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CONFLICT OF LAW RULES AND INTERNATIONAL TRADE

A Transaction Costs Approach

by

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Abstract

Drawing on Transaction Costs Economics, this paper develops a new approach to conflict of law rules. It outlines a concept of constitutional uncertainty in international trade and presents a model of international transactions in the presence of a diversity of legal orders. We develop a general analytical concept of an international legal order and analyze the impact of different specifications of international legal orders on international transactions.

JEL classification: F02, F15, K33

Keywords: conflict of law, international private law, transaction costs, enforcement of judgments.

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I. INTRODUCTION

This paper analyzes the impact of conflict of law rules on international trade from a transaction cost economics perspective. The core question of transaction cost economics, as a part of New Institutional Economics, is how transaction costs influence social interaction and productive activities. It analyses how institutions economize on transaction costs that may reduce, or even completely discourage, socially desirable activity (see Williamson 1989).

Transaction costs are the costs of negotiating, drafting and enforcing contracts. They include search and information costs, bargaining and decision costs, policing and enforcement costs and, moreover, the efficiency losses that result when conflicts are not perfectly resolved. In this paper we will focus on the costs related to enforcing agreements. As it is well established by social contract theory, a properly working legal system is one of the most important institutions for economizing on transaction costs. In reality however, a multitude of legal orders exists, associated with a law enforcement technology based on the territoriality principle. Both factors give rise to two questions:

1. Which law governs an international transaction?
2. How can a judgment be enforced when the defendant has assets only in another state?¹

For domestic transactions it is one monopolist, the state, who defines the applicable law and fulfils the task of law enforcement. Legal rules within each state can be judged—at least in principle—as unequivocal. International transactions, to the contrary, involve a multitude of legal systems claiming monopoly power within their respective boundaries.² The international legal system is characterized by collisions of norms and gaps between different norm systems. Consistency of court decisions is often merely coincidental, and the assistance of the judicial and penal institutions in foreign countries is not always reliable.

Conflict of law rules (i.e., private international law) do not change this picture dramatically.³ These rules determine which court has jurisdiction and which law applies

¹ “Enforcement of a foreign judgment involves a court's taking steps to coerce a defendant to comply with the terms of the foreign judgment. Recognition is inherent in an enforcement of a judgment” (Dashwood et al. 1987: 38).

² Note, however, that in modern times this principle does not imply that only judgments given by domestic courts and based on domestic law are enforced; foreign judgments based on whatever law can also be recognized and enforced under certain conditions. One example is corporate law. E.g., see Carney 1997 for an analysis of international competition in this field.

³ “At present, domestic legal systems do a poor job of resolving conflicts amongst themselves. That is, they do not have an effective and efficient choice-of-law-system” (Guzman 2002: 884).

“whenever a legal dispute involves parties, property or events that have a relevant connection with more than one legal system” (Parisi and O’Hara 1998: 387). They are rules of national origin which cope with interjurisdictional problems: “Despite their intrinsic transnational nature, the resolution of conflicts of law issues has historically depended upon the disjointed efforts of individual national courts and legislatures. While nations occasionally attempt to unify the conflict of law rules through international treaties, this area of the law remains fragmented. Disagreement over the appropriate way to approach conflict of law issues as well as the inability of national legislators to endorse a singular solution to these many issues leaves the international community burdened with problematic coordination failures” (Parisi and O’Hara 1998: 387).

For agents involved in foreign trade these coordination failures are the source of an uncertainty, which we call “constitutional uncertainty”. This uncertainty creates specific coordination problems whose solution requires the parties to bear additional transaction costs:⁴ “Contracts whose parties operate under separate domestic legal systems (and no over-arching one) face hazards not usually present in contracts subsumed under a single legal system. These hazards imply higher negotiation, monitoring, and enforcement costs.” (Yarbrough and Yarbrough 1994: 244).

Consider the following example: in the autumn of 1981, a Cairo-based company agreed to purchase a number of second-hand vehicles from a Belgian exporter. He introduced a German supplier, who received a letter of credit and drafted a bill of lading on the form of a bankrupt Middle Eastern shipping company. These documents were presented to a bank in Zurich and immediate payment was made. However, the cars never arrived (ICC 1986: 6). Actually, the matter was even more complex; legal battles became inevitable. As several legal orders were involved, it was unclear which law was to be applied.

Conflict of law is an issue that has gone unnoticed by economists as well as law and economics scholars for a long time.⁵ Only during the last 10–15 years has the field attracted more attention (see Whincop and Keyes 2001; for an overview see Parisi and O’Hara 1998 or Guzman 2002 and O’Hara and Ribstein 2000 with further references). However, it would be

⁴ Ex ante transaction costs must be incurred in order to design a proper contract; ex post transaction costs are associated with monitoring and enforcement activities (in case of breach of contract). A third type of transaction cost consists of gains from trade foregone due to inefficient governance structures.

⁵ Carney 1997: 303 claims that comparative law “has been relatively free of economic analysis”. Perhaps this contributes to the observation of Eisenberg/Wells 1998: 408 that comparative law and international law belong to the legal fields which enjoy the lowest citation rates.

an exaggeration to say that economic analysis has made considerable contributions to this legal area (see O’Hara and Ribstein 2000: 1151; for reasons see also Guzman 2002). The state of research in this field is widely considered unsatisfactory (see Guzman 2002: 884, note 1). The goal of this paper is to improve our understanding in this area. In particular, we derive in this paper some “conflict of law lessons” that might prove helpful for creating an efficient conflict of law system. A conflict of law system is efficient if it provides sufficient assurance to the parties involved in an international transaction that the contract will be honored and thereby fosters mutually beneficial transactions.

Our paper has much in common with those by Guzman (2002) and O’Hara and Ribstein (2000). Whereas the traditional analysis focuses on state interests and notions of sovereignty, these two papers develop an efficiency approach to the conflict of law. On the one hand, our paper joins these authors by focusing on the costs of uncertainty and the welfare of the parties affected by the conflict of law rules. It shares their view that the choice of an international law regime should facilitate the international division of labor and, thereby, improve the wealth of nations (see also Guzman 2002: 885).⁶

On the other hand, our paper differs considerably from both papers mentioned. O’Hara and Ribstein (2000) emphasize individual choice of law over government interests. Guzman (2002) addresses international regulatory issues (see Guzman 2002: 889) and the question of how self-interested behavior of nations could be aligned with those of the global community so that global welfare is maximized (see Guzman 2002: 885). Our paper analyzes the recognition and enforcement of foreign court judgments on (voluntary) international transactions. Rather than taking regulatory issues as *the* starting point by asking how to provide countries with an incentive to regulate more efficiently, we are interested in individual decision-making and the contractual hazards regarding single transactions.⁷

We set up a simple model of international trade which allows us to identify the expected transaction costs of doing international business and to analyze their impact on

⁶ “Although the notions of sovereignty that form the basis of traditional choice of law scholarship may represent values worth considering, it is striking that choice of law scholarship has paid virtually no attention to how individuals and their behavior are affected by the chosen rules” (Guzman 2002: 885). Not everybody would accept the view that modern conflict of law centers on the notion of sovereignties. Since Savigny it is the generally held view that courts are not limited to enforce the *lex fori*; rather they devote themselves to the enforcement of whatever law that has been declared applicable. Courts apply foreign law in cases that have some significant contact with a foreign legal system (see Parisi and O’Hara 1998: 388).

