Regulatory Functions of Contract Law: The Scopes of Good Faith

Contract law has been mainly seen as an instrument to design markets and to govern transactional planning. According to this perspective while property rights and contracts are instrumental to market creation, government and administrative law should be used to address market failures. However, this paper moves from the assumption that contract law may be viewed as a regulatory instrument (Collins, 1999, Collins, 2004). Regulatory function of contract law means the ability of contract law to address market failures. We argue that traditional Law and Economics understanding of contract law as a primarily facilitative device (Cooter and Ulen, 2004, Shavell, 2004, Hermelin et al., forthcoming) is insufficient because it does not take into account the development of new regulatory techniques using market based mechanisms to correct market failures. We also argue that this is not only a recent development but the use of contract law as an instrument through which regulatory objectives are implemented has solid historical roots. Accordingly, in this paper we show – using an example of good faith – that, as a descriptive matter, contract law does not perform only facilitative functions but also contributes to market regulation. As a normative claim, in turn, we advocate an expansion of the use of contract law as a regulatory instrument as a complement of public regulation.

In this paper we adopt a functional notion of regulation. Traditionally, the term “regulation” has been used by economic and legal scholars to denote a distinctive set of techniques employed by states to control the operations of markets. Within this narrow perspective regulation and private law are viewed as competing regimes; while the former has directive function, is public in its nature, centralized in character, and operates ex ante, the latter is facilitative, private, decentralized, and works ex post (Ogus, 1994). However, such a distinction is not satisfactory because does not take into account the incentive effects created by contracts. Thus, it is more helpful to employ a generic concept of regulation that refers to any system of rules intended to govern the behavior of its subjects, which consists of three essential functions: (1) standard-setting, (2) monitoring, and (3) enforcement (Collins, 1999).
It follows that within this functional definition private law can also be thought of as a regulatory regime.

The important role of good faith in contract law is widely acknowledged both in legal and economic scholarship (Collins, 1994, Brownsword et al., 1999, Zimmermann and Whittaker, 2000, Beatson and Friedmann, 2002, D'Angelo et al., 2005, Burton, 1980, Gillette, 1981, Mackaay and Leblanc, 2003, Schäfer and Ott, 2004, Sepe, 2006). It is generally associated to distributive justice and the need to introduce social values into the market order. We provide a complementary explanation by addressing efficiency-driven reasons to use good faith.

Legislatures and courts have been imposing an obligation of good faith performance and enforcement of contracts in various settings. In general, it is possible to distinguish three functions of good faith: (1) expansion and establishment of contractual duties; (2) limitation of contractual rights; (3) transformation of contract (Teubner, 1998, Schlechtriem, 2006). Traditional private law scholarship contends that good faith is a general corrective principle through which a legal system may establish what it considers to be the appropriate balance of interests between the parties (Zimmermann and Whittaker, 2000). In this paper we reinterpret traditional legal literature on good faith from the regulatory perspective.

The point of departure of this paper is that good faith is not confined only to the “internal” relationship between the parties to a contract. Good faith as a regulatory measure goes beyond the safeguard of a fair and just transaction among the individuals; the regulatory use of good faith can affect third parties. We want to prove that in both cases good faith performs regulatory functions but in different ways given also the principle of freedom of contract. The testing of this hypothesis requires us to evaluate (1) whether good faith indeed opens up the self-referential and closed contract law reasoning in order to internalize the externalities a particular agreement creates; and (2) what regulatory objectives can be implemented through good faith to a given contractual arrangement.

The analysis considers two sets of relationships: (1) between the contracting parties, and (2) contracting parties vis-à-vis third parties. In the first case, we focus on asymmetry of information; in the second case, we focus on externalities. Within this framework the analysis is carried out both in B2B and B2C setting. However, since the regulatory function of contract law operates differently in these two settings, we adjust the analytical framework accordingly.

The main focus of the analysis is on externalities. The parties to a contract usually do not care whether third parties are affected: their only interest is in maximizing their private gains from the exchange. However, most contracts may adversely affect at least some third
parties (Aghion and Bolton, 1987, Trebilcock, 1993). Externalities therefore must be taken into account in any analysis of contracting. We show that courts that have refused to enforce particular contracts or contractual provisions have focused on the potential harm to third parties. The question which we are asking is whether the good faith principle may be rationalized as an instrument of addressing externalities which a given contractual relationship may create.

We carry out the analysis along the distinction between intentional and negligent harmful contracts towards third parties. In both cases contract law instruments have been used to address the harm to third parties. Traditionally, the good faith has been applied only in the latter setting, i.e. triggering liability for negligent behavior. Intentional harm cases, in turn, have been dealt with by other legal doctrines, such as misrepresentation (fraud) in the domain of information regulation (Craswell, 2006).

We provide historical account of the role of good faith as a regulatory device in pre-regulatory state regimes and shortly examine how the evolution of the regulatory state has changed the regulatory function of good faith. This historical analysis will enable us to address the institutional question concerning the desirability of contract law designed as a complement or alternative to public regulation. In doing this we address the institutional implications of using good faith with a particular focus on the role of judges and that of regulators.

Accordingly, we ask how good faith copes with weaknesses of the regulatory capabilities of contract law. Particular attention is given to standard-setting problems: (1) incorporation of externalities; (2) lack of specificity of standards; and (3) lack of expertise of judges in choosing between standards. The assumption is that standards should be differentiated with respect to the regulated activity (Collins, 1999). Bearing in mind complementarity hypothesis, the focal point of concern is what kind of strategy should be adopted to integrate public and private regulatory techniques. Regulation is based on deterrence, whereas contract law on compensation. Accordingly, two important questions arise: (1) Is there divergence or convergence of compensation and deterrence? (2) Can good faith be an instrument of deterrence?

The examples on which the analysis is built are drawn from the following five legal systems: Germany, France, Italy, UK, and Poland. The Polish case study is particularly relevant for the comparison of the use of good faith in post-communist countries with an objective to answer the question whether transformation to market economy have expanded or reduced the role of general clauses in contract law.
This paper has two implications. First, the regulatory use of contract law affects the relationship between private law and public regulation. As a consequence, contract law should not be viewed as an alternative but as a complement to public regulation. Second, recognition of the regulatory functions of good faith should be incorporated into the design of principles of European contract law (Common Frame of Reference). Particular attention should be given also to the role good faith in regulated sectors, such as telecommunications (Directive 2002/19/EC – Access Directive) and investment services (Directive 2006/73/EC implementing the MiFID Directive).
Bibliography:


