



Enforcing contracts

How judicial efficiency supports freedom of contract

- In regulating freedom of contract, authorities around the world have had to strike a balance between the desire to give contracting parties the ability to enter into mutually beneficial arrangements and the need to provide adequate safeguards against possible abuse.
- Worldwide, the most common limitations to freedom of contract stem from local legislation, through which the government attempts to draw a boundary between the use and misuse of bargaining power. Other limitations stem from the courts, which play a vital role in shaping freedom of contract by deciding whether or not to enforce certain agreements.
- In a sample of 34 economies, none allow the parties to a contract to exclude liability for gross negligence or for damages resulting in personal injury. Similarly, all of the economies consider contracts void or voidable if concluded in contravention of public policy or under duress, fraud or coercion. Only 4—the Democratic Republic of Congo, Pakistan, the Philippines and Sri Lanka—set no statutory limit on interest rates. Almost half (14) explicitly prohibit covenants restricting the alienation of real property.
- Even where there is considerable freedom of contract, slow resolution of contract disputes can impose implicit limitations. Without reasonably expeditious dispute resolution, the meaning of freedom of contract can be greatly eroded.

Freedom of contract is the ability of adults and groups—such as corporations and other legal entities—to freely decide whether to enter into an enforceable agreement and to determine the rights and obligations of their bargain. This freedom is essential to an efficient economy: without it, and without enforcement of contracts, there would be little stability in financial arrangements, and uncertainty and lack of trust would discourage people from participating in economic life.

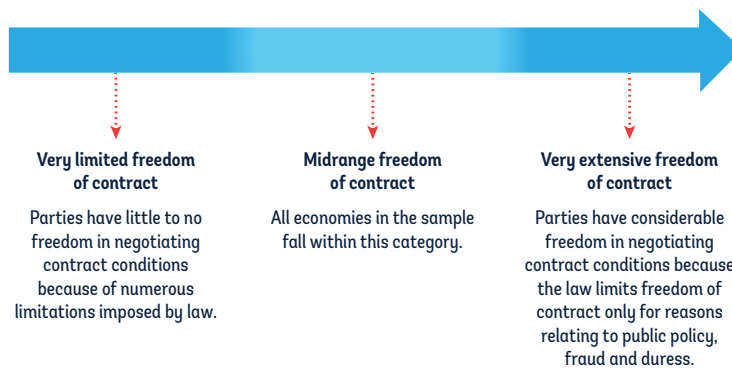
This case study explores what freedom of contract means and examines how it is regulated in a sample of 34 economies belonging to different regions and income groups, chosen mostly on the basis of the quality of the data collected by the *Doing Business* team in each economy.¹ It also looks at judicial efficiency in contract resolution in the same 34 economies, using data for the enforcing contracts indicators as a proxy for judicial efficiency. Even substantial freedom of contract could become irrelevant without effective mechanisms for resolving commercial disputes, because firms would find themselves operating in an environment where compliance with contractual obligations is not the norm.² As in previous years, the ranking on the ease of enforcing contracts continues to be based exclusively on the time, cost and procedural complexity of resolving commercial disputes before local first-instance courts. This year's research on freedom of contract is a one-time exercise that will not be replicated in

future editions of the report and has no implications for the data or rankings for enforcing contracts. Additionally, in carrying out this exercise the team does not intend to advocate in favor of more or less freedom of contract but instead aims to provide an overview of local regulations.

In regulating freedom of contract, economies worldwide have had to draw the line between very extensive and very limited freedom of contract (figure 11.1). Most have drawn the line somewhere in between. Where freedom of contract is very narrowly regulated, most transactions fall within the strict schemes dictated by the law, leaving the contracting parties with limited negotiating power. But where it is not narrowly regulated, the law contains only the most common limitations (such as for public policy reasons and to prevent fraud and duress), allowing the parties to freely negotiate the terms of their agreement.

Where there are few limitations to freedom of contract, 2 capable and consenting adults would be able to conclude a 10-year loan contract with an interest rate of 50% or even contract to sell a house worth \$1 million for a penny. But they would not be able to circumvent public policy limitations and conclude a contract by which, for example, one of the parties sells himself as a slave or forces the other into an unwanted agreement—limitations of this sort have become widely accepted in modern law. While most would agree

FIGURE 11.1 Spectrum of the possible limitations to freedom of contract



that contracts contravening public policy should be illegitimate, some would disagree on whether the first 2 contracts should be enforced.