⁷ This is not to deny that conflict of law rules may encourage countries to internalize costs and benefits of their rules (see Guzman 2002: 899–900) and also must preserve governments’ ability to regulate where externalities create inefficiencies (see O’Hara and Ribstein 2000: 1163–1165).

mutually beneficial trade. We also develop a general analytical concept of an international legal order that enables us to analyze the impact of different specifications of the international legal order on international commerce. We will distinguish three types of international orders:

- international anarchy,
- territoriality-based legal orders
- legal orders based on a movement of judgments.

International anarchy refers to a situation where a multitude of national legal orders exists, none of which offers legal recourse for international disputes. In territoriality-based legal orders the courts only enforce domestic judgments. Legal orders based on a movement of judgments assure that a judgment issued by the court of one state is recognized and enforced by the court of another state. It is well known that an international anarchy, despite the absence of a formal international legal system, may nonetheless bring about some form of governance, which allows economic actors to conduct transactions efficiently. This result is also possible in situations in which laws are weak or law enforcement is slow, corrupt, or biased.

The focus of this paper will be on rules determining adjudicatory jurisdiction rather than on choice of law issues (for the difference see Parisi and O'Hara 1998: 388). We do not intend to analyze conflict of law as an isolated phenomenon but rather how conflict of law rules influence economic activity. Thus, our perspective is not an ex post one asking "what is best in an interjurisdictional conflict". We rather ask which law is efficient from an ex ante perspective and analyze the impact of the international legal order on the parties' incentives.

The paper is organized as follows: section II, in a first step, presents a model of an international transaction in the absence of an international legal order. In a second step, the model is extended by the introduction of an international legal order. Conditions are derived under which the international transaction is effectively protected by the international legal order.

Our analytical framework allows the setup of a formal typology of international legal orders. In section III we examine the impact of three different types on international trade: international anarchy, territoriality-based legal orders and legal orders based on a movement of judgments. In that section we also review how private ordering can overcome constitutional uncertainty in the absence of any international legal order. Section IV derives some "conflict of law lessons". These lessons provide some insights concerning the efficient allocation of jurisdiction when transactions cross borders. Section V concludes the paper.

II. MODELLING INTERNATIONAL TRANSACTIONS

1. The international exchange game

Consider a potential international transaction between a member of state A and a member of state E. We assume both actors to be risk neutral. Adam, a citizen of state A, promises to deliver a good which he values with X in exchange for a good, to be delivered by Eve, a citizen of country E, valued with Y by both. Eve's valuation of the good delivered by A is denoted Z . We assume $Z > Y > X > 0$. Hence, the parties would mutually benefit if both promises were fulfilled.⁸ However, this condition is not sufficient to guarantee that the parties will actually act as agreed: the agreement is not self-enforcing.⁹ Assume that Eve can observe Adam's move before making her own decision. The extensive form of this one-shot game (which is known as the "trust game") is represented by Figure 1.

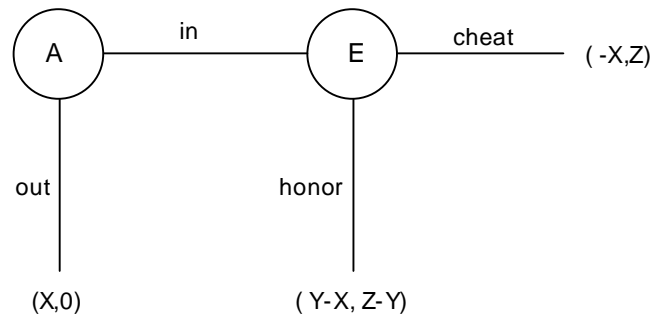


Fig. 1: Exchange game in extensive form

Adam's payoff is the first entry in the brackets, Eve's payoff is the second. Adam has two strategies: $\{in, out\}$. The strategy *in* means delivering the good; strategy *out* can be interpreted as a national transaction (among citizens of state A), which yields a net gain of X . Eve has two strategies $\{cheat, honor\}$. Eve is tempted to cheat instead of honor the agreement. The unique subgame-perfect equilibrium of this game is the strategy profile $(out, cheat)$. The equilibrium is Pareto-inefficient, since both parties would have been better off playing the path $(in, honor)$. In anticipation of Eve's opportunism, however, Adam choose *out*.

⁸ For ease of exposition, we rule out third-party effects.

⁹ An analysis of an international transaction considered as a prisoner's dilemma game, which implies double-sided contractual hazards, is presented in Schmidt-Trenz and Schmidtchen 1991.

The inefficiency is due to the lack of any mechanism that protects Adam's interests. From Adam's point of view, the costs of enforcing the terms of the contract are infinite. Adam's not honoring the agreement leads to opportunity costs in terms of $Z-X$, which are shared in accordance with the terms of trade Y . Hence, both parties would agree to employ an institution that makes the option *in* Adam's preferred choice as long as the gain from cooperation $Z-X$ exceeds the costs of this device.

2. The extended exchange game

Mutually beneficial agreements are doomed to fail if at least one of the parties fears that the other one is tempted to cheat. Litigation is supposed to prevent this opportunism. In this section we add a litigation stage to the trust game introduced in section III.1. In the extended game (see Fig. 2), Adam is given the option of suing Eve for Y (see node A_2).¹⁰ Hence, Y is the amount at stake.

