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978-0-521-19053-4 - Unconscionability in European Private Financial Transactions:  
Protecting the Vulnerable

Edited by Mel Kenny, James Devenney and Lorna Fox O'Mahony

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## Introduction: conceptualising unconscionability in Europe

MEL KENNY, JAMES DEVENNEY AND LORNA  
FOX O'MAHONY

Unconscionability is not a simple, easily defined concept. While unconscionability even within the common law is essentially contested, in Europe unconscionability or its equivalents is an even broader concept which is to be found in a plurality of sources; it is therefore perhaps best described as a multi-dimensional concept taking its place in a polycontextual environment of national contract laws and instruments aimed at protecting the vulnerable in a variety of contexts: arising variously in consumer, family or non-professional transactions. Traditionally, in some private law systems, unconscionability may only be resorted to sparingly, as an exception to the fundamental principle of freedom of contract; in others it may be resorted to more widely as an instrument of ensuring ideas of fairness or solidarity between contracting parties. Similarly, the concept may involve stringent procedural or more invasive substantive approaches; and the effective level of protection produced by either of these approaches may vary considerably. In yet other legal orders and within those orders in specific fields of law unconscionability may be delivered indirectly through the intervention of substantive constitutional law (fundamental rights) or, alternatively, and less spectacularly, through property law principles. Some form of unconscionability or its equivalent may thus be found in all European legal orders.

This book represents the results drawn and developed from the conference 'Conceptualising Unconscionability in Europe', an event held at Durham Castle on 8–9 September 2008. The conference was held as the first of a series of events organised within the work programme 'Credit and Debt: protecting the vulnerable in Europe'; a project placing special emphasis on vulnerability in financial transactions and based at the Centre for Law and Legal Studies at Leeds Law School. The project

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[More information](#)

2 MEL KENNY, JAMES DEVENNEY AND LORNA FOX O'MAHONY

owes its genesis to work originally organised under the umbrella of the Commission's Sixth Framework Programme (FP6) on the protection of vulnerable family sureties, an ambitious Transfer of Knowledge project coordinated by Dr Aurelia Colombi Ciacchi at the Centre for Law and Politics at Bremen University and Professor Stephen Weatherill at the Institute of European and Comparative Law at Oxford and based at the Centre for Law and Politics at Bremen University. It was only logical to develop in this project some of the ideas which can be traced to that original research in Bremen – with the valuable collaboration of Professor Gert Brüggemeier (Bremen), Professor Gerry McCormack (Leeds) and Professor Sjef van Erp (Maastricht).

The project would not have been possible without the generous support it has received from Marie Curie research funds through the European Commission (European Reintegration Grant 223605) within the Seventh Framework Programme (FP7). In Brussels we are grateful for the assistance of Pascale Dupont, Chantal Huts and Laurent Correia, our FP7 project officers. The first stage of the work programme and the Durham conference was organised by the editors of this volume.

This work is divided into two parts: in Part I of this work we focus on fleshing out the broad contours of the concept of unconscionability. Colombi Ciacchi begins with a comparative exploration of the relationship between the concepts of freedom of contract and unconscionability in Europe. She notes that there has always been a degree of antagonism between these two concepts but examines whether freedom of contract and unconscionability could converge (Chapter 1). Waddams then engages in an examination of the theoretical basis of unconscionability in English law (Chapter 2). Barral Viñals and Saintier go on to explore concepts of unconscionability in Spanish and French Law (respectively in Chapters 3 and 4). Voyiakis then examines various theoretical justifications of doctrines of unconscionability, with particular emphasis on the value of choice (Chapter 5). Wightman, in his contribution, sets unconscionability discourse in the context of relational contract theory (Chapter 6). The section concludes with Zhou's paper, which explores the concept of unconscionability from an economic perspective (Chapter 7).

