Steps of Contract Enforcement: The Lawyer’s Guide for the Applied Economist

Miriam Frey¹, Stela Ivanova²

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Abstract

The recent empirical literature on international trade has highlighted the importance of the quality of institutions as trade flows and trade patterns react to legal settings. Economists usually refer to these institutions as the rule of law. This concept encompasses various aspects of legal institutions such as property rights, corruption and contract enforcement. At the same time, the rule of law is often only covered by a single indicator in empirical economic studies. We argue that it is worth to have a closer look especially at the different steps of contract enforcement (1. constitution of rights and obligations in the phase of contract drafting 2. ways to a judgment 3. enforcement of a judgment) when studying international trade issues as transnational contracts on the delivery of goods and services require an interaction between the legal systems of different countries. Therefore, the aim of this paper is to critically assess the role of the enforceability of transnational contracts in empirical trade analyses.

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¹ Responsible author; Institute for East and Southeast European Studies; Landshuter Str. 4, 93047 Regensburg, Germany; email: frey@ios-regensburg.de; phone: 0049 941 943 5435; fax: 0049 941 943 5427

² Institute for East European Law; email: ivanova@ostrecht.de
1. Motivation

The recent empirical literature on international trade has highlighted the importance of the quality of institutions as trade flows and trade patterns react to legal settings. Economists usually refer to these institutions as the rule of law. This concept encompasses various aspects of legal institutions such as property rights, corruption and contract enforcement. At the same time, the rule of law is often only covered by a single indicator in empirical economic studies. This allows the researcher to get a good sense of the overall legal situation in a country but also implies that more details on the different aspects of the rule of law are lacking. We argue that it is worth to have a closer look especially at the different steps of contract enforcement when studying international trade issues as transnational contracts on the delivery of goods and services require an interaction between the legal systems of different countries. Therefore, the aim of this paper is to critically assess the existing rule of law indicators in terms of their ability to cover transnational commercial disputes and to study the role of the enforceability of transnational contracts in empirical trade analyses.

In general, three steps of contract enforcement can be distinguished:

1) constitution of rights and obligations in the phase of contract drafting

2) ways to a judgment

3) enforcement of a judgment

Looking at these steps allows us to analyze contract enforcement in a given country. However, if we would like to get to know more about the role of contract enforcement in international trade we would also have to include a comparative aspect as the contracting parties might be based in different countries. In this case, it would also be important to consider the enforceability of a foreign judgment. Accordingly, in the first step, we are critically assessing the rule of law indicators most commonly used in empirical trade analyses. The empirical importance of the enforceability of a foreign judgment, is studied in the second step by applying a gravity approach.
The paper is organized as follows. The subsequent section presents some information on the juridical background of the paper, which will be followed by a discussion of the rule of indicators used in empirical trade analyses. An empirical assessment of the importance of the enforceability of a foreign judgment is provided in section four. The results are discussed in section five and the final section concludes.

2. Juridical Background

Authors from the common-law tradition have had the chance to criticize the approach we are about to describe as “pointless” and “Eurocentric”\(^3\). However, it is quite obvious that despite strong ongoing trends of unification the world of men still consist of different communities. These have predominantly organized themselves in nations as carriers of states and have given themselves obliging rules on social behaviour characterized by own interdependencies, institutions and understandings on such issues as the essence of law, its sources of legitimacy and its ways of functioning. Being internally consistent, such systems of legal rules and notions have been called (national) legal systems.

**Legal Families**

It should be one axiomatic truth that (national) legal systems differ from each other. No less axiomatic should be the assumption that such differences are, in return, not similar in their intensity. Consequently, some (national) legal systems actually share their approach to fundamental problems of law while others choose deviating ways to deal with them. Modern comparative legal science has repeatedly committed itself to the idea of identifying those legal challenges which deserve to be raised to fundamentality from a systematical point of view. In particular, it has declared for fundamental the culturally specific concepts on what legitimates the law, which sources of legal norms prevail and to what extent legal concept are translatable to other cultures. Once ready with that task, comparative legal science has proceeded to typecast the

variety of solutions known to be accordingly provided by separate (national) legal systems. Thus identified, clusters of similar (national) legal systems have been called legal families.