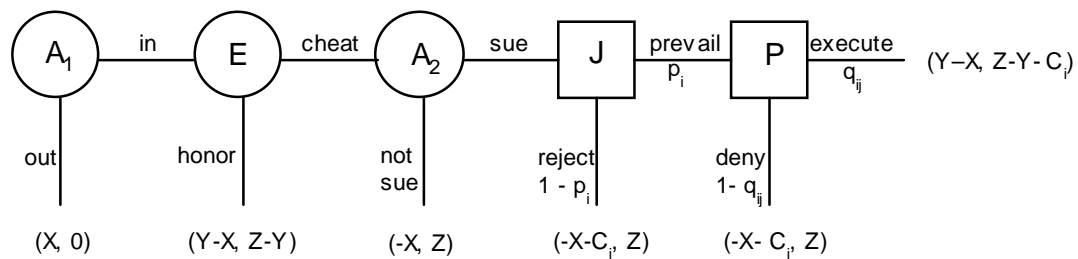


Fig. 2: The contract game

If Adam chooses to sue, the game reaches the node labeled J, which represents a judicial decision. In this paper we do not analyze the court's decision-making process itself, but represent it by the plaintiff's probability of prevailing. The judge J decides in favor of the plaintiff Adam with probability p_i ; with $1-p_i$ the defendant Eve prevails. Index i indicates the

¹⁰ To give Adam the option of suing Eve may serve as a device against contractual opportunism, but it opens up another source of opportunistic behavior: Adam might bring suit even though he knows that the other party has fulfilled her contractual obligation. We neglect this type of litigation which can be labeled as opportunistic litigation (for a comprehensive analysis see Kirstein and Schmidtchen 1997).

nationality of the court to which action is brought, with $i \in \{A; E; H\}$, where A denotes Adam's home court, E denotes Eve's home court, and H denotes a court in another country. For the moment, we assume that Adam can bring suit in only one country i . This assumption is relaxed subsequently.

Laws of conflicts accompanied by bilateral or multilateral agreements among sovereign states define the options available for bringing a suit. If Adam prevails, then an additional problem arises if Eve does not hold assets in the country where the judgment was issued. In this case, the court ruling only becomes effective as an enforcement device if it is acknowledged in a state where Eve holds assets, denoted as j .¹¹ Usually, recognition of foreign judgments and their enforcement it is a court's matter (indicated in Fig. 2 by node P). Again, we represent this court by a probability distribution. We denote the probability that court P in country j acknowledges the foreign judgment of state i (and gives permission to enforce it) as q_{ij} (with $i, j \in \{A; E; H\}$). With probability $(1-q_{ij})$, this is denied. We are now in a position to define constitutional uncertainty in a precise manner by the following inequalities: an international transaction suffers from constitutional uncertainty if

$$p_i \neq p_j \vee q_{ij} < 1$$

with $i, j \in \{A; E; H\}$ and $i \neq j$. For ease of exposition, we assume that recognition and enforcement do not produce additional costs. Plaintiff Adam has to pay the litigation costs before the hearing proceeds. We first apply the British rule of cost allocation, which means that the loser of a suit must bear the litigation costs of both parties (denoted C_i). The payoffs for each path through the game tree are straightforward and indicated at the respective end nodes. In a second step, the American rule of cost allocation is analyzed according to which each party has to bear its own litigation costs regardless of the outcome of the trial.

¹¹ In a world with several sovereign states, a judgement that is spoken in a specific country is not automatically enforceable in another country, and if it is enforceable, there is no guarantee that payment of the amount awarded can be enforced.

3) Subgame-perfect equilibria

a) British cost allocation rule

We are interested in the impact of the litigation stage on the underlying behavior (as modeled by the exchange game). To be more specific, we derive a condition for bilateral contractual compliance, i.e., that the contract will be honored by both parties. Applying the logic of backwards induction, the analysis starts at node A_2 . At this node, a breach of contract has occurred and Adam must decide whether or not to bring a suit (and where).

Assume, for the moment, that Adam has only one option for taking legal action against Eve, namely in country i , and can only enforce a verdict in land j . In this situation, he would bring suit in country E if the following condition holds:

$$(1) p_i[q_{ij}(Y-X) + (1-q_{ij})(-X - C_i)] + (1-p_i)(-X - C_i) \geq -X.$$

This condition can be simplified to

$$(2) p_i \cdot q_{ij} \geq \frac{C_i}{Y + C_i}.$$

Thus, the likelihood of effective legal protection must exceed a threshold determined by the litigation costs C_i and the value of the case Y . If condition (2) is fulfilled, then Eve expects Adam to bring suit (in country i). She then prefers to honor the contract (over breaching it) if

$$(3) Z - Y \geq p_i[q_{ij}(Z - Y - C_i) + (1 - q_{ij})Z] + (1 - p_i)(Z).$$

This is equivalent to

$$(4) p_i \cdot q_{ij} \geq \frac{Y}{Y + C_i}.$$

Conditions (2) and (4) are necessary and sufficient for bilateral contractual compliance, as the last step of backwards induction demonstrates: Adam has a choice (at A_1) between *out*, which brings him payoff 0, and *in*, which yields $Y - X$. He chooses *in*, and Eve chooses *honor*. This establishes our first proposition:

Proposition 1: Given the British cost allocation rule in the contract game, the option to sue in country i and enforce the judgment in country j induces bilateral contractual compliance if and only if

$$(5) \frac{C_i}{Y + C_i} \leq p_i \cdot q_{ij} \geq \frac{Y}{Y + C_i}.$$

Note that expression (5) is equivalent to $p_i \cdot q_{ij}(Y + C_i) \geq \max\{Y; C_i\}$. We now relax the assumption that legal protection can be sought in only one country. If Adam may choose where to bring suit against Eve and Eve possibly possesses assets in more than just one country, then this leads to the following corollary to the above proposition:

Corollary 1: Given the British cost allocation rule in a contract game with the option to sue in country $i \in \{A; E; H\}$ and to enforce the judgment in country $j \in \{A; E; H\}$, only the maximum of all possible values of the product $p_i q_{ij}$ is relevant for bilateral contractual compliance.

Bilateral contractual compliance means that the transaction proceeds smoothly, i.e., the courts are not called upon: the international transaction proceeds in the shadow of the courts.¹² Condition (5) allows for the following interpretation: the higher Y , p_i , or q_{ij} , or the lower C_i , the higher is the likelihood of a mutually beneficial international transaction. Reformulating condition (2) and (4) allows us to isolate the transaction costs and to show their impact on bilateral contractual compliance. Adam brings an action if

$$(2 \text{ a}) p_i \cdot q_{ij} Y \geq (1 - p_i q_{ij}) \cdot C_i.$$

¹² One can also derive conditions for one-sided contractual compliance or for equilibria in which both parties cheat. As for the former, Adam could be motivated to fulfill his part of the contract if $p_i \cdot q_{ij} > (X+C)/(Y+C)$ and condition (2) holds. It pays to take the risk of being cheated. For a comprehensive analysis see Kirstein and Neunzig 1998.

