolding was on customers' construction sites, this quantity could not be checked or verified by the purchaser. BHG NJW 1979, 33. See also Picot, Unternehmenskauf und Restrukturierung § V Rn. 90 (2. Aufl. 1998); THOMAS RÖDDER, OLIVER HÖTZEL, & THOMAS MUELLER-THUNS, UNTERNEHMENSKAUF UNTERNEHMENSVERKAUF § 9 Rn. 145 (2003). For a very detailed and critical comparative discussion of *cic*, see GEHARD REHM, AUFKLÄRUNGSPFLICHTEN IM VERTRAGSRECHT 200-02

Our verdict on German law on good faith is rather more mixed than our verdict on the other aspects of German law, procedure, and norms we discuss in this Article. The scope of German law on good faith is uncertain;<sup>68</sup> parties may incur costs to assess the scope, and may feel constrained in their behavior in order to leave a margin for error. Indeed, the law may be forcing on some sophisticated parties higher standards of conduct than they would require of one another.

But there are benefits. For instance, Section 9 may encourage efficient information-provision by a drafting party. She must direct the non-drafting party's attention to any provision that she fears may be deemed "unfairly surprising" or "unfairly detrimental" or risk that the provision will be invalidated. The non-drafting party may therefore be able to truncate its review of the draft.

More broadly, if and to the extent parties (or at least a majority of them) would agree upon, and comport themselves consistently with, these standards in any event, or, expressively, the standards contribute to the existence and perpetuation of norms and reputational communities which make for less costly transacting overall, the good faith obligations might be beneficial. On balance, therefore, our assessment as to whether the laws on good faith help German contracts do as much with fewer words is mixed. They may help German contracts have fewer words, but perhaps only at the cost of limiting the parties' ability to get the deal they want, and of introducing some uncertainty as to how courts will interpret contractual obligations.

### C. Standardized Solutions

#### 1. In General

The foregoing has dealt with opportunism: the concern each party has that the other party will try to benefit itself at the expense of the aggregate transactional pie. But contracting has its non-adversarial components as well. Germany does better in helping parties deal with non-adversarial components of contracting by providing standardized "good enough" solutions to common transacting prob-

(2003). Semler, *in* Hölters, *Handbuch des Unternehmens- und Beteiligungskaufs* § VI Rn. 14 (4. Aufl. 1996), notes that there are progressively fewer cases of failure to make unsolicited disclosures as due diligence lists become more standard and comprehensive.

68. This is a view held by many commentators. See, for instance, HOLZAPFEL & PÖLLATH, *supra* note 63, at Rn. 518, who argue that *cic* should be waived "to reduce uncertainty by the seller as to the circumstances under which he may be liable."

lems. And the standardized “good enough” solutions should help parties reduce transaction costs of dealing with adversarial problems as well. That there are standardized “good enough” solutions in Germany owes not inconsiderably to the “stopping sooner” norm we discussed in the previous Part. Without such a norm, the benefits to either developing or using standardized solutions would be low. But with such a norm, the benefits to standardized solutions are considerable. Certainly, there are network effects of having standardized solutions in common use: quick recognition that a known provision is being used truncates costs of review of a document, and the likelihood that a definitive interpretation of the provision itself exists is increased.

## 2. Standardized Solutions In The Law

Many of the standardized solutions are found in the law itself. There is much more statutory contract law applicable to complex transactions in Germany than in the United States.<sup>69</sup> And, because Germany is a civil law system with only one jurisdiction at issue, the law is generally quite uniform.<sup>70</sup> There are also detailed commentaries that are generally regarded as authoritative sources of law.<sup>71</sup>

Most of the German statutory provisions applicable to contracts are in the German Law of Obligations, which is part of the German Civil Code (BGB).<sup>72</sup> The Law of Obligations has a chapter containing rules relevant to all obligations, including contractual obligations.<sup>73</sup>

69. There is considerable variation within the United States in this respect. More code-oriented states, such as Louisiana, California, and a number of the Western states, have a statutory law of obligations that contains “comprehensive” general rules on the law of contracts. New York, on the other hand, has a General Obligations Law that only governs particular issues in contract law. A number of other states rely principally on common law and only govern particular types of contracts by statute. But even the most detailed of the U.S. codes, such as the California Civil Code, is much less comprehensive in its detailed rules on contract law than the German BGB and HGB.

70. Dreier-Stettner, *Grundgesetz Kommentar*, Art. 74 Rn 15 GG.

71. The commentary regarded as the most authoritative on the German Civil Code (the BGB) is probably PALANDT, which is in its sixty-third edition (2004). The commentary is commonly available in German law offices and law libraries; almost all German law students own their own copies.

72. Book 2, §§ 241–853 BGB.

73. §§ 241–304 BGB. Note that the concept of a contract (German: *Vertrag*) is generally broader than the American concept and includes such matters as gifts and transfers of property (for example, the transfer of real property in satisfaction of an obligation to transfer the property, say, under a court order). There are a few other legal relationships other than tort and contract to which the law of obligations applies, such as restitution (§§ 812–822 BGB) and *Geschäftsführung ohne Auftrag* (§§ 677–687 BGB), a legal concept with no clear U.S. counterpart covering some cases in which U.S. law would cover by implied contracts, others covered by



These include rules on interpretation, performance, and default. Compared with the United States, there are many more rules for filling contractual gaps. In the United States, many of the formal gap-filling rules are in Article 2 of the UCC, which applies only to sales of goods and does not encompass most complex business transactions. In both the U.S. and Germany, gap-filling rules are often in the form of “standards” specifying, for instance, “reasonable” quality, quantity or notice.

Some German contract law is in the form of definitions or elaborations of standard legal terms and concepts, typically as default or optional provisions that parties may, and not infrequently do, adopt. Concepts defined or elucidated in the German statute include substantial performance, allocation of risk of mistake, and cure rights. In U.S. law, these concepts are extensively addressed, but in Germany, there is a detailed and uniform elaboration in the statute and commentaries. German statutes also specify when a time period for notice starts,<sup>74</sup> (including notice of default),<sup>75</sup> when the period ends,<sup>76</sup> and the number of days to be counted in a month or year (*e.g.*, for calculating interest),<sup>77</sup> and define business days,<sup>78</sup> affiliate,<sup>79</sup> related person,<sup>80</sup> real property,<sup>81</sup> and many other commonly used terms. In the U.S., parties typically would not have available either a common-law or statutory definition that could be readily incorporated. German law also considerably shortens the contractual space needed to address a common problem: the authority of a document’s signatory to bind the entity she purports to be binding.<sup>82</sup> In the lengthier U.S. solution, authority

unjust enrichment or constructive trusts, and others in which there would be no cause of action in the United States.

74. The day on which the notice is given does not count for the period. § 187 BGB.

75. § 286 BGB; § 377 HGB.

76. § 188 BGB specifies when a notice period ends depending on how it is phrased (in days, months, etc.). For example, Paragraph (German: Absatz) 2 explains that if the contract dated May 15 says “in six months” this is presumed to mean the end of the sixth full month, *i.e.*, November 30, not November 15. A term saying “six weeks” would mean the end of the sixth full week, which might be more than 52 days, if the starting day is in the middle of a week.

77. § 191 BGB.

78. § 193 BGB.

79. § 15 Aktiengesetz, v. 6.9.1965 (BGBl. I S.1089), translated in GERMAN STOCK CORPORATION ACT 37 (Friedrich K. Juenger & Lajos Schmidt trans., 1967).

80. § 15 Abgabenordnung (AO) [Tax Code].

81. §§ 94–98 BGB § 3 Grundbuchordnung [Land Registration Act], v. 24.3.1897 (RGBl. S.139), available at <http://bundesrecht.juris.de/bundesrecht/gbo/index.html>.

82. The combination of the personal liability of the signatory without authority under § 179 BGB, German doctrines of apparent authority, and, most importantly, the protection of reliance on entries in the Commercial Register in § 15 HGB obviate in practice the need for secretaries’ and incumbency certificates as well as warranties of authority in German transactions.

is typically vouched for using several warranties and certificates; the language of the warranties and certificates may be a subject for negotiation.

The German statutes also provide default remedies provisions.<sup>83</sup> The provisions are more often contracted around than many other default provisions; they are, however, available for adoption and many parties do adopt them. German law also is more apt than U.S. law to respect parties' specification of an amount as liquidated damages.<sup>84</sup> In the United States, liquidated damages may very well be invalidated as unenforceable "penalties;" parties have to draft their damages provisions carefully to minimize the chance of invalidation,<sup>85</sup> and have to take into account the possibility that despite their efforts, their specification of amount will not be respected.

Germany also has laws applicable to particular types of contracts, such as purchase agreements, loans, and rental of chattels or real estate.<sup>86</sup> There is also a set of rules for construction contracts, *Verdin-*

83. Specific performance is nominally the primary remedy, although several scholars have noted that in most cases, damages are the remedy sought and awarded. See B.S. MARKENSIS, W. LORENZ, G. DANNEMANN, *THE GERMAN LAW OF OBLIGATIONS, VOLUME 1: THE LAW OF CONTRACTS AND RESTITUTION: A COMPARATIVE INTRODUCTION* 30 (1997); see also Henrik Lando & Caspar Rose, *The Myth of Specific Performance in Civil Law Countries* (LEFIC Working Paper No. 2003-14, Nov. 21, 2003), available at <http://www.cbs.dk/lefic/Working%20papers/2003/wplefic142003new.pdf>. Lando and Rose argue that "specific performance has become irrelevant for action breaches due to the extra costs and difficulties it entails at the stage of final execution when the breaching party must be coerced into performing certain actions."

84. While § 343 BGB allows an obligor to seek a judgment reforming a contract to reduce a contractual penalty that is unreasonably high, § 348 HGB does not permit such a reduction for commercial parties except where the amount is "unconscionably high," a threshold that is very hard to meet in commercial cases. Palandt/Heinrichs, *supra* note 63, at Rn. 9 zu § 343 BGB.

85. As we mention in the text accompanying note 104, *infra*, Lundmark, *supra* note 11, also makes this observation. Other common-law doctrines also may require extensive drafting, either to assure or rebut the application of thereof: examples include covenants not to compete and guarantees. This being said, contract law seems to dictate the contents of contracts far more in Germany than it does in the U.S.: In the U.S., because contracts are so customized and because there is comparatively less contract law, there is very often no applicable statute or common law for parties to adopt or contract around. We discuss this matter in Section II.D, *infra*.

86. The sections in the BGB on purchase agreements have very broad application; they apply not only to the sale of goods, but also to intangibles such as shares in a privately held company. § 453 BGB. See Palandt/Putzo, at Rn. 7 zu § 453 BGB, Wolfgang Wertnauer, *Der Unternehmenskauf nach neuem Kaufrecht*, NJW 2000, 2511, 2513. The BGB also provides specific rules for specialized types of contracts. One example is *Pacht*, a form of contract used to lease an entire business or a property such as a hotel or restaurant that includes furnishings and equipment. §§ 581–597 BGB. Other types of contracts (so-called "*Inominatverträge*") are not expressly covered by the BGB but are still subject to general rules in the BGB and other German statutes; other rules for other types of specialized contracts also may apply by analogy. One example is franchising or link agreements between Internet providers.

*gungsordnung für Bauleistungen* (VOB).<sup>87</sup> VOB is chosen by the majority of builders and construction companies for at least some of their work.<sup>88</sup> Again, the U.S. has far less statutory law dealing with these areas than does Germany, and certainly, no real analogue to Germany's detailed authoritative commentaries, even in caselaw.

### 3. Other Standardized Solutions

While most of the solutions are to be found in the law itself, there are also more standardized "private" solutions in Germany than in the United States. Perhaps most importantly, standardized solutions can be found in forms in common use prepared by trade associations. Trade associations are far more important in Germany than they are in the United States.

Under German law, the provisions in some trade association and certain other forms can be incorporated by reference.<sup>89</sup> Thus, for instance, loan documents can be quite short because they can incorporate by reference the general terms set forth in the General Terms and Conditions of Banks, a standard form.<sup>90</sup> While parties do not always use trade association forms, they do so often; the forms' existence clearly contributes to greater standardization of contract provisions overall. Furthermore, law firms are more apt to publish form documents than in the United States, and these are more apt to be broadly used;<sup>91</sup> by contrast, in the United States, each transactional law firm, and, often, many subgroups of lawyers within a law firm, has its own form.

87. The VOB has many schedules and provisions relating to different types of construction work as well as standards for performance. The VOB is mandatory for most government procurement of such services when the amount contracted exceeds €5 million. § 7 Verordnung über die Vergabe öffentlicher Aufträge.

88. Most builders and construction companies choose the VOB-B, which is the part of the VOB dealing with performance. Indeed, it is increasingly being argued that the VOB-B should be treated as a custom of the trade, applicable unless the parties expressly contract out of it.

89. § 305 (2) and (3) BGB.

90. See, e.g., Peter Bülow, Heidelberg Kommentar zum WechselG / ScheckG / AGB (2000).

91. We note in Part II.C.5 below that law firm competition in the U.S. includes competition on "forms," whereas German law firm competition is far less "form-driven." Interestingly, an organization of in-house lawyers in England is attempting to obtain from law firms and post on the web for their members forms for various types of transactions. See Rachel Rothwell, *In-House Lawyers Ask Firms To Give Out Precedents*, LAW SOCIETY GAZETTE, Nov. 20, 2003.

#### 4. Discussion and Analysis

German contract law, complemented by trade association forms and law firm forms, helps German contracts contain fewer words than U.S. contracts. The mandatory and default provisions in German contract law are applicable without the need for any reference thereto in the contract. And for provisions in the law that require express adoption, the task can be accomplished by the use of comparatively few words. For example, Section 463 of the BGB provides a statutory procedure for a right of first refusal. If the parties are satisfied with the statutory procedure, then only one sentence is necessary (“A grants B a right of first refusal in respect of the share in X Co.”); the parties needn’t then specify how the right of first refusal operates. If the parties want to change just one aspect—for instance, the price is to be fixed instead of being based on the price offered by the third party—then only the changed terms need be included. It also tends to take very few words to contract around default provisions should the parties choose to do so; that being said, however, the need to contract around a provision may yield more words than would have been the case had the default provision not been in the law.

Adoption of the trade association and law firm forms is of course optional. All or part of the trade association forms can often be adopted with only a brief reference, as noted above. Adoption of the law firms’ forms in toto is straightforward as well, and the forms themselves are shorter, as we note in Part I.A.<sup>92</sup> The net effect is that German contracts are on balance shorter.<sup>93</sup>

The harder and more interesting question is whether and how the existence of all these mandatory, optional, and default provisions help German contracts do as much with fewer words—in other words, whether the reduction in length is achieved without much sacrifice to parties’ ability to obtain (or at least specify) precisely the deal they want. The mandatory provisions on their face would seem to limit parties from getting the deal they want. The default provisions might seem to have the same effect to the extent that contracting around them was costly. Indeed, more broadly, the ready availability of stan-

92. Indeed, the German forms resemble “true” fill-in-the-blanks forms far more than do U.S. “forms.” The U.S. “forms” are precedents used in an earlier transaction, itself the product of cumulation as discussed above.

93. It helps, too, that there are simply fewer synonyms in German than in English, thanks to English having both French and German roots. Many of the “pairs” in U.S. drafting are the Norman French and Germanic synonyms, *e.g.*, “null and void,” “cease and desist,” “fit and proper,” etc.

standardized solutions, in law or in forms commonly used in practice, may make parties adopt those solutions because contracting around them (or not adopting the optional but commonly used provision included in a form) is costly; had the parties not had to incur those costs, they might have adopted something that suited them both better.<sup>94</sup> Moreover, in an agency cost dynamic, a German lawyer might compromise on some specifics that her client might have wanted lest she be thought of as overly aggressive.

But the limitation on parties' ability to get or specify the deal they want is small relative to the benefit. And the limitation is rather small in any event. There are very few mandatory provisions, and parties can choose whether they want to be bound by the default or optional provisions. And it's generally not difficult to contract around the default provisions. But, more importantly, the benefit is considerable, consisting of the transaction cost savings of using the readily and cheaply available provisions in the laws rather than elaborately custom tailored provisions. Our argument is that the laws' provisions, supplemented by provisions in trade association forms and the forms commonly published by German law firms,<sup>95</sup> are mostly "good enough;" in many cases, custom tailoring modifying those provisions costs more than it is worth.<sup>96</sup>

The benefits of having standardized provisions for boilerplate and like concepts (such as the definition of "business day") should be obvious. But we think that for many provisions, cheap "good enough" solutions can be preferable to much more expensive custom tailored provisions. As we discuss below, adoption of the standardized solution (a) should save transaction costs at the contract formation stage; (b) shouldn't prevent the parties from conducting their relationship as they please when they are getting along; and (c) perhaps counterintui-

94. Schwartz & Scott, *supra* note 6, at 548, note that contracting around inefficient defaults raises parties' transaction costs.

95. We do acknowledge, though, that at a certain point, a plethora of standardized solutions can scarcely be characterized as "standardized." Most of the solutions are standardized—there are many solutions, but to different problems; consider the trade association forms. Solutions that compete with one another are the trickier case, but thus far, the norm to stop sooner seems to have swamped the "battle of the boilerplate" that not infrequently occurs in U.S. negotiations.

96. See Scott, *supra* note 5, at 93, discussing when it will be appropriate for the state to write default rules. We largely agree with the spirit of Scott's analysis, but because we think that parties purportedly "free" to choose their own terms are, at least in the United States, hobbled by a path-dependent and agency-cost-ridden trajectory into customizing their agreements far more than is needed to achieve their aims, we are more apt to think that particular state-supplied default rules will be worthwhile.

tively, might yield no greater interpretive error than would a more customized provision.

It is helpful for our analysis to distinguish between three periods: when the parties are establishing their relationship, when they are maintaining their relationship, and during any end-game in which they may find themselves if their relationship sours. Relative to U.S. contracting, German contracting should minimize the sum of relationship establishment costs, relationship maintenance costs and end-game costs.