Part II goes on to elaborate the concept of unconscionability in the specialised context of financial transactions. Swain and Fairweather, Capper and Nield in their opening contributions examine the changing responses to unconscionability in England and Wales. Swain and Fairweather begin by looking to the early development of usury and

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judicial regulation in the seventeenth and eighteenth centuries (Chapter 8); Capper analyses the development of the doctrine of misrepresentation (Chapter 9); and Nield the evolution of notions of unconscionability for borrowers in England and Wales (Chapter 10). Cartwright and then Williams reflect on regulatory responses to unconscionability: Cartwright on the lessons which can be drawn for the financial services industry (Chapter 11) while Williams supplies a critical analysis of the fairness regimes governing UK financial contracts (Chapter 12). Cherednychenko then develops the analysis by examining unconscionability in financial transactions in Europe and asks how public and private law approaches could be converged (Chapter 13). This theme is further elaborated by Smaliukas, Kalus and Habdas and Amato in their contributions on the development of the notion of unconscionability in the contexts of: post-soviet era legal transplants (Smaliukas, Chapter 14); loan agreements in Poland (Kalus and Habdas, Chapter 15); and financial contracts and junk titles (Amato, Chapter 16). The section concludes by looking at unconscionability in financial transactions in the context of particular EU harmonisation initiatives: Rott and Halfmeier on the Markets in Financial Instruments Directive (Chapter 17) and Willett on unfairness under the Consumer Protection from Unfair Trading Regulations 2008 (Chapter 18).

The book concludes with a final chapter by Kenny, Devenney and Fox O'Mahony on the elaboration of unconscionability in Europe in the light of a fundamentally contested private law paradigm, threatened by the treble challenges presented by constitutionalisation, European regulation and codification. Moreover, as the authors argue, since the collapse of Lehman Brothers and the advent of the Credit Crunch, our discourse is placed in the context of radically changed understandings of vulnerability, risk and responsibility (Chapter 19).

The organisers and editors are particularly indebted to all those who submitted proposals, held papers, chaired sessions and made contributions to the conference. We are particularly grateful to all those who went on to contribute to this volume and to Professor Allan Beever (Southampton) and Howard Johnson (Bangor) for their academic support. Our thanks also to Professor Teresa Rodriguez de la Heras (Carlos III, Madrid), Dr Magdalena Zielińska and Dr Jakub Szczerbowski (Olzstyn), Blanka Tomančáková (Olmuc), Steve Greenfield and Guy Osborn (Westminster) and Professor Roger Halson (Leeds). Crucial support has also been given by the highly dedicated staff at Cambridge University Press; in particular we would like to thank Richard Woodham, Daniel Dunlavey, Brenda Burke and Finola O'Sullivan for

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Excerpt

[More information](#)

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4 MEL KENNY, JAMES DEVENNEY AND LORNA FOX O'MAHONY

their efficient management of the production process. Editorial assistance to the project was enthusiastically delivered by Claire Devenney. Research assistance to the project was provided by Gabe Cantu (Durham). In Leeds we remain grateful for ongoing support for the project to Professor Gerry McCormack, Professor Roger Halson and Professor Dagmar Schiek.

Any conference and any project relies on the cooperation and dedication of many otherwise unsung members of the support staff, we would like to take the opportunity to thank Rupert and Joanne Prudom, Claire Graham (Prudhoe), Helen Hewitson, Patricia Bell, Julie Platten, Rachel Tucker, Hayley Wharton and Sarah Menday-Hall at Durham Law School for their inexhaustible patience and practical help. We would also like to thank the staff at Durham Castle and Event Durham for the professional organisation of the conference. We are also indebted at an institutional and material level to the Institute of Corporate and Commercial law at Durham and to the Centre of European Law and Legal Studies at Leeds. We are also grateful to University College, Durham and Hatfield College, Durham for their generous hosting of the conference. Information on the ongoing work and forthcoming events under the project can be obtained from the programme coordinators.

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## PART I

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### Conceptualising unconscionability

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## 1

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## Freedom of contract as freedom from unconscionable contracts

AURELIA COLOMBI CIACCHI

**Freedom of contract: from the form to the substance**

'Conceptualising unconscionability in Europe' means also conceptualising the relationship between freedom of contract and protection from unconscionable contracts. Freedom of contract and protection of vulnerable parties in contract law have traditionally been understood as antagonistic, conflicting principles. Legislative rules or doctrines providing remedies against unconscionable contracts are mostly seen as exceptions to the principle of freedom of contract. The high rank of this principle, which relies on the liberty and autonomy of private individuals vis-à-vis public powers, leads to the assumption that exceptions to freedom of contract should possibly be avoided, or, at least, restricted to a minimum.