This is equivalent to

$$(2 \text{ b}) \ Y \geq \frac{1 - p_i \cdot q_{ij}}{p_i \cdot q_{ij}} \cdot C_i =: \bar{Y}_A.$$

The right-hand side of inequality (2a), defined as \bar{Y}_A , is the threshold value which governs Adam's decision situation. If the amount at stake, Y , is at least as high as this threshold, then Adam is motivated to bring a suit. This threshold depends on parameters determined by the expected transaction costs of international trade from Adam's point of view. The expected transaction costs appear in the numerator of the threshold value: the higher $(1 - p_i \cdot q_{ij}) \cdot C_i$, the higher the threshold value \bar{Y}_A .

We can take the value of $p_i \cdot q_{ij}$ as an indicator of the degree of constitutional uncertainty; condition (2b) then reveals that constitutional uncertainty affects the threshold value via the numerator and the denominator. A similar formula can be derived from (4):

$$(4 \text{ a}) \ p_i \cdot q_{ij} (Y + C_i) \geq Y$$

which is equivalent to

$$(4 \text{ b}) \ Y \leq \frac{p_i \cdot q_{ij}}{1 - p_i \cdot q_{ij}} \cdot C_i =: \bar{Y}_E.$$

\bar{Y}_E is a threshold value relevant to Eve's decision situation. If the amount at stake Y exceeds this value, then Eve is not motivated to honor the contract. Her threshold value depends on parameters determining the expected costs of cheating. These costs are $p_i \cdot q_{ij} \cdot C_i$. The lower $p_i \cdot q_{ij}$ or C_i , the lower are the expected cheating costs, and the higher is the threshold value \bar{Y}_E . Since a lower value of $p_i \cdot q_{ij}$ means a higher degree of constitutional uncertainty, we can conclude that a higher degree of constitutional uncertainty reduces the threshold value \bar{Y}_E . This effect is brought about via the numerator and the denominator of \bar{Y}_E .

Bilateral contractual compliance requires:

$$(5 \text{ a}) \ \bar{Y}_A \leq Y \leq \bar{Y}_E.$$

Note that Adam's expected transaction costs are inversely related to Eve's expected cheating costs: the lower Eve's expected cheating costs, the higher are Adam's expected transaction costs (and vice versa). Since \bar{Y}_A is decreasing and \bar{Y}_E is increasing in $p_i \cdot q_{ij}$, a higher value $p_i \cdot q_{ij}$ makes it more likely that condition (5 a) will be fulfilled. High Y and low C_i have the same impact.

Interpreting Y as the terms of trade (5 a) allows for an interesting conclusion: for international trade to occur, two constraints must be met—the terms of trade have to fulfill the “Pareto constraint” $Y \in [X; Z]$ and, simultaneously, the “contractual compliance constraint” $Y \geq \max\{\bar{Y}_E, \bar{Y}_A\}$.

Since the expected transaction costs of doing international business entirely depend on the policy variables (p_i, q_{ij}, C_i) , legislators can choose these, in principle, so as to induce international trade. In this case, the ex post transaction costs are zero, since there will be no need for Adam to bring action. However, if condition (5 a) is violated, then transaction costs end up undermining the profitability of the international transaction, a situation we define as “coordination inefficiency”.¹³

b) American cost allocation rule

According to the American cost allocation rule, each party has to bear its own litigation costs regardless of the outcome in court. A condition for bilateral contractual compliance can be derived in a similar manner as for the British rule. Let P denote the litigation costs to be borne by the plaintiff Adam, while D denotes Eve's (the defendant's) litigation costs. To

¹³ It is worth noting that coordination inefficiency does not depend on the existence of trade barriers in the traditional sense. Even if all those barriers (for example, tariffs, quotas) would be eliminated, there would still be room for coordination inefficiency. Traditional international economics has long acknowledged the existence of additional risks in doing international business (see Herring 1984). However, “uncertainty is imposed as a model-exogenous datum, on preferences, technology or endowments” (Pomery 1984: 420). Usually, it is treated in the form of random shocks that originate from various sources (see Helpman 1985: 72). Although in practice, trade—whether national or international—is based on contracts, questions of international contracting were put into the background by the traditional economics of international trade. Following the general equilibrium approach, this theory is interested in the allocation of factors of production and the exchange of goods. As Pomery puts it: “Walrasian price-coordination has dominated the traditional literature...” (Pomery 1984: 425).

induce Adam to bring an action in country i and seek enforcement in country j , the following must hold:

$$(6) p_i [q_{ij} \cdot (Y-X) + (1-q_{ij}) \cdot (-X)] + (1-p_i) \cdot (-X) - P_i \geq -X.$$

This is equivalent to

$$(7) p_i \cdot q_{ij} \geq \frac{P_i}{Y}.$$

The likelihood of an effective legal protection must exceed a threshold value determined by the plaintiff's litigation cost P and the value of the case Y . If (7) holds, then Eve honors the contract if

$$(8) Z-Y \geq p_i [q_{ij} (Z-Y) + (1-q_{ij}) \cdot Z] + (1-p_i) \cdot Z - D_i$$

which is equivalent to

$$(9) p_i \cdot q_{ij} \geq \frac{Y - D_i}{Y}.$$

If conditions (7) and (9) are simultaneously fulfilled, this is necessary and sufficient for bilateral contractual compliance, since Adam has an incentive to choose in . Thereby, we have established the next proposition and, as an implication, a corollary:

Proposition 2: Given the American cost allocation rule in the contract game, the option to sue in country i and enforce in country j induces bilateral contractual compliance if and only if

$$(10) \frac{P_i}{Y} \leq p_i \cdot q_{ij} \wedge p_i \cdot q_{ij} \geq \frac{Y - D_i}{Y}.$$

Corollary 2: Given the American cost allocation rule in a contract game with the option to sue in country $i \in \{A; E; H\}$ and enforce the judgment in country $j \in \{A; E; H\}$, only the maximum of $p_i \cdot q_{ij}$ is relevant for bilateral contractual compliance.

If the conditions for bilateral contractual compliance are fulfilled, then the transaction proceeds smoothly, i.e., the courts are not called upon. Condition (10) allows for the following interpretation: the higher p_i , q_{ij} , Y , or D_i , or the lower P_i is, the higher is the likelihood of a mutually beneficial transaction. Rearranging (7) we receive

$$(7 \text{ a}) Y \geq \frac{P}{p_i \cdot q_{ij}} =: \tilde{Y}_A.$$

\tilde{Y}_A is a threshold value defining a lower limit which the amount at stake Y must at least reach in order to induce Adam to bring a suit. This threshold depends on a parameter standing for the enforcement costs P_i and a parameter reflecting the degree of constitutional uncertainty $p_i \cdot q_{ij}$. Rearranging (9) leads to

$$(9 \text{ a}) Y \leq p_i \cdot q_{ij} \cdot Y + D_i =: \tilde{Y}_E.$$

The term on the right hand side of (9 a) represents Eve's threshold value which must not be exceeded by the terms of trade so as to induce her to honor the contract. We now compare the threshold value under the British rule (\bar{Y}_A) with the threshold value under the American rule (\tilde{Y}_A), but restrict our analysis to Adam. His threshold value under the British rule exceeds the one under the American rule if

$$(11) (1 - p_i \cdot q_{ij}) \cdot \frac{C_i}{P_i} > 1.$$

For simplicity,¹⁴ assume $C_i = P_i + D_i$; then (11) implies

$$(11 \text{ a}) D_i > p_i \cdot q_{ij} (P_i + D_i).$$

It is obvious that (11 a) cannot hold in the absence of constitutional uncertainty (i.e., if $p_i \cdot q_{ij} = 1$). Another implication is that the threshold value under the British rule can be zero while the one under the American rule is positive. However, with low values of $p_i \cdot q_{ij}$, even $\bar{Y}_A > \tilde{Y}_A$ is possible.

III. INTERNATIONAL LEGAL ORDERS

In this section we want to give more body to the analysis of international legal orders. We start with a definition of a general analytical concept of an international legal order.

¹⁴ It is not necessarily the case that the parties' litigation costs in court systems using the American rule are identical with those in court systems governed by the British rule.

1. Definition

The legal order of each state i can be characterized by a quintuple $(p_i, \mathbf{q}_{ij}, P_i, D_i, R_i)$, where the vector \mathbf{q}_{ij} represents all values of q_{ij} in i for $j \in \{A, E, H\}$, and $R_i \in \{a, b\}$ denotes the cost allocation rule ($a = \text{American rule}$, $b = \text{British rule}$). This notation allows for a precise quantitative representation of each possible international legal order by specifying the respective combination of the legal parameters $(p_i, \mathbf{q}_{ij}, P_i, D_i, R_i)$ for each country involved. The following table contains a complete description of the international legal order in the case of three countries $i \in \{A, E, H\}$. Note that country H may represent any state other than A or E.

| i | P_i, D_i | p_i | $j = A$ | $j = E$ | $j = H$ | R_i |
|-----|------------|-------|----------|----------|----------|-------|
| A | P_A, D_A | p_A | q_{AA} | q_{AE} | q_{AH} | R_A |
| E | P_E, D_E | p_E | q_{EA} | q_{EE} | q_{EH} | R_E |
| H | P_H, D_H | p_H | q_{HA} | q_{HE} | q_{HH} | R_H |

Table 1: Complete international legal order

Given n countries, this description of an international legal order consists of $3n + n^2$ components. Some examples for the winning and enforcement probabilities may illustrate the nature of an international legal order (focusing only on the relationship between countries A and E):

- If the domestic law in both A and E allows for legal action only in E, then the following holds: $p_A = 0$; $q_{AE} = 0$; $p_E \geq 0$; $q_{EE} = 1$.
- If the domestic law in A and E prescribes that action can only be brought at home, then the following holds: $p_E \geq 0$; $q_{EE} = 1$; $q_{EA} = 0$; $p_A \geq 0$; $q_{AE} = 0$; $q_{AA} = 1$.
- Here is an example of a conflict of law resulting in $p_i q_{ij} = 0$: the law in each state requires that action can only be brought in the other state: $p_A = 0 = p_E$; $q_{AE} = 0 = q_{EA}$.
- The domestic legal orders may also allow action to be brought in both countries, but require the acknowledgement of foreign judgments by a domestic judge: $p_A \geq 0$; $1 \geq q_{AE} \geq 0$; $p_E \geq 0$; $1 \geq q_{EA} \geq 0$; $q_{AA} = 1$; $q_{EE} = 1$.

- An agreement between A and E to mutually acknowledge and enforce foreign judgements leads to $q_{AA} = q_{AE} = q_{EA} = q_{EE} = 1$.

The model allows for international differences in the winning probabilities. Consider the case $p_A > p_E > 0$: such a difference can be due to different propensities for discrimination (“domestic” or “xenophobic” bias): E-judges are rather unfriendly to plaintiffs from A in comparison to A-judges. The difference in the probabilities could alternatively be explained by differences in the substantive applicable law or the procedural law.¹⁵

2. Applications

We have defined an international legal order in stylized parameters which are relevant for economic decision-making. This allows us to model any factual and any conceivable conflict of law rules and doctrines. For simplicity, we assume that Eve holds all of her assets in her home country E.

Subsequently, we distinguish three polar types of international legal orders:

- international anarchy,
- territoriality based legal orders, and
- legal orders which allow for the enforcement of foreign judgments by domestic courts.

The term ‘territoriality based legal orders’ describes systems in which foreign court judgments are not enforced by a domestic court and should, therefore, not be confused with the ‘territoriality principle’. The latter means that the power of a nation state to enforce law is restricted to its territory, while the former refers to the source of the law the judgment is based

¹⁴ Note that the international private law is national law. There are as many ‘conflicts of laws’ as we have nation states. Thus, we have conflicts of laws on the level of the conflict of law rules. Table 1 reveals that an international legal order is a rather complex system. This insight raises the question whether the nature of constitutional uncertainty is actually captured by the model.

In the model constitutional uncertainty appears as a kind of risk. If the parties know the identity of i and j , they are assumed to surely know p_i and q_{ij} . Thus, it is easy to figure out whether or not conditions (5) or (10) are violated. In reality, matters are much more complex, suggesting an interpretation of constitutional uncertainty as a kind of Knightian uncertainty. This means that the parties do not know the exact values of p_i and q_{ij} . The parties are prone to commit errors. This uncertainty as to the true values of the probabilities increases the transaction costs of international trade. Even worse, the parties to an international transaction might be uncertain about the i and j which must be considered as relevant for their transaction.

upon. In territoriality based legal orders only the judgments of home courts are enforceable within a territory.¹⁶

a) International anarchy and private ordering

International anarchy is a world in which no court has jurisdiction over issues concerning international affairs. There are no legal rules for international transactions; hence, foreign judgments are not enforceable: $q_{ij} = 0$ for $i \neq j$, which implies $p_i q_{ij} = 0$ even if $p_i > 0$. It is obvious that international anarchy is best described by the simple international exchange game (see Fig. 1). Transaction costs create a barrier to international trade. If transactions occur, then this can be explained by “private ordering”.¹⁷

Private ordering refers to institutions or rules for settling conflicts in the absence of—or as amendments to—courts (see Eisenberg 1976; Galanter 1981: 8, 23; Williamson 1984: 208). Examples for private ordering are trust, reputation, collaterals, hands-tying, repeated transactions, multinational firms, arbitration, informal institutions, and informal norms such as reciprocity, loyalty, or ideology. Although the distinction between ‘private ordering’ on the one hand and ‘legal centralism’ on the other is crucial, in reality any order usually rests on a mixture.