It is our idea to focus the current discussion on the legal systems of those Central and Eastern European countries which started their reform process a quarter of a century ago. Using the approach of David/Grasmann it will not be difficult to assign these national legal systems to a legal family:

In answering the question on their leading idea in an ethically-philosophical aspect CEE national legal systems take up, as a first step, a worldly socio-economic approach legitimating the deeds of man through his will. In doing this, they are clearly distinct from national legal systems which look up to tradition or to theology as a primary source of their legitimacy. This is how we know that the national legal systems of the CEE reform states do not count to the widely heterogynous family of custom-based and religious legal systems. As a second step, CEE national legal systems have, in the course of the last twenty-five years, dedicated themselves to the essential principles of individual and economic freedom developed by Western capitalistic cultures. Thus, they have largely negated the collectivistic approach characteristic for the Soviet world to which once these countries belonged. This is how we know that the national legal systems of CEE reform states no longer belong to the meanwhile largely discontinued Soviet legal family.

When dealing with the issue what the predominant source of law should be CEE national legal systems are united in their idea that this is the normative act in its essence of a written catalogue of binding texts authored by a democratically chosen legislative body or, upon its explicit authorization, by some organ of the executive. In devoting themselves to the notion of the normative act CEE national legal systems distinctly differ from solutions under which the law is an already existing reality to be discovered, explored and described on a case-to-case basis by precedent-setting court practice. Through this difference we know that the national legal systems of reform CEE states do not belong to the legal family of Common Law to which economically, politically and culturally most influential nations such as the USA and England count.

\footnote{DAVID/GRASSMANN, Einführung in die großen Rechtssysteme der Gegenwart, C.H.Beck, 2. Auflage, München 1988.}
Finally, when it comes to the question how transferrable the way of legal reasoning beyond national boundaries is, we will find out that legal concepts and terminology domiciled in a CEE national legal system are most easily explainable to legal experts from another legal tradition located on the European continent. Depending on the historical background of a chosen reform CEE state its national law will indicate a preference either to the German or to the French (these are recognized sub-types), or to another tradition such as the Austrian, Italian or Scandinavian law. This is how we know that the national legal systems of reform CEE states have returned to the legal family known as Continental law which they largely had taken over through reception before the rise of communism.

Steps of Contract Enforcement

Once we picture a national legal system as a separate entity we should ask ourselves if and how it intersects with other national legal systems. The question is particularly interesting when economic achievement in a progressively globalized world must rely on a national system of law to ascertain performance under given contractual duties by state force. This, we should ask ourselves whether and to what extent two entrepreneurs based in two different countries from possibly different legal families can obtain adequate legal support when it comes to enforcing their rights out of a transnational contract on delivery of goods and/or services.

Here, from a legal point of view we have to identify and clarify a sequence of four steps. All four steps have their peculiarities depending on the legal family to which a given national legal system counts.

In the first place, the constitution of rights and obligation in the phase of contract-drafting is of interest. Here, it will generally be of great importance whether the contract in preparation is subjected to a national law from the Common law or from the Continental law family. As a rule,

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5 Here, the basics of substantial law will be given by the United Nations Convention on Contracts for the International Sale of Goods (CISG) and will be known to the entrepreneur in advance. However, although the Haague Conference on Private International Law has numerous, some quite successful, unification initiatives in form of international treaties, procedural law, that is the set of rules under which the substantial law will be applied by a judicial body, still stays within the realm of national state justice. In the ideal case the debtor’s national legal system will be completely unknown to the creditor but the latter will nevertheless have to submit his case for decision by it.
contracts under Common law will try to eliminate any element of incompleteness and/or unpredictability that may result from the idea of precedent and, thus, tend to be very specific. Providing for numerous definitions of vocabulary, they will strive to establish with utmost preciseness undisputable definitions on those rights and obligations on which the parties agree; providing for contractual solutions to numerous life situations they will attempt at covering any thinkable event that might develop the potential to disrupt proper performance. Contracts under Continental law would usually take a more relaxed standing. Largely in reliance on systemized national codifications of material law, such contracts will usually concentrate on those terms and conditions the parties would like to govern in deviation from the terms and conditions the respective national normative act provides for in default of a differing contractual ruling. Thus, the notion of “imperfect” contracts meaning such contracts that do not provide contractual solutions to disruptive events is rather strange for legal specialists from the Continental legal family.

