

# CONVERGENCE, CONCURRENCE ET HARMONISATION DES SYSTÈMES JURIDIQUES

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# Relative Competitiveness of Different Legal Systems: The Point of View of an American Practitioner

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A map of the world, where civil law countries are colored in blue and the common law countries in red, reveals that civil law countries cover approximately 2/3 of the world's area and that common law countries represent only approximately 6.5% of the world's population.<sup>1</sup> Then why should one even question the relative competitiveness of these two legal systems?

In practice, we observe that in numerous fields related to business the influence of Anglo-Saxon law and principally of American law is growing. Why?

Several factors have to be considered: English has become the *lingua franca* of business; the internationalization of commerce and finance has increased the need for flexibility and reliability sought by users.

## I. The Influence of the Choice of Language

However much one might regret the loss of the place of the French language on the international scene, we are compelled to recognize, if not accept, that English has become the language of business. It is now customary to see a contract between two French companies or between two Italian companies drafted in English.

This practice has two consequences:

1. the use of Anglo-Saxon models and precedents, and
2. the introduction, through the back door, of concepts of common law into civil law contracts.

Civil law contracts were traditionally short – the draftsmen felt no need to repeat the provisions of the civil code. Thus, a civil law draftsman need not specify that a contracting party is excused for non-performance due to force majeure, since the code already so provides.<sup>2</sup> In contradistinction, as a corollary of the absence of codification, the drafting philosophy of Anglo-Saxon contracts, anticipates as many situations as possible, leaving as little as possible to the appreciation and discretion of the judge, and describing the will of the parties in great detail, which leads to very long agreements.

Contract precedents come both from practice, such as acquisition agreements or licensing agreements, and from the enormous work performed by numerous private or public bodies. As the exhaustive analysis of the contributions to the standardization of contracts that bodies such as UNCITRAL or Unidroit among others have made goes beyond the scope of this paper, I will limit myself to mentioning three

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<sup>1</sup> Out of 364 jurisdictions reviewed by the law school of the University of Ottawa, only 42 are common law jurisdictions. See: [www.droitcivil.uottawa.ca/world-legal-systems/fra-monde.php](http://www.droitcivil.uottawa.ca/world-legal-systems/fra-monde.php); [www.droitcivil.uottawa.ca/world-legalsystems/fra-population.php](http://www.droitcivil.uottawa.ca/world-legalsystems/fra-population.php); [http://en.wikipedia.org/wiki/Image:Legal\\_SystemsoftheWorldMap.png](http://en.wikipedia.org/wiki/Image:Legal_SystemsoftheWorldMap.png).

<sup>2</sup> Art. 1148 French civil code, Art. 1470 C.C.Q. To avoid confusion, the French civil code is abbreviated C.C. and the Quebec one C.C.Q.

examples that are particularly pertinent to practitioners. The role played by the large international law firms is also worth noting: the diversity in the training of the team members and the frequent moves by lawyers from one international firm to another, have led to the development of a usage in drafting.

In the financial arena in the last twenty years, we have witnessed an increase, otherwise highly understandable, of the standardization of documentation. The models elaborated by the International Swap and Derivatives Association ("ISDA") for swaps, credit derivatives and financial guaranty contracts are used all over the world.<sup>3</sup> When new products, such as emission credits are created, professionals turn to ISDA to adapt the standard documentation to the new products.

Similarly, the models of documentary credits and the INCOTERMS elaborated by the International Chamber of Commerce<sup>4</sup> are widely used in the world and thus simplify international trade.

In London, the Loan Market Association of banks, law firms and finance professionals has prepared a model, criticized by some,<sup>5</sup> of syndicated credit documentation.

This recourse to Anglo-Saxon precedents has resulted also in the introduction of alien common law concepts into classical civil law constructions.

A few examples will illustrate this point.

The English word "payment" has the usual meaning of discharging by the payment of a sum of money.<sup>6</sup> The Civil Code defines "payment" as follows: "Payment means not only the turning over of a sum of money in satisfaction of an obligation, but also the actual performance of whatever forms the object of the obligation."<sup>7</sup>

Thus, when a contract drafted in English is subject to civil law, and the word "payment" is used, the interpreter of the contract must ask what meaning of the word the parties ascribed to it.

In contract drafting practice, it is customary to see "best efforts" or "commercially reasonable efforts" clauses. If a contract thus drafted on the basis of an Anglo-Saxon precedent is governed by civil law, what is the nature of the obligations so contracted: is that an obligation of means or an obligation of results?

Another example: often contractual relations start with a memorandum of understanding ("MOU") or by a letter of intent. These documents contain numerous obligations of the parties, while stating that the document does not bind the parties. If

<sup>3</sup> The list of models may be found at: [www.isda.org](http://www.isda.org)

<sup>4</sup> Uniform Rules and Customs relating to Documentary Credits RUN600 (Rev. 2007), International Rules and Customs relating to Standby (RPI598); INCOTERMS: [www.incoterms.com](http://www.incoterms.com)

<sup>5</sup> M. FAVERO, La standardisation contractuelle, enjeu de pouvoir entre les parties et de compétition entre systèmes juridiques, RTD Com. 2003 p. 429.

<sup>6</sup> *Black's Law Dictionary*, sub nomine "Payment".

<sup>7</sup> Article 1553 C.C.Q.

in such an MOU you have the conditions that normally give rise to a synallagmatic contract, should the document be analyzed, notwithstanding the declaration that it is non-binding, as a contract with conditional or suspensive obligations<sup>8</sup> with the retroactive effects upon fulfillment of the conditions that are set out in the civil code?

The letter of intent, or "lettre d'intention" in literal translation, is another false friend. For an Anglo-Saxon draftsman, the letter of intent and MOU are interchangeable. The "lettre d'intention" in French corresponds to the "letter of comfort" of Anglo-Saxon banking practice. The French "lettre d'intention" is now classified as a personal security as stated by Article 2287-1 of the Civil Code. It is now in the same chapter as suretyship. It is defined at Article 2322 of the Civil Code as "the undertaking to do or not to do whose purpose is the support provided to a debtor in the performance of his obligation in respect of his creditor." Classified as a security, the "lettre d'intention" seems to have moved further away from the obligation of means, to come closer to suretyship without, albeit, reaching it.<sup>9</sup>

By contrast, under New York law, a well-drafted comfort letter does not create any obligation for the issuer of the letter.<sup>10</sup>

The third-party beneficiary clause, which is often found in Anglo-Saxon precedents stating that no third party can avail itself of the rights created by the contract, is superfluous in a contract governed by civil law, since the civil code already states what the effect of the contracts is.<sup>11</sup> The same observation can be made with respect to the "pari passu" clauses, since in France the law determines the order of creditors.

## II. The Role Played by Finance

Finance, and especially its international development, has played a major role in the primacy of one legal system over another. To illustrate that role, let us examine the needs of our clients in the case of specific financial operations: financial guaranty, project finance, and art collection financing.

Our clients need a robust legal system, need simplicity in the creation of the security interest, and an easy and reliable way to collect on the collateral – either by taking the collateral or by netting.

<sup>8</sup> Cf. Art. 1497 et 1507 C.C.Q.; Articles 1168 et 1182 C.C.

<sup>9</sup> Articles 2322 et 2287-1 C.C.; Paul LE CANNU "Les lettres d'intention conquises par le code civil" RTD Com. 2006, p. 241; C. CHAMPAUD & D. DANET, note sur Weintraub c/Sté Balmain, Com. 20 février 2007, D. 2007 AJ. 897, obs, X. Delpech, RTD Com. 2007 p. 369; J. STOUFFLET "La reconnaissance par l'ordonnance du 23 mars 2006 de deux types de garanties issues de la pratique: la garantie autonome et la lettre d'intention", *Revue des Sociétés*, 2006 p. 473.

<sup>10</sup> Cf. K. BLOCK & J. STEINER, "Comfort Letters: Casual drafting can turn one into a guaranty", *NY Law J.*, v. 31, no. 13, Jan. 21, 2004.