It is easy to see how German contracting minimizes costs of establishing the parties' relationship. The main component of such costs is sometimes referred to in the literature as "specification costs."<sup>97</sup> These costs are clearly lower in Germany, given the standardized mandatory, default and optional provisions (and, of course, relatedly, the norm of "stopping sooner"). But there are also other relationship establishment costs; indeed, Hill has argued<sup>98</sup> that a significant function of U.S. contract negotiation is for the parties to find out what they want from the transaction and from one another. Negotiations conducted pursuant to the customization norm may yield a great deal of such information. However, given the considerable expense of customization, the value of this information is probably smaller than the associated cost. Moreover, customizing the words in a contract is only one way to get information about one's prospective contracting partner and the transaction both parties contemplate; it isn't the only way. There is no reason to suppose German parties wouldn't conduct negotiations or discussions until they were satisfied that they had the information they needed about the relationship they sought to establish.

Relationship maintenance costs ought to be the same, since these don't much turn on what's in the contract. But perhaps the threat to initiate litigation based on a particular provision in the contract helps keep parties in line; more customized contracts might reduce relationship maintenance costs because a more specific threat to litigate could be more forcefully made. We think, though, that this reduction is lower than the reduction in specification costs from less customized contracts. We think, too, that in the U.S., the increment by which a

97. See, e. g., Jody S. Kraus & Steven D. Walt, *In Defense Of The Incorporation Strategy*, in THE JURISPRUDENTIAL FOUNDATIONS OF CORPORATE AND COMMERCIAL LAW (Jody S. Kraus & Steven D. Walt eds., 2000).

98. See *Language and Norms*, *supra* note 22, and accompanying text.

threat to litigate would motivate more conciliatory behavior wouldn't be much increased on account of a provision's being customized; it's the threat of litigation itself that probably has most of the in terrorem effect.

End game costs—a significant component of which is sometimes referred to in the literature as “interpretive error”<sup>99</sup>—should present the major difficulty: after all, what parties gain in not having specified more thoroughly in the first instance they should lose when asking a court to enforce their contract, since the court is apt to make more errors with a less customized contract. The very large savings in specification costs probably exceeds the cost of even fairly large interpretive errors, especially since the likelihood of litigation is fairly low (and in any event far less than one). But a more ambitious claim might be warranted: interpretive error costs themselves might be lower in Germany. Our arguments in this subsection are bolstered by our view that German judges' qualifications and experience make them better suited to contract litigation, but they still hold, albeit with less force, even if the judges are no better than U.S. judges.

Our argument is this: Parties to complex contracts in the U.S. can't readily get the benefits of their careful drafting should they go to court. They seek to capture every possible increment of precision; the resultant provisions will often be complex, hard to interpret, and, in spite of the parties' best efforts, susceptible of one or more strategic misinterpretations. Moreover, the more customized the provision, the less likely that it has been interpreted in a prior case; even if there has been a prior interpretation of a comparable provision, the provision may be sufficiently different that the interpretation can be argued not to apply. And the more complex and singular the provision, as customized provisions are apt to be, the more costly the litigation, all else equal.

German parties, by contrast, are more likely to be using standardized provisions. Thus, the provisions to be interpreted in a particular case may very well have been interpreted before, including in detailed commentaries. We cannot make too much of this point, however: if the provision's interpretation and application were completely clear, parties presumably would not be in litigation. But even customized provisions, such as the more transaction-specific provisions, will probably be easier to interpret than U.S. customized provisions, and

99. *Id.*

be less amenable to misinterpretation, whether strategic or benign, for all the reasons we have discussed, most notably that that customization in Germany stops sooner and doesn't cumulate from form to form, that a general statement suffices without a litany of examples, that standard definitions and concepts are available for adoption even in customized provisions, and that various features of the German language make for clearer referents.<sup>100</sup>

In sum, when German parties adopt "good enough" provisions, they are not specifying "exactly what they want." But agreement on a customized provision isn't that reliable a way to get "exactly what one wants" in court.<sup>101</sup> Especially given that litigation may never arise, but

100. Commercially expert German judges may also be better at determining words' ordinary meaning, as opposed to a (that is, any) meaning countenanced by the dictionary, the "plain" meaning. This distinction is discussed in Lawrence M. Solan, *Ordinary Meaning and Legal Interpretation*, forthcoming, conference proceedings of the Italian-American Congress of Comparative Law: Ordinary Language and Legal Language in Public and Private Law (Guiffre 2004).

101. Another point should be made. There is some indication that German courts may respect parties' choice of interpretive convention more than do U.S. courts. The contract literature distinguishes between textual or formalist conventions of interpretation, and "contextual" conventions of interpretation on the other. Textual or formalist conventions look more at the words of the contract, and in particular, the "plain meaning" of the words. Contextual conventions look at parol and other extrinsic evidence, notably course of performance of the contract at issue, course of dealing of these parties in other contracts with one another, and usage of trade and custom. There is an extensive literature debating which mode is preferable. See generally Avery Wiener Katz, *The Economics of Form and Substance in Contract Interpretation*, 104 COLUM. L. REV. 496 (2004); Paul G. Mahoney, *Goetz & Scott: The Collaboration That Transformed Contract Law*, 6 VA. J. 12 (2003); Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions between Express and Implied Contract Terms*, 73 CAL. L. REV. 261 (1985); Schwartz & Scott, *supra* note 6; Bernstein, *Creating Cooperation*, *supra* note 29. The literature considers whether parties would want formalistic or contextual modes of interpretation, whether one or the other should be the default mode of interpretation in all or particular cases, whether purely formalistic interpretation is possible or whether all interpretation is at base somewhat contextual, and so on. (Hill takes no position on this debate, except to agree that "pure" formalism is surely a fiction; King is persuaded by Katz's argument that for some types of contracts, such as contracts between parties who "engage in many similar transactions or do business together regularly," the default rule ought to be textual interpretation, but that in various other types of contracts, the default rule ought to be contextual interpretation. See Katz, *supra*, at 528.)

Even if German courts don't respect parties' choice more, there's no indication that they would respect it less. And there's certainly no reason to suppose German judges would apply an interpretive convention in a more error-ridden manner than would a U.S. judge; in fact, we might conclude the contrary if we believe German judges are smart and commercially savvy.

Even if German parties' specification were respected less, the results might nevertheless be more certain and predictable than results in U.S. litigation. There are two possibilities. Either the specification is of a contextual convention and a textual convention is applied, or the specification is of a textual convention and a contextual convention is applied. Since the results of the textual convention are predictable in most cases, such a result should be within the contemplation of the parties even if it is not their desired result. If the parties want a textual convention and instead get a contextual convention, even then the results might be superior to those in the U.S. Because there is more homogeneity among transacting sub-communities (that



contract drafting and negotiation are certain, customizing a provision when a “good enough” cheaply available alternative exists may not be cost-effective.

### 5. Standardization in the U.S.?

If standardized solutions are so advantageous, why can't they be achieved in the United States? One reason is presumably that in Germany almost all civil law is federal,<sup>102</sup> whereas the United States has fifty state statutes as well as the common law. As is well known, even “uniform” laws aren't always enacted or interpreted uniformly. But why can't the solutions be achieved privately? Certainly, private standardized solutions are achieved in Germany with trade association forms. But there may be less activity to this end in the United States; U.S. trade associations' efforts to standardize contracts might be suspect under the antitrust laws.<sup>103</sup>

Germany's comparatively more homogeneous and repeat transactional community (and different antitrust laws) may not only permit the development of more trade associations, but may also maximize the number of provisions as to which standardization is advantageous; comparatively stronger extra-legal forces can allow for the development and enforcement of relational norms that effectively modify the standardized provisions in day-to-day business activity. There is also a strong path-dependence story: once lawyers compete by touting their forms, they will be hard pressed to support much standardization. Indeed, U.S. law firms compete by touting the comprehensiveness of their forms, as well as the contract that is drafted and negotiated on the basis on those forms: the forms “cover everything” and the firms' lawyers think of, and argue for, “everything” as

is, “trades”) in which transactions typically occur, custom and usage of trade, key components of the contextual inquiry, should be more readily and more certainly determined. (Of course, should the German transacting community become more heterogeneous, custom and usage of trade should become harder to determine.) German parties should thus be able to narrow the universe of possible outcomes appreciably, and should be able to exclude many particularly problematic possibilities.

102. Although the German Basic Law in Art. 74 Abs. 1 Nr. 1 GG permits the Länder to legislate in the area of civil law to the extent not preempted by federal legislation, the area of the law of contracts and commercial law has been all but completely preempted by federal legislation. In fact, the only legislation of the Länder that bears on this Article would be the implementing legislation of the individual Länder setting up panels for commercial disputes, since the lower courts are courts of the Länder.

103. See, e.g., *Dillard v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 961 F.2d 1148, 1157–59 (5th Cir. 1992) (agreement of forms for arbitration in the securities industry was thought to be a conspiracy in violation of Section 1 of the Sherman Act).

well. By contrast, competition among law firms in Germany has apparently been far less form-driven. German lawyers not infrequently publish their forms; competing on the basis of having the better form is difficult when others can readily use the form.<sup>104</sup>

And certainly, a lawyer or law firm is hard pressed (and ill advised) to tout his firm's willingness to "lay down its arms" when others are not doing so as well. Collective action problems also might prevent clients from getting together to try to force standardization. And it's not obvious who standardization's other effective and motivated proponents would be. For all these reasons, standardized solutions may have been easier or more worthwhile to develop in Germany than in the United States.<sup>105</sup> We think U.S. contracting parties would benefit from more of such solutions but we think that the various dynamics we have outlined may make it unlikely that many will be developed.<sup>106</sup>

