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An economic analysis of the duty  
to inspect goods pursuant to the CISG and CESL

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## Riga Graduate School of Law

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## SUMMARY

The research is focused on the economic analysis of the duty to inspect goods pursuant to the CISG and CESL. At the beginning it gives a brief introduction to the economic analysis of law and the concept of legal rules and efficiency, which is then followed by analysis of the buyer's duty to inspect goods and its interaction with such issues as transaction costs, risks and legal certainty. The central idea of the research is that legal rules should facilitate efficiency of international sales transactions.

The preamble of the CISG states that one of the CISG's goals is to promote international trade. Therefore, the main aim of the research is to test whether the legal norms of the CISG reflect that goal. As this test does not necessarily require analysis of all articles of the CISG, legal norms regulating the duty to inspect goods have been chosen as substantive material for the research.

Although the main emphasis has been put on the relevant norms of the CISG, the relevant regulation of the CESL has also been analyzed in order to obtain a comparative perspective and thus more extensive analysis. Despite the fact that the relevant legal norms of the CISG and the CESL are rather similar, the CESL, by coming into force, will invent a new approach regarding the time limit within which the buyer has to inspect goods. Moreover, it will change the balance between sellers and buyers in the market of international sale of goods. This difference allows comparing the efficiency of relevant legal norms of the CISG and the CESL, and evaluating their impact on cross-border sale transactions.

Indeed, the concept of 14 days instead of "within as short a period as is practicable in the circumstances" will significantly influence cross-border sale of goods by increasing transaction costs and putting a buyer under additional risks. Furthermore, these facts might be the reason why buyers will not be willing to choose the CESL as the applicable law.

Within the framework of the research it has been concluded that CESL norms regulating the duty to inspect the goods are in favor of the seller, while the CISG protects the buyer more. As buyers are in a weaker position regarding the duty to inspect goods in particular and international sales transactions in general, CISG regulation can be considered as more efficient, because *inter alia* it allocates transaction costs and risks in a way that promotes the overall efficiency of the transaction. The CESL by coming into force will not

only change the market situation but will also create substance for new research from both the comparative and economic perspectives.

# INTRODUCTION

The sale of goods is one of the earliest forms of business transactions, existing from the time when money was first introduced to replace barter.<sup>1</sup> Since the very beginning it has always been in direct interaction with the development of economy and social welfare. Nowadays international sale of goods has a significant role in transborder commercial activities and a rather important impact on the world economy as well.

As international sale of goods has been developing and increasing very fast during recent decades the need for efficient legal regulation has also increased. Namely, in many ways development now is being treated as a fundamentally legal/institutional reform project rather than a purely “economic” one.<sup>2</sup> Law is considered not just as a legal framework for certain activities, but it is also said to be a tool for improving the business environment, creating efficiency and maximizing the use of limited resources. Therefore, the interaction between legal regulations and economic efficiency becomes more and more important.

There is no doubt that all business transactions, including the sale of goods, require precise, clear and efficient legal regulation which creates legal certainty for the parties and in that way allows to predict the outcome and consequences of each particular deal. It becomes even more important when there is a transborder business transaction in which parties come from different states. Although parties are entitled to freely choose the applicable law and although there are private international law rules which allow determining the applicable law in the absence of choice, still it does not create legal certainty and does not facilitate international trade.

According to one of the latest researches, nearly 99 percent of companies registered in the European Union (EU) cannot afford to trade across EU borders because selling abroad means adapting sales contracts for up to 26 different legal systems.<sup>3</sup> Indeed, this can be considered as an obstacle for successful international sale of goods. Therefore, it can be admitted that there is a need for an efficient unified international sales law which facilitates

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<sup>1</sup> R. Goode, *Commercial Law 3<sup>rd</sup> edition*, London, Penguin Books, 2004, p.183.

<sup>2</sup> K. Rittich, “The Future of Law and Development: Second Generation Reforms and the Incorporation of the Social”, (2004) 26 Mich. J. Int’l L. (*Michigan Journal of International Law*) 199, at p.199. See also: I. Glinavos, “Regulation and the Role of Law in Economic Crisis”, (2010) E.B.L. Economic Crisis”, (2010) E.B.L.Rev. 2010, 21(4) (*European Business Law Review*).539.-557, at p. 539.

<sup>3</sup> European Commission (2011). *A Common Sales Law for Europe. General Fact sheet*. Available at: [http://ec.europa.eu/justice/newsroom/news/20111011\\_en.htm](http://ec.europa.eu/justice/newsroom/news/20111011_en.htm). Last visited on 8 February, 2012.

cross-border trade.

Currently one of the most important legal acts for international sale of goods is the United Nations Convention on Contracts for the International Sale of Goods<sup>4</sup> (CISG). 77 states, including the United States, the Russian Federation and the People's Republic of China, which have among the world's largest economies, have adopted it,<sup>5</sup> and it is widely used all around the world.

The preamble of the CISG, *inter alia*, states that

(...) the adoption of uniform rules which govern contracts for the international sale of goods (...) would contribute to the removal of legal barriers in international trade and promote the development of international trade.

This indicates and confirms that one of the goals of the CISG is to increase the efficiency of international sales transactions. In order to test whether the CISG is efficient and determine whether it achieves the goal stated in its preamble, the relevant articles regulating the duty to inspect goods will be analyzed. The duty to inspect goods as a substance for analysis has been chosen because of its rather high importance in sales transactions.

Nevertheless, despite the success of the CISG, a new proposal for regulation of transborder sales has been created. Namely, the European Commission suggests adopting a Common European Sales Law<sup>6</sup> (CESL) which would be applicable to international sale of goods if one of the parties were registered in the EU. Furthermore, one of the CESL's aims is also to promote cross-border trade.<sup>7</sup>

These circumstances lead to the necessity to analyze differences between the CISG and CESL in order to understand their impact on cross-border sale of goods and evaluate the efficiency of specific legal norms in each regulation. As the CISG and CESL have divergent approaches regarding the time limit for inspection of goods, and as time is a valuable asset in the modern business world, then it is important to determine which regulation is more efficient. Also, taking into consideration that the CESL, by introducing a fixed and precise

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<sup>4</sup> *United Nations Convention on Contracts for the International Sale of Goods*. Adopted in Vienna 11 April, 1980; entered into force in 1 January, 1988. Available at: <http://www.cisg.law.pace.edu/cisg/text/treaty.html>. Last visited on 5 February, 2012.

<sup>5</sup> United Nations, *United Nations Treaty Collection Data Base*. Available at: [http://treaties.un.org/Pages/ViewDetails.aspx?src=TREATY&mtdsg\\_no=X-10&chapter=10&lang=en](http://treaties.un.org/Pages/ViewDetails.aspx?src=TREATY&mtdsg_no=X-10&chapter=10&lang=en). Last visited on 9 February, 2012.

<sup>6</sup> Proposal available at: [http://ec.europa.eu/justice/newsroom/news/20111011\\_en.htm](http://ec.europa.eu/justice/newsroom/news/20111011_en.htm). Last visited on 5 February, 2012.

<sup>7</sup> See: European Commission, *Common European Sales Law to Boost Trade and Expand Consumers Choice*. Available at: [http://ec.europa.eu/justice/newsroom/news/20111011\\_en.htm](http://ec.europa.eu/justice/newsroom/news/20111011_en.htm). Last visited on 10 June, 2012.

time limit in which the buyer has to inspect the goods, completely changes currently existing commercial practice, the necessity of this particular research increases.

Although there are several methods, for instance, micro comparison, which might be used for such an analysis, the economic analysis of law will be applied in this research. The concept of law and economics is rather new<sup>8</sup>, and it is not yet that widespread among scholars and law practitioners, especially in civil law countries. Nevertheless, it does not decrease the significance of the economic analysis of law when it comes to the question how to determine if legal rules are efficient.

Despite the fact that sometimes the economic approach to law is criticized for ignoring “justice”<sup>9</sup>, still there are other opinions which support this method<sup>10</sup>. For example, it has been said that economic analysis “encourages the creation of legal rules that facilitate the maximization of society’s welfare”.<sup>11</sup> Therefore, the economic analysis of law is an appropriate method for determining if the relevant provisions of the CISG and CESL, regarding the duty to inspect goods, can be considered efficient.

Although the CISG has already been widely analyzed by many scholars there are only few academic researches devoted to economic analysis of it, and hardly any of them deals with the duty to inspect goods. Also there are only few academic commentaries about the CESL, and very few of them contain in-depth analysis of particular aspects of international sale of goods related to the economic analysis of law.

The research consists of four chapters. The first chapter is devoted to an introduction to the economic analysis of law - its history, definition and application. In the second chapter the concept of legal rules and efficiency has been described. In the third chapter I analyze the role of the duty to inspect goods in the market of international sale of goods. And last but not least in the fourth chapter I look at the duty to inspect goods pursuant to the CISG and CESL from the perspective of transaction costs, risks, legal certainty and the balance between buyer and a seller.

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<sup>8</sup> Until about 1960 the method of economic analysis of law was mostly applied to antitrust law. The new understanding of the concept of law and economics began by academic research by Guido Calabresi and Ronald Coase (for further information see also R. A. Posner, *Economic Analysis of Law*, 6<sup>th</sup> edition, New York, Aspen Publishers, 2003, p.23).

<sup>9</sup> R.A. Posner, *Economic Analysis of Law*, 6<sup>th</sup> edition, New York, Aspen Publishers, 2003, p.27.

<sup>10</sup> F. Faust, “Comparative Law and Economic Analysis of Law”, in M. Reimann, R. Zimmermann (eds), *The Oxford Handbook of Comparative Law*, New York, Oxford University Press Inc., 2006.

<sup>11</sup> J.N.E. Varuhas, “Law and Economics: Net Benefit or Deadweight Loss”, (2006) 12 NZBLQ (*New Zealand Business Law Quarterly*) 270, at p.293.



The main aim of the research is to test whether regulation of the buyer's duty to inspect goods pursuant to the CISG and CESL is efficient and promotes international trade.

The research has been done from the legal perspective, i.e., assumptions are made and evaluation is done, based on legal principles, thinking and aims. Therefore, the outcome of the research should not be considered as absolute and indisputable. The other way round – it should be a background for different opinions and further discussions.

# 1. THE ECONOMIC ANALYSIS OF LAW – HISTORY, DEFINITION AND APPLICATION

*“You cannot learn economics from any one book (...). A feel for, skill in, and comfort with economics grows gradually, just as with law.”<sup>12</sup>*

(Richard A. Posner)

Agreeing with this statement, it can be admitted that the economic analysis of law, as well as economics and law, cannot be learnt and cannot be taught mechanically. However, the process of its understanding should start with basic principles and concepts. Therefore, the first chapter of this research will be devoted to the essence of the economic analysis of law. At first the history and definition of the economic analysis of law will be looked at and then a brief insight into its application will be given.

## 1.1. History of the economic analysis of law

Probably for quite large part of law practitioners, especially for those who come from Continental Europe, the first impression, after having heard the words “economic analysis of law”, would be that this is something certainly not for lawyers, but rather for economists. Indeed, the economic analysis of law is not widely known or used among lawyers in Europe.<sup>13</sup> However, the situation is different in the United States of America, where the roots of this particular approach for analyzing legal rules can be found.

A little more than fifty years ago scholars in the United States of America began intensive work on developing a new interdisciplinary field. It is said that the background for the economic analysis of law or, in other words, law and economics, can be found in two academic publications – Guido Calabresi's article “Some Thoughts on Risk Distribution and the Law of Torts”<sup>14</sup>, and Ronald Coase's article “The Problem of Social Costs”<sup>15</sup>.<sup>16</sup> Although

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<sup>12</sup> R. A. Posner, *Economic Analysis of Law*, 6<sup>th</sup> edition, New York, Aspen Publishers, 2003, p.xix.

<sup>13</sup> See, e.g., N. Garoupa, “The Law and Economics of Legal Parochialism”, (2011) 2011 U. Ill. L. Rev. (*University of Illinois Law Review*) 1517, at p.1517.

<sup>14</sup> See G. Calabresi, “Some Thoughts on Risk Distribution and the Law of Torts”, (1961) 70 *Yale L. J.* (*Yale Law Journal*) 499.

<sup>15</sup> See R. Coase, “The Problem of Social Cost”, (1960) 3 *J. L. & Econ.* (*The Journal of law and Economics*) 1.

<sup>16</sup> R.A. Posner, *Economic Analysis of Law*, 6<sup>th</sup> edition, New York, Aspen Publishers, 2003, p.23.

these articles were the first modern attempts to apply economic analysis systematically to areas of law that do not regulate economic relationships,<sup>17</sup> American scholar Richard Posner is considered to be the one who invented the economic analysis of law as an academic discipline.<sup>18</sup>

In 1973 Richard Posner published the book “Economic Analysis of Law”.<sup>19</sup> It contained extensive research of the interaction between different branches of common law and several issues related to financial markets and legal processes. Although legal scholars and economists had highly divergent opinions about the publication, even nowadays it is still considered to be one of the most important academic works on the economic analysis of law.

At the very beginning economic analysis of law was mainly understood as economic analysis of antitrust law, but starting from 1960 it has been applied to various fields of law.<sup>20</sup> The number of legal issues which have been analyzed from the perspective of economic analysis of law has significantly increased. Scholars all around the world dare to use this approach more and more, regardless of the fact that the economic analysis of law still faces criticism from the side of its opponents.<sup>21</sup>

Indeed, the economic analysis of law is a rather controversial issue. Namely, “the opposite side”, if it may be called so, claim, e.g., that it is not clear why wealth maximization, which is one of the central ideas of the economic analysis of law, should be considered as a “worthy goal”.<sup>22</sup> Professor Ronald Dworkin indicates that

[w]ho would think that a society that has more wealth, as defined, is either better or better off than a society that has less.<sup>23</sup>

This argument is strongly connected with other criticisms devoted to the concept of efficiency and its use.<sup>24</sup>

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<sup>17</sup> *Ibid*, p.23–24.

<sup>18</sup> Although Richard Posner is not the first scholar of law and economics he is considered to be the most prominent one who has made a high contribution to the development of the economic analysis of law. For further information see T. Gibbons, “Property Rights in Resource Consents: Some Thoughts from Law and Economics”, (2012) 25 NZULR (*New Zealand Universities Law Review*), at p.46.

<sup>19</sup> The first edition of the book was published in 1973. In 2003 the sixth edition was published by Aspen Publishers, New York.

<sup>20</sup> R.A. Posner, *Economic Analysis of Law*, 6<sup>th</sup> edition, New York, Aspen Publishers, 2003, p.23.

<sup>21</sup> See, e.g., A. Kronmanp, *The Lost Lawyer: Failing Ideals of the Legal Profession*, Cambridge, Harvard University Press, 1995, pp.225.-240.

<sup>22</sup> R. Dworkin, “Is Wealth a Value”, (1980) 9 J. Legal Stud. (*Journal of Legal Studies*) 191, at p.194.

<sup>23</sup> *Ibid*.

<sup>24</sup> See, e.g., M. Rizzo, “Mirage of Efficiency”, (1980) 8 Hofstra L. Rev. (*Hofstra Law Review*) 641, at

Nowadays one of the concerns regarding the economic analysis of law is that there is a gap between academic research and practical life problems. Many scholars “lack familiarity with the professional world outside the law schools”.<sup>25</sup> Therefore, research might not always have practical usefulness. From my perspective a problem is also that not all lawyers are ready to step back from the traditional approach to law and accept such a modern tool as the economic analysis of law. Moreover, there is a possibility that in some countries, e.g., previous Soviet Union states which still are in the process of transition and where the development of modern legal thinking has just started, the economic analysis of law will not be just misunderstood, but might even be rejected.