<sup>11</sup> Art. 1440 C.C.Q.

In analyzing a financial guaranty, three different sets of laws must be examined:

1. the law chosen by the parties to apply to the financial guaranty contract
2. the *lex rei sitae*, the law of the country where the object given as collateral is located
3. the bankruptcy law; if the debtor becomes bankrupt in general it will be the law of the principal domicile of the debtor which will apply .

In classical civil law, a security could only be created pursuant to a legal text. Thus, when the film industry developed in France a specific law was needed in 1944 – the cinematographic industry code – to allow a producer to obtain bank financing by pledging the future gate receipts.<sup>12</sup>

Before the recent reforms in France,<sup>13</sup> the creation of a pledge in classical civil law was subject to a tedious formalism and the pledged object had to be turned over to the creditor. Furthermore, a debtor and a creditor could not agree at the time of creation of the pledge that the ownership of the object of the pledge would be transferred to the creditor in case of default of the debtor (this is called a “*pacte comissoire*.”) In France, in case of bankruptcy, the pledgee was ranked after the so-called super-secured creditors. The formalism surrounding the creation of a pledge raised all sorts of thorny questions in the drafting of inter-creditor agreements for the sharing of collateral pledged between creditors of the same rank or of different ranks.

The law of the State of New York and the federal bankruptcy law in the United States have historically demonstrated a much greater flexibility than classical civil law. Under the Uniform Commercial Code (UCC), the security interest is a contractual creation and the formalities are simplified. The UCC has also been swiftly amended to be adapted to new conditions. Thus, approximately ten years ago, articles 8 and 9 of the UCC<sup>14</sup> were amended to solve the problems stemming from the de-materialization of securities, while the same problem is still not resolved in Europe, since The Hague Securities Convention of 5 July 2006 has not yet entered into force.<sup>15</sup>

In the United States, for bankruptcies governed by the Federal Bankruptcy Code,<sup>16</sup> exercising one's rights in the collateral is an easy matter: the secured cred-

<sup>12</sup> Y. PICARD, Rep. Dalloz – Droit Commercial, janvier 2002, v. Nantissement no. 106.

<sup>13</sup> Cf. *infra* for the discussion of the French ordinance of March 23, 2006.

<sup>14</sup> Cf. P. A. HAKES, “UCC Article 8: Will the Indirect Holding of Securities Survive the Light of Day?” *Loyola of Los Angeles Law Review*, 35:661, 2003.

<sup>15</sup> The state of ratification can be accessed at [www.hcch.net](http://www.hcch.net) cf. Diego DEVOS, “Legal Protection of Payment and Securities Settlement System and of Collateral Transactions in European Union Legislation”, presented at the IMF Conference on Financial Law, Washington, October 23-27, 2006 and European Legislation on Financial Markets, by the European Central Bank, June 2007.

<sup>16</sup> During these troubled times one major exception must be noted: insurance companies are regulated by the states and not by the Federal Government, as each state has its own insurance company bankruptcy statute. Netting must be examined in each of these statutes and differs in major ways from the netting provisions of the Bankruptcy Code. This point is of particular importance for financial transactions guaranteed by an insurance company.

itor can use self-help and netting is authorized. The 2005 reform of the Federal Bankruptcy Code evidences the intent of Congress to extend to a much broader set of financial instruments the derogations to the normal bankruptcy regime which have already applied since 1978 to certain types of financial contracts and to certain specified parties.<sup>17</sup> In order to extend the application of the derogations, Congress has considerably enlarged the definition of swap contracts to include therein all transactions which are or may become common in financial markets.<sup>18</sup> The innovation of the reform, which is a good illustration of the pragmatic American approach, no longer consists in just protecting a class of persons and a class of contracts, but a market in its entirety, that of financial instruments.<sup>19</sup> Beyond the five categories of financial transactions which already existed<sup>20</sup> but whose definitions have been extended, the law creates a new category – the master netting agreement – which allows parties to fix their rights of termination, acceleration and set off within and across multiple financial transactions within a single contract.<sup>21</sup>