In the second place, the ways to a judgment are of relevance although less relevant. Here, a national legal system must supply effective court institutions and adequate civil procedure regulations governing the access to and the rules of the game in front of a judge up to the moment where a dispute between two entrepreneurs with regard to the constraint to perform a contractual duty is resolved by means of a final judicial act about to be enforced. Here, the influence of differences attributable to Common and Continental law is perceptible, stronger judges generally attributed to Common law while Continental law is said to host less distinctive judge formats. However, we should keep in mind that different rules of procedural law can, as theoretical principle, serve the same system of material-law regulations. Besides, for the quality of institutions and the reliability of their functioning elements of surrounding culture such as corruption climate and/or legal qualification may prove to have greater importance than the legal family. Thus, India and Bulgaria could be expected to face similar problems in ascertaining the production of proper judgments irrespectively of their affiliation to two different legal families.

In the third place, the ways to enforce a judgment are of interest. While this is not a must, here continental law would generally take a more conservative approach, its execution officers being
predominantly public servants and its procedural rules taking care not to pauperize the debtor in such a way that he/she would rely on state welfare or be unable to meet his/her financial duties towards the public hand.

On an additional, inter-stage level (between steps two and three), the enforceability of a foreign judgment is of importance. Under enforceability, we understand the possibility to use a judgment issued by the judge of one state on the territory of another state in such a way that it would be recognized there as an act of authority ending a certain legal dispute and would be enforced. Such usage of foreign judgments is by far not a matter of course. In the contrary, in an increasingly globalizing world the enforceability of foreign judgments has remained a domain of mostly bilateral, confusing set of interstate arrangements which reflects mutual justice quality assessments but also the political ambitions of nations. Thus, a merchant nowadays will not be able to offhandedly shop his forum there where this would possible from a legal and most appropriate from a purely economic perspective. In order to make sure that the future judgment will be enforced at all a creditor might just as well face the necessity to sue the debtor at the latter’s home although the debtor’s national justice system might be inconvenient, expensive, inefficient and/or corrupt.

3. Discussion of Rule of Law Indicators

As the aim of this paper is to study the role of contract enforcement in empirical trade analyses, we should first assess the relevant existing rule of law indicators with respect to their ability to cover this aspect. Our selection of indicators is based on two factors. First, we have collected the rule of law indicators most commonly used in empirical studies on international trade. Second, we have chosen those for our analysis which explicitly account for contract enforcement. These indicators are analyzed with regard to the following questions: Do they cover different steps of contract enforcement? Do they allow for the execution of foreign judgments?

*Doing Business Indicator*. The authors of his indicator limit their research on measuring the resources (time is weighed by 33,3% and cost is also weighed by 33,3%) necessary for having a

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6 http://www.doingbusiness.org/methodology/enforcing-contracts
commercial dispute resolved by a first-instance local court. Given most legal systems in our world offer a civil procedure comprising of two or three instances, it becomes clear that the doing business indicator enlightens only one partial aspect of step 2 (“ways to a judgment”). In 2016, the authors of the doing business indicator widened the scope of their measurements by introducing the quality of judicial processes index, also weighed by 33.3% and addressing matters of court organization including automation and case management which, too, must be attributed to step 2. Step 1 does not appear and step 3 is underrepresented in both methodology and questionnaire. No attention is attributed to the possibility and procedure to have a foreign judgment enacted and executed by the local legal system.

_Economic Freedom Index_\(^7\) measures four components, namely: Rule of Law (property rights, freedom from corruption); Limited Government (fiscal freedom, government spending); Regulatory Efficiency (business freedom, labor freedom, monetary freedom); and Open Markets (trade freedom, investment freedom, financial freedom). As part of the rule-of-law component, subcomponent “Property Rights” the access to efficient justice is assessed. On a scale from 100 (best score) to 0 (worst score), the authors submit subjective assessments on countries by their ability to maintain courts which enforce contracts efficiently and quickly. No difference between steps 1, 2 or 3 is made. As it seems, no separate research is done on the possibility and procedure to have a foreign judgment enacted and executed by the local legal system.

_Economic Freedom of the World_\(^8\). The authors of this index take into consideration seven components of which component V (“Legal structure and security of private ownership”) is relevant for our subject. There are three factors here\(^9\): (A) Legal Security of Private Ownership Rights indicating the risk of confiscation (weight .345); (B) Viability of Contracts indicating the risk of contract repudiation by the government (weight .339) and (C) Rule of Law: Legal Institutions, Including Access to a Nondiscriminatory Judiciary (weight .317). At that, the rule-of-law variable "reflects the degree to which the citizens of a country are willing to accept the

\(^7\) [http://www.heritage.org/index/book/methodology](http://www.heritage.org/index/book/methodology)

\(^8\) [http://oldfraser.lexi.net/publications/books/econ_free_2000/section_06.html](http://oldfraser.lexi.net/publications/books/econ_free_2000/section_06.html)

\(^9\) [http://oldfraser.lexi.net/publications/books/econ_free98/area5.html](http://oldfraser.lexi.net/publications/books/econ_free98/area5.html)
established institutions to make and implement laws and adjudicate disputes." As it seems, no difference between steps 1, 2 or 3 is made. Also, no separate research is conducted on the possibility and procedure to have a foreign judgment enacted and executed by the local legal system.

*Institutional Profiles Database*\(^{10}\). This index is divided in nine functions of which number 6 ("Security of transactions and contracts") deals with the level of security for property rights and contracts as well as the treatment of commercial disputes. The questionnaire\(^{11}\) which has been in effect since 2012 indicates a low-level differentiation between steps 1 (variable 126 dealing with the degree of observance of contractual terms between private stake-holders) and 2 (variable 128 dealing with timelines of judicial judgments in commercial matters). Also, there is a low-level differentiation between cases of purely domestical character and cases between national and foreign stakeholders (see variables 127 and 131). Nevertheless, step 3 is underrepresented and no separate research is done on the possibility and procedure to have a foreign judgment enacted and executed by the local legal system.

As the above assessment shows, none of the analyzed indicators covers all steps of enforcing a transnational contract.

### 4. Empirical Analysis

In order to study the importance of the enforceability of a foreign judment, we analyze trade between Germany and its trading partners using a gravity approach. The most important variable of interest is the “mutual recognition of court judgments”. This dummy variable is derived from the publications of Baumbach et al.\(^{12}\) and is equal to 1 if there is a bilateral enforceability of a judgement issued by a German judge on the territory of the trading partner and vice versa.

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\(^{10}\) [http://www.cepii.fr/institutions/EN/ipd.asp](http://www.cepii.fr/institutions/EN/ipd.asp)

\(^{11}\) [http://www.cepii.fr/institutions/EN/download.asp](http://www.cepii.fr/institutions/EN/download.asp)

\(^{12}\) BAUMBACH/LAUTERBACH/ALBERS/HARTMANN, Kommentar zur Zivilprozessordnung: ZPO, C.H.Beck, München
Figure 1: Number of Germany’s trading partner countries per year with a “mutual recognition of court judgments“

Figure 1 shows the number of countries for different years, for which there is a “mutual recognition of court judgments“ with Germany in place. As one can see, the number of countries increased over time. This is not only due to bilateral agreements, but also due to multilateral actions like for example the accession of the Central and Eastern European countries to the EU in 2004 as according to EU regulation a judgment issued in one of the member states has to be enforced in all other EU countries.

5. Discussion

6. Conclusion