Despite all obstacles, the economic analysis of law continues to spread. Now as an academic subject it is offered not only in the universities in the United States of America, but also in Europe and other parts of the world. Therefore, it is just a question of time until its practical application will overcome national borders, thus making the economic analysis of law a globally accepted tool for analyzing and applying law.

## **1.2. Definition of the economic analysis of law**

Coming back to the basics of the economic analysis of law, the meaning of this term should be described. There are several definitions which explain the essence of the economic analysis of law. For example: 1) “[t]he economic analysis of law is the use of economic principles and reasoning to understand legal materials”<sup>26</sup>, or 2) “economic analysis of law applies the tools of microeconomic theory to the analysis of legal rules and institutions”.<sup>27</sup>

Although after reading these definitions it still might seem that it is a suitable method for economists and not for lawyers, this is not true. It can be used equally well by both. However, it must be admitted that use of the economic analysis of law requires at least a minimum understanding of economics (especially microeconomics) for lawyers and some background of law for economists.

There are two branches of the economic analysis of law: the positive and the

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p.641.

<sup>25</sup> A. Schwartz, “Two Culture Problems in Law and Economics”, (2011) 2011 U. Ill. L. Rev. (*University of Illinois Law Review*) 1531, at p.1536.

<sup>26</sup> G. P. Miller, “Law and Economics versus Economic Analysis of Law”, (2011) 19 Am. Bankr. Inst. L. Rev. (*American Bankruptcy Institute Law Review*) 459, at p.459.

<sup>27</sup> L. Kornhauser, “The Economic Analysis of Law”, published in the Stanford Encyclopaedia of Philosophy (Fall 2011 edition). Available at: <http://plato.stanford.edu/entries/legal-econanalysis/>. Last visited on 13 March, 2012.

normative.<sup>28</sup> The positive branch uses economic theory to explain or predict certain facts.<sup>29</sup> Meanwhile, normative economic analysis is based on the assumption that legal rules should prevent waste of resources, so that, with limited resources available, we can satisfy as many needs as possible. In other words, the goal of normative economic analysis is to find the best solution.<sup>30</sup>

Choice between positive and normative economic analysis of law is strongly connected with the chosen research issue and the purpose of the research. Therefore, it is necessary to understand the difference between positive and normative economic analysis in order to be able to decide which one is better for the particular research topic.

Moreover, the choice between the positive and normative approaches most likely will affect the research methodology, structure and applicable tools. As both branches have their own peculiarities which have to be taken into the consideration, they require different approaches to the research topic.

By using positive economic analysis, taking into consideration that persons' behavior usually is rational, "the influence of legal rules on behavior can be ascertained".<sup>31</sup> Positive economic analysis is related to reality, i.e., it "seeks to describe the world as it is, not as one thinks it should be (...)"<sup>32</sup>. The rather realistic approach allows identifying and analyzing changes in that it allows "looking to the future in an effort to compare the consequences of alternative incentive structures"<sup>33</sup>. From this it turns out that positive analysis mainly deals with real life situations and problems.

Indeed, positive economic analysis is strongly connected with reality. Research shows that most academic papers regarding the economic analysis of law have been written using the positive approach. Also it can be admitted that positive analysis is much more practical and allows making conclusions with high practical usefulness.

Moreover, by applying positive analysis, it is possible not just to evaluate legal norms, but also to explain choices of social groups, to predict consequences of changes in regulations, compare several possible outcomes, and so on. This means that the positive

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<sup>28</sup> Some authors use the word "descriptive" instead of "positive". See, e.g., S. Shavell, *Foundations of Economic Analysis of Law*, Harvard University Press, 2004, p.1.

<sup>29</sup> F. Faust, "Comparative Law and Economic Analysis of Law", in M. Reimann, R. Zimmermann (eds), *The Oxford Handbook of Comparative Law*, New York, Oxford University Press Inc., 2006, p.839.

<sup>30</sup> *Ibid.* p.851.

<sup>31</sup> S. Shavell, *Foundations of Economic Analysis of Law*, Harvard University Press, 2004, p.1.

<sup>32</sup> H.N. Butler, *Economic Analysis for Lawyers*, Carolina Academic Press, 1998, p.66.

<sup>33</sup> *Ibid.*

economic analysis of law can be widely applicable, which makes it even more attractive.

Due to its characteristics, positive economic analysis is also sometimes called “predictive”.<sup>34</sup> Moreover, it has been indicated that it “is a necessary prelude to most forms of normative analysis.”<sup>35</sup> This statement emphasizes the diverse character of the positive economic analysis of law.

In order to better understand positive economic analysis, it is worth looking at an example. In 1985 Richard Posner together with William Landes published the article “A Positive Economic Analysis of Products Liability”.<sup>36</sup> The article clearly shows the practical use of the positive economic analysis of law. The authors created seven different situations which might cause injuries to consumers due to defective products. Then the authors by applying economic principles evaluated how existing legal norms would deal with liability issues deriving from the defective products.

It can be assumed that the positive approach is relatively easier than the normative one. Its realistic nature makes it more understandable. However, that does not necessarily mean that it is easier to practically apply it.

Normative economic analysis of law is often said to be highly controversial.<sup>37</sup> However, it can be very important for normative comparative research if the goal is not to find a solution to a specific problem of national law but rather comparatively to evaluate different national solutions to a real-life problem.<sup>38</sup> Especially important might be when legal transplants are involved, because “each transplantation of a rule from one legal system into another one causes transaction costs”<sup>39</sup>. Therefore, the normative economic analysis of law might be a useful tool for predicting and evaluating these costs.

Contrary to the positive approach, normative analysis “makes value judgments when it describes the world as it “ought to be””<sup>40</sup>. Although normative analysis can also deal with real things, the analysis and outcome pursuant to the normative approach will be based more on assumptions and theoretical statements, rather than practical conclusions.

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<sup>34</sup> A.I. Ogus, “Economics and Law Reform: Thirty Years of Law Commission Endeavour”, (1995), L.Q.R. 1995, 111(Jul) (*Law Quarterly Review*) 407-420, at p.417.

<sup>35</sup> *Ibid.*

<sup>36</sup> W.M. Landes, R. Posner, “A Positive Economic Analysis of Products Liability”, (1985) 14 J. Legal Stud. (*Journal of Legal Studies*) 535, at p.535.

<sup>37</sup> F. Faust, “Comparative Law and Economic Analysis of Law”, in M. Reimann, R. Zimmermann (eds), *The Oxford Handbook of Comparative Law*, New York, Oxford University Press Inc., 2006, p.842.

<sup>38</sup> *Ibid*, p.848.

<sup>39</sup> *Ibid*, p.847.

<sup>40</sup> H.N., Butler, *Economic Analysis for Lawyers*, Carolina Academic Press, 1998, p.66.

However,

there is no scientific way to show whether or not so called normative statements are correct. Normative statements cannot be empirically tested. They cannot be falsified.<sup>41</sup>

Therefore, the outcome of the normative economic analysis of law is more theoretical and afterwards can hardly be practically applied. This peculiarity gives normative analysis its controversial character.

To summarize so far, it can be concluded that both positive and normative approaches cover a wide range of issues that can be analyzed. And both can be used for all legal issues. Regarding the choice between them, the most important is the research purpose and the aim that the researcher wants to achieve.

Last but not least the purpose of the economic analysis of law should be discussed. The research shows that by applying the economic analysis of law several goals can be achieved. For example, influence of legal norms on certain social issues can be analyzed; efficiency of legal regulations can be evaluated and, moreover, potential outcome of future legal norms can be predicted. The common idea is very well explained in the following statement:

Laws are not just arcane technical arguments; they are instruments for achieving important social goals. In order to know the effects of laws on those goals, judges and other lawmakers must have a method for evaluating laws' effects in important social values.<sup>42</sup>

Indeed, the economic analysis of law allows achieving all those goals.

To sum up it can be said that the economic analysis of law in its broader meaning is an interdisciplinary academic field which deals with the interaction between law and economics, but in its narrower meaning it is a method or a tool to evaluate the efficiency of law in general or of certain legal rules in particular.

### **1.3. Application of the economic analysis of law**

There is no single approach or methodology to use the economic analysis of law. However, at the same time there exist some basic cornerstones which create the framework for its practical application. For example, it is obvious that economic principles or tools have to be used and that the goal of the analysis should be orientated towards evaluation of legal norms, not just a pure description or comparison of them. Nevertheless, economic analysis of

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<sup>41</sup> *Ibid.*

<sup>42</sup> R. Cooter, T. Ulen, *Law and Economics, 3<sup>rd</sup> edition*, Addison Wesley, 2000, p.3.

law lets its user be creative rather than bound or limited.

Instead of following the *ex post* perspective that is usually used in traditional legal analysis and research, the economic analysis of law deals with the *ex ante* perspective.<sup>43</sup> This means that, “opposite to legal analysis, the economic approach is oriented towards the future consequences of today’s actions”.<sup>44</sup> Therefore, the methodology involves making assumptions and predicting outcomes in the future instead of analyzing actions in the past.

After looking at several academic papers devoted to the economic analysis of law, it can be concluded that each of them contains a different approach to this interdisciplinary field. However, it has to be said that much depends on the professional qualification of each and every author, i.e., papers written by economists are more based on mathematical calculations, formulas, and graphs, while papers written by lawyers contain more analysis based on economic principles and theories. Therefore, it can be concluded that probably the same issue analyzed by a lawyer and an economist would have a different format and methodological approach.

This leads to the hypothesis – whether different approaches to the same issue can create different outcomes of the analysis. In other words, can a legal norm be efficient and inefficient at the same time, depending on the approach (i.e., will a lawyer and an economist each have different conclusions). Although it cannot be tested within the framework of this research, the answer could be both positive and negative.

In any case the creative character of the economic analysis of law provides that there cannot be wrong approaches. Therefore, it is always up to the researcher to decide the research strategy and choose the structure.

The first step of the application of the economic analysis of law certainly would be the choice of the issue which will be analyzed.

Every type of scientific research starts from a problem, from some question or series of questions. Sometimes a simple observation of facts leads rather spontaneously to a research question.<sup>45</sup>

Although the above statement is correct regarding the economic analysis of law, a problem question or issue is not necessarily needed. It is possible also to apply the economic analysis of law to legal rules in general, not just to specific legal problems.

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<sup>43</sup> H.N. Butler, *Economic Analysis for Lawyers*, Carolina Academic Press, 1998, p.57.

<sup>44</sup> *Ibid.* p.57-58.

<sup>45</sup> M. Van Hoecke (ed.), *Methodologies of Legal Research. Which Kind of Method for What Kind of Discipline?* Oxford, Hart Publishing, 2011, p.12.



However, it is clear that most likely the economic analysis of law in general, i.e., of law as such, will not be a successful research topic just because the material for analysis is too broad and diverse. Nevertheless, it is possible to apply the economic analysis of law for such huge and complicated branches of law as, e.g., contract law, tort law or criminal law.<sup>46</sup> The most effective use of the economic analysis of law probably would be for narrower and more precise legal issues.

Can each and every legal issue be analyzed by using the economic analysis of law? It seems that there is no reason why the answer should be negative. It has been admitted that “economic analysis of law provides valuable insights to most, if not all, legal issues and policy debates”.<sup>47</sup> Therefore, there should be no doubt that every legal issue could be analyzed by applying the economic analysis of law. It just should be borne in mind that in that case most likely the approaches will be different, taking into consideration the diversity among legal issues.

“[T]he research task must be specified with as much precision as is possible”.<sup>48</sup> Therefore, starting from the very beginning the author has to define what exactly will be analyzed. Thus, taking into consideration the rather complex nature of the economic analysis of law, it helps both – the writer and the reader – to follow the analysis and understand the main idea.

Identification of the issue depends on the planned goal of the research. If the aim is to evaluate the efficiency of a particular branch of law then probably that will be the issue. But if the author wants to analyze the issue not only from an economic, but also from a comparative perspective, then it might be a little more complicated to define a good research issue. Namely, in that case at first the researcher should find good material for comparison and then apply the economic analysis of law.

Regardless of all the above,

[t]he best and most enjoyable, research is typically done where there is a natural fit between the researcher and the topic, and where the researcher has chosen the topic out of a strong interest in it.<sup>49</sup>

This statement can be strongly related also to the economic analysis of law. The author

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<sup>46</sup> See, e.g., R. Posner, *Economic Analysis of Law*, 6<sup>th</sup> edition, New York, Aspen Publishers, 2003, pp.31-215.

<sup>47</sup> J. Demot, B. Depoorter, “The Cross-Atlantic Law and Economics Divide: A Dissent”, (2011) 2011 U. Ill. L. Rev. (*University of Illinois Law Review*) 1593, at p.1594.

<sup>48</sup> D. Svantesson, “A Legal Method for Solving Issues of Internet Regulation”, (2011) 19 Int’l J.L. & Info. Tech. (*International Journal of Law and Information Technology*) 243, at p.247.

<sup>49</sup> *Ibid*, p.248.

should choose a topic in which he has knowledge, understanding and interest.

As previously mentioned, “the economic analysis of law involves use of economic principles and reasoning to understand legal materials”.<sup>50</sup> Therefore, everyone who would like to use this approach will have to apply some economic theories, tools or at least principles.

Several microeconomic theories might be useful for the economic analysis of law. For example, Game theory, Rational choice theory, Consumer theory, General equilibrium or Welfare economics.<sup>51</sup> At the same time a researcher may choose among economic aspects, such as transaction costs, utility maximization or risks. In any case the choice will depend on the particular research issue.

Microeconomics is the study of how individuals and firms make themselves as well of as possible in a world of scarcity and the consequences of those individual decisions for markets and the entire economy.<sup>52</sup>

As derived from the definition, this branch of economy is directly related to the decision making process. Therefore, it is more suitable for the economic analysis of law than macroeconomics could be.

However, not all legal issues can be analyzed just by applying one or more microeconomic theories. Namely, the narrower the research issue, more precise economic principles have to be used. For example, Consumer theory as such would suit analyzing consumer laws in general or larger issues such as differences between prices and their impact on consumer choice. At the same time, smaller issues, like the choice between buying shoes on-line vs. buying them in a market, would focus more on transaction costs, risks and decision making under uncertainty, rather than Consumer theory in general. This means that the applicable economic tools strongly depend on the research issue.

There are many different economic tools which can be used. Therefore, a lawyer needs to have at least a basic knowledge and understanding of economics in order to be able to choose the most appropriate economic theories and principles of analyzing legal norms. However, extensive knowledge of economics does not necessarily increase the quality of the research. What matters is the ability to see coherences and interactions between law and

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<sup>50</sup> G.P. Miller, “Law and Economics versus Economic Analysis of Law”, (2011) 19 Am. Bankr. Inst. L. Rev. (*American Bankruptcy Institute Law Review*) 459, at p.459.

<sup>51</sup> For more information see, e.g., J. Perloff, *Microeconomics 5<sup>th</sup>, edition*, Boston, Pearson Education, Inc., 2009.

<sup>52</sup> *Ibid*, p.1.

economics and being able to make assumptions, decisions and conclusions, based on them.

Regarding the practical aspects of the application process, research shows that the first step almost always is a brief description about the research issue, its relevance, available and used data and the purpose of the analysis. This introduces the reader to the research topic and provides some background for further analysis.

The process of analysis usually starts with some assumptions based on economic theories or principles. "Assumption is a fact or statement, taken as true or correct."<sup>53</sup> Making assumptions certainly helps to clarify the scope of the research. Additionally it sets a certain framework for the analysis and limits the extent of all possible outcomes. For example, in order to evaluate the development of a specific legal norm related to construction industry, the authors collected all possible state appellate decisions and made assumptions out of them.<sup>54</sup>

Weak assumptions can lead to weak decisions and conclusions. Thus, every assumption that has been made should have been very well considered and reasoned. Especially important is when matters of rather high importance, i.e., basics of the research, have to be assumed. Therefore, for beginners in the sphere of economic analysis of law the positive approach would be more appropriate.

Besides making assumptions, which would be more related to the normative approach, a researcher will definitely have to use data from real situations. Their use can differ. Namely, the researcher can make a description or statistics, or charts, and the like. Probably economists will choose to replace facts with numbers, mathematical formulae and different calculations. They will try to express their assumptions, analysis and outcomes in graphs and numerical results. At the same time lawyers will not tend to use of mathematics. Instead, they will focus, e.g., on statistics and conclusions which can be made out of them.

The process of analysis is connected with interpretation of legal rules. It has been admitted that

[l]egal scholarship calls for the exercise of a disciplined and intelligent imagination in order to reconstruct the fragmentary material issued by decision makers into rational, coherent and systematic wholes.<sup>55</sup>

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<sup>53</sup> B. Garner (ed.), *Black's Law Dictionary, 9<sup>th</sup> edition*, St.Paul, Thomson Reuters, 2009, p.143.

<sup>54</sup> See A. Niblett, R. Posner, A. Shleifer, "The Evolution of a Legal Rule", (2010) 39 J. Legal Stud. (*Journal of Legal Studies*) 325.

<sup>55</sup> Z. Bankowski, D. MacCormick, R. Summers, J. Wroblewski, "On Method and Methodology", in D. MacCormick, R. Summers, *Interpreting Statutes. A Comparative Study*, Aldershot, Ashgate Publishing Company Limited, 2002, p.19.

Thus, the researcher has not just to apply economic principles, but also interpret law, in order to find the essence of it.

From the above it also turns out that during the process of application of the economic analysis of law all law interpretation methods – grammatical, systemic, teleological and historical – might be needed. As legal norms do not work separately “on their own”, but in conjunction with other norms of the same regulation or even with other regulations, then by applying economic analysis the researcher will have to look not just at the particular legal norm which is the object of the analysis but to other norms as well.

To sum up, the practical value of the economic analysis of law should be emphasized. It allows seeing and predicting the consequences which legal rules might leave on society. Moreover, the results and conclusions which arise by analyzing law from the perspective of economy are rather practical than theoretical. Therefore, it is easier to directly implement them.

Another aspect is that the results can be understood by both lawyers and economists. Thus, the economic analysis of law can be considered as more efficient than any other method for evaluating legal rules, because its results can be more widely applicable.

Last but not least, it should be mentioned that the economic analysis of law by itself is more often used for more practical than theoretical issues, which are important for a larger part of the society than pure theoretical legal issues could ever be.

## 2. THE INTERACTION BETWEEN LEGAL RULES AND EFFICIENCY

Legal rules or, in other words, law, most often primarily are related to justice, and not to efficiency. This understanding is strongly connected with the presumption that law is supposed to provide justice. Indeed, when talking about law, “justice” and “equity” are usually the first key words which are used in order to explain what law is.<sup>56</sup>

Although at first it might seem that law should always be efficient and should not affect equity and justice just because of being efficient, it should be taken into consideration that “[a]n efficient legal solution may not be equitable, and an equitable one may not be efficient”.<sup>57</sup> This leads to a discussion whether legal rules should ensure justice or should provide efficient, and at the same time maybe not always equitable, regulation for the life of society.

It has been indicated that

[t]he laws each society creates reflect the values that bind it together and represent that society's own compromise between ideals and realities of human nature.<sup>58</sup>

Therefore, it can be stated that analysis of particular legal rules often shows the characteristics of the society that has created these rules. However, this statement is not absolute. Taking into consideration the actual law-making process, it can be concluded that law is actually created by a small group of people who do not necessarily reflect society as such.

Law, regulating commercial transactions, as well as all other law is created by legal bodies (usually governments) which are not directly involved in everyday business matters. Although working groups often exist, consisting of academics, practitioners and experts in a particular field, their actual ability to affect the legislative process is rather low. This leads to the situation that academically and theoretically good laws are usually adopted, but they do not fit for practical use.<sup>59</sup>

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<sup>56</sup> See: e.g., J. Adams, R. Brownsword, *Understanding Law, 2<sup>nd</sup> edition*, London, Sweet&Maxwell, 1999; J. Rawls, *A Theory of Justice*, New York, Oxford University Press, 1973, and R. Cooter, T. Ulen, *Law and Economics, 3<sup>rd</sup> edition*, Addison Wesley, 2000, p.7.

<sup>57</sup> U. Mattei, *Comparative Law and Economics*, Michigan, The University of Michigan Press, 1997, p.1.

<sup>58</sup> “Symposium on Efficiency as a Legal Concern”, (1980) 8 Hofstra L. R. (*Hofstra Law Review*) 485 (1979-1980), at p.485 [the author of the article has not been indicated].

<sup>59</sup> E.g., Many criticisms have been devoted to the Law on Insolvency of the Republic of Latvia with regard to the so called “Pallink insolvency case”, which has attracted the attention of the European

Professor Ugo Mattei indicates that [s]ince the beginning of the Western legal tradition lawyers have been arguing about whether law should be more of a theoretical doctrinal enterprise or just a practical business.<sup>60</sup>

Although there is no right or wrong answer and both parties have strong arguments, it could be admitted that, with regard to international commercial law, a practical, business orientated approach to law should prevail, simply because business is a practical rather than a theoretical issue. Moreover, taking into consideration the importance of international commercial activities in the global business environment and economy, merely theoretically correct and academically perfect legal norms should not be permitted.

Although the history of different economic theories related to the concept of efficiency is several centuries long, it can be assumed that the modern understanding of the concept of legal rules and efficiency exists only for a little over fifty years, i.e., it started to significantly develop together with the growth of the economic analysis of law in the 1960s<sup>61</sup>.

The concept of legal rules and efficiency should not be understood too narrowly. Legal rules create a legal system. Therefore, they always have to be analyzed from the perspective of the particular legal system. This leads to the question: if the rules are efficient, should the legal system also be efficient, and vice versa? From my perspective, unless it is possible to prove this statement, it cannot automatically be assumed that if a legal system or legal act in general is considered to be efficient, then each and every legal norm is automatically efficient as well.

Academic literature offers several definitions regarding an efficient legal system. Two of them are rather similar:

1. An efficient legal system is one in which property rights are assigned and liability rules are formulated so as to duplicate the allocation of rights obtained by a market in a world in which transaction costs are zero.<sup>62</sup>
2. An efficient legal system is one in which property rights are assigned and liability rules are formulated so that the value of things present in the society, as measured by willingness to pay, is maximized over all alternative legal environments given the costs of transacting.<sup>63</sup>

As can be seen from these definitions, the second is more realistic because transaction costs

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<sup>60</sup> U. Mattei, *Comparative Law and Economics*, Michigan, The University of Michigan Press, 1997, p.20.

<sup>61</sup> It can be assumed that the development of the concept of legal rules and efficiency started with the publication of R.A. Posner's book "Economic analysis of law". See also *supra* note No.18.

<sup>62</sup> S.E. Margolis, "Two Definitions of Efficiency in Law and Economics", (1987) 16 J. Legal Stud. (*Journal of Legal Studies*) 471, at p.472.

<sup>63</sup> *Ibid.* p.473-474.

are rarely zero. However, the first definition would fit for normative economic analysis, provided that the researcher assumes a situation with perfect market conditions.

The concept of law and efficiency is strongly connected with maximization. This is so because “most people are rational, and rationality requires maximization”<sup>64</sup>. From that it turns out that efficient legal rules are those which promote the maximization process or at least facilitate the wish to do that.

All the above leads to the need to look at the interaction between law and economic factors and their connection to economic efficiency. Understanding the concept of legal rules and efficiency is mandatory for further use of the economic analysis of law, because its application is strongly connected with evaluation of legal rules. However,

[t]here is confusion in the law and economics literature over what it would mean for a norm to be efficient and why this matters, and whether a single conception of efficiency would be appropriate for different models of social interaction.<sup>65</sup>

After a brief introduction to the interaction between legal rules and efficiency it can, *inter alia*, be concluded that it is not possible to set a clear border between efficiency and equity. As “[i]n many instances, equity and efficiency goals appear to be incompatible”<sup>66</sup>, one of the tasks of the economic analysis of law should be to try to find the equilibrium between those two concepts that would provide the most efficient and at the same time equitable outcome.

## 2.1. The concept of efficiency

The first ideas of the concept of efficiency were already developed in the late 18<sup>th</sup> century. Adam Smith in his work “The Wealth of Nations” indicated that division of labor creates efficiency and brings economic growth.<sup>67</sup> In other words, wise and correct allocation of resources can maximize profit and provide a more efficient outcome.

“For a long time efficiency was defined simply as the ability to produce more at a lower cost.”<sup>68</sup> Currently the understanding of efficiency has become more detailed and, at the same time, more complicated. It can be admitted that it has been adjusted to the diversity of

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<sup>64</sup> R. Cooter, T. Ulen, *Law and Economics*, 3<sup>rd</sup> edition, Addison-Wesley, 2000, p.11.

<sup>65</sup> P. Newman (ed.), *The New Palgrave Dictionary of Economics and the Law*, Volume 2, Eccleston Place, Macmillan Reference Limited, 1998, p.21.

<sup>66</sup> H.N. Butler, *Economic Analysis for Lawyers*, Carolina Academic Press, 1998, p.78.

<sup>67</sup> A. Smith, *The Wealth of Nations*, published in 1796. The text of the book is available online at: <http://www.econlib.org/library/Smith/smWN.html>. Last visited on 3 March, 2012. For the reference see chapters 1.1., 1.2., 1.3.

<sup>68</sup> “Symposium on Efficiency as a Legal Concern”, (1980) 8 Hofstra L. R. (*Hofstra Law Review*) 485 (1979-1980), at p.486 [the author of the article has not been indicated].

the modern business world.

There are several efficiency-related notions, for example, 1) productive efficiency; 2) Pareto optimality; 3) Pareto superiority; 4) Kaldor-Hicks efficiency; 5) Posner's wealth maximization.<sup>69</sup> However, research shows that most often Pareto and Kaldor-Hicks efficiency principles are used, leaving other theories for more detailed and more theoretical research.

According to the Pareto efficiency principle

efficient allocation of resources (...) is one in which the welfare of any other member of society cannot be improved without reducing the welfare of any other member of society.<sup>70</sup>

Or in other words:

An efficient allocation of resources is one from which no person can be made to feel better off without making another person to feel worse off.<sup>71</sup>

A Pareto efficient situation might lead to Pareto superiority which can be determined

[i]f a change in the allocation of resources would result in a greater benefit to one party than cost to another party, then one would expect to see a voluntary transaction take place to capture the gain – assuming the gain is greater than the costs of engaging in the transaction.<sup>72</sup>

The characteristics of Pareto efficiency and Pareto superiority require that “in order to satisfy the Pareto criterion, there must be unanimity among the parties affected by any transaction”.<sup>73</sup>

Pursuant to Kaldor-Hicks efficiency a change in the allocation of resources is Kaldor-Hicks superior

if those who gain from the change (...) could compensate theoretically those that have been harmed by the change and still have a net gain.<sup>74</sup>

By comparing Pareto efficiency with Kaldor-Hicks efficiency, it can be concluded that the latter more reflects the actual everyday situation, because hardly anyone is willing to voluntarily compensate losses for those who have helped to gain a profit. This has been explained in the following statement:

The Kaldor-Hicks criterion is thought by planners to be a more practical basis for evaluating alternative public policies than the Pareto rule for the simple reason that the

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<sup>69</sup> J.L. Coleman, “Efficiency, Utility and Wealth Maximization”, (1980) 8 *Hofstra L. Rev. (Hofstra Law Review)* 509, at p.512.

<sup>70</sup> H.N. Butler, *Economic Analysis for Lawyers*, Carolina Academic Press, 1998, p.77.

<sup>71</sup> U.E. Reinhardt, “Reflections on the Meaning of Efficiency: Can Efficiency be Separated from Equity?”, (1992) 10 *Yale L. & Pol'y Rev. (Yale Law and Policy Review)* 302, at p.307.

<sup>72</sup> H.N. Butler, *Economic Analysis for Lawyers*, Carolina Academic Press, 1998, p.77.

<sup>73</sup> *Ibid.*

<sup>74</sup> *Ibid*, p.77-78.



Pareto standard has severe informational requirements. Since it is virtually impossible to identify or measure all of the impacts of a change in legal rules, much of the impact being subjective and thus immeasurable, when most public policy analysts speak of efficiency, they mean Kaldor-Hicks efficiency.<sup>75</sup>

Taking into consideration these different understandings, whenever the term “efficiency” is used, its meaning should be explained, thus setting borders for its application.

It has been admitted that “[e]fficiency cannot be defined in absolute terms”.<sup>76</sup> Indeed, it is hard to find a complete definition of this term. Moreover, its understanding can also depend on the legal system. For example, “[r]ecent work by legal economists has emphasized the superiority of the common law system over French civil law (...).”<sup>77</sup> This means that efficiency sometimes is not understood as a global issue which is not bound by jurisdictions, but it is also connected with the particular legal system.

Most commonly “efficiency” is associated with wealth maximization, stating that efficiency exists when “a judgment, an action, or a law enhances (...) wealth rather than utility”.<sup>78</sup> This definition completely complies with the demands of the business world, where the main goal is to increase profit, market power and market share, or, in other words, to maximize wealth.

For the purposes of the economic analysis of law two different understandings of the term “efficiency” should be taken into consideration. There exists productive efficiency, which means that “goods and services are produced at the lowest cost of production”, and there is “allocative efficiency”, which requires that “resources are allocated to their highest value use”.<sup>79</sup> The application and the choice between these two understandings will depend on the research issue. The first would be more suitable for analysis of commercial issues, while the second would be better for analysis of social matters.

The concept of efficiency by itself is a very strong tool, which can be used in order to support and influence not just legal argumentation but also legislative procedure and the policy field. This derives from the following statement:

It is widely taken for granted that an efficient approach is ipso facto superior to an inefficient

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<sup>75</sup> *Ibid*, p.78.

<sup>76</sup> A. Marciano, “Optimization, Path Dependence and the Law: Can Judges promote Efficiency?” (2012) 32 *Int’l Rev. L. & Econ. (International Review of Law & Economics)* 72, at p.72.

<sup>77</sup>See, e.g., N. Garoupa, C. G. Ligüerre, “The Syndrome of the Efficiency of the Common Law”, (2011) 29 *B. U. Int’l L. J. (Boston University International Law Journal)* 287.

<sup>78</sup> A. Marciano, E.L. Khalil, “Optimization, Path Dependence and the Law: Can Judges promote Efficiency?” (2012) 32 *Int’l Rev. L. & Econ. (International Review of Law & Economics)* 72, at p.72.

<sup>79</sup> N.H. Butler, *Economic Analysis for Lawyers*, Carolina Academic Press, 1998, p.77.

one. The fastest way to eliminate a rival policy from the field is simply to brand it inefficient.<sup>80</sup> Indeed, as soon as, e.g., a proposal for a new legal regulation has been declared inefficient, it is discarded and is no longer considered. Declaring something efficient or inefficient is a particularly important and strong tool for influencing society. Usually due to lack of relevant knowledge and information society is not able to critically evaluate such statements.

Moreover, the assumption that “greater efficiency is in and of itself a desirable goal”<sup>81</sup> plays its role. Focusing on it might lead to the situation when all other aspects or considerations are ignored, just in order to ensure efficiency and not to lose the path towards it. This might be particularly dangerous in the sphere of social welfare.

To sum up, it can be concluded that the meaning of efficiency is complicated and not always unambiguous. Nevertheless, efficiency can interact not just with legal rules, but also with other economic issues, such as transaction costs and risk. Therefore, this interaction will be briefly looked at in the next two sub-chapters.

### **2.1.1. Efficiency and transaction costs**

When talking about the concept of efficiency and transaction costs the ultimate questions are whether the aspiration for wealth maximization affects transaction costs and how transaction costs by themselves influence the overall efficiency of the transaction.

Transaction costs have already been known for a long time. In 1937 Professor Ronald Coase wrote an article “The Nature of the Firm”, which contains several indications to transaction costs. For example, Professor Coase emphasizes that

[t]he costs of negotiating and concluding a separate contract for each exchange transaction which takes place on a market must also be taken into account.<sup>82</sup>

This allows the conclusion that even over 70 years ago business entities were aware of additional costs which influenced their total costs, and thus the overall efficiency of the transaction. Nowadays their significance has increased even more.

Transaction costs are costs “connected with a process transaction”.<sup>83</sup> In other words, all costs (e.g., costs of legal or marketing services, costs of getting or distributing information

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<sup>80</sup> U.E. Reinhardt, “Reflections on the Meaning of Efficiency: Can Efficiency be Separated from Equity?”, (1992) 10 *Yale L. & Pol'y Rev.* (*Yale Law and Policy Review*) 302, at p.302.

<sup>81</sup> *Ibid*, p.315.

<sup>82</sup> R. Coase, “The Nature of the Firm”, (1937) *Economica* 4 (13-16), at p. 390.-391. Available online at <http://onlinelibrary.wiley.com/doi/10.1111/j.1468-0335.1937.tb00002.x/full>. Last visited on 12 December, 2012.

<sup>83</sup> B. Garner (ed.), *Black's Law Dictionary, 9<sup>th</sup> edition*, St. Paul, Thomson Reuters, 2009.

etc.) which cannot be avoided in order to ensure the transaction occurs are transaction costs.

The amount of transaction costs is one of the elements which make a particular transaction both efficient and lucrative, or, the other way round, inefficient and loss producing. Therefore, it can be assumed that efficient legal rules, including rules regulating the duty to inspect goods, are those which decrease transaction costs or at least do not unnecessarily increase them.

When speaking about transaction costs, as a rather mandatory element should be mentioned the "Coase theorem", which states that:

If there are zero transaction costs and mutually beneficial trades are always made when transaction costs are low, then, whatever the initial assignment of entitlements (a) the outcome will be efficient and (b) the outcome will be the same when changes in distribution of wealth do not affect consumption patterns.<sup>84</sup>

Professor Donald Wittman has paraphrased the theorem as follows:

when transaction costs are low, the final allocation of entitlements is independent of the original allocation of entitlements.<sup>85</sup>

Regarding the international sale of goods, there are different kinds of transaction costs.

Broadly they can be divided into four areas:

- 1) costs of entering and keeping markets;
- 2) transport and product adoption costs;
- 3) monetary costs;
- 4) statutory costs.<sup>86</sup>

Transaction costs of entering and keeping markets basically arise out of marketing purposes. (...) [T]ransport and product adaptation costs include, for example, freight and packaging (terminal) costs as well as transport insurance. (...) Monetary transaction costs occur out of financial transactions, from (...) payments for received goods or services. (...) They consist of bank fees for international money transactions and of costs for protection against possible exchange rate fluctuations. (...) [T]he last category relates to statutory transaction costs, which arise partly due to political decisions to restrict international trade. They consist, among others, of custom tariffs, non-tariff barriers, (...) special (export) taxes or costs related to restrictions of the movement of capital flows.<sup>87</sup>

The above can be characterized as basic costs, which in most cases cannot be avoided.

However, if something goes wrong, e.g., goods are found to be defective and need to be

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<sup>84</sup> D. Wittman, *Economic Foundations of Law and Organization*, New York, Cambridge University Press, 2006, p.34.

<sup>85</sup> D. Wittman, *Economic Foundations of Law and Organization*, New York, Cambridge University Press, 2006, p.37.

<sup>86</sup> M. Busse, "Competition Intensity, Potential Competition and Transaction Cost Economics", (2002) 25 *W. Comp. (World Competition Law and Economics Review)* 3, at p.351.

<sup>87</sup> *Ibid*, p.351-352.

changed or fixed, or a dispute between the parties arises, then additional transaction costs appear. All of these costs together plus total income from the particular transaction allow determination of the outcome and evaluation of the efficiency of the transaction. Therefore, there is no doubt that, in order to make the transaction more efficient, the parties wish to decrease their transaction costs, i.e., they are not willing to pay more than needed to ensure the transaction occurs.

Regardless of the interaction among legal rules, efficiency and transaction cost is not rigid, i.e., it changes following changes of external circumstances.

The rule that results in economic efficiency when transaction costs are very low is not necessarily the rule that results in efficiency when transaction costs are high. (...) [w]hen transaction costs are low, the efficient rule is maybe one that promotes bargaining. When transaction costs are high, the efficient rule is more likely to put the burden of action on the party that can make efficient adjustments more cheaply.<sup>88</sup>

Transaction costs can be determined not only for international sale of goods in general, but also for the duty to inspect goods in particular. Every action that a buyer has to do costs something – either time, or money, or other resources. Moreover a seller has to face additional transaction costs while the buyer is inspecting the goods. For example, the seller most likely has to wait for full payment of the purchase price or has to remedy defects found.

From this it turns out that transaction costs can directly influence the overall efficiency of the transaction. Especially from the perspective of the Kaldor-Hicks efficiency, it is important that transaction costs for those “who have been harmed by the transaction”, i.e., the weaker party, should not be unnecessarily high. Indeed, allocation of transaction costs can change the outcome of the transaction. Furthermore, it can leave ongoing consequences.

### 2.1.2. Efficiency and risks

As well as efficiency, the term “risk” also has several definitions and understandings. The economist Frank Knight has indicated that “the term “risk” refers to probabilities that are “measurable” in the sense that they can be precisely estimated”.<sup>89</sup> In a more extensive view it has been explained as follows:

On one understanding, “risk” means the probability (however measurable or uncertain) of some event occurring, with a word like “gravity” being used to refer to the adverse consequences of the event if it does in fact occur. But on another understanding, an equally common one, these

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<sup>88</sup> R.O. Zerbe, “An Integration of Equity and Efficiency”, (1998) 73 Wash. L. Rev. (*Washington Law Review*) 349, at p.50.

<sup>89</sup> P. Newman (ed.), *The New Palgrave Dictionary of Economics and the Law*, Volume 3, Eccleston Place, Macmillan Reference Limited, 1998, p.347.

meanings are conflated, so that “risk” denotes the product obtained when the gravity of a consequence is discounted (multiplied) by its probability, to yield an expected value.<sup>90</sup>

Nevertheless, it should be borne in mind that “[r]isk is not, as such, the same as hazard or danger”.<sup>91</sup> Risk does not necessarily always have to be understood in a negative meaning. It can also leave a positive impact on the transaction, by forcing the parties to negotiate upon mutually beneficial and less risk containing solutions.

There are several assumptions related to risk, i.e., a market player can be risk-averse, risk-neutral and risk-seeking.<sup>92</sup>

A person is said to be risk-averse if she considers the utility of a certain prospect of money income to be higher than the expected utility of an uncertain prospect of equal expected monetary value.<sup>93</sup>

In other words, a person chooses that option which is the most certain, even if it does not bring the best outcome.

Risk-neutral market players do not see any risk-affected difference between their choices and possible outcomes. Risk-seeking parties are willing to choose more risky options if there is a possibility that they might bring a better outcome.<sup>94</sup> A risk-seeking attitude is said to be “[p]erhaps the most basic attitude towards risk (...) that assign a higher probability to more desired outcomes”.<sup>95</sup>

The main questions regarding efficiency and risks would be how the attitude towards risks affects the efficiency of the transaction. Moreover, another issue which derives from the first question is which attitude could be considered as the most efficient, assuming that all involved parties seek to get the best outcome by using their limited resources. Most likely there would not be one correct answer to those questions.

When talking about commercial entities (including the buyer and the seller under the CISG and CESL), it is usually assumed that they are risk-neutral.<sup>96</sup> Thus, they act according to the choice they consider the best, without considering additional external circumstances or potential risks.

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<sup>90</sup> *Ibid.*

<sup>91</sup> A. Giddens, “Risk and Responsibility”, (1999) *The Modern Law Review*. Vol.62, No.1, January 1999, p.1-10, at p.3.

R. Cooter, T. Ulen, *Law and Economics*, 3<sup>rd</sup> edition, Addison-Wesley, 2000, p.46.-48.

<sup>93</sup> *Ibid*, p.46.

<sup>94</sup> R. Cooter, T. Ulen, *Law and Economics*, 3<sup>rd</sup> edition, Addison-Wesley, 2000, p.46.

<sup>95</sup> P. Newman (ed.), *The New Palgrave Dictionary of Economics and the Law*, Volume 1, Eccleston Place, Macmillan Reference Limited, 1998, p.115.

<sup>96</sup> *Ibid*, p.47.

However, even if it can be assumed that business organizations and commercial entities are usually risk-neutral, they can determine their attitude towards risks, when contracts are concluded.

In essence, freedom of contract allows parties to allocate risk according to which party is willing to accept the risk in light of the price adjustment.<sup>97</sup>

Thus, the parties may allocate the risk as they consider being the most useful, in that way influencing the efficiency of the planned transaction. However, “[t]he traditional approach to risk allocation involves isolating each risk and finding the most efficient method of allocating that risk.”<sup>98</sup>

Parties’ attitude towards risks is an internal issue, which is different from external risks that exist independently and can equally significantly affect the transaction. Some of these risks can and some cannot be either predicted or avoided. For example, international sales transactions can be affected by sudden changes in currency markets. Neither buyer nor seller can predict and even less likely avoid it before concluding a sales contract.

One of the options to deal with possible external risks is to insure them. However, buying an insurance policy increases transaction costs and, thus, in most cases decreases the overall efficiency of the transaction. Therefore, a careful comparison of possible gains and losses has to be made.

By buying an insurance policy a “risk-averse person might prefer a lower certain income to a higher uncertain income”.<sup>99</sup> Although the price for an insurance policy usually minimizes the total income from the transaction, at the same time it might be the factor which maximizes the profit. In other words, if the insured occasion does not occur, then the money spent on the insurance policy can be considered as wasted. The other way round – if the insured occasion affects the transaction, the money spent on the insurance policy can be considered as an investment.

The clear conclusion is that fear of risks and precautionary measures are directly connected with the efficiency of transactions. Attitude towards risks can affect the outcome of the transaction.

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<sup>97</sup> N.H. Butler, *Economic Analysis for Lawyers*, Carolina Academic Press, 1998, p.593.

<sup>98</sup> J. Delmon, *Project Finance, BOT Projects and Risk*, The Hague, Kluwer Law International, 2005, p.39.

<sup>99</sup> R. Cooter, T. Ulen, *Law and Economics, 3<sup>rd</sup> edition*, Addison-Wesley, 2000, p.49.

## 2.2. The need for legal certainty

In discussing the concept of legal rules and efficiency, one of the mandatory elements is legal certainty. The essence of legal certainty lies in the ability to provide the same understanding and application of each and every legal rule for all its users. Although this sounds more like a legal issue, not an economic one, it is not that unambiguous. Several economic aspects deal with decision making under uncertainty, which, *inter alia*, also include the impact of legal certainty.

It can be admitted that the level of legal certainty directly or indirectly affects every commercial activity. Every decision and choice that has to be made depends on the amount of information and confidence that the outcome will be as expected. Therefore, the more certain legal rules are, the more confident market players can be, and the more rational decisions they can make.

At first it should be mentioned that the term “legal certainty” belongs to British English. In American English the same concept is usually called “legal indeterminacy”.<sup>100</sup> However, the essence of both terms is the same, and it can be interpreted as “absence of doubt” or “absolute confidence”.<sup>101</sup>

No single definition would clearly explain the essence of legal certainty.

Legal certainty has been defined as a principle that makes reference to the fundamental premise that those subject to the law must know what the law is so as to be able to plan their actions accordingly.<sup>102</sup>

Another explanation of this term is as follows:

Certainty in the law (...) implies that “a citizen, before committing himself to any course of action, should be able to know in advance what are the legal consequences that will flow from it”.<sup>103</sup>

Nevertheless, the common idea of all definitions is the same.

Legal certainty can be understood in two ways: horizontal and vertical. In the former it deals with “interactions between state institutions and citizens”, while in the latter it

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<sup>100</sup> J.R. Maxeiner, “Some Realism about Legal Certainty in the Globalization of the Rule of Law”, (2008) 31 *Hous. J. Int'l L. (Houston Journal of International Law)* 27, at p.28.

<sup>101</sup> W.C. Burton, *Burton's Legal Thesaurus 3<sup>rd</sup> edition*, New York, Macmillan Library Reference USA, 1998, p.77.

<sup>102</sup> C.A.R. Yong, “Providing Legal Certainty in South America: Can Mercosur help?”, (2010) 2 No. 3 *Pace Int'l L. Rev. Online Companion (Pace International Law Review Online Companion)* 1, at p.1.

<sup>103</sup> J. Barnes, “Sources of Doubt and the Quest for Legal Certainty”, (2008) *Legisprudence, International Journal for the study of legislation*, Volume 2, No.2, p.119.-120. See also *Black-Clawson International Ltd v Papierwerke Waldhof-Ashaffenburg AG* [1975] AC 591 at 638 (H L) per Lord Diplock.

relates to “relations between citizens themselves”.<sup>104</sup> Nevertheless, in both cases it is equally important.

Legal certainty derives from legal rules. As only they are legally binding, a person relies on them when making decisions.

It is generally believed that legal rules provide the virtues of certainty and predictability, while legal standards afford flexibility, accommodate equitable solutions and allow for a more informed development of a law.<sup>105</sup>

Therefore, it can be concluded that the optimal solution would be if there were equilibrium between legal rules and legal standards. And that is what legal certainty can provide. Moreover, “[l]egal certainty requires a balance between stability and flexibility.”<sup>106</sup> Thus, it can be concluded that equal co-existence between legal rules and legal standards is rather mandatory than optional.

Legal theory offers two branches of legal uncertainty: the objective and the subjective.<sup>107</sup> Examples of objective legal uncertainty, for example, are absence of law, legal instability, and denial of law. At the same time subjective legal uncertainty is different for every individual.<sup>108</sup>

In the sub-chapter devoted to efficiency and transaction costs, several types of transaction costs existing in international trade were described. Therefore, it would be worth looking at the division of transaction costs caused by legal uncertainty.

Legal uncertainty generates the following transaction costs: 1) costs of collecting information; 2) costs of legal disputes; 3) costs of setting incentives for pushing through legal claims; 4) other transaction costs.<sup>109</sup>

Clearly legal certainty has a rather significant role in providing the necessary circumstances for an efficient transaction. Although it is hardly ever complete and absolute, its level can still be determined and compared.

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<sup>104</sup> D. Martiny, “Traditional Private and Commercial Law Rules under the Pressure of Global Transactions: The Role for an International Order”, in R.P. Appelbaum, W.L.F. Felstiner, V. Gessner (eds), *Rules and Networks. The Legal Culture of Global Business Transactions*, Oxford, Hart Publishing, 2001, p.125.

<sup>105</sup> O. Raban, “The Fallacy of Legal Certainty: Why Vague Legal Standards May be Better for Capitalism and Liberalism”, (2010) 19 B.U. Pub. Int. L.J. (*Boston University Public Interest Law Journal*) 175, at p.175.

<sup>106</sup> E. Paunino, “Beyond Predictability – Reflections on Legal Certainty and the Discourse Theory of Law in the EU Legal Order”, (2009) 10 German L.J. (*German Law Journal*) 1469, at p.1469.

<sup>107</sup> See, e.g., H. Wagner, “Economic Analysis of Cross-Border Legal Uncertainty. The Example of the European Union”, in J. Smits (ed.), *The Need for a European Contract Law. Empirical and Legal Perspectives*, Groningen, Europa Law Publishing, 2005, p.30.

<sup>108</sup> *Ibid.*

<sup>109</sup> *Ibid.*, p.31.



German legal scholar Gustav Radbruch included legal certainty among the three precepts of law (the other two were purposiveness and justice), thus emphasizing its importance.<sup>110</sup> Moreover, he indicated that

[a]n important part of legal certainty is the justice it provides through, if nothing else, its predictability. The primary goal of legal certainty is to ensure peace and order.<sup>111</sup>

Last but not least, it should be mentioned that the need for legal certainty derives also from the characteristics of human beings. As people are said to be rational, there is no doubt that rationality goes together with the ability to rely on circumstances, legal norms and, thus, consequences of human made decisions.

### **2.3. The interaction between international sales law and efficiency**

The introduction to the concepts of efficiency and legal certainty allows going further into analysis of the interaction between international sales law and efficiency. Regarding this issue the key question is: how and if international sales law can promote efficiency of transborder sales transactions? In order to find the answer to that, at first it is worth looking at the advantages and disadvantages of international and domestic sales law.

When negotiating terms and drafting a contract for international sale of goods the ultimate question which each party has to answer is: which law will apply to this particular transaction? There are several possibilities to solve this issue. For example:

- 1) parties may negotiate and agree to apply the law of the state in which one party has its domicile;
- 2) parties may choose to apply the law of another state;
- 3) parties, if they comply with certain criteria, may agree upon application of the CISG (or the CESL when it comes into force);
- 4) parties may leave the choice of law clause empty, i.e., in case of dispute let the private international law rules determine the applicable law.

Regardless of which of the previously mentioned possibilities is chosen, both parties will try to insist on that law which benefits their interests most. This “fight” for the applicable law can significantly influence the efficiency of the transaction.

Legal scholars have admitted that one of the goals and advantages of the unification

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<sup>110</sup> H. Leawoods, “Gustav Radbruch: An Extraordinary Legal Philosopher”, (2000) 2 Wash. U. J.L. & Pol’y (*Washington University Journal of Law and Policy*) 489, at p.493.

<sup>111</sup> *Ibid.*

of substantive law is to prevent so called “forum shopping”.<sup>112</sup> Indeed, if the parties choose, for example, the CISG as the applicable law to their sales contract, then it automatically excludes any situation which might benefit one of the parties. However, it cannot be denied that at the same time there are advantages and disadvantages to both international and domestic sales law.

Reasons for choosing domestic law might be different, but one of them certainly would be that it is easier for courts to apply domestic rather than international law. The court of the forum is used to its domestic laws and knows how to interpret and apply them. For example, there might be a situation when a judge had barely heard about the CISG and had never read it before the case was assigned to him. Thus, in such a situation it would be harder to apply it.

A disadvantage of choosing the law of the state where one of the parties comes from is that in that way the particular party benefits. Its transaction costs become lower, simply because it does not have to hire lawyers who would have to understand the domestic law of the other party. Also in the case of dispute, the particular party can feel more confident because it knows and understands the relevant law, and probably has some experience of its application.

The advantages and disadvantages of choosing international law are directly opposite to the advantages and disadvantages of choosing domestic law, i.e., as already mentioned, most courts are not used to applying international sales law, but at the same time international sales law provides a higher level of legal certainty and allows both parties to be in a more equal situation.

Summarizing, it can be concluded that regarding international sales contracts, a choice of the CISG or CESL certainly would be more efficient than choice of one party’s domestic law. By choosing the CISG or the CESL:

- 1) the parties will be in an equal position;
- 2) the level of legal certainty will increase;
- 3) transaction costs will be lower.

In order better to see the interaction between international sales law and efficiency, it is worth looking at the CISG, because it

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<sup>112</sup> F. Ferrari, ““Forum Shopping” Despite International Uniform Contract Law Conventions”, (2002) I. C. L. Q. 2002, 51(3) (*International & Comparative Law Quarterly*) 689-707, at p.689.

(...) provides an opportunity to examine, from an efficiency perspective, some of the remaining vestiges of divergence in the law of sales.<sup>113</sup>

Indeed, taking into account the characteristics and global acceptance of the CISG, it can be considered good substantive material for looking at the interaction between international sales law and efficiency.

For example, regarding non-conformity of goods the regulation of the CISG is different from the regulation of, e.g., the United States of America. It has been adjusted to the needs and efficiency requirements of the international sale of goods, by limiting the buyer's rights to reject goods, because reshipping and reselling at international level cost more than within the borders of one state.<sup>114</sup>

Another example is the difference between Common law and the CISG with regard to acceptance of the offer. It has been admitted that the CISG, by rejecting the Common law approach of the so called "mail box" rule, provides more efficient allocation of the transmission risk.<sup>115</sup>

However, at the same there is an opposite opinion which states that the CISG has failed to increase legal certainty and reduce transaction costs.<sup>116</sup> Moreover, criticism, *inter alia*, is based on the fact that due to the diversity of persons who drafted the CISG its rules are rather vague:

[t]he Convention was drafted by representatives of more than fifty states representing all legal traditions. Although the diversity of the individual drafters must have complicated the enterprise of negotiating a complete law of sales, it has been shown that the incentives of the drafters likely led them to settle on unsatisfactory results in order to reach a final resolution.<sup>117</sup>

Despite the fact that there exist different arguments about the CISG and efficiency, it cannot be denied that currently the CISG is the most efficient legal regulation for international sales transactions. Therefore, instead of criticizing gaps in the CISG, legal solutions to most efficiently fill these gaps should be sought.

International sales law offers standard rules which can equally easily be understood and interpreted by every person in the world. This is the main reason why international sales law should be considered as efficiency-promoting and wealth-maximizing.

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<sup>113</sup> L.A., DiMatteo, D.T, Ostas, "Comparative Efficiency in International Sales Law", (2011) 26 AMUILR (*American University International Law Review*) 371, at p.435.

<sup>114</sup> *Ibid*, p.377.

<sup>115</sup> *Ibid*, p. 419.

<sup>116</sup> G. Cuniberti, "Is the CISG Benefitting Anybody?", (2006) 39 VNJTL (*Vanderbilt Journal of Transnational Law*) 1511, at p.1511.

<sup>117</sup> *Ibid*, p.1516.

### **3. THE IMPORTANCE OF THE DUTY TO INSPECT GOODS IN THE MARKET OF INTERNATIONAL SALE OF GOODS**

International sales transactions consist of several different elements which interact and thus provide the expected outcome. One of them is the buyer's duty to inspect goods. As this is directly connected with conformity with quality standards, it can be justifiably admitted as one of the most important elements of the market of international sale of goods.

Indeed, in every sales transaction buyers are interested in getting goods which conform with certain quality standards – either agreed by the parties, or stated in legal acts. Therefore, the buyer's duty to inspect goods is an important element of international sales transactions for the following reasons:

- 1) it excludes any allegations of possible non-conformity with quality standards;
- 2) it forces the parties to perform the transaction with high diligence;
- 3) it promotes the overall efficiency of the transaction.

Taking into consideration the characteristics of the market of international sales of goods, i.e., long distances between the parties and rather complex nature of the transaction itself, it is necessary that the duty to inspect the goods is mandatory, not optional. This can be proved by analyzing the following issues:

- 1) market of international sale of goods;
- 2) the role of the duty to inspect goods.

As, despite the above, there are legal acts pursuant to which the duty to inspect goods is optional, not mandatory, a brief comparison between these and the CISG/CESL will be given, thus providing a broader insight into the importance of the duty to inspect goods.

#### **3.1. Market of international sale of goods**

Lawyers in their everyday practice, perhaps, are not used to analysis of different markets and problems related to them. Therefore, at the first moment it might seem that transactions among buyers and sellers depend only on them and are not affected by the relevant market situation. However, the reality is different, as can be proved by analyzing the relevant market, which in this case is the market of international sale of goods.

Few people would say that the market is absolutely perfect, i.e., everything functions according to economic theories and the outcome is always the best possible (marginal benefit

and marginal costs for every good and service are equal). If it were so, this situation would be called general equilibrium.<sup>118</sup>

General equilibrium is “the specification of conditions under which the independent decisions of utility-maximizing consumers and profit-maximizing firms will lead to the inevitable, spontaneous establishment of equilibrium in all markets simultaneously”.<sup>119</sup> As it turns out from the above definition, general equilibrium leads to a perfect market situation, which is the aim of almost all economic systems.

However, in reality almost always there is a market failure instead of a perfect market. Regarding the international sale of goods, one of the sources of market failure is severe informational asymmetry. That is, the information between parties – sellers and buyers – is in imbalance.<sup>120</sup> Therefore one party is put in a better position compared to the other.

When sellers know more about a product than do buyers, or vice versa, information is said to be distributed asymmetrically in the market.<sup>121</sup>

Indeed, regarding the international sale of goods, sellers most likely are always more informed about the goods they sell than buyers can be. Although this is a natural situation, and even if a seller is not willing to abuse its superiority, still it leads to market failure. This allows the assumption that international sale of goods and thus also the inspection procedure of goods usually takes place in imperfect market conditions. Therefore, the importance of efficient legal norms is even higher. Legal rules can be one of the tools which help to equalize the existing imbalance between buyers and sellers.

“[T]he degree of information asymmetry is not a fixed constant.”<sup>122</sup> It might change, following changes of allocation of information. The level of the imbalance decreases whenever a seller discloses some information to a buyer. Although it might seem that the imbalance would turn into equilibrium if a seller disclosed all the information about the goods, still there would be a market failure. Even if it were assumed that allocation of information for a moment is equal, i.e., both parties have the same type and amount of information, that kind of situation would not be constant, because 1) as soon as some actions

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<sup>118</sup> R. Coote, T. Ulen, *Law and Economics*, 3<sup>rd</sup> edition, Addison-Wesley, 2000, p.39.-40.

<sup>119</sup> *Ibid.* p.39.

<sup>120</sup> *Ibid.* p.43

<sup>121</sup> *Ibid.*

<sup>122</sup> A.R. Fremeth, G.L.F. Holburn, “Information Asymmetries and Regulatory Decision Costs: an Analysis of U.S. Electric Utility Rate Changes 1980-2000”, (2012) 28 *J.L. Econ. & Org. (Journal of Law, Economics & Organization)* 127, at p.131.

with the goods were done, one party again would be more informed; 2) externalities, like other involved persons or circumstances would facilitate the existence of market failure. Sellers and buyers can improve the market situation by collaborating, but in the current market situation it is rarely possible.

As information is particularly important regarding the duty to inspect the goods, then it can be concluded that market failure – informational asymmetry – is one of the factors which decrease the level of efficiency. Taking into consideration that neither the CISG, nor CESL contain an obligation to both parties to fully disclose all information they have about goods and always keep the other party fully informed, then another conclusion is that currently neither regulation can solve the problem of informational asymmetry.

As it turns out from the above, collaboration between buyer and seller could be a key for effective transactions. Currently the level of collaboration and the wish to do so are rather voluntary. Although, by systematically interpreting the relevant norms of the CISG and CESL, it might be possible to say that regulation requires both seller and buyer to collaborate, at the same time there should be legal reasons which would prescribe some consequences for non-collaborative activities. Therefore, it can be concluded that lack of such imperative norms decreases the efficiency of the goods' inspection procedure.

Another aspect which characterizes the market of international sales of goods is not just allocation of information but also the diversity of persons operating in the market. Although pursuant to the CESL consumers are also admitted to be part of the market of international sale of goods, within the framework of this research the type of market players is limited to commercial entities.

The status of a commercial entity puts additional requirements not only pursuant to international sale of goods law but also according to domestic law. As buyers and sellers are commercial entities, it is considered that they are informed market players and therefore a higher responsibility from them can be required. This is confirmed, e.g., by article 393(1) of the Commercial Code of Latvia which states that “a merchant has a duty to act with the diligence of a respectable and accurate merchant”.<sup>123</sup> This means that international sales transactions are done in circumstances of a high level of knowledge.

Allocation of information and diversity of market players are not the only things

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<sup>123</sup> Latvijas Republikas Komerclikums (The Commercial Code of the Republic of Latvia), (01.05.2012.). Available at: <http://www.likumi.lv/doc.php?id=5490>. Last visited on 16 May, 2012.

which have to be borne in mind when analyzing the market of international sale of goods. Another thing is externalities, which exist independently and which cannot be influenced by market players. In other words this factor could also be expressed as market stability.

Indeed, the stability of the market of international sales of goods is rather highly dependent on several different external factors, such as currency fluctuation, transport issues, state economic policies, and so on. Furthermore, the likelihood that changes in these factors could be timely predicted or avoided is low. Therefore, buyers and sellers accept a risk when concluding each and every sales contract.

For example, what happens if carriers have decided to go on strike, or what to do if a state suddenly announces a prohibition to import some particular goods? These situations are very realistic, and from time to time they happen.

Although usually international sales contracts include a force majeure clause, which would be applied in such circumstances, nevertheless, the efficiency of the transaction is damaged. Even if a strike ends in two days, most likely the buyer has already replaced the order because he needed the goods immediately, and the seller now cannot sell them and get the expected profit.

The above is just a brief insight into the market of international sale of goods. Many other economic aspects can also affect sales transactions. Nevertheless, it is clear that the market situation is important and it affects not just international sale of goods in general but also the duty to inspect goods in particular.

### **3.2. The role of the duty to inspect goods**

As in the previous sub-chapter the market of international sale of goods has been described, now it is possible to look at the essence of the duty to inspect goods, i.e., what its role is and why it is so important in global sales transactions.

More than 50 percent of all cases where the CISG has been applied have dealt with quality standards of goods and the duty to inspect them.<sup>124</sup> This fact, as well as the character of the market of international sale of goods, confirms that this issue has rather high importance in international sale transactions.

The inspection procedure has two main goals: first, it protects the buyer against

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<sup>124</sup> I. Schwenzer, "Buyer's Remedies in the Case of Non-conforming Goods: Some Problems in a Core Area of the CISG", (2007) 101 Am. Soc'y Int'l L. Proc. (*American Society of International Law Proceedings*) 416, at p.416.

having bought defective goods. Second, it protects the seller from possible later allegations of having sold defective goods. Furthermore, it increases the seller's responsibility and facilitates good commercial attitudes towards the transaction. Moreover, it equalizes the existing information asymmetry and imbalance between the buyer and the seller. Therefore, it can be admitted that the duty to inspect goods fulfills a function of a preventive remedy, even before damage has happened.

The diverse character of the duty to inspect goods leads to the assumption that it should be included in all sales law as a mandatory act that the buyer has to carry out. However, not in all jurisdictions is it mandatory. For example, from United Kingdom relevant regulation – article 34 of the Sale of Goods Act (1979)<sup>125</sup> – it turns out that the duty to inspect goods is optional:

Unless otherwise agreed, when the seller tenders delivery of goods to the buyer, he is bound on request to afford the buyer a reasonable opportunity of examining the goods for the purpose of ascertaining whether they are in conformity with the contract, and in the case of a contract for sale by sample, of comparing the bulk with the sample.

This means that the buyer does not necessarily have to inspect the goods. Therefore, the consecutive question should arise – how the parties (and especially the buyer) can protect themselves from all possible disputes regarding possible non-conformity with quality standards.

Pursuant to articles 35, 35A and 36 of the Sale of Goods Act (1979) a buyer may use the right to reject the goods. Moreover, in such case the buyer does not even have to bring the goods back to the seller. However, if a buyer accepts the goods or even a part of them he is precluded from later rejection.<sup>126</sup> This is a direct difference from the regulation of the CISG and the CESL.

As the Sale of Goods Act is a product of a Common law country, then it is worth looking at another legal act – the Uniform Commercial Code of the United States of America<sup>127</sup> – which also represents the Common law legal system. Its article 2-513 states:

Unless otherwise agreed and subject to subsection (3), where the goods are tendered or delivered or identified to the contract for sale, the buyer has a right before payment or acceptance to inspect them at any reasonable place and time and in any reasonable manner. When the seller is required or authorized to send the goods to the buyer, the inspection may be after their arrival.

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<sup>125</sup> Sale of Goods Act (1979) (year of modification – 2008). Available at: <http://www.legislation.gov.uk/ukpga/1979/54>. Last visited on 7 May, 2012

<sup>126</sup> P. Dobson, R. Stokes, *Commercial Law 7<sup>th</sup> edition*, London, Sweet&Maxwell, 2008, p.199.

<sup>127</sup> The Uniform Commercial Code (23.01.2003.). Available at: <http://www.law.cornell.edu/ucc/2/>. Last visited on 13 May, 2012.



From the above it turns out that in the two biggest Common law system countries the duty to inspect goods is not mandatory, i.e., the buyer can choose whether to use the right to inspect goods or not. This leads to the necessity to look at examples from Civil law system countries.

For example, according to article 411(1) of the Commercial Code of the Republic of Latvia<sup>128</sup> the buyer has a mandatory duty to inspect goods. Also pursuant to article 219(1) of the Law of Obligations Act of the Republic of Estonia<sup>129</sup> the buyer has an obligation to examine goods. This allows the assumption that Civil law countries have made the inspection procedure an obligation, not an option.

The mandatory character of the buyer's duty to inspect goods can be considered as efficient, because in a broader perspective it helps to decrease possible costs, related to, e.g., litigation, in the future. Another aspect is that, although pursuant to, e.g., the CISG and the CESL, this is a mandatory duty, it is up to the buyer whether to fulfill it or not. However, if the buyer does not inspect the goods, he takes all the risks arising from possible non-conformity.

The duty to inspect goods has an impact on risk allocation between the parties. As an international sales transaction is risky by itself, the inspection procedure provides the buyer with an opportunity to minimize the risk of buying defective goods. Thus, the risk, which generally is higher to the buyer, can be allocated more equally. In that way the overall efficiency of the transaction is promoted.

Another aspect which makes inspection of goods irreplaceable is the lack of effective remedies that the buyer could use in case of having bought defective goods. This fact can also be considered as a useful criterion for evaluating the impact of the duty to inspect the goods on the general efficiency of the transaction. In other words – would transactions become more efficient if there were no duty to inspect the goods?

The determination of efficient legal rules requires an answer to a further question too often neglected by legal economists: what are the activity's alternatives? Even if an activity is more efficient than its absence, it may produce less wealth (perhaps significantly less wealth) than its alternatives, once its harms are taken into account.<sup>130</sup>

Indeed, if the buyer could not inspect the goods, the number of international sales

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<sup>128</sup> Latvijas Republikas Komerclikums (The Commercial Code of the Republic of Latvia) (01.05.2012.). Available at: <http://www.likumi.lv/doc.php?id=5490>. Last visited on 13 May, 2012.

<sup>129</sup> The Law of Obligations Act of the Republic of Estonia (01.05.2009.). Available at: <http://www.legaltext.ee/et/andmebaas/tekst.asp?loc=text&dok=X30085K4&keel=en&pg=1&ptyyp=RT&tyyp=X&query=v%F51a%F5igusseadus>. Last visited on 16 May, 2012.

<sup>130</sup> S.J. Bayern, "False Efficiency and Missed Opportunities in Law and Economics", (2011) 86 Tul. L. Rev. (*Tulane Law Review*) 135, at p.135.

transactions most likely would significantly decrease. Buying goods without being able to check their quality would be highly risky.

Continuing from the above, it can be admitted that there is hardly any alternative for the buyer to check the quality of goods and ensure that the buyer does not accept defective goods. Indeed, neither the CISG, nor the CESL offer any other reasonable solution.

The next question is – would international sales transactions become more efficient if there were no duty to inspect the goods? The answer to this question is not that unambiguous, i.e., it depends from which perspective the question is looked at.

If international sales transactions were analyzed from the perspective of traders, then most likely they would admit that the easier the transaction is (i.e., the less different elements there are), the more efficient it becomes. This approach could be understood because any mandatory additional action that traders have to do increases the transaction costs and makes the whole transaction more complicated and thus less predictable, transparent and efficient.

At the same time from a legal perspective the duty to inspect the goods is seen as a necessary element which helps to determine the conformity of goods to quality standards. Its existence provides stability for both parties and thus promotes the wish to trade and the overall efficiency of the transaction. To sum up, it can be concluded that the market of international sales of goods has its own peculiarities, which requires additional attention, and the duty to inspect the goods has a rather high importance in it.

## **4. AN ECONOMIC ANALYSIS OF THE DUTY TO INSPECT GOODS PURSUANT TO THE CISG AND CESL**

The aim of economic analysis of the duty to inspect goods pursuant to the CISG and CESL is to evaluate if the relevant legal rules are efficient and promote efficiency of international sales transactions as such. In order to achieve the aim, the elements of the duty to inspect goods will be analyzed from the perspective of the following economic issues: transaction costs, certainty and the attitude towards risks.

The main elements of the buyer's duty to inspect goods pursuant to the CISG and the CESL are:

- 1) time limit for the inspection procedure;
- 2) buyer's duty to inform about non-conformity;
- 3) methods of inspection;
- 4) seller's duty to disclose information about the goods;
- 5) burden of proof.

All these elements interact and thus influence the overall efficiency of international sales transactions in general and the duty to inspect the goods in particular. As they exist independently, they will be analyzed separately, *inter alia*, thus making the analysis easier to follow. Taking into consideration that most of the CISG and CESL legal norms regulating the duty to inspect the goods are similar, the main emphasis will be put on the differences, considering them as a valuable source for objective evaluation of efficiency.

### **4.1. Article 38(1) CISG vs. 121(1) CESL**

The CISG and the CESL contain completely divergent regulation regarding the time limit within which the buyer has to inspect the goods. According to article 38(1) CISG the inspection procedure must be carried out "within as short a period as is practicable in the circumstances", while pursuant to article 121(CESL) the time spent on the inspection must not exceed 14 days. The particular difference creates substance for a comparison of the effect that each regulation leaves on efficiency.

In order to have a more extensive analysis, the difference between articles 38(1) CISG and 121(1) CESL will be separately described from the perspective of transaction costs, legal certainty and risks. However, at first a brief insight into the main sources of the relevant

articles will be given, thus, allowing to determine if the sources and the legislative history of the particular articles have affected their content.

#### 4.1.1. The sources of articles 38(1) CISG and 121(1) CESL

The main source of article 38(1) CISG is article 38(1) of the Convention relating to a Uniform Law on the International Sale of Goods (ULIS).<sup>131</sup> Although the latter stated that the goods have to be examined “promptly”<sup>132</sup> instead of “within as short a period as is practicable in the circumstances”, both regulations are similar. Also both terms describing the time limit for the inspection procedure are flexible, i.e. both of them can be interpreted taking into consideration the circumstances of each case individually. Therefore, the regulation of the ULIS can be considered as a primary source for article 38(1) CISG.

However, it should be mentioned that at the beginning of the legislative process of the CISG, there was a proposal to express the article 38(1)<sup>133</sup> as follows:

Where the goods are delivered to the buyer, he is not deemed to have accepted them unless and until he has had a reasonable opportunity of examining them for the purpose of ascertaining whether they are in conformity with the contract.<sup>134</sup>

Although this proposal was rejected, it shows that there have been discussions and the current formulation of the article 38(1) CISG has been carefully selected.

Another source of the currently existing CISG regulation regarding the duty to inspect the goods was concerns of developing countries, *inter alia*, due to which regulation of the duty to inspect the goods was made more favorable to the buyer.<sup>135</sup> The concerns were based on the fact that developing countries did not have so developed transport and communication systems which would be necessary in order to comply with requirements set for the buyer regarding the duty to inspect the goods.<sup>136</sup> Moreover, these countries did not have completely developed contract law, and that was also considered as a possible obstacle

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<sup>131</sup> I. Schwenzer (ed.), *Commentary on the UN Convention on the International Sale of Goods (CISG) third edition*, New York, Oxford University Press, 2010, p.607.

<sup>132</sup> Article 38(1) ULIS: “The buyer shall examine the goods, or cause them to be examined, promptly”.

<sup>133</sup> According to the article numeration of the first draft of the CISG, currently existing article 38(1) was then article No.22(1).

<sup>134</sup> Report of the Committee of the Whole I relating to the draft Convention on the International Sale of Goods. Available at: <http://cisgw3.law.pace.edu/cisg/legislative/B01-38.html>. Last visited on 6 May, 2012.

<sup>135</sup> I. Schwenzer (ed.), *Commentary on the UN Convention on the International Sale of Goods (CISG) third edition*, New York, Oxford University Press, 2010, p.608.

<sup>136</sup> R.M. Birch, “Article 44 of the U.N. Sales Convention (CISG): A Possible Divergence in Interpretation by Courts from the Original Intent of the Framers of the Compromise”, (2006) 4 Regent J. Int’l L (Regent Journal of International Law) 1, at p.3.

which might create an imbalance between traders from, e.g., western countries and developing countries.<sup>137</sup> These facts indicate that the CISG was designed by taking into consideration opinions of all involved parties. Therefore, that could also be one of the reasons why the CISG is so widely accepted. Furthermore, this aspect is another argument which might be used in order to support the assumption that the relevant regulation of the CISG is efficient, because efficiency requires mutual benefit, thus leading to equilibrium.

The legislative history of the CESL (thus, also of article 121(1)) dates back to the beginning of the last decade, when the “Communication from the European Commission to the Council and the European Parliament on European Contract Law” was published.<sup>138</sup> However, only on January 7<sup>th</sup>, 2010, did the European Commission publish the Green Paper on Policy Options for Progress Towards a European Contract Law for Consumers and Businesses<sup>139</sup>. And following the Green Paper the proposal for the CESL was published on 11 October, 2011.

In the Green Paper several sources of the CESL can be found: first, the need for legal certainty; second, elimination of obstacles which prevent efficient use of the Single market; and last but not least, unification of sales law in the European Union. All of them are completely reflected in article 121(1) CESL.

Indeed, article 121(1) gives legal certainty and thus facilitates use of the Single market. Also it offers one unified regulation. Therefore, traders do not have to negotiate upon applicable substantive law. Without going into detail, it can be concluded that the sources of the CESL have been integrated into article 121(1) CESL and thus it has achieved the aim of the regulation.

Although the CESL contains many legal transplants, especially from the CISG, it does not have a predecessor. Therefore, the newly invented legal norms and combinations of transplants have never been practically tested and currently exist only as theoretical proposals. The lack of verified legal sources can be a significant obstacle in the legislative process. Furthermore, as research shows, article 121(1) CESL is contrary to the relevant

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<sup>137</sup> *Ibid.*

<sup>138</sup> L. Smith, “The European Commission’s Draft Common European Sales Law”, (2012) 15 No. 8J. *Internet L. (Journal of Internet Law)* 16, at p.16.

<sup>139</sup> The European Commission, *Green Paper on Policy Options for Progress Towards a European Contract Law for Consumers and Businesses*. Available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0348:FIN:en:PDF>. Last visited on 6 May, 2012.

regulation of almost all EU states.<sup>140</sup> Thus, it cannot be predicted how traders will react – if they accept the new regulation or not.

By looking at the sources of articles 38(1) CISG and 121(1) CESL, it can be concluded that the difference between articles, *inter alia*, derives from differences of sources and legislative history. Article 38(1) CISG has a rather long history and is a result of discussions and compromises, while article 121(1) is newly invented and has been drafted mainly for a specific audience – traders from the EU.

#### **4.1.2. Transaction costs**

Time is a valuable asset, especially in the business world. Nowadays, when business activities tend to be faster, hesitation and waste of time can significantly decrease profit and affect overall growth of business. Therefore, the ultimate question regarding the duty to inspect goods in 14 days or “within as short a period as is practicable in the circumstances”, certainly is which of these two regulations decreases transaction costs for the buyer and the seller, or, in other words, makes the duty to inspect the goods and thus also the transaction, more efficient. In order to find out, transaction costs which arise by applying the CISG and CESL have to be compared.

An example could be made by imagining two companies, of which one sells goods, and the other buys them. The seller is not the original producer of goods, i.e., it just distributes them. So the seller has got the goods from the original producer and wishes to sell them on. It concludes an agreement with a buyer, which, *inter alia*, states that the buyer has to pay the full amount of the purchase price after the goods have been delivered and the buyer has admitted them to be in compliance with agreed quality standards. When the goods are delivered, due to some circumstances the buyer cannot provide immediate inspection. The longer the buyer hesitates to inspect the goods, the longer the seller has to wait for the money. This might lead to the situation that the seller cannot use the expected money and buy new goods for further distribution. Moreover, there is a possibility that the seller cannot invest the money in development of the company, or, even worse, cannot pay for the shipping of goods delivered to the buyer, in that way creating losses for another party. At the same time, the longer the buyer inspects the goods, the more additional costs (costs for

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<sup>140</sup> Within the framework of this research several relevant regulations of the EU states have been examined.

storage, salaries for employees etc.) appear.

This example proves that the period which is spent for inspection of goods can directly affect seller and buyer interests and in some cases even create losses either to both the seller and the buyer or, indirectly, to another, third party. Furthermore, it allows the assumption that the more time is spent, the higher the transaction costs for the parties are. However, at the same time the buyer's transaction costs are not necessarily directly dependent only on the amount of time spent on the inspection procedure. They can also be influenced by other aspects.

Regarding the duty to inspect goods, the following main types of transaction costs can be identified:

- 1) costs of the inspection procedure, i.e., costs of specialists, analysis, etc.;
- 2) costs of storage of goods while they are being inspected;
- 3) costs of human resources, who have to organize and follow the inspection procedure;
- 4) seller's costs of waiting for the expected purchase price.

There is no doubt that, regarding the duty to inspect the goods, the buyer normally has much higher transaction costs than the seller. Therefore, the legal rules should correct the existing imbalance, and not make it even bigger. Or the other way round – legal rules should provide allocation of the transaction costs (even if it means increasing the existing significant imbalance) which can increase the total outcome of the transaction. This has been explained in the following statement:

Both parties benefit if these costs are allocated to the party who can best absorb them at a lower cost. Such an allocation generates an exchange surplus that the parties can divide.<sup>141</sup>

Indeed, if it is not possible to make the transaction costs equal, then they should be allocated in a way that the strongest party takes more, but at the same time it does not seriously affect its position. Therefore, it should be evaluated if either the seller or the buyer is able to carry more of the transaction costs.

Although this evaluation would lead to the conclusion that the seller is in a better position and therefore could cover more of the total transaction costs, practically it would be hard to implement it. As in most cases a sales contract also involves carriage of goods, the buyer inspects the goods after receiving them. Therefore, there is not much that the seller

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<sup>141</sup> L.A. DiMatteo, D.T. Ostas, "Comparative Efficiency in International Sales Law", (2011) 26 AMUILR (*American University International Law Review*) 371, at p.391.

could actually do. However, if the inspection procedure happens at the place where the purchase has been made, both parties could be actively and equally involved in the inspection procedure. In this case allocation of transaction costs would be more equal and it would increase the overall efficiency of the transaction.

Coming back to the difference between articles 38(1) CISG and 121(1) CESL, it is obvious that the difference in the time limit for the inspection procedure will certainly affect the transaction costs of the parties. Most likely, pursuant to article 121(1) CESL they will unnecessarily increase for the buyer (because he will be forced to pay more in order to have the goods examined faster), and for the seller the costs will remain the same or even decrease (because he will get full payment faster).

As the buyer has the duty to inspect goods and, thus, perform all necessary acts, it can be concluded that during the inspection procedure the buyer is active and the seller is passive. Moreover, the limited time pursuant to article 121(1) CESL makes the buyer even more active, and allows the seller to keep holding its passive position. This leads to the fact that the CESL increases the transaction costs for the buyer, while for the seller they remain the same. Therefore, it can be concluded that, regarding this issue, the CESL will not bring efficiency. The other way round, the CESL, by increasing the transaction costs for the buyer, will make the total outcome of the transaction less efficient.

#### **4.1.3. Legal certainty**

There is no doubt that a period expressed in days is more certain than a period expressed in flexible legal terms. Therefore, at first it might seem that legal regulation would be more efficient and the level of legal certainty would be higher if a precise period (expressed in days) for the inspection procedure is stated. In that way market players could avoid legal uncertainty and better plan their market activities because they could rely on legal rules which can be interpreted only in one way. However, this statement is not unambiguous, because it is based on the entrepreneur's approach and perspective, without taking into consideration legal aspects and also the diversity of goods.

In order to determine whether the regulation of the CISG is certain or uncertain and how it affects the overall efficiency of the inspection procedure, interpretation of article 38(1) CISG has to be looked at. Analysis of judgments related to article 38(1) CISG clearly shows that the time limit "as short a period as is practicable in the circumstances" strongly depends



on the type of goods. For example, in case No.S6/1215 (*Skin care products case*)<sup>142</sup> the Helsinki Court of Appeal concluded that approximately ten weeks between the date of delivery and actual inspection is acceptable, because the product – skin care creams – needed to be specifically tested.

At the same time the Foreign Trade of Arbitration in Belgrade ruled that, regardless of the fact that goods after the examination were found to be in non-conformity, the buyer could have inspected them faster than in 20 days because the defects were apparent, not hidden.<sup>143</sup> Moreover, the court indicated that: “The relevant time limit for examining the conformity of the goods is the moment of passing of the risk (...). The rules on short time limits are dictated by the traders needs and established in order to eliminate uncertainty.”<sup>144</sup>

The flexibility of article 38(1) CISG has been very well described by the District Court of Salzburg in the *Hydraulic Crane case*<sup>145</sup>:

The length of the short period for examination pursuant to article 38(1) CISG is to be determined considering the size of the buyer's company, the type of goods, their complexity or deleteriousness or their character as seasonal goods, the amount of goods sold, the effort required for examination, and so forth.

This statement proves that, although the term “within as short a period as is practicable in the circumstances” at the first moment might seem rather uncertain, its flexibility provides certainty. In other words, the buyer can rely on the fact that if he does not hesitate and can prove that the particular type of goods could only be inspected in the particular time period, his actions most likely will not be considered as a breach of article 38(1) CISG.

By looking at the previously mentioned interpretations of article 38(1) CISG it is possible to conclude that to some extent article 38(1) CISG is even more certain than article 121(1) CESL. The latter does not give any indications how the buyer could inspect these goods which due to their characteristics simply cannot be inspected within 14 days.

When making decisions about, e.g., investments or other matters, the possible outcome under various circumstances is considered. Although no one can know with clear certainty what the future outcome will be, at least it is possible to say that some outcomes are

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<sup>142</sup> Case No.S66/1215 (*Skin care products case*), Ep S.A. vs. FP Oy, (30 June, 1998, unreported). Available at: <http://cisgw3.law.pace.edu/cases/980630f5.html>. Last visited on 6 May, 2012.

<sup>143</sup> See the judgment in the *Baby Beef Hide Case* of the Foreign Trade Court of Arbitration attached to the Yugoslav Chamber of Commerce in Belgrade, (12 July, 1994, unreported). Available at: <http://cisgw3.law.pace.edu/cases/940712sb.html>. Last visited on 6 May, 2012.

<sup>144</sup> *Ibid.*

<sup>145</sup> See the judgment of the District Court of Salzburg (2 February, 2005, unreported). Available at: <http://cisgw3.law.pace.edu/cases/050202a3.html>. Last visited on 11 May, 2012.

more likely than others.<sup>146</sup> This can also be related to regulation of articles 38(1) CISG, i.e.; even if the regulation contains a flexible legal term which can be differently interpreted, still it is possible to predict the possible outcome of such interpretation. Therefore, the wording of article 38(1) CISG cannot be considered as a factor that might prevent efficiency.

Although at first it might seem that article 121(1) CESL is completely certain, after careful grammatical analysis of the legal norm it can be concluded that it also contains uncertainty. The article states:

In a contract between traders the buyer is expected to examine the goods, or cause them to be examined, within as short a period as is reasonable not exceeding 14 days from the date of the delivery of the goods (...).

The arising uncertainty is as follows: it can turn out that even 14 days can be admitted to be too long for inspection because the buyer could have been faster and could have inspected the goods “within as short a period as is reasonable”. In other words, it is clear that 14 days is the maximum time limit for inspection in all cases but the question is if the deadline can be shorter, taking into consideration the type of goods. Currently the CESL does not provide the answer to this question. Therefore, it can be concluded that the CESL does not provide traders with absolute certainty. It also contains the possibility to be differently interpreted.

To sum up the analysis of legal certainty, it can be concluded that the difference between the level of legal certainty of articles 38(1) CISG and 121(1) CESL is not that big, that it could significantly influence the overall efficiency of the inspection procedure and the whole sales transaction. Moreover, the regulation of the CISG, by containing flexible legal terms, to some extent can be considered even more certain than the article 121(1) CESL.

#### **4.1.4. Risks**

Another aspect which might influence the inspection procedure is the attitude of buyer and seller towards risks. Indeed, uncertainty and limited time provide a higher risk that the transaction might not give the expected outcome and puts additional pressure and strain on the parties.

Regarding articles 38(1) CISG and 121(1) CESL, it is obvious that both of them create a legal risk which cannot be avoided.

Legal risk is the risk that the content of the law and its effect will not prove to be what one or both parties to the contract expect. This risk is always present in transactions, because there is a

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<sup>146</sup> J.M. Perloff, *Microeconomics 5<sup>th</sup> edition*, Pearson Education Inc., 2009, p.572.

chance that the law may be interpreted in an unforeseen way by a court.<sup>147</sup>

Thus, the buyer's attitude towards risk can affect the inspection procedure. More precisely, pursuant to article 38(1) CISG the risk is that the seller (and later the court) may decide that the buyer did not inspect the goods "within as short a period as is reasonable", and pursuant to article 121(1) CESL the buyer risks not being able to inspect the goods within such limited period.

The fact that the buyer is under pressure of a short time limit and has to carry higher risk may:

1. Negatively impact the quality of the inspection.
2. Unnecessarily increase transaction costs of the buyer.

In other words, if the buyer has to hurry because he has to fit in the fixed time limit, he may be cursory or careless. This may lead to the circumstances that the goods have not been properly inspected and have been delivered in a non-conforming quality to retailers or final consumers. Furthermore, this possibility may lead to even more negative consequences. If defects are later found, then the buyer's reputation, and, thus, also business will be damaged.

Another negative aspect which derives from the buyer's attitude towards risks is the unnecessary increase of the buyer's transaction costs. Most likely, the limited time for the inspection procedure will increase the costs related to the inspection procedure. For example, there might be a situation when some chemical analysis or other tests have to be done, but accelerating them costs more. Therefore, the buyer will pay more simply in order to comply with the requirements of legal regulation.

As buyers are commercial entities, it can be assumed that they are not risk-seeking. However, at least regarding the duty to inspect the goods, it can be concluded that buyers are more risk-averse than risk-neutral. Therefore, they will do everything that is possible in order to decrease or completely avoid any risks.

## **4.2. Duty to notify about non-conformity**

Article 39(1) CISG states that:

The buyer loses the right to rely on a lack of conformity of the goods if he does not give notice to the seller specifying the nature of the lack of conformity within a reasonable time after he has discovered it or ought to have discovered it.

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<sup>147</sup> H. Collins, "Transaction Costs and Subsidiarity in European Contract Law", in S. Grundmann, J. Stuyck (eds), *An Academic Green Paper on European Contract Law*, The Hague, Kluwer Law International, 2002, p.272.

And the regulation of article 122(1) CESL is as follows:

In a contract between traders the buyer may not rely on the lack of conformity if the buyer does not give notice to the seller within reasonable time specifying the nature of the lack of conformity. The time starts to run when the goods are supplied or when the buyer discovers or could be expected to discover the lack of conformity, whichever is later.

As it turns out from the wording, both regulations are rather similar and contain the same duty for the buyer – to notify the seller about lack of conformity within a reasonable time.

As well as article 38(1) CISG also article 39(1) is similar to the relevant regulation of the ULIS. However, again the word “promptly” has been replaced with “reasonable time”.<sup>148</sup> This allows the conclusion that both articles have a similar legislative history and thus article 39(1) CISG is also more in favor of a buyer than of a seller.

The wording of both articles identifies at least three issues which might cause discussions. The first is the concept of reasonable time; the second would be the method/format of giving notice; and the third would be related to the duty to specify the nature of lack of conformity.

The concept of reasonable time is similar to the idea of “as short a period as is practicable in the circumstances”. However, its application is more rigid because there is hardly any excuse why the buyer could not notify the seller immediately, as soon as defects are found. Therefore courts also look at the factual circumstances more strictly. The following judgments prove this very well.

For example, in case No.C1 97 288<sup>149</sup> the court admitted that eight months after delivery of goods cannot be considered a reasonable time. However, in a case heard in the China International Economic & Trade Arbitration Commission<sup>150</sup>, 13 days were admitted to be in compliance with the time limit set in article 39(1) CISG.

Nevertheless, the concept of “reasonable time” must be interpreted in every case individually:

In order to determine the reasonable time under the article 39(1) CISG, all objective and subjective circumstances of the individual case must be taken into account, among them the

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<sup>148</sup> I. Schwenzer (ed.), *Commentary on the UN Convention on the International Sale of Goods (CISG) third edition*, New York, Oxford University Press, 2010, p.622.-623.

<sup>149</sup> Case No.C1 97 288, *G. & C. v. I. SA*, Canton Appellate Court, (29 June, 1998, unreported). Available at: <http://cisgw3.law.pace.edu/cases/980629s1.html>. Last visited on 27 March, 2012. Also see case *C. & M. S.r.l. v. D. Bankintzopoulos & O.E* (30 January, 1997, unreported). Available at: <http://cisgw3.law.pace.edu/cases/970130i3.html>. Last visited on 27 March, 2012.

<sup>150</sup> Case number, date and name of parties are unavailable. China International Economic & Trade Arbitration Commission (17 April, 1996, unreported). Case text available at: <http://cisgw3.law.pace.edu/cases/960417c1.html>. Last visited on 27 March, 2012.

buyer's commercial and personal position, parameters of the particular goods, the amount of goods sold and the type of remedy exercised.<sup>151</sup>

Regarding the method/format of giving notice it can be admitted that courts are rather flexible. Namely, according to article 27 CISG they accept not only official, registered letters, sent by post, but also fax messages and e-mails<sup>152</sup>, and even orally given notices<sup>153</sup>.

According to article 122(1) CESL “[i]n a contract between traders the buyer may not rely on a lack of conformity if the buyer does not give notice to the seller within a reasonable time specifying the nature of the lack of conformity.” At can be seen by comparing the relevant articles of the CISG and CESL the wording is almost the same, and no doubt the general idea of the articles certainly is the same.

However the difference is that the CESL provides a legally binding definition of reasonableness. Namely, article 5(1) states that “[r]easonableness is to be objectively ascertained, having regard to the nature and purpose of the contract, to the circumstances of the case and to the usage and practices of the trades and professions involved”. Moreover, article 5(2) adds that “[a]ny reference to what can be expected of or by a person, or in a particular situation, is a reference to what can be reasonably expected”. This allows the conclusion that the European Commission by drafting the CESL has tried to set certain guidelines for interpretation of the concept of reasonableness and perhaps in that way to help courts to apply this term.

Even if the buyer has failed to properly notify the seller about non-conformity of goods pursuant to article 44 CISG, the buyer still has a chance to protect himself. The buyer can reduce the price or claim damages if he has a reasonable excuse why he failed to give notice of non-conformity pursuant to article 39(1) CISG. The CESL does not offer such an option. This possibility obviously is in favor of a buyer. Therefore, the fact that the CESL does not contain it proves the intention to create the CESL more in favor of the seller.

As to the period for giving notice to the seller, it should be clearly determined when this starts. According to Professor D. Girsberger, the total period within which the buyer has

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<sup>151</sup> See the judgment in case No.6 Cg 42/04m, of the District Court of Salzburg (2 February, 2005, unreported). Available at: <http://cisgw3.law.pace.edu/cases/050202a3.html>. Last visited on 11 May, 2012.

<sup>152</sup> See, e.g., case No.172920 / HA ZA 08-1228, Court of First Instance Arhem, (11 February, 2009, unreported). Available at: <http://cisgw3.law.pace.edu/cases/090211n1.html>. Last visited on 27 March, 2012.