However, even if netting is authorized, there are still a number of difficult situations. Suppose that a master agreement authorizes the entering into contracts between the different subsidiaries of party A and party B by means of annexes to the master agreement; can one net the sums owed by subsidiary A1 to B2 against the sums that B3 may owe to A4? As part of the efforts to develop a master netting agreement under the auspices of the Edison Electric Institute and of ISDA, these questions have been and continue to be heavily debated.<sup>22</sup> In spite of the 2005 reforms of the Federal Bankruptcy Code, netting still remains bilateral.<sup>23</sup>

One should not be astonished by the preference of our clients to choose New York law to govern their financial guaranty contracts. From 2000 to December 31, 2007, the number of financial contracts has jumped from 12,000 to 149,322 and the amount of the collateral has been multiplied by a factor of 10, jumping from 200 billion dollars to 2,200 billion dollars. According to ISDA, 85% of these contracts use the ISDA models, and 60% of the contracts are New York law contracts, while 25% are governed by UK law.<sup>24</sup>

Historically, the law applicable to project financing is either New York or UK law. New York law is traditionally used for financings in Central and Latin America, while

<sup>17</sup> *Bankruptcy Reform Act of 1978*, Pub. L., No 95-598 §§ 362(b)(6), 548(d) U.S.C.C.A.N. (92 Stat.) 2549.

<sup>18</sup> H.R. Rep. No 109-31, p. 123.

<sup>19</sup> H.R. Rep. No. 109-31, p. 3: The intent of lawyers is to have “provisions designed to reduce systemic risk.”

<sup>20</sup> § 741(7), “securities contracts”, “swaps” “repurchase agreements”, “forwards” et “commodity contracts”, 11 U.S.C. §§ 101(2S), (47) (53B) et 76114.

<sup>21</sup> 11 U.S.C. §§ 362(b)(27), 546(j), 548(d)(2)(E) et 561.

<sup>22</sup> See Master Netting Agreement at [www.eei.org](http://www.eei.org) and the 2006 ISDA Model Netting Agreement.

<sup>23</sup> Cf. E. MORRISON & J. RIEGEL, “Financial Contracts and the New Bankruptcy Code, Insulating Markets from Bankrupt Debtors and Bankruptcy Judges.”, Jan. 25, 2006, *Columbia Law School Center for Law and Economic Studies*, Working Paper No. 291, <http://ssrn.com/abstracts=878328>, p11 N.55.

<sup>24</sup> ISDA Margin Survey 2008, Table 4.1, available on the ISDA website, [www.isda.org](http://www.isda.org)

UK law is found for projects in Africa (outside of French-speaking Africa) and in Southeast Asia. Why this historical trend in Latin American countries which are after all civil law countries? The classic project finance involved a special purpose vehicle created for that project and an off-taker who agreed in a long-term contract to take the output of the project. The financing rested upon the ability to pledge the future receipts as guarantee for the financing, thus transforming the risk of the project into a credit risk on the credit of the off-taker. The success of the financing rests thus upon the ability of the borrower to pledge the receipts of future sales as guarantee for the financing. The classical civil mechanisms did not allow this pledge.<sup>25</sup> The UCC allows the grant of a security interest in such future sales proceeds with reduced formalities.<sup>26</sup> To arrive at the same result in civil law, it was necessary to have tripartite contracts between the borrower, the off-taker and the lenders; a solution, which had neither the simplicity nor the flexibility of the UCC.

The problems in classical civil law relating to the non-possessory security interest have been solved by numerous civil codes in the last few years. Should one attribute the introduction of the moveable hypothec in the 1994 Quebec Civil Code to Quebec's proximity to the United States?<sup>27</sup> In France, the ordinance of 23 March 2006 has introduced the non-possessory security interest.<sup>28</sup>

For financial guaranties, the problems of netting in bankruptcy proceedings have been largely solved by the European Union 22/47/EC directive concerning financial guaranty contracts. Article 4(1.4) of the directive allows pledgees to seize the object of the collateral without judicial proceeding and suspends the ordinary rules relating to suspect periods in case of bankruptcy. The transposition of the directive into French law only occurred in 2005.<sup>29</sup> With the amendments to Article 431-7 of the monetary and financial code, it is possible to stipulate global netting, even if the parties are bound by several master agreements. The contractual netting is opposable to third parties, including seizing creditors, and to bankruptcies. The creation mechanism has been greatly simplified; it is no longer necessary to obtain the written agreement of the debtor for the assignment, a simple modification for the debtor suffices. Part II of the revised article 431-7 also allows the creditor to become owner of the collateral in case of debtor default.