One reason why we can observe an extensive international division of labor in the presence of anarchy is the fact that interaction does not take place one time only, but repeatedly: international traders play iterated games. The other reason would be a direct manipulation of the payoff structure in the one-shot game (of Fig. 1).

A game is “iterated” if the single transaction is embedded in a long-term contract relationship, which gives scope for conditional cooperative behavior. Let us examine the situation where Adam and Eve experience a finitely repeated game with uncertainty about the

¹⁶ The term is coined in analogy to an idea that is at the heart of conflict of law doctrines, according to which the law of jurisdiction has to be applied where actions took place or where property was located. In ‘territoriality based legal orders’ the location of the forum defines the territory within which enforcement can take place. Territoriality based legal orders have a lot in common with systems in which the choice of applicable law has been linked to the adjudicatory jurisdiction of the court (see Parisi and O’Hara 1998: 388): “In such a hypothetical world, cases would have been decided by the jurisdiction most closely connected to the case and courts would have never applied foreign law” (Parisi/O’Hara 1998: 388). However, modern conflict of law systems treat jurisdictional and choice of law issues differently (see Parisi/O’Hara 1998: 388).

¹⁷ On the incentives to honor trade agreements when formal national or transnational institutions that enforce contracts and protect property rights are weak or absent, see Milgrom, North, and Weingast 1990, Greif 1992, 1993, Greif, Milgrom, and Weingast 1994, Schmidtchen and Schmidt-Trenz 1990a, 1990b, Schmidt-Trenz and Schmidtchen 1991.

future. A finitely repeated game has a finite number of stage games, but the players are uncertain about when the game ends. Within a repeated interaction, Adam and Eve can adopt conditional punishment strategies that induce the trading partner to honor the contract. These strategies allow for punishing other players if they deviate from the terms of the agreement. If the prospect of the punishment is sufficiently severe, Adam and Eve will be deterred from deviation.

Even under anonymity, cooperation can be explained if the international transaction is carried out by one or several mediators, e.g., export-import houses that—due to iteration—maintain a long-term self-enforcing business relationship.¹⁸ In such a case Adam and Eve draw up enforceable contracts with domestic business partners, and the international transaction and the risk associated with it lies in the hands of international traders who rely on private ordering.

The wide-spread institution of “documentary letters of credit” works in a similar way. Here, international payments are carried out by international correspondent banks which stand in a long-term relationship to each other and therefore act cooperatively without the need for legal centralism.¹⁹

Obviously, the category of “relational contracts” (Macneil 1978) is of predominant importance to overcome international anarchy. It analyzes contracts as governance structures for long-term relationships. Discrete transactions between anonymous agents (trade between “faceless buyers and sellers”) would hardly work in anarchy, but require a developed legal system and a protective safeguard as in an ideal domestic economy.²⁰

Just as cooperation can be brought about by a manipulation of the probability of a new business deal, it can be influenced by the manipulation of Eve’s payoff, i.e., condition (3), in case of the British rule, or condition (8), in case of the American rule. One way to ensure cooperation is through “hands-tying” (see Kronman 1985) by sinking specific investments or

¹⁸ See Schmidt-Trenz and Schmidtchen 1990: 335, where the function of a mediator is discussed for an iterated prisoner’s dilemma game in which the players play the Tit-for-Tat strategy.

¹⁹ Explanation of changes in international trade should, therefore, refer to the nexus between trade and financial services. Usually, there is a strong relationship between the volume and the structure of international trade and the evolution of its institutional framework (governance structures).

²⁰ Numerous analyses confirm our hypothesis that foreign trade is dominated by long-term business relationships such as “F-connections” (Ben-Porath 1980): foreign trade is dominated by the categories family, friendship, and firms. For the family as an institutional arrangement consider the Jewish trading network during the Middle Ages. The formation of trade clubs (Carr and Landa 1983; Cooter and Landa 1984), such as the Hanseatic League, can be classified as a “trade friendship”. Accordingly, the multinational firm can be explained as a relational contract (Schmidtchen and Schmidt-Trenz 1990b). Any form of vertical integration across state borders can be regarded as a means to construct indispensable reciprocal relationships which prove to be self-supporting even in the absence of effective protective authorities.

transferring hostages—think of bank guarantees—so that the cooperative behavior is induced. A hostage is a good valuable only to the “giver”. Let h_E be Eve’s hostage to Adam. Posting the hostage by Eve yields, e.g., $u_A(h_E) = 0$ and $u_E(h_E) = Y$, with u_A , u_E representing the value of the hostage to Adam and Eve respectively. Hostage-giving would change Eve’s pay-off from cheating to $Z - Y$, which is identical to her honor-payoff. Thus, bilateral contractual compliance would be induced.²¹ The exchange of the hostage reduces the “cheating interest” and strengthens the “honoring interest”.

b) Territoriality based legal orders

In territoriality based legal orders the courts of the states will only enforce domestic judgments, but not foreign ones. This implies $p_A \geq 0$; $p_E \geq 0$; $q_{AA} = 1$; $q_{EE} = 1$; $q_{AE} = 0$; $q_{EA} = 0$; $p_A \cdot q_{AE} = 0$ and $p_E \cdot q_{EE} \geq 0$. If Eve holds all her assets in her home country E, then a judgment only has value for Adam if it enforceable in her home country. Leaving private ordering aside, if Adam does not have the right to bring suit in E, then the international transaction would fail (due to a lack of effective legal protection). When $p_E \cdot q_{EE}$ has a positive value, this allows foreigners to litigate in courts in countries where the defendant holds assets, which may enhance the international exchange of goods and therefore the division of labor.²² But, recalling conditions (5) and (10), the values of p_E and q_{EE} must exceed certain limits for legal formalism to have a positive impact on international trade. If, however, the probabilities of winning in court or enforcement of a judgment are too low, then it is not worth suing, since Adam has to bear the litigation costs if he loses in court. Therefore, having the option to sue will not alter Adam’s decision if he believes that the legal system of his trading partner will not sufficiently protect his property rights.

One reason for low values of p and q might be caused by a *domestic* or *xenophobic bias*—the attitude of judges to willingly favor all litigants of the home country.²³ If country E’s courts are xenophobic (i.e., p_E or q_{AE} are very low), this will certainly have an influence on the

²¹ Note that the assumption $u_A(h_E) = 0$ is crucial. If Adam knows that Eve values the hostage at Y , he might be tempted to propose a bargain. A way out is to deposit the hostage with a honest trustee.

²² If, contrary to our assumption, domicile and location of assets do not coincide, this result can be generalized by allowing a party to a contract to bring suit in those countries where the assets are located.

²³ For a more comprehensive discussion of inefficient lawmaking by judges see O’Hara/Ribstein 1999: 8–9.

contractual behavior. Adam's willingness to transact with a member of country E may be reduced if private ordering is too costly.²⁴

An additional problem might occur if E's international private law rules that an action must be brought to a court in A. Since $p_E=0$, litigation in E would be fruitless. Adam may bring suit in A, but this may also be insufficient to induce bilateral contractual compliance if the court in E is xenophobic: even with $p_A>0$, the product $p_A \cdot q_{AE}$ might be too small so that conditions (5) or (10) are violated. (Moreover, if A's international private law rules that an action must be brought to a court in E, we would observe a true conflict of law.)

c) Legal orders based on a movement of judgements

A movement of judgments can be provided for by bilateral or multilateral arrangements. In the following, we focus on multilateral arrangements. Multilateral conventions concerning the movement of judgments lay down the rules of recognition and enforcement of court judgments, which the parties to the convention agree to apply.²⁵ These mutually agreed upon rules substitute and amend the national rules of the conflict of law. Thus, multilateral conventions are means to harmonize the national rules of conflict of law. In particular, multilateral conventions deal with the following topics:

- The conditions under which a foreign judgment has to be recognized by a state.

It is necessary to agree upon unambiguously which court should have jurisdiction and

²⁴ The probabilities of winning and enforcement increase (a) when courts exercise impartiality in their proceedings and rulings and when (b) the courts are sufficiently competent to handle the cases. "Impartiality refers to absence of corruption and to the lack of any home bias that may influence the court's verdict" (Berkowitz et. al 2003: 7).

²⁵ An example is the Brussels Convention of 1968 (BC) on jurisdiction and the enforcement of judgments in civil and commercial matters. Its purpose is "to create a legal environment favorable to the objectives of the community, and more particularly that of a well-functioning common market in which goods and services, and the labour, enterprise and capital that produce them, would move unhampered by national frontiers" (Dashwood et. al. 1987:3). As the European Commission puts it, the convention "ensures that judgments given by the courts of the Member States are recognized throughout the whole community and sets up a mechanism to facilitate the enforcement of judgments given in one contracting state in another contracting state" (European Commission 1995: 331). The Brussels Convention seeks to ensure that there is a basic legal environment in which commerce can prosper. Based on the Rome Treaty article 220 "all Member States are required to ratify it and it is a condition on accession to the EU that accession states accept the system, which has been achieved through accession conventions" (European Commission 1995: 332). The scope of the Convention, however, is limited. It is confined to civil and commercial matters and does neither extend to revenue, customs or administrative matters, nor to family matters, social security, bankruptcy or arbitration (see European Commission 1995: 331).

which procedural rules have to be applied by the courts in order to receive recognition of the judgment.

- The circumstances under which a foreign judgment can be enforced.
- The determination of a superior court to which the litigants and/or courts could appeal, if there is any doubt that the convention was not obeyed by the courts of the states.
- The means to enforce decisions of the superior court.

A legal order implying a movement of judgments can formally be represented as follows: $p_i \geq 0$, with $i \in \{A;E;H\}$; $q_{ij} \geq 0$, with $i \neq j$ and $j \in \{A;E;H\}$; $q_{ij} = 1$, with $i = j$. Free movement of judgments comes down to an automatic recognition and enforcement of them. If the acknowledgement of a foreign judgment requires examination by a domestic court, then the enforcement probabilities may be smaller than 1:

$$q_{EE} = 1; 0 < q_{AE} < 1; 0 < q_{HE} < 1.$$

However, these values may still suffice for conditions (5) or (10) to be fulfilled. Thus, within our model, moving towards a system with automatic recognition will always foster the efficiency of international trade.²⁶

IV. CONFLICT OF LAW LESSONS

There are several policy implications emerging from our analysis.

(1) *The parties to the transaction should be permitted to choose the applicable law through contract if third-party effects are absent*

Since the parties of a transaction will seek the highest possible return, they have an interest in economizing on transaction costs (in our model: to honor the contract). They can do this to the extent that they are permitted to choose both the applicable law and the court through contract. However, there is a caveat: freedom to choose maximizes the private welfare of the parties involved; private welfare does not necessarily coincide with social welfare in the

²⁶ In a model that allows for opportunistic suits (suits without merit) the examination of foreign judgments can improve matters if the foreign court has a bias in favor of the plaintiff. With automatic recognition, only Eve would honor the contract. Examination in Eve's state reduces q_{AE} such that $p_A \cdot q_{AE}$ can fulfill condition (5) or (10). See Kirstein/Neunzig 1999: 357-359 for this positive impact of the examinations of foreign judgments.

presence of third-party effects. If third-party effects exist, they should be taken account for through restrictions on the choice available to the parties to the transaction. Dissipation of rents due to forum shopping, however, is not an objection: forum shopping means unilateral forum choice after the conflict has arisen, not mutual ex-ante agreements.

If the laws of conflict do not prescribe the (legal) domicile, then the parties can specify the court of law where any disputes arising under the contract are to be decided. Knowing the winning and the enforcement probabilities as well as the litigation costs, rational parties will determine the terms of trade, i.e. Y , and the (legal) domicile in a way that bilateral contractual compliance results. According to the Coase-Theorem the parties will negotiate a Pareto-efficient solution if it is feasible. In formal terms: if the terms of trade can be set in a way that fulfills condition (5) or (10), then parties will conclude an efficient deal. If, however, there is no feasible efficient solution, then this situation cannot be improved by modifying the laws of conflict or multilateral or bilateral conventions. (This does not necessarily imply that transactions are doomed to fail, because means of private ordering might be available.)

