Contract law as fairness: a Rawlsian perspective on the position of SMEs in European contract law

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7 Personal scope

7.1 The notions of consumer and trader

The definitions of consumer and trader are, except for some slightly different phrasing, materially the same in both the Unfair Terms Directive and the Consumer Rights Directive as well as in the CESL.\(^{305}\) In brief, a consumer is any natural person who is acting for purposes which are outside that person’s trade, business, craft, or profession, while a trader is any natural or legal person who is acting for purposes relating to that person’s trade, business, craft, or profession.\(^{306}\) This means there is no gray zone, no in-between: a person is either a consumer or a trader.\(^{307}\)

There are three important elements of the consumer definition to focus on. First of all, only natural persons can be classified as consumers. A question often posed was whether legal persons acting outside the scope of their (normal) business could qualify as consumers, but in the Cape/Idealservice case\(^{308}\) the CJEU decided that by definition a legal person cannot be regarded as a consumer.\(^{309}\) Some Member States, however, have extended the definition of consumer to include certain legal persons, like charitable organizations purchasing for private use.\(^{310}\) Secondly, the definition of a consumer in EU law excludes traders concluding atypical contracts, i.e. contracts outside the normal trade or profession of the trader. For example France extended the notion of consumer to a trader who concluded a contract that did not have a direct

\(^{305}\) In the Unfair Terms Directive the trader is referred to as seller or supplier, but I will treat that as synonymous to trader as there seems to be no substantive difference between the definitions.

\(^{306}\) Article 2 Unfair Terms Directive, Article 2 CRD, and Article 2 CESL.


\(^{309}\) Loos 2008, pp. 32.

\(^{310}\) Schulte-Nölke, Twigg-Flesner and Ebers (eds.) 2008, Schulte-Nölke, Twigg-Flesner and Ebers (eds.) 2008p. 460-461. It is not entirely clear whether this is still possible, considering the maximum harmonization character of the CRD, see Loos 2008 NTER.
relation to his business activity.\textsuperscript{311} Already in the \textit{Di Pinto}-case, the CJEU made clear that any trader acting in the course of his trade, even if it is unrelated to his normal business activity, cannot be regarded as a consumer.\textsuperscript{312} Finally, the consumer definition excludes mixed contracts, i.e. contracts with both a private and a professional use, from consumer protection. In the \textit{Gruber}-case\textsuperscript{313} the CJEU ruled that the Brussels I Regulation Articles 15-17\textsuperscript{314} could only be invoked if the professional use was negligible.\textsuperscript{315} In conclusion, the definition of a consumer is restrictive on all three counts.\textsuperscript{316}

\section*{7.2 The Notion of SME}

As the CESL is the first instrument in European contract law that concerns itself with the position of SMEs specifically as a group, it is also the first to provide a definition for private law purposes.\textsuperscript{317} Article 7 of the proposed regulation determines that if both parties to the contract are traders, they can only opt into the CESL if at least one of the traders is an SME. For the purposes of the CESL, an SME is a trader which employs fewer than 250 persons and has an annual turnover not exceeding EUR 50 million or alternatively an annual balance sheet not exceeding EUR 43 million.\textsuperscript{318} This definition