The reform of the law of secured transactions in various civil law countries allows it to better meet the needs of today's world of finance, but there are still limitations which affect the perception that users may have of the competitiveness of one system compared to another. When a bank seeks to loan money to an art col-

<sup>25</sup> Cf. MESTRE, D.1982, Chron. p.141; MALAURY et AYNES, *Les sûretés, La publicité foncière*, 2004, n° 501 et CABRILLAC et MOULY, *Droit des sûretés*, 7<sup>e</sup> éd. Litec 2004, n° 558 for a discussion of the possibility of pledging future flows.

<sup>26</sup> The security interest at 9-308 UCC.

<sup>27</sup> Article 2696 et seq. C.C.Q.

<sup>28</sup> New art. 2341 al.2 C.C.

<sup>29</sup> Ord. no 2005-171 du 24 février 2005 simplifiant les procédures de constitution et de réalisation de garantie financière, A. LIENHARD, *Transposition de la directive contrats de garantie financière*, Dalloz 2005.634; M. STORK, "Transposition de la directive communautaire relative aux contrats de garantie financière", RTD Com.2005, p.375.



lector, the bank's objective of finding an applicable law which provides a guaranty and ease of execution, and the collector's interest in being able to enjoy the art collection without dispossession, must be reconciled. The 2006 reforms in France or the 1994 reforms in Quebec allow the reconciliation of those objectives, but the Luxembourg law of 5 August 2005 in its reform of security interests, unlike French law, has maintained a distinction between the civil pledge and the commercial pledge.<sup>30</sup> The non-possessory security interest is only allowed in the case of commercial pledges. For that reason, Luxembourg law does not allow for the balancing of the interests of the parties; the pledge of artwork by a collector is a civil pledge the validity of which still requires dispossession in Luxembourg. Thus, one can no longer debate the respective competitiveness of common law and civil law solutions, but the relative competitiveness of different civil codes.

The needs of finance have brought about a convergence of the solutions to the same problems by both the common law and the civil law. This modernization of civil law is in part attributable to the influence of the European Union, which through its elaboration of directives has pushed member countries to adopt the necessary reforms of their civil codes. Although one may sometimes regret that the chosen solutions do not easily fit into the theoretical framework of the civil code, one can only applaud their adaptedness to market conditions. The introduction of the trust into French law<sup>31</sup> in 2007 rests on the notion of trust property, a notion which is difficult to fit within the classical civil theory of the unity of the patrimony. As was underscored by Mr. Pascal Clement, Justice Minister, in his presentation of the draft law on trusts before the French Parliament: "*the opening of borders and the internationalization of trade have rendered indispensable the creation of a comparable tool to allow investors who are familiar with the Anglo-Saxon trust to feel confidence in French law, which is often too little known by our international partners. In addition, and the situation is paradoxical, French companies often resort to foreign trusts because they do not have a suitable instrument in internal law. This situation is regrettable, since it brings about a delocalization of operations outside of our borders.*"<sup>32</sup>

Will the reforms that have been passed – and their convergence towards the solutions offered by the common law – be sufficient to allow the civil law to regain market share? One is permitted to doubt it.

<sup>30</sup> Article 114 al. 3 of the commercial code and art. 2076 of the civil code of Luxembourg.

<sup>31</sup> Law No. 2007-211 of 19 February 19, 2007 modifying articles 2011 et seq. of the civil code, articles 1260-1298 C.C.Q.

<sup>32</sup> Octobre 10, 2006.