#### D. *The Literature*

We are not the first to consider why German contracts are shorter than U.S. contracts. Other scholars have proposed various answers, including the following: Georges Van Hecke, a German lawyer, points to the "perfectionism" of U.S. lawyers, the fact that a contract may be litigated in, and under the laws of, several different states, as well as the relative uncertainty of the common law.<sup>107</sup> John H. Langbein, an American law professor, points to what he views as the superior system of civil procedure in Germany, with smarter and

104. Claims have been successfully made in England for copyright violations for using clauses from a law firm's forms. See Victoria MacCallum, *Legal Documents Bound By Rules of Copyright*, L. GAZETTE (London), May 12, 2002, available at <http://www.lawgazette.co.uk/>. Such claims are unknown in Germany. Interestingly, as discussed in *supra*, note 91, English in-house lawyers are trying to persuade English law firms to post precedents (that is, forms) on the in-house lawyers' website.

105. It will be interesting to see the results of the European Community initiative discussed in *supra*, note 3, to develop standardized contract provisions.

106. Indeed, it would be interesting to see what effect the existence of U.C.C. Article 2 has on the length of contracts. Interesting—but perhaps impossible in principle to measure. One might think that for lawyers who do commercial law generally and don't specialize in U.C.C. Article 2 contracts, their general habits and familiarities would trump the effect we're describing. In any event, they might very well be facing a lawyer who didn't "stop sooner," making it unlikely that they would. A good test could be the contract drafted and negotiated by two lawyers who both focused their practices on U.C.C. Article 2. Contracts among trade association members would be of interest as well, but less so than might initially appear if the trade at issue is a simple commodity, and all the possible problems and solutions involving transactions in the commodity are known.

107. Van Hecke, *supra* note 18, at 10–12.

more expert judges having control of fact-finding and having considerable ability to limit strategic behavior by the parties.<sup>108</sup> Graf von Westphalen, a name partner in a large and prominent German law firm and the author of a leading treatise in contract law, points to the fact that under German law, obligations of good faith are stronger, hence limiting parties' need to specify and constrain particular behavior that a general obligation to act in good faith encompasses. Graf von Westphalen also notes that German law contains many more general terms that the parties can easily adopt with a few words.<sup>109</sup> Thomas Lundmark, an American-born German law professor, points to a general U.S. distrust of judges and the legal system coupled with a strong devotion to the idea of freedom of contract.<sup>110</sup> He also notes that the U.S. law restricting contractual "penalties" may contribute to longer U.S. contracts, as parties struggle to couch their remedies in a manner that won't be deemed a penalty.<sup>111</sup> Lundmark believes, too, that because of growing distrust of the legal system in Germany, it is more likely that German contracts will come to resemble U.S. contracts than that U.S. contracts could come to resemble German contracts.<sup>112</sup> We deal with each of these points below.

As we have explained, we agree that the relative clarity of the substantive law, the availability of easy-to-adopt general terms, and the relative superiority of German civil procedure for this type of litigation play an important role. In particular, we partly agree with the spirit of Langbein's views: the "German advantage" in civil procedure means that parties don't need to worry as much about strategic misinterpretations of contracts being advanced, and therefore, don't need to spend time and effort thinking through all possible interpretations and clarifying which one is intended. But we think that the United States' comparatively messier judicial system is neither necessary nor sufficient to explain its longer contracts. One of us has argued that U.S. contracts are rationally and deliberately *not* written in a manner that lends itself to easy interpretation and enforcement by a judge. For various reasons, including path-dependence, the contracts are quite complex, and nobody has the incentive to "clean them up;"<sup>113</sup> this fact is used by the parties as a bond that they will

108. Langbein, *The German Advantage*, *supra* note 35.

109. Von Westphalen, *supra* note 14.

110. Lundmark, *supra* note 11, at 130–31.

111. *Id.* at 123–24.

112. *Id.* at 131.

113. Hill, *Legalese*, *supra* note 7, at 69, 75–81.

attempt to resolve disputes through extra-legal means such as negotiation rather than going readily to court. Distrust of the legal system thus may influence the length of contracts, but perhaps not quite in as direct or important a way as Lundmark may be thinking it does. Moreover, a contract's ability to bind the parties thereto under law is only a small part of its function.