\textsuperscript{311} See Cass. Civ. of 28 April 1987 (JCP 1987. II. 20893 Juris-classeur periodique); It must be noted that in more recent cases the Cass. Civ. has narrowed the interpretation of consumer in this regard to be more in line with the notion of consumer in the Unfair Terms Directive. Schulte-Nölke, Twigg-Flesner and Ebers (eds.) 2008 pp. 458-459.
\textsuperscript{312} ECJ 14 March 1991, Case C-361/89 (\textit{Di Pinto}), [1991] ECR I-1189, paras. 14-19. This case concerned the old Directive 85/577/EC, but since the definition of consumer did not change with the introduction of the CRD it can be assumed that this case law is still relevant.
\textsuperscript{315} Although it is not entirely settled whether this ruling also extends to the Directives discussed here, it seems reasonable to assume it would. Loos and Luzak 2011, pp. 170-171. Cf. the DCFR’s definition of consumer includes persons who act \textit{primarily} for purposes outside of their trade.
\textsuperscript{316} Hesselink 2010, pp. 69-73; Loos 2012, p. 792. Note also how this notion of consumer does not seem to align with the notion of a reasonably circumspect consumer as found in the unfair commercial practices law, see Mak 2011a.
\textsuperscript{317} Schulze (ed.) 2012, p. 54.
\textsuperscript{318} The staff headcount and annual turnover/balance sheet requirements are cumulative.
is based on a European Commission Recommendation.\textsuperscript{319} The Recommendation makes a further distinction between micro, small and medium-sized enterprises, where medium-sized enterprises are defined as above, small enterprises as not employing more than 50 persons and an annual turnover not exceeding EUR 10 million, and micro enterprises as not employing more than 10 people and an annual turnover not exceeding EUR 2 million.\textsuperscript{320} The definition of the CESL covers all of these three categories indiscriminately.\textsuperscript{321} Finally, the Recommendation also clarifies the term enterprise: any entity engaged in an economic activity, irrespective of its legal form.\textsuperscript{322} Accordingly, this also covers self-employed persons.

\subsection*{7.3 Underlying rationales}

A clear distinction is made between consumers and businesses in the \textit{acquis}.\textsuperscript{323} As discussed further below, consumers are granted more rights across the board. Hence, the distinction between consumers and businesses often demarcates who is afforded protection and who is not.\textsuperscript{324} What then are the justifications provided for such a distinction? The general argument runs as follow: any protective measures are a departure from the norm of freedom of contract and hence require good reasons. The reasons that justify such protection for consumers do not apply to businesses and hence the two categories should be distinguished from one another. More specifically, there are generally three types of reasons that are given to justify consumer protection that are said not to apply to businesses.\textsuperscript{325}

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\begin{itemize}
\item \textsuperscript{319} Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises, \textit{OJ L} 2003, 20 May 2003, 124/36. See also Hesselink 2007a, pp. 350-351.
\item \textsuperscript{320} Article 2 Recommendation of 6 May 2003.
\item \textsuperscript{321} Recital 21 CESL.
\item \textsuperscript{322} Article 1 Recommendation of 6 May 2003.
\item \textsuperscript{323} Hesselink 2007a, p. 363.
\item \textsuperscript{324} Under the Directives, the dichotomy is simply between consumers and non-consumers, while this is slightly more complex under the CESL because of the introduction of the notion of SMEs. However, for the purposes of this section SMEs are a subgroup of the non-consumers as in the rules of the CESL they consistently fall under the ‘business-side’. See Loos 2010, p. 19.
\item \textsuperscript{325} Most of these reasons will be discussed in more detail as justifications for the particular rules of pre-contractual information duties, rights of withdrawal and unfair terms protection below.
\end{itemize}
Chapter 7

First of all, consumers tend to be in a weaker position in their relations to businesses. Because they have no market power to speak of, they are unable to bargain with businesses and instead are left with take-it-or-leave-it offers. This inequality of bargaining power leads to a situation in which businesses are able to exploit consumers. When, on the contrary, businesses are dealing with other businesses there is an equality of arms, or at least a justified presumption of such equality.\textsuperscript{326} Since there is no structural inequality of bargaining power, there are no good reasons for protecting businesses and hence this distinction is justified.\textsuperscript{327}

Secondly, a justification for protection is found in the information asymmetry between consumers and businesses. Consumers often lack the information necessary to make the right decisions.\textsuperscript{328} Businesses have more experience with the products they sell and with the contracts that govern these sales. Consumers on the other hand usually only contract for certain products and with a specific counter-party every so often. The consumer’s lack of information both as to the product and to the contract terms make him prone to error and hence he deserves to be protected.\textsuperscript{329} When businesses deal with one another, however, they generally engage in the same type of transactions often (i.e. they are ‘repeat players’) and hence no such information asymmetry can be assumed.