Scholars who see freedom of contract and weaker party's protection as conflicting principles tend to challenge the predominance of freedom of contract, if they share a concern for social justice in contract law.<sup>1</sup> For example, the Social Justice Manifesto<sup>2</sup> criticised the European Commission's approach according to which in the Common Frame of Reference for a European contract law (CFR) exceptions to freedom of contract could only be admitted if justified by good reasons.<sup>3</sup> The Manifesto raised the

<sup>1</sup> See M. W. Hesselink, 'The Principles of European Contract Law: Some Choices Made by the Lando Commission', in *Principles of European Contract Law* (preliminary reports Vereniging voor Burgerlijk Recht) (Deventer: Kluwer, 2001) 7, 49; B. Lurger, 'The "Social" Side of Contract Law and the New Principle of Regard and Fairness', in A. S. Hartkamp, M. Veldman et al. (eds.), *Towards a European Civil Code*, 3rd edn (Nijmegen, The Hague: Ars Aequi Libri, Kluwer Law International, 2004) 273ff; T. Wilhelmsson, 'Varieties of Welfarism in European Contract Law' (2004) 10 *European Law Journal* 712ff.

<sup>2</sup> Study Group on Social Justice in European Private Law, 'Social Justice in European Contract Law: A Manifesto' (2004) 10 *European Law Journal* 653.

<sup>3</sup> So the Commission's Communication 'A More Coherent European Contract Law: An Action Plan', Brussels, 2.2.2003, COM (2003) 68 final, 62.

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provoking question: 'Why should the principle of freedom of contract have such a privileged position . . .? Why not reverse the burden of proof so that those who wish to deregulate market transactions should have the burden of explaining the potential advantages to be gained by the parties to these transactions from the absence of mandatory rules?'<sup>4</sup>

This chapter, being written by a co-author of the Social Justice Manifesto, endorses the proposition that fairness and solidarity should be the guiding principles in contract law. However, it does not view fairness and solidarity as conflicting with freedom of contract. It starts from the assumption that this antagonism derives from an old, formal understanding of freedom of contract, which was barely compatible with modern twentieth-century private law, and is certainly no longer fit for purpose in the twenty-first century.

It is submitted that the modern understanding of freedom of contract is a substantive one.<sup>5</sup> Achieving substantive freedom of contract involves preventing and eliminating the harm caused by an unconscionable contract to a party who was only formally, but not substantively free to conclude it. The same applies if one party is only formally, but not substantively free to terminate a contract whose conditions have been unilaterally changed by the other party. Precisely because self-determination is crucial to private law, private law has to provide remedies for contracts that are the product of a factual subjugation of the weaker party.<sup>6</sup>

There is an evident parallelism between freedom and equality. Today, nobody doubts that attaining equality in the sense of non-discrimination requires more than simple, formal equal treatment. Taking the equality principle seriously means embracing a substantive understanding of equality, which includes the need for positive action to counterbalance existing factual and social imbalances that make people dramatically unequal. Similarly, taking freedom of contract seriously means embracing a substantive understanding of this freedom, which includes the need for positive action to counterbalance existing factual and social constraints that make one contractual party dramatically less free than the other.

<sup>4</sup> Study Group on Social Justice in European Private Law (n. 2 above) 663–4.

<sup>5</sup> See Canaris, 'Wandlungen des Schuldvertragsrechts – Tendenzen zu seiner "Materialisierung"' (2000) 200 *Archiv für die civilistische Praxis* 273; S. Grundmann, 'European Contract Law(s) of What Colour?' (2005) 1 *European Review of Contract Law* 184; O. Cherednychenko, *Fundamental Rights, Contract Law and the Protection of the Weaker Party* (Munich: Sellier, 2007) 10–11 and *passim*.

<sup>6</sup> Cf. BVerfG 7 February 1990, BVerfGE 81, 242; BVerfG 19 October 1993, BVerfGE 89, 214. Also nn. 12, 15 below.

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Some scholars conceptualise the difference, which this chapter expresses in terms of 'form' and 'substance', in terms of 'negative' and 'positive' freedom of contract. These scholars consider the freedom from (state) intervention in the contractual relationship as the negative side of freedom of contract, whereas they view the positive side of this freedom in the self-determination and free development of personality of both contracting parties.<sup>7</sup>

The substantive understanding of freedom of contract is no longer a pure scholarly construct. It has already been acknowledged by the highest courts of some continental legal systems such as Germany and Slovenia, and by lower courts in other legal systems such as Greece.<sup>8</sup>

### Substantive freedom of contract as a human right or constitutional principle: Germany, Slovenia, Greece and the Netherlands

A common thread which connects the developments concerning the principle of substantive equality and the principle of substantive freedom of contract is their constitutional dimension. All continental European doctrines on substantive freedom of contract, of which this author is aware, have so far embedded this principle in national constitutions or in the European Convