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

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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 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 Introduction

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 (e.g. Levchenko (2007), Nunn (2007), Chor (2010)). Economists usually refer to these institutions as the rule of law. This concept encompasses various aspects of legal institutions such as the protection of property rights, the extent of 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 the different aspects of contract enforcement 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, which might exhibit different legal institutions. The latter is widely acknowledged by economists. Thus they do not only use rule of law indicators to capture differences concerning the design and the quality of nationl legal institutions (e.g. Levchenko (2007), Nunn (2007)), but they are also interested in the role of legal families (e.g. Islam and Reshef (2006), La Porta et al. (2008)). The main differentiation in this regard is made between countries from the common law and the civil law tradition. While the aim of these approaches is to measure the quality of the rule of law in a single country, there are also papers, which are accounting for the institutional distance between two countries (e.g. De Groot et al. (2004), Kuncic (2012)).

In case of a commercial dispute between trading partners from different countries, several options for dispute resolution are available. The most prominent one might be arbitration. This means that a dispute

can be settled outside national courts. Empirical trade economists account for this by using data on the New York Arbitration Convention on the Recognition and Enforcement of Foreign Arbitral Awards from June 10, 1958[1] (e.g. Berkowitz et al. (2006), Leeson (2008)). Countries which have signed this multinational treaty do not only recognize arbitration awards, but also declare to enforce them. However, if arbitration is not chosen by the contracting parties, the national legal systems would have to interact, especially with regard to the question whether or not a foreign judgment is recognized and enforced. This is the core of our argument. Thus, our paper contributes to the existing empirical literature on trade and institutions by highlighting an additional aspect of legal institutions, namely the recognition of foreign court judgements, which has so far been neglected.

One might argue that our point is of minor importance because the majority of international commercial contracts includes an arbitration clause. However, as one of the arguments in favor of arbitration in contrast to court litigation is confidentiality, specific data regarding international arbitration is lacking[2]. If arbitration would be the only relevant option for dispute resolution, we would not expect to find any effect of our mutual recognition variable on trade. Accordingly, our paper also contributes to the discussion about the importance of arbitration for international trade.

The paper is organized as follows. The subsequent section presents some information on the juridical background of the paper by looking at the different steps of contract enforcement and their characteristics in more detail. This 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 final section concludes.

2 Steps of Contract Enforcement

Once we think of a national legal system as a separate entity we should analyze if and how it intersects with other national legal systems in context of a globalized world. Thus, we should ask ourselves whether and to what extent two entrepreneurs based in two different countries from potentially different legal families can obtain adequate legal support when it comes to enforcing their rights out of a transnational contract on the delivery of goods[3] and/or services.

[1] In the following this treaty will be abbreviated by NYC.

[2] Even if there are no consistent statistics available, there are, however, estimates about the importance of arbitration. Casella (1996), for example, states that more than 80% of private international contracts include an arbitration clause.

[3] 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 Hague Conference on Private

From a legal point of view we have to identify and clarify a sequence of three plus one steps. All steps have their peculiarities depending on the legal family to which a given national legal system belongs to.

In the *first step*, the constitution of rights and obligations in the phase of contract-drafting is of interest. Here, it will generally be of great importance whether the contract in preparation is subject to a national law from the common law or the civil law family. As a rule, 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 numerous definitions of terms, they will strive to establish with utmost preciseness indisputable definitions on those rights and obligations on which the parties agree; providing contractual solutions to numerous life situations, they will attempt to covert any possible event that might develop the potential to disrupt proper performance. Contracts under civil 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 which the parties would like to govern in deviation from the terms and conditions the respective national normative act provides by default of a differing contractual ruling.

The *second step* constitutes the ways to a judgment. 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. Again a difference between common law and civil law arises. Stronger judges are generally attributed to common law while civil law is said to host less distinctive judge formats. However, we should keep in mind that different rules of procedural law can serve the same system of material-law regulations. Moreover, for the quality of legal institutions and the reliability of their functioning, elements of the surrounding culture such as the extent of corruption and/or the legal qualification may have greater importance than the legal family. Thus, India and Bulgaria are expected to face similar problems in ascertaining the production of proper judgments irrespectively of them belonging to two different legal families.

In the *third step*, the ways to enforce a judgment are considered. While this is not necessarily the case, here civil law would generally take a more conservative approach as its execution officers are predominantly public servants and its procedural rules are 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 sector.

International Law has numerous, some quite successful, unification initiatives in the form of international treaties, procedural law, which 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.

These three steps of contract enforcement would also be relevant if the contracting partners would be based in the same country. But in the context of transnational contracts, one additional step is necessary, which arises from the fact that trading partners are based in different countries. Thus, we should also take into account an inter-stage level (between steps two and three): the enforceability of a foreign judgment. By enforceability we mean 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 accordingly be enforced. However, the enforceability of foreign judgments is not a matter of course. Even in an increasingly globalized world, the enforceability of foreign judgments is still subject to a vast number of mostly bilateral interstate arrangements, which reflect mutual justice quality assessments but also the political ambitions of nations. This heterogeneity enables us to study the relevance of the enforcement of foreign judgments for international trade.

3 Discussion of Rule of Law Indicators

As the aim of this paper is to analyze 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 criteria. First, we have picked 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 the different steps of contract enforcement? Do they allow for the enforceability of foreign judgments?

Doing Business Indicator.[4] The authors of this indicator limit their research to measuring the resources (time is weighted by 33,3% and cost is also weighted by 33,3%) necessary for having a commercial dispute resolved by a first-instance local court. Given that most legal systems in our world offer a civil procedure consisting 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 have widened the scope of their measurement by introducing the quality of judicial processes index (also weighted by 33,3%) and by addressing matters of court organization including automation and case management which is also attributed to step 2. Step 1 does not appear and step 3 is underrepresented in both, the methodology and the questionnaire. No attention is given to the possibility and procedure of having a foreign judgment enacted and executed by the

[4] http://www.doingbusiness.org/methodology/enforcing-contracts

local legal system.

Economic Freedom Index.[5] This index is comprised of four components: Rule of Law (property rights, freedom from corruption); Limited Government (fiscal freedom, government spending); Regulatory Efficiency (business freedom, labor freedom, monetary freedom); Open Markets (trade freedom, investment freedom, financial freedom). As part of the rule of law component, the subcomponent 'Property Rights' assesses the access to efficient judiciary. On a scale from 0 (worst score) to 100 (best score), the authors submit subjective assessments on countries by their ability to maintain courts which enforce contracts efficiently and quickly. No differentiation is made between steps 1, 2 or 3. The possibility and procedure to have a foreign judgment recognized and enforced by the local legal system is also not considered.

Economic Freedom of the World.[6] The authors of this index take seven components into consideration of which component V ('Legal structure and security of private ownership') is relevant for our analysis. This component consists of three factors[7]: (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); (C) Rule of Law: Legal Institutions, Including Access to a Nondiscriminatory Judiciary (weight .317). The rule of law variable 'reflects the degree to which the citizens of a country are willing to accept the established institutions to make and implement laws and adjudicate disputes.' Apparently, no differentiation between steps 1, 2 or 3 is made. An assessment on the recognition and enforcement of a foreign judgment is also lacking.

Institutional Profiles Database.[8] 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[9] which has been used 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). There is also a low-level differentiation between purely domestic cases and cases between national and foreign stakeholders (see variables 127 and 131). Nevertheless, step 3 is underrepresented and the possibility and procedure of having a foreign judgment enacted and executed by the local legal system is neglected.

[5] http://www.heritage.org/index/book/methodology

[6] http://oldfraser.lexi.net/publications/books/econ$_f ree_2$000/$section_0$6.*html*

[7] http://oldfraser.lexi.net/publications/books/econ$_f ree$98/$area$5.*html*

[8] http://www.cepii.fr/institutions/EN/ipd.asp

[9] http://www.cepii.fr/institutions/EN/download.asp

As the above assessment shows, none of the analyzed indicators covers all steps of enforcing a transnational contract. Accordingly, in the next section our paper proposes one possibility to incorporate the step of international contract enforcement, which to the best of our knowledge has so far not yet been used in empirical trade analyses, namely the mutual recognition of court judgments.

4 Empirical Analysis

In order to study the importance of the enforceability of a foreign judgment, 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. and is equal to 1 if a judgement issued by a German judge is recognized and enforced on the territory of the trading partner and vice versa.