Not only are consumers often imperfectly informed, they often are unable to process and assess the information they do have. Consumers, like all human beings, make mistakes. The information might be too complicated or extensive or the consumer simply might be tired or affected by emotions. In the terminology associated with behavioural economics, consumers are only limitedly rational.\textsuperscript{330} For example, they often underestimate long-term costs and risks, while overestimating short-term advantages.\textsuperscript{331} Consumer protection can be justified as a correction for these types of

\textsuperscript{326} Cf. Lando 2006, p. 829.
\textsuperscript{328} Hesselink 2007a, pp. 358-359.
\textsuperscript{329} Hesselink 2010, pp. 94-95.
\textsuperscript{330} Duivenvoorde 2010.
\textsuperscript{331} Bar-Gill 2012, pp. 21-23.
mistakes. Even though people (who make mistakes) run businesses, businesses have the advantage of being able to structure their company. Through a division of labour, businesses can incorporate checks and balances to minimize mistakes in ways consumers cannot. Hence, once again a distinction between the two groups could be justified.

The third argument is slightly different in nature from the previous two arguments. This justification concerns the questions to what extent or in what domain protection, i.e. some form of paternalism, is appropriate. The idea is that, even though consumers and businesses both make mistakes (albeit not to the same degree) only consumers should be protected from themselves. Unlike consumers, businesses are commercially active with a view to making a profit. However, if they consistently make mistakes they will go bankrupt. Not only is this bankruptcy part of the risk/reward structure inherent to running a business (and hence an assumed risk), it also fosters competition as bad businesses will cease to exist. Capital invested in these bad businesses can then be re-invested, freeing up capital for more successful businesses. The same kind of reasoning cannot be applied to the success of the lives of consumers and hence it is justified to treat businesses and consumers differently.

7.4 Is a distinction between consumers and SMEs justified?

The previous section outlined the underlying principles for distinguishing between consumers and businesses in general. As the aforementioned discussion on the formal scope showed, SMEs will always fall into the category of businesses in this dichotomy under both the directives and the CESL. This means that they are excluded from the weaker party protection that consumers enjoy. As I argued above, such weaker party protection can be seen as an implementation of the difference principle, aiming at improving the position of the worst-off in society through aiding the group of weaker parties. Prima facie, SMEs operate in a very similar position to consumers in their

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332 Hesslink 2010, p. 95.
333 Hesslink 2011b, pp. 139-141.
334 Hesslink 2010, pp. 99-100.
contractual relations. The central question is: can the rationales discussed above justify the exclusion of SMEs from weaker party protection?

The first rationale for making a distinction between consumers and businesses relates to the inequality of bargaining power that is presumed to exist in B2C contracts. In B2B relations, on the contrary, an equality of arms is presumed. In the case of SMEs, such a presumption of equality of arms does not hold. Small businesses tend to be in a similar economic position as consumers and hence lack the effective bargaining power to substantially influence negotiations with larger businesses. A journalist working from home will not be able to influence the contract for a laptop for professional use any more than a consumer buying the same laptop for private use. In fact, a small enterprise could very well be more dependent on a large company because it has fewer options to choose from than a consumer, reducing his bargaining power even further. A typical SME will thus face the same danger of exploitation as a typical consumer. Accordingly, a presumption of inequality of bargaining power for SMEs seems justified parallel to this presumption with regard to consumers. Such a presumption increases in plausibility as the size of the company decreases: smaller SMEs need greater protection.

The second argument to demarcate consumers and businesses concerns information asymmetry and bounded rationality. People lack information and the capacity to handle information properly and thus are bound to make mistakes, while businesses can be expected to organize themselves in such a manner as to minimize the effect of such mistakes. However, this expectation is not reasonable with regard to SMEs in the same way it is for larger businesses. A large company will be able to hire staff and lawyers to process all relevant information, but for a small company this could well be too expensive. The same goes for a division of labour in order to minimize the effects of bounded rationality. People are just as likely to make mistakes at work as they are at home and a small company will not have the resources to

\[ ^{335} \text{Hesselink 2007a, p. 359.} \]
\[ ^{336} \text{Micklitz 2013, p. 288.} \]
incorporate the checks and balances required to prevent such mistakes.\footnote{337 Hesselink 2010, pp. 94-95.} So, also the distinction between consumers and SMEs seems unjustified with regard to information asymmetry and again, the smaller the company the greater the probability that this will be the case.