<sup>153</sup> See, e.g., case No.2 Ob 191/98x, Supreme Court of Austria, (15 October, 1998, unreported). Available at: <http://cisgw3.law.pace.edu/cases/981015a3.html>. Last visited on 27 March, 2012.

to notify the seller about non-conformity can be divided into two parts. The first part starts running after the goods have been delivered and it goes together with time spent on the inspection. However, the “reasonable time” period, as is stated in article 39(1) CISG, starts counting only after defects have been discovered.<sup>154</sup>

Nevertheless, both regulations of the buyer’s duty to notify the seller about defects within a reasonable time can be considered as efficient. It is justifiably demanded that the buyer must not hesitate and must inform the seller as soon as possible. Such regulation provides that the transaction is completed without unnecessary delay and also ensures efficient circulation of both goods and money.

### **4.3. Methods of inspection**

As it turns out from the wording of article 38 CISG, goods can be examined either by the buyer or by any other third party. The same derives from article 121 CESL. Neither the CISG nor the CESL precisely regulates the possible methods of inspection. Therefore, clues for that must be sought in other sources, for example, contracts between parties. Contractual terms regarding the inspection methods can be very useful when it comes to the necessity to determine whether the buyer has or has not properly inspected the goods.

If parties have not agreed upon inspection methods then common usage or commercial practice between the parties can be used. An applicable usage has the same effect as a contract.<sup>155</sup> Therefore, the parties should bear it in mind when drafting their contract.

Another option to determine inspection methods is to use the concept of “appropriate manner”, which again is a flexible legal term and requires interpretation.

Rather extensive explanation of inspection methods has been given by the Aschaffenburg District Court in the *Cotton twilled fabric case*<sup>156</sup>:

The examination pursuant to Art. 38 CISG may be conducted by the buyer himself, its employees, or others. The buyer and the seller may examine the goods together, or may agree to leave the examination to an institution suitable for inspections of that kind. In cases like this, where a considerable risk of consequential damages was foreseeable to [Buyer], Art. 38 CISG requires an even closer examination of the goods by [Buyer]. If a cursory overall inspection indicates that the goods may not be of the agreed quality or description, samples must be taken.

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<sup>154</sup> D. Girsberger, “The Time Limits of Article 39 CISG”, (2006) 25 J.L. & Com. (*Journal of Law and Commerce*) 241, at p.242.

<sup>155</sup> S. Kuoppala (2000). *Examination of the Goods under the CISG and the Finnish Sale of Goods Act*. Available at: <http://cisgw3.law.pace.edu/cisg/biblio/kuoppala.html>. Last visited on 4 April, 2012.

<sup>156</sup> See judgment of Aschaffenburg District Court in case 1 HK O 89/03 (20 April, 2006, unreported.) Available at: <http://cisgw3.law.pace.edu/cases/060420g1.html>. Last visited on 11 May, 2012.

For the deliveries of large quantities, the buyer may also confine himself to taking samples for the examination under Art. 38 CISG. If, in that case, the delivered goods are meant to be used in production, as in the case at hand, samples must be processed first as a test (...).

Methods applied for the inspection procedure are highly dependent on the particular goods. Namely, for some goods, it is enough to look at them, but some goods at the same time may require taking samples or even asking for a professional examination. Nevertheless, regardless of which method the buyer chooses, it does not affect the seller, who is more like a neutral observer and does not have any active role regarding choice of inspection methods.

From the above, it turns out that regulation of inspection methods is rather flexible and allows several possibilities. Therefore, it can be considered that this approach is efficient, due to the fact that it offers flexibility to act according to the circumstances. Although inspection methods are directly related to transaction costs, these costs are predictable and therefore cannot be a determinative factor that might affect the overall efficiency of the transaction.

#### **4.4. Seller's duty to disclose information**

In the inspection procedure a buyer has a more active role than the seller. In order to balance the burden of duties, articles 40 CISG and 122(6) CESL have been included in the regulations. However, there is a significant difference between them. According to article 40 CISG the seller cannot rely on the provisions of articles 38 and 39 CISG if the lack of conformity relates to facts of which the seller knew or could not have been unaware and which he did not disclose to the buyer. In other words, the seller cannot assert that the buyer had been inspecting the goods for too long or had not informed the seller about non-conformity within a reasonable time if the seller knew or ought to have known that the goods do not conform to quality standards.

At the same time, pursuant to the CESL, this principle can be related only to the buyer's duty to notify the seller within a reasonable time, i.e., if the buyer breached article 121(1) CESL and did not inspect the goods within 14 days, then even if the seller knew about the defects, the fact that the seller knew about them has no importance.

The previously mentioned difference again proves that regulation of the duty to inspect goods under the CESL is more in favor of a seller. Furthermore, it is neither just nor efficient and it increases the existing informational asymmetry in the market of international sale of goods.

Regarding article 40 CISG the Austrian Supreme Court in the *Water-jet cutting machine case*<sup>157</sup> indicated that it would be “unjust and unnecessary formalism” if the buyer had to inform the seller about defects the seller knows or ought to have known of. We can agree with this statement because every additional activity increases transaction costs. Therefore, it would not be reasonable if the seller could demand to be formally informed if he knows the facts himself.

The relevant regulation of the CISG ensures that the seller has a higher risk if he is not diligent enough or decides not to disclose information about possible defects. Pursuant to the relevant regulation of the CESL the seller has a bigger chance to be dishonest and conceal possible defects in the goods, i.e., the seller has to wait while the limit of 14 days ends, and then under no circumstances will the buyer be able to claim that the seller knew about the defects, so that the delayed inspection procedure should be justified. Thus, it can be concluded that pursuant to article 122(6) CESL the distribution of risks is not equal, and it decreases the efficiency not just of the inspection procedure, but also of the overall sales transaction.

#### **4.5. Burden of proof**

The CISG does not contain precise and clear regulation of the burden of proof. Therefore, this is still a rather open issue, where opinions of legal scholars diverge. Some authors think that, as the CISG does not govern it, domestic law should be applied. Others at the same time indicate that the problem could be solved by applying *lex fori*, taking into consideration that the burden of proof is a question of procedural law.<sup>158</sup> The legislative history of the CISG shows that “it was not the intention to deal in the Convention with any questions concerning the burden-of-proof.”<sup>159</sup> This confirms that this question has been intentionally left to the procedural law of the court of the forum.

Indeed, the CISG does not contain any article which would stipulate conditions or requirements for parties regarding the burden of proof. Moreover, even by systematically

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<sup>157</sup> Case No.6 Ob 257/06x (*Water-jet cutting machine case*). Judgment of the Supreme Court of Austria (30 November, 2006, unreported). Available at: <http://cisgw3.law.pace.edu/cases/061130a3.html>. Last visited on 10 June, 2012.

<sup>158</sup> F. Ferrari, *Burden of Proof under the CISG*. Available at <http://cisgw3.law.pace.edu/cisg/biblio/ferrari5.html>. Last visited on 3 April, 2012.

<sup>159</sup> S. Kröll, “The Burden of Proof for the Non-Conformity of Goods Under Art. 35 CISG”, (2011) 15 VJ (*Vindobona Journal of International Commercial Law & Arbitration*) 33, at p.38.



and teleologically interpreting CISG norms it is rather hard to make some guidelines on the burden of proof. Only articles 11 and 79 contain some indications to this issue, but they are insufficient for making some well-grounded conclusions.

In contrast to the CISG, the CESL contains four articles<sup>160</sup> in which the burden of proof has been mentioned. However, these articles are related to business-consumer relationships, therefore their usefulness regarding the business-business relationship is rather insignificant.

It is obvious that neither the CISG nor the CESL can regulate all possible issues. Therefore existing gaps somehow have to be fulfilled. *Inter alia*, this can be done by applying general principles of law.

The general principle at least in so called “civil law” countries, is that the burden of proof rests on the party which claims the particular thing being or not being done. This principle could also be applied regarding the duty to inspect goods in international sales contracts.

After analyzing articles 38, 39 CISG and 121, 122 CESL it can be concluded that the burden of proof for the buyer is higher. Namely, a buyer will always have to prove that it has inspected the goods in due time, that it has sent notice of non-conformity within a reasonable time, that it has provided necessary evidence which proves non-conformity, etc. This leads to an imbalance between buyers and sellers, which can significantly affect the outcome of the transaction and its level of efficiency.

As well as in all other civil procedures, also regarding the duty to inspect goods pursuant to the CISG and CESL, all possible methods of proving something are accepted. For example, according to article 11 CISG it is possible to use witnesses for proving the existence of a contract. Although this article is not directly related to inspection of goods, by systemically interpreting CISG provisions, it could also be applied for proving other things.

Burden of proof has a strong impact on the efficiency of international sales contracts. Namely, if a dispute arises between the parties and they have to resolve it in court, the party which has the higher burden of proof will have higher litigation expenses. And even if the parties do not go to court then one of them has to pay more attention and invest more resources in order to provide all the necessary proof, even if it is just for safety reasons. Thus, it can be concluded that the party with a higher burden of proof at the same time might face

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<sup>160</sup> See articles 21, 26, 41(5), 85(a) CESL.

higher transaction costs, assuming that all other costs for the party are more or less but equal.

#### **4.6. Outcome of analysis**

To sum up the economic analysis of the buyer's duty to inspect the goods pursuant to the CISG and CESL, the following main conclusions can be made:

1. The time limit for the duty to inspect the goods, expressed as "within as short a period as is practicable in the circumstances", is more efficient than a fixed term – 14 days.
2. The relevant regulation of the CISG provides more efficient allocation of risks and transaction costs than the relevant regulation of the CESL.
3. The difference between the level of legal certainty under the relevant regulation of the CISG and CESL is not high and it cannot be considered as a determinative factor that could affect evaluation of the overall efficiency of the transaction.
4. The CISG, regarding the duty to inspect goods, protects the weaker party – the buyer – while the CESL is not just more in favor of the seller but increases the imbalance between sellers and buyers even more.
5. The relevant regulation of the CESL will put buyers under additional strain and risks, thus creating a possibility that goods will not be properly inspected and letting defective goods enter the market.

From the above it turns out that the duty to inspect the goods pursuant to the CISG reflects the aims stated in the CISG's preamble, while the relevant regulation of the CESL does not comply with its aims and will not promote international trade.

## 5. CONCLUSION AND OUTLOOK

This thesis is devoted to the economic analysis of the duty to inspect goods pursuant to the CISG and CESL. The particular method has been chosen due to the following reasons. First, it allows evaluating efficiency of legal rules. Second, it provides a different perspective for the analysis of law. Last but not least it allows predicting consequences that new legal rules could lead to. Furthermore, taking into consideration that the object of this thesis is closely related with international business, which demands efficiency, economic analysis can be justifiably admitted as a suitable method for this research.

Although economic analysis is a relatively new approach for legal research, this has proved to be a valuable tool for evaluating and analyzing the efficiency of law. Moreover, its rather flexible nature provides that it can be applied to various kinds of legal issues. Thus, the economic analysis of law, even despite its controversial character, can be practically used not just in academic research, but also in everyday practice as well.

The contemporary business world requires efficient legal regulation that would, *inter alia*, promote international trade. Indeed, the market of international sale of goods is strongly dependent on legal rules. Legislators, by adopting legal norms, can influence both domestic and global sales transactions and thus also affect their outcome. Therefore, laws should be created and used so as to facilitate the economy and business in general and international trade in particular. Moreover, laws should correct failures of the market, which cannot be corrected by economic principles and tools.

These aims, *inter alia*, have been included in the preamble of the CISG, according to which the CISG is supposed to increase international trade. In order to test whether the legal norms of the CISG reflect its goals, the relevant regulation of the buyer's duty to inspect the goods was analyzed. The CISG was chosen because of its rather significant role in the market of international sale of goods.

Indeed, the buyer's duty to inspect goods is one of the most important elements of the market of international sale of goods. Although not in all jurisdictions is it a mandatory act, pursuant to the CISG and the CESL a buyer must inspect the goods in order to ensure that defective goods are not accepted. Thus, the duty to inspect goods can also be considered as a specific, preventive remedy, which can be used before damage occurs.

The core issue regarding the duty to inspect the goods is the time limit within which the buyer has to carry out the inspection procedure. The CISG and the CESL offer different

regulations, which lead to different legal and economic consequences. While the regulation of the CISG is more flexible and provides more efficient allocation of transaction costs and risks, the CESL puts an additional burden on the buyer.

The fact that pursuant to the CESL the inspection procedure cannot be longer than 14 days leads to the possibility that the buyer's transaction costs will unnecessarily increase and the buyer will be influenced by more risks. Furthermore, the limited time period might be the reason for rushed inspection procedures and missed hidden defects. Thus, it may also leave global consequences because if defective goods are let into the market other persons, e.g., consumers, might be affected.

Although the CESL is said to be increasing legal certainty among traders, at least with regard to the duty to inspect goods it cannot be considered as significantly more certain. The current CISG regulation can also be considered as legally certain. Furthermore, the wording of the relevant CESL articles also brings uncertainty and raises questions. Therefore, the argument of the CESL and its ability to increase legal certainty is not that unambiguous.

After analysis of the legal rules regulating the duty to inspect goods, it can be concluded that the CESL is favorable to the seller, while the CISG protects the buyer more. Moreover, the new regulation introduced by the CESL will make the inspection procedure even more favorable to the seller, thus also increasing the existing imbalance among buyers and sellers and decreasing the overall efficiency of international sales transactions.

The reason why the CESL has been created more in favor of a seller can be found in its sources. As one of the aims of the CESL is to increase trade in the EU, it is logical that this can be done, *inter alia*, by protecting sellers and facilitating their wish to sell. However, the CESL, from the perspective of the buyer's duty to inspect goods, will be less efficient than the CISG. Therefore, most likely traders will still choose the CISG instead of the CESL as the applicable law for their sales contracts.

Furthermore, as analysis of the market of international sale of goods proves that the buyer is in a weaker position, especially regarding the duty to inspect goods, international sales law should protect the buyer more. Therefore, the regulation of the CISG can justifiably be considered as more efficient than the relevant regulation of the CESL.

Although the current regulation of the CISG is efficient, overall efficiency can still be increased. One of the possibilities to do this would be to facilitate collaboration between the buyer and the seller. Currently the seller has a passive role regarding the inspection

procedure of goods, while the buyer has the entire burden of inspection, notification and proof. If the seller were also involved in the inspection procedure, then the transaction would become faster and more efficient, because both parties would be interested in doing their best in order to maximize the outcome of the transaction.

However, it can be admitted that it would be hard to increase collaboration between buyers and sellers on a legally binding level. Collaboration and, e.g., voluntary disclosure of information, are questions more about good commercial practice between parties rather than mandatory obligations. Moreover, taking into consideration the characteristics of international sales transactions, *inter alia*, the need for speed, additional mandatory duties at the same time might decrease overall efficiency.

The economic analysis of the duty to inspect goods pursuant to the CISG and CESL proves that the relevant regulation of the CISG reflects the aims, stated in its preamble – the legal norms regulating the buyer’s duty to inspect the goods help to promote international trade. At the same time, although the CESL has the same aims, its relevant regulation, and in particular article 121(1), instead of increasing efficiency and thus promoting trade, most likely will decrease it.

Nevertheless, both the CISG and the CESL are examples of attempts to harmonize and create efficient and widely accepted international sales law. It can be admitted that the CISG has reached that aim, while the future of the CESL remains uncertain.