HOW THE LITERATURE DEFINES FREEDOM OF CONTRACT

In the legal and economic literature there is wide consensus on a definition of freedom of contract, intended to be the power of contracting parties to freely determine the content of their agreement without interference from the government or from other individuals.³ The concept is generally given both a negative and a positive meaning. Negative freedom of contract is freedom from interference by the government or by other individuals, while positive freedom of contract is the ability of parties to freely determine the content of an agreement.⁴

While there is broad agreement on a general definition, every economy limits freedom of contract in different ways. In regulating these limitations, the main debate has centered on the role that should be played by the courts and by the state in general. In the late 1800s and early 1900s legislators, influenced by classical contract theory, relied on the notion that only the parties

to a contract can evaluate whether it is beneficial, leading to the idea that whether agreements are prudent and profitable should be determined not by the courts but by the parties themselves.⁵ At the time, the private sphere represented a realm in which individual freedom and autonomy were protected from state intervention. Any legislation that disturbed parties' equality with liberty of contract, which no government could legally justify. In this context freedom of contract had few limitations; legislators were more concerned with protecting the sanctity of the bargain because they believed that maximizing individual profits through freedom of contract would promote efficiency in commercial markets.⁶

During the mid-1900s, however, governments and courts started to acknowledge the tension between the parties' desire for certainty and stability in private agreements and the need to ensure fairness for weak and vulnerable individuals; concepts such as fraud, duress and undue influence began to play a bigger role in court decisions on limitations to freedom of contract.⁷ In this context freedom of contract was no longer seen as absolute but instead as a liberty to be enjoyed within the framework of the law, designed to protect individuals from

threats to health, safety, morals and welfare. The court decisions spurred a debate over the government's role in imposing limitations on freedom of contract, and a more paternalistic approach emerged. This entailed overruling individuals' contractual preferences for their own good, to protect them from the damaging consequences of their agreements.⁸ Several countries started to regulate contractual relationships under the assumption that in certain circumstances people are unable to identify their own preferences.⁹

Today most economies regulate limitations to freedom of contract by pairing this paternalistic approach with a program of social justice animated by distributive motives, economic efficiency and overall fairness, which has led to rules favoring some groups in the struggle for welfare.¹⁰

U.S. labor law offers a great example of this evolution. In the late 1800s and early 1900s courts invalidated laws that limited freedom of contract, including laws with minimum wage requirements, laws with restrictions on maximum working hours or union participation and federal child labor laws.¹¹ In these cases the court assumed a near equality of bargaining power and found it anomalous that the law would favor one party over the other. This approach dominated in the early 1900s and culminated in the 1905 decision *Lochner v. New York*, in which the court invalidated a New York law limiting the daily number of hours a baker could work. However, this *Lochnerian* freedom of contract, the freedom that required parties to live with their duly executed contracts however overreaching or disadvantageous to the weaker party, succumbed to the state's interests.¹² During the late 1930s legislation and case law relying on the notion that countries should retain the right to protect individuals from entering into a contract against their health, safety or welfare started to emerge. Laws

regulating child labor, maximum hours, health and safety, sexual and moral harassment, and nondiscrimination in recruitment and hiring were more and more often enforced by the courts. When distributive motives started to play a bigger role in labor laws, so did measures regulating minimum wage and retirement security.

Today, despite the differences in approaches to setting the boundary between the use and misuse of bargaining power, some limitations—such as those relating to voluntariness, freedom from coercion, and natural and legal capacity—are universally accepted. Worldwide, there are laws intended to prevent people from using force, secrecy, duress or fraud to compel others to enter into contracts that they would not agree to under different circumstances. Similarly, there are contract rules in effect to void agreements that appear to have been freely entered into but were not in actuality, because of the incapacity of one of the contracting parties.

These limitations have become an indispensable part of any comprehensive definition of freedom of contract, now intended to be both freedom of the parties from interference by the state and freedom from imposition by one another.¹³ Among the 34 economies in the sample, all have legislation deeming contracts unenforceable for reasons of public policy, duress, coercion, fraud, incapacity or undue influence.