Joining Guzman (2002: 913) we would consider this lesson a “recognition of, and deference to, private ordering”, even though the choice of the applicable law and the court which applies it is a recourse to legal centralism. In New Institutional Economics, private ordering is generally understood in a narrow sense as a substitute for legal centralism. A contract clause according to which Lex Mercatoria has to be applied, and all disputes have to be decided upon by an arbitration panel, is an example of this narrow view of private ordering. But this view is too narrow. Arbitration in the European Union, e.g., awards “legal tender” and, therefore, rests on the centralistic enforcement system. Thus, the boundary between legal centralism and private ordering becomes blurred. Private ordering takes place in the shadow of the law.

(2) Default rules matter if the parties fail to contractually choose the law, or a particular choice of law clause is not enforced.

Note that the rules of conflict of law *are* default rules. However, as it has been argued in the beginning, since these rules are national rules, they contribute to the constitutional uncertainty. Whincop and Keyes suggest formulating rules specific to transaction types. For contracts involving services or the sale of goods they favor the place of performance or the place of contracting because they best capture the presumed intent of the parties (Whincop and Keyes 2001: 44). However, in the transaction cost framework this argument implies that

default rules economize on transaction costs relative to other rules. Alternative rules like “always apply the forum’s law” or “apply the law of the jurisdiction with the presumed regulatory advantage” may work. If such a rule prevails and the parties consider it inefficient, they can contract around it.

(3) From an efficiency point of view, conflict of law rules should be evaluated with respect to how they facilitate international transactions.

Most of the literature on conflict of law is only concerned with after-the-conflict issues. It does not discuss the link to the underlying behavior. From an economic point of view, however, what happens *after* a breach of contract is only relevant to the extent to which incentives are set for bilateral contractual compliance. This is the ex-ante decision whether or not parties engage in a transaction and fulfill their contractual obligations without pursuing illegitimate lawsuits. Inequality (5) or (10) provides a point of orientation. Conflict of law rules should be formulated such that they increase the likelihood of (5) or (10) to be fulfilled.

(4) The objective of conflict of law rules should be the reduction of transaction costs. If, for example a potential defendant does not have any assets in a specific country, but the rules of conflict of law only allows for bringing suit in this country, this may increase the transaction costs of doing international business to a level that blocks welfare-improving transactions. As a way out, free movement of judgments should be introduced, or a plaintiff should be free to choose the court. Note, however, that freedom to choose the court after the conflict has arisen might result in forum shopping and rent dissipation. Thus, freedom to choose ex ante the court and the applicable law in the contract in combination with a free movement of judgments would be the better option.

(5) From an efficiency point of view, neither the domicile nor the residence of a party should be a criterion for the allocation of jurisdiction.

Admittedly, these rules have the advantage of being easy to observe and to verify. But, in order to facilitate international commerce, the rules of conflict of law should economize on transaction costs. In many cases, residence and domicile are factors that decrease the transaction costs of pursuing a law suit. These rules may, therefore, serve as a proxy for the efficient bases of jurisdiction (see for a similar conclusion Guzman 2002: 920).

(6) *The location of the activity, the place of contracting, and the place where the action is brought are not relevant to the conflict of law question.*

This lesson is similar to Lesson 8 in Guzman 2002: 921, yet for a different issue. Guzman presents the following rationale: “Among the tests commonly used to determine jurisdiction is what is termed the ‘conduct test’. This test bases jurisdiction on the location of the relevant conduct and presents one of the most traditional bases for jurisdiction” (Guzman 2002: 921). From an efficiency point of view, to obey the location of activity is neither a necessary nor a sufficient condition for assigning jurisdiction.

Suppose, for example, that Adam and Eve consider concluding their contract on the territory of country H. Assigning the jurisdiction to a court in H would imply that the applicable law has to be determined according to H’s rules of conflict of law. Assume furthermore that, according to these rules, the law of country A has to be applied. This combination of rules might imply a low value of p_H , since H-judges had to apply a substantive law they are not familiar with. Moreover, the question of recognition and enforcement arises. Since a “highly territorial, rule-oriented, and formalist method of resolving choice of law questions” characterizes the vested rights theory (see Solimine 2002:209), our analysis supports the criticism of this theory.

Although the location of an activity does not itself serve as an appropriate basis for jurisdiction, it may (just like residence and domicile) serve as a proxy for an assignment economizing on transaction costs. However, the location of an activity is becoming a less reliable proxy as the costs of travel and communication decrease (see for a similar argument Guzman 2002: 923).

(7) *The governmental interest approach cannot be supported.*

According to this more policy-based approach, the law of the state “with the most significant contacts or relationship to the dispute” (Solimine 2002: 209) should be applied. It is yet not easy to determine which state is ‘most interested’ in the outcome of the lawsuit. Both A and E could be considered, but for different reasons. State A has an interest in protecting the property rights of Adam since this increases both Adam’s and state A’s wealth. But a similar argument holds for the interests of state E from an ex ante (yet not ex post) point of view.

(8) *Neither law nor courts should discriminate against foreigners.*

This lesson coincides with what Guzman called national treatment of foreign plaintiffs (see Guzman 2002: 927–930). Discrimination of foreign plaintiffs can reduce p_i and q_{ij} such that inequality (5) or (10) is violated. If private ordering does not work, then welfare improving international trade would be blocked.

V. Conclusion

Traditional conflict of law scholarship has largely failed to present an efficiency-based approach to conflict of law rules. This paper has applied transaction cost analysis to this field and set up a new fundament upon which an economic theory of conflict of law can be erected. The new approach should, however, not be taken as a substitute for careful reading of complex legal material. To the contrary, the parameters of the international legal order have to be derived from the contents of the legal rules. In this sense, the new approach opens up a new perspective for the interpretation of the law:

- It presents a framework useful for considering the conflict of law questions from an ex ante point of view.
- It demonstrates how conflict of law rules (just as means of private ordering) allow economic actors to conduct international transactions efficiently.
- It allows us to answer both the question of how changes in legal rules influence behavior (via the parameters quintuples) and whether this influence fosters efficiency. Properly extended and interpreted, the new approach could even be applied to matters of regulation and other areas of law.

Furthermore, the paper has developed policy implications answering in part the question as to how to achieve an efficient international legal regime. The transaction costs of international business can be reduced by a workable international legal order. In particular, choice of jurisdiction and free movement of judgments play a crucial role in facilitating international transactions.

In contrast to the traditional literature concerned with rules of conflict of law and choice of laws, this paper discusses the issues within an economic model of international trade. We purposefully restricted our attention to a model with perfect and complete information and applied a rather stylized litigation model. This allowed us to highlight the basic structure of the issue. Further research should take into account more sophisticated models of litigation.

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