We are a bit skeptical about the importance of fifty different states' laws,<sup>114</sup> and the need to rebut particular common law doctrines. In our experience, many of the types of provisions that are longest in U.S. contracts are the ones as to which the law will typically honor what the parties agree upon, and there is no applicable common-law precedent. We agree that being able to simply set forth a contractual penalty and not worry much that it be deemed unenforceable might make for shorter contracts, but again, in our experience, these types of provisions aren't where the real heft of contracts is to be found. We find plausible the idea that less needs to be specified in German contracts because of the residual obligations of good faith and related provisions in the statute, but for reasons discussed above, we don't necessarily feel that these fewer words help German contracts do as much as U.S. contracts, since we feel that German parties may to some extent be holding themselves and each other to a higher standard of conduct than they would agree to if left to contract freely, and may be subjecting themselves to inefficient uncertainty.

We are sympathetic to the idea that U.S. parties may resist more law in the form of mandatory and even default provisions because of a greater attachment to the idea of freedom of contract; that being said, we note that U.S. parties could achieve some more standardization through private solutions such as trade associations and generally do not.<sup>115</sup> In any event, once law firm competition on forms is underway, having more law probably won't help unless it is mandatory. In this regard, consider that German cross-border transactions, including

114. Interestingly, a closely analogous argument is made by practitioners in Europe doing cross-border transactions: that the parties need customized contracts that virtually "stand alone" from statutory law of any particular jurisdiction, so the parties understand equally well what their contract says. We think it's plausible (indeed, King thinks it is likely) that lawyers might advance this argument more strongly than the reality warrants. A lawyer might do so sincerely, or might do so opportunistically, seeking to carve out a larger and more lucrative role for her services. It is interesting in this regard that, as discussed in *supra*, note 3, the European community is studying the development of standardized terms for contracts among Europeans.

115. We don't want to overstate the case here. There are some standardized forms in the United States; one notable example is the form used by the International Swap Dealers' Association. *See id.* at 59 n.2. Furthermore, as we discuss in *supra*, note 96 and accompanying text, U.S. antitrust concerns may discourage the formation of trade associations in the United States.

those governed by German law, are increasingly using the Anglo-American model and not accepting, or at least modifying significantly, the default provisions found in law as the “arms race” begins.<sup>116</sup>

Finally, we are sympathetic to the characterization of U.S. lawyers as “perfectionists” insofar as they strive for ever-increasing increments of precision; we have, of course, argued throughout this Article that this “practice” does not make “perfect.”

In sum, in our view, some of the explanations in the literature are partially right, some are partially wrong, and none is wholly right. In particular, the explanations give both too much and too little of a role to law, don’t give enough of a role to reputation and norms, and don’t give the right sort of role to lawyers.

### CONCLUSION

In this Article, we have explained how German contracts can do as much as U.S. contracts with fewer words. In Germany, legal and extra-legal forces combine to make the costs of “stopping sooner” in the contracting process lower than they are in the United States. Parties in both countries will contract until the costs exceed the benefits; that point has come sooner in Germany than it has in the United States, for reasons we explain.

But we are then left to explain a notable trend: starting in cross-border transactions, and increasingly, in purely domestic transactions within Germany, Anglo-American style contracting, with its additional words is becoming more common.

We have two explanations. One is more charitable to the Anglo-American style of contracting: that the manner in which German contracting constrains opportunism requires considerable homogeneity and extensive repeat interactions among transacting partners; without such homogeneity and repeat interactions, recourse to courts will become more important, because it is harder to agree upon, police, and enforce norms in a more heterogeneous community. With looser reputational ties, accepting standardized provisions may become less advisable since a scheme in which the standardized provisions are mostly “for the court” and the parties develop their own more flexible norms to govern their relationship when they are get-

116. *But see supra*, notes 3 and 98, regarding the European Community initiative to create standardized contract terms.

ting along, as has been described in the literature by Lisa Bernstein,<sup>117</sup> will be harder to develop and enforce. Moreover, the protracted negotiations involved in elaborate customization may be more useful for parties coming to know each other for the first time who do not expect to become part of a very repeat reputational community: consider, for example, the situation of a private equity fund making acquisitions in various industries in different countries.

But we also propose a different and less charitable explanation. Once enough people who do not subscribe to the stopping sooner norm enter the community, the norm becomes quite hard to sustain. The norm only makes sense if both sides will abide by it; if the other side is going to argue for a customized provision, the savings to “just saying no” are likely to be limited, and a lawyer will rationally try to make the best of the situation and argue for her client’s desired customized provision. Perhaps U.S. style form-oriented competition among German law firms is next.

In sum, differences in German law and civil procedure may not suffice to keep the stopping sooner norm intact. While some dilution was probably inevitable as markets became more globalized, some of the dilution may be attributable to a trajectory in which expensive increments of precision must be purchased to keep up with an arms race.

117. Bernstein, *Creating Cooperation*, *supra* note 29.