WHY FREEDOM OF CONTRACT MATTERS FOR FIRMS

Freedom of contract is a critical instrument for economic progress and efficiency.¹⁴ Its unrestricted exercise by parties with equal bargaining power, comparable skills and good knowledge of relevant market conditions maximizes individual welfare and promotes the most efficient allocation of resources in

the marketplace.¹⁵ In addition, freedom of contract contributes to the establishment of a functional economy in which predictability is prized.¹⁶

Worldwide, the most common limitations to freedom of contract stem from the government, through its attempt to draw a boundary between the use and misuse of bargaining power. Others stem from the courts, which play a vital role in shaping freedom of contract when deciding whether to enforce certain agreements. Indeed, people have true freedom of contract only if the courts enforce their agreements.¹⁷ Courts have a dual role in this context—both to protect individuals from unreasonable government regulations and to clarify and apply rightful limitations. Additionally, the judiciary must also make sure that freedom of

contract remains meaningful by ensuring timely enforcement of contracts.

WHAT METHODOLOGY WAS USED

To investigate limitations to freedom of contract in the 34 sampled economies, the *Doing Business* team added several new questions to this year's questionnaire on enforcing contracts. These questions focus on 10 possible limitations to freedom of contract, relating to issues ranging from land transfers to consideration, choice of law and limited liability clauses (box 11.1). To observe meaningful differences between economies, the team focused on issues that have been extensively debated throughout the relevant literature and case law, although a consensus has

BOX 11.1 Possible limitations to freedom of contract explored through this year's research

- Statutory limits on interest rates
- Limitations on consideration and on determination of contract price in future agreements
- Limitations on clauses restricting land transfers
- Limitations on "choice of law" clauses in commercial contracts (clauses specifying that any dispute arising under the contract will be determined in accordance with the law of a particular jurisdiction)
- Limitations relating to asymmetry of power and to unconscionability (a doctrine in contract law referring to terms that are so one-sided in favor of a party with superior bargaining power that they are contrary to good conscience)
- Limitations on disclaimers on implied warranties (guarantees that the item sold is merchantable and fit for the purpose intended)
- Limitations on clauses allowing termination at will (clauses usually included in employment agreements that permit an employee or employer to terminate the employment relationship at any time for any or no reason at all)
- Limitations on clauses limiting liability, such as for negligence (conduct that departs from what would be expected of a reasonably prudent person acting under similar circumstances)
- Restrictions on terms included in standard-form contracts (contracts between 2 parties in which the terms and conditions are set by one of the parties and the other party has little or no ability to negotiate more favorable terms)
- Limitations for reasons relating to public policy, capacity, duress, coercion, fraud and undue influence

been reached on most of them. The 34 economies were chosen from the 189 covered by *Doing Business* in a way that ensures a representative sample across regions and income groups.

One area explored through this research deals with the limitations imposed by national laws on consideration, traditionally defined as anything of value promised to the other party when concluding a contract. Consideration often takes the form of money, though it does not have to. In the sale of a house, for example, the selling party's consideration could be the purchase price or a promise to pay this price, while the buyer's consideration could be the house. The team investigated whether local courts can exercise any scrutiny on the adequacy of consideration and whether the determination of consideration can be left to a future agreement between the parties. If freedom of contract is not restricted, courts should exercise no scrutiny on consideration as long as the parties willingly and knowingly accepted the terms of the contract. But if freedom of contract is restricted, courts may rule on the adequacy of consideration to ensure the fairness of all transactions carried out in the marketplace.

The inclusion of choice-of-law clauses in international contracts was also examined. These clauses specify that any dispute arising under the contract will be determined under the law of a particular jurisdiction. Economies limiting freedom of contract in this area usually do not allow such clauses or allow them only if the parties have a relationship with the chosen jurisdiction. Those without strict limitations on freedom of contract do not forbid such provisions.

Other areas of research included in this year's questionnaire are somewhat more controversial from a social, economic and philosophical perspective. Two research questions in particular provide an interesting example of this

controversy: whether an economy has any regulations setting a cap on interest rates and what rules govern asymmetry of power. These questions go to the heart of whether usury laws and laws governing an imbalance in bargaining power should legitimately impose limits on freedom of contract. Both sides of the debate have been defended at length. Those arguing in favor of these laws conclude that without them, free markets would produce perverse incentives to take excessive credit risks, which drive up the cost of the welfare system as a whole.¹⁸ Those arguing against them conclude that courts should enforce all voluntary contracts that do not produce negative consequences for others—while redistribution of wealth should occur through the welfare system, not through laws and regulations.¹⁹

On the question of asymmetry of negotiating power, those who defend freedom of contract argue that if contracts signed between parties with unequal bargaining power were treated as invalid because of this asymmetry, those with more power would refuse to sign contracts with people with less power, leading to the exclusion of these people from the market.²⁰ To capture the differences in the legal treatment of asymmetry of power in contracts, the team collected data on whether local laws contain restrictions on terms that can be used in standard-form contracts or on provisions allowing termination at will. In both cases, as in all other cases covered in this study, it is assumed that both parties have full legal capacity and entered into the contract freely.

After analyzing the laws addressing these issues in the sampled economies, the team counted the number of limitations to freedom of contract in each economy. The higher the number of limitations, the more limited the freedom of contract. The maximum number of limitations in the study is

10. Any limitation, even in the form of an exception to a general principle, is counted; no relevance is given to the intensity of the limitation. For limitations on contract provisions restricting land transfers, for example, 1 point is given even if the limitations are not imposed on all transactions but apply only to those involving foreigners.

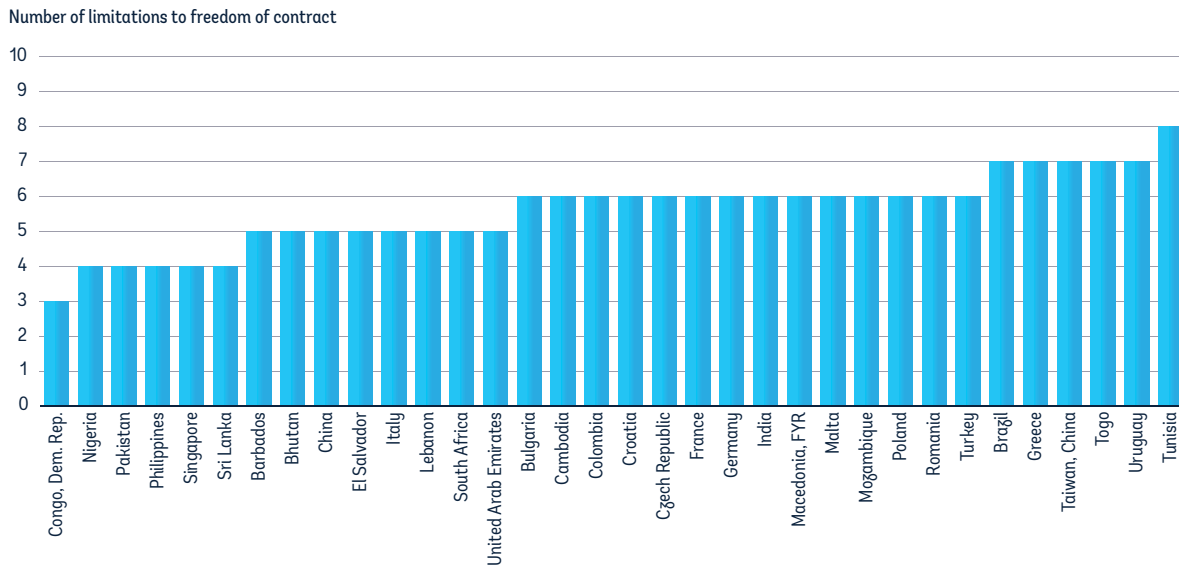
In carrying out this exercise the team does not intend to advocate in favor of more or less freedom of contract but instead aims to provide an overview of local regulations. Furthermore, in counting the number of limitations the team does not intend to suggest that a lower number—connected with greater freedom of contract in laws and regulations—is more desirable. The sole purpose in providing the number of limitations is to understand how the sampled economies regulate freedom of contract, without giving any judgment on the quality of the regulations or on their desirability.

WHAT THE RESULTS SHOW

Among the 34 economies covered, Tunisia has the highest number of limitations to freedom of contract, with 8 of the 10 limitations measured. At the opposite end of the spectrum is the Democratic Republic of Congo, with only 3 of the 10 limitations (figure 11.2).

The results not only show that all 34 economies have struck a balance between the extremes of very limited and very extensive freedom of contract; they also reflect some consensus on the limitations that should be imposed. For example, none of the economies allow the parties to a contract to exclude liability for gross negligence or for damages resulting in personal injury. Similarly, none of them allow contracts concluded in contravention of public policy or under duress, fraud or coercion. And only 4 of the economies—the Democratic Republic

FIGURE 11.2 The Democratic Republic of Congo has the fewest limitations to freedom of contract



Source: Doing Business database.

of Congo, Pakistan, the Philippines and Sri Lanka—set no statutory limit on interest rates.

But there is less agreement on other limitations to freedom of contract. For example, there is great variation among the economies on whether the law prohibits covenants restricting alienation of real property. A clause of this type would, for example, forbid the buyer from selling the property for a certain number of years after purchasing it. Of the 34 economies, 14 explicitly prohibit this kind of covenant, though 9 of these 14 economies allow restrictions on alienation of real property when foreigners are involved in the transaction. The rest of the economies allow these contract provisions.

Among the 7 regions covered, Europe and Central Asia is the only one in which no variation was found in the number and type of limitations imposed on freedom of contract. All sampled economies in the region have the following 6 limitations:

- A cap is imposed by law on interest rates.

- Courts can exercise scrutiny on the adequacy of consideration.
- The determination of a contract price cannot be left to a future agreement, unless the contract already establishes how the price will be determined.
- Limitations are imposed by law on clauses that can be included in standard-form contracts.
- Liability for gross negligence cannot be excluded through mutual agreement of the parties.
- A contract cannot be agreed upon if its terms are against public policy or if one of the parties does not have full legal capacity.

The other 6 regions show more variation in the number and type of limitations. Sub-Saharan Africa is a good example. While the Democratic Republic of Congo has the smallest number of limitations in the overall sample, with 3, Togo has one of the largest numbers, with 7. Togo is the only Sub-Saharan African economy in the sample that allows the courts to deny enforcement of a contract on the basis of inadequate consideration. In addition, only 2 of the 5 Sub-Saharan African economies in the sample do not

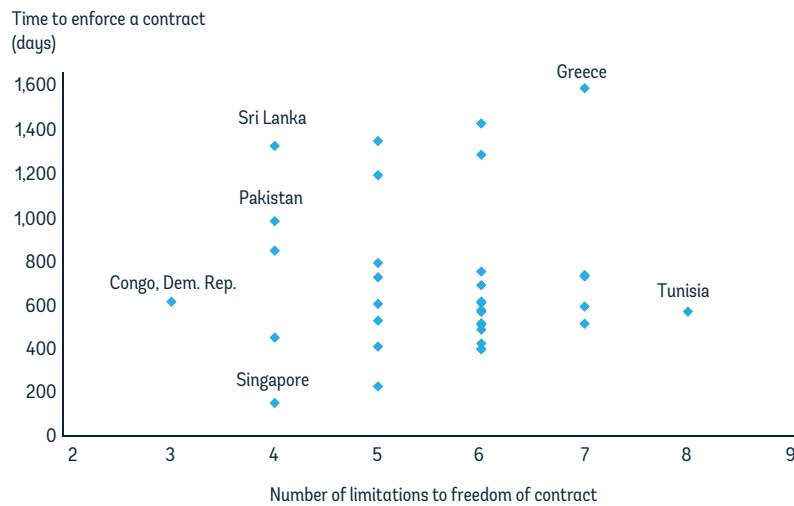
limit the terms that can be included in a standard-form contract, while all 5 allow termination at will, choice-of-law clauses and disclaimers on implied warranties as long as the seller was not acting in bad faith.

Across all regions, only 3 economies forbid choice-of-law clauses in international contracts. All 3—Brazil, Colombia and Uruguay—are in Latin America and the Caribbean.

Even where there is considerable freedom of contract, slow resolution of contract disputes can impose implicit limitations. Without reasonably expeditious dispute resolution, the meaning of freedom of contract is eroded; parties might be able to conclude most contracts on their own terms, but long contract resolution times would ultimately frustrate that ability.