The third argument for treating businesses differently from consumers is that businesses engage in commercial activity, which is supposedly a difference relevant for the question of who is supposed to be protected.\footnote{338 Hesselink 2010, p. 99.} This argument seems to rest on the assumption that being protected as a consumer is more important for the success of a person’s life than being protected in running a small business. However, this is by no means obvious. Often, the products purchased by consumers are of relatively modest impact on their well-being, while a person running a small business may be dependent on protection as an aspect of his ability to run a business well and hence to make a livelihood.\footnote{339 Hesselink 2010, pp. 95-96.} Of course, one could still argue that paternalism is never appropriate, but in this respect it cannot suffice as a justification for distinguishing between consumers and small businesses.\footnote{340 Furthermore, one could cast doubt on whether this can be sensibly called paternalism at all. As Seanna Shiffrin has argued with regard to unconscionability, the state can have a legitimate, non-paternalistic interest in not lending itself to aid in the enforcement of exploitative contracts. The same could be argued with regard to weaker party protection and SMEs, where the state has a legitimate and non-paternalistic interest in denying the enforceability of contracts that exploit weaker parties like SMEs; See Shiffrin 2000.}

The argument of commercial activity can also refer to the situation that when companies go bankrupt the person who runs the company is protected from the effects of bankruptcy because of the legal separation between personal assets and the company debt. However, this is only the case for some of the legal persons that fall under the scope of what counts as an SME; many other enterprises, for example a self-employed person,\footnote{341 Self-employed persons are explicitly covered under the definition of SMEs. See Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises, \textit{OJ L} 2003, 20 May 2003, 124/36, art. 1.} do not enjoy such debt separation.
Accordingly, the three underlying rationales for distinguishing between consumers and businesses generally do not justify the exclusion of SMEs from weaker party protection. A final argument against including SMEs in the category of weaker parties to be protected, however, could be that including the entire group of SMEs would result in overprotection, i.e. protection of parties that do not need it, or would lead to a reduction in legal certainty because delineating the group of SMEs might pose difficulties. To include SMEs as a group might indeed lead to some overprotection. However, this is inevitable under the categorical approach to weaker party protection that follows from justice as fairness. One response to such overprotection could be to drop categorical protection altogether and extend protection only to those parties that are actually and concretely in need of it through the operation of an open norm, like an expanded notion of good faith and fair dealing.\footnote{Hesselink 2007a, p. 362.} However, such an approach would not fit well with the Rawlsian perspective on contract law.\footnote{See Chapter 3.4.} The relevant social positions that are considered under the difference principle are characterized by groups; to depart from that categorical approach would jeopardize the institutional division of labour between contract law, as part of the basic structure, and the rules applying directly to individuals.\footnote{Rawls 2005, p. 269.} As soon as a categorical approach is taken, then some overinclusion (as well as underinclusion!) is unavoidable. This is characteristic of categories, not of SMEs. The same issue characterizes the category of consumers, as some consumers that do not actually need it nevertheless are granted protection. Accordingly, the risk of overinclusion does not in itself justify a distinction between SMEs and consumers. The same can be said with regard to the question of legal certainty. The Commission provided a precise definition of what counts as an SME in its Recommendation.\footnote{Commission Recommendation of 6 May 2003 Article 2.} This is a well-defined category with clear boundaries, and at least as clear as the category of consumers. It is not obvious why also protecting that category would impair legal certainty.
A narrower counterargument would be that although overprotection is not necessarily always bad, the category of SMEs as currently defined in e.g. the CESL is simply too inclusive. SMEs are defined as any enterprise that employs fewer than 250 persons and has an annual turnover not exceeding EUR 50 million or alternatively an annual balance sheet not exceeding EUR 43 million. This means that the current category of SMEs includes the vast majority of enterprises in the EU. The critics have a point here. As described above, the arguments of inequality of bargaining power and of information asymmetry gain strength when the companies concerned are smaller. The Commission originally adopted the definition of SMEs not specifically with contract law in mind, but rather with the position of SMEs on a broader policy level in mind. The EU has many programs targeted to SMEs on the internal market, so with that purpose in mind it was attractive to adopt a broad definition of SMEs. For contract law, however, I would argue that a narrower definition of SMEs would be more appropriate. A narrower category is readily available, as the same Recommendation also defines the subcategories of micro-, small- and medium sized enterprises. In the case of weaker party protection, it would be more in line with the underlying principles described above to focus on micro- and small enterprises. This would also reduce the risk of consumer protection being hollowed out because the category of weaker parties is overstretched to include relatively large companies. However, a Rawlsian perspective cannot offer a precise answer to the question of how the category of SMEs should be defined. As argued above, some indeterminacy in justice exists, especially in economic arrangements. To quote Rawls once more:

“We are entitled at some point to plead practical considerations, for sooner or later the capacity of philosophical or other arguments to make finer discriminations must run out.”

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346 Micklitz 2013, p. 352.
348 Rawls 1999, p. 84.
Various definitions of SMEs, within certain boundaries, could be considered to be equally just. This does not undermine the fundamental argument to include SMEs, however precisely defined, into the category of weaker parties.

Furthermore, and maybe more importantly, overprotection is in itself not necessarily problematic under justice as fairness. The difference principle requires that the position of the worst-off be improved, but remains largely silent on the social positions of the remaining groups.\textsuperscript{349} Hence, if a set of rules, like weaker party protection rules, improves the situation of the least advantaged, then it does not matter, from a Rawlsian perspective, whether some others who are also better off take advantage of those same rules.\textsuperscript{350} As long as the inclusion of SMEs in the overall structure of weaker party protection benefits the worst-off it is a sufficient reason for their inclusion.

A final question that is to be considered here is what weaker party protection for SMEs would mean for contracts where the counterparty is another SME (SME2SME contracts). As we saw above, an important part of the rationales underlying weaker party protection is found in the relational weakness of one party versus its counterparty. Accordingly, these rationales do in principle not support the application of weaker party protection in the case where an SME deals with another SME.\textsuperscript{351} Therefore, the situation under consideration will be that of B2SME contracts where B is not also an SME. This means that the impact of extending protection to SMEs is directly tied to the definition of the category as SMEs. On the one hand, when SMEs are defined inclusively, as currently is the case, most businesses fall within this category but conversely many contracts will fall outside of the scope of protection as the counterparty will also be considered an SME. On the other hand, when SMEs are defined more narrowly, as I have argued above would be appropriate, fewer

\textsuperscript{349} Rawls 2005, pp. 22-28.
\textsuperscript{350} See also Chapter 3.4.
\textsuperscript{351} Note that the fact that SMEs are in a similar position as consumers with regard to dealing with larger businesses does not yet mean that SMEs and consumers are in the same position when dealing with one another, but I will leave this issue aside and focus on B2SME contracts.
businesses will actually fall within this category, but for the ones that do their counterparty will more often be considered to be a larger business.\footnote{An interesting idea could be to shift attention from \textit{weaker} party protection to \textit{weak} party protection. Not all rationales stress relational weakness and sometimes a case could be made for protection, even if both parties are weak. However, given the current shape of consumer protection law (e.g. the lack of C2C protection) and its underlying rationales (that focus on relational weakness) I will not further develop this notion.}

In conclusion, contract law as fairness shows why categorical weaker party protection is a worthy goal. Excluding a group from the category of weaker parties without justification is thus, in the Rawlsian sense, unfair. None of the rationales discussed above provide a justification for the categorical exclusion of SMEs from weaker party protection. On the contrary, SMEs typically share the main characteristics that justify the protection consumers receive and hence in contract law as fairness SMEs should, in principle, be included in the category to whom weaker party protection is granted. Nevertheless, it is still possible that the principles underlying pre-contractual information duties, rights of withdrawal and unfair terms contain reasons that could justify an exclusion of SMEs with regard to the protection provided by those specific legal mechanisms. Therefore, I will now address these specific doctrines of consumer protection and their underlying rationales.