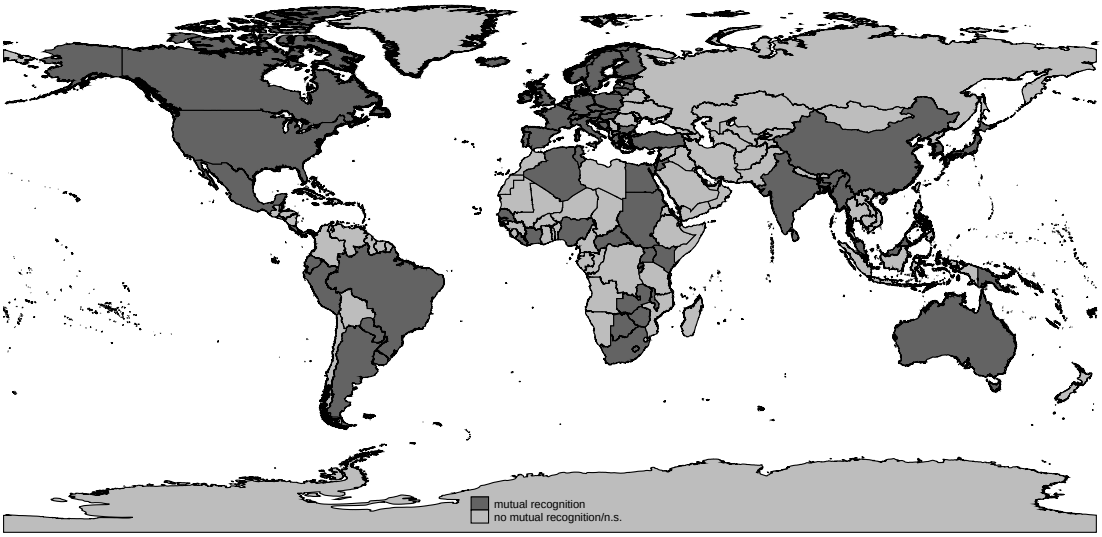

Figure 1: Mutual Recognition of Germany and its Trading Partners in 2014

Figure 1 shows the countries for which there is a *mutual recognition of court judgments* with Germany in place in 2014. The number of countries increased over time from 72 in 1994 to 95 in 2014. 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.

Apart from this dummy variable we are also including the GDPs of Germany and its trading partners (see Table 1). In order to account for the effect of arbitration we are controlling for the NYC. As already

explained in the introduction, countries which have signed this multinational treaty are committing themselves to recognize and enforce any decision made by an arbitration court. This dummy variable is equal to 1 if the NYC has come into force in Germany[10] and in its respective trading partner's country.

Variable	Source	Definition
ln_FLOW	CEPII	Bilateral trade flow in current British pounds
ln_GDP_o	CEPII	GDP of the origin country in British pounds
ln_GDP_d	CEPII	GDP of the destination country in British pounds
mutrec	own generation based on Baumbach et al.	mutual recognition of court judgements between Germany and its trading partners (dummy variable)
NYC	United Nations Commission on International Trade Law	signing of the NYC by Germany and its trading partners (dummy variable)

Table 1: Description of Variables

Table 2 presents the first results from the fixed effects estimation[11]. Most interestingly, the coefficient on our mutual recognition variable is positive and statistically significant. This would indicate a positive correlation between the mutual recognition of court judgments and the trade flows between Germany and its trading partners. The coefficient on the NYC also has the expected sign, even if it is not statistically significant.

[10] In Germany, the NYC went into force in 1961. Therefore, given the specific structure of our panel dataset we cannot create a dummy variable that would be equal to 1 if only one of the trading partners has signed the NYC.

[11] The use of random effects is rejected by the Hausman test.

	(1)
VARIABLES	ln_FLOW
ln_GDP_o	0.574***
	(0.115)
ln_GDP_d	1.061***
	(0.0766)
mutrec	0.294***
	(0.106)
NYC	0.114
	(0.0881)
Observations	7,609
Number of groups	378
R-squared	0.207

Robust standard errors in parentheses

Intercept and year dummies not reported

*** p<0.01, ** p<0.05, * p<0.1

Table 2: Results of the Fixed Effects Estimation

5 Conclusion

In this paper we have shed some light on the importance of contract enforcement for empirical studies on international trade. None of the existing rule of law indicators seems to cover all steps of contract enforcement. However, we propose one possibility to introduce the enforceability of a foreign judgment into empirical trade analyses. According to the first empirical results this seems to be important indeed. We are very well aware that this is just a case study and that a broader dataset will be needed in order to study the relevance of the mutual recognition of court judgments for empirical trade economists more appropriately. However, as our paper has shown, it is at least worth to consider the recognition and enforcement of a foreign judgment as a potential determinant of international trade in addition to the already known institutional factors like the rule of law and the NYC.

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