In Singapore parties not only have broad negotiating power; they also have the certainty that their contracts will be enforced promptly. The country imposes few limitations on freedom of contract, and resolving

FIGURE 11.3 Singapore is among the economies with both the fewest limitations to freedom of contract and the fastest contract resolution



Source: *Doing Business* database.

a standardized commercial dispute through the courts—from the filing of the case to the enforcement of the contract—takes 150 days as measured by *Doing Business* (figure 11.3), a global best practice. In Sri Lanka there are equally few limitations to freedom of contract, but resolving the standardized dispute through the courts takes 1,318 days—almost 4 years. Parties might be able to include a wide array of covenants in their agreements, but long enforcement times can nullify the utility of those covenants. A slow contract resolution process frustrates freedom of contract.

The Democratic Republic of Congo is another economy where long enforcement times frustrate freedom of contract. It limits freedom of contract only in the areas of future determination of contract price, exclusion of liability for gross negligence, and public policy and legal capacity. But resolving the standardized dispute takes 610 days—almost 2 years. Pakistan provides a similar example: there are only 4 limitations to freedom of contract, but resolving the standardized dispute takes 976 days in Karachi.

Freedom of contract and efficient contract enforcement are often mutually dependent because one can lose meaning without the other, as shown in the examples above. Among the 34 economies in the sample, however, Greece is a clear example. Not only does Greece have one of the highest numbers of limitations (7), it also has among the longest resolution times in the sample. Resolving the standardized dispute in Athens takes 1,580 days—more than 4 years. Similarly, in Tunisia, the economy with the highest number of limitations in the sample (8), enforcing a contract takes 565 days.

CONCLUSION

Freedom of contract and efficient contract enforcement matter to businesses. The exercise of freedom of contract by parties with similar negotiating power and good knowledge of market conditions promotes efficiency in the allocation of resources, maximizing individual welfare and spurring efficiency in the marketplace.²¹ Efficient contract enforcement promotes investment by

influencing the decisions of economic actors. By promoting investment, good judicial institutions can also contribute to economic growth and development. Indeed, an effective judiciary, by providing a structured, timely and orderly framework for resolving disputes, fosters economic stability and growth. Moreover, efficient contract enforcement is essential to allow true freedom of contract. Even where the law allows extensive freedom of contract, the benefits of this can be greatly undermined if not matched by efficient contract enforcement. Without that, the predictability of the legal framework—which is highly valued by firms operating in the market—would be compromised.²²

NOTES

This case study was written by Erica Bosio and Tanya Maria Santillan.

1. The 34 economies in the sample are Barbados; Bhutan; Brazil; Bulgaria; Cambodia; China; Colombia; the Democratic Republic of Congo; Croatia; the Czech Republic; El Salvador; France; Germany; Greece; India; Italy; Lebanon; the former Yugoslav Republic of Macedonia; Malta; Mozambique; Nigeria; Pakistan; the Philippines; Poland; Romania; Singapore; South Africa; Sri Lanka; Taiwan, China; Togo; Tunisia; Turkey; the United Arab Emirates; and Uruguay.
2. Ramello and Voigt 2012.
3. Braucher 1969.
4. Berlin 1969.
5. Eisenberg 1995; Edwards 2009; Marella 2006.
6. Scott 2002.
7. Edwards 2009; DiMatteo and Rich 2006.
8. Kronman 1983.
9. Shapiro 1988; Marella 2006.
10. Kennedy 1982, 2006; Kronman 1983.
11. *Adkins v. Children's Hospital*; *Adair v. United States*; *Coppage v. Kansas*; *Hammer v. Dagenhart*; *Carter v. Carter Coal Company*; Weber 2013.
12. *West Coast Hotel Co. v. Parrish*; Weber 2013.
13. Kennedy 1982.
14. Basu 2006; Edwards 2009.
15. Edwards 2009.
16. Weber 2013.
17. Kennedy 1982.
18. Posner 1995.
19. Pettit 1999; Posner 1995.
20. Basu 2006.
21. Edwards 2009.
22. Brunetti, Kisunko and Weder 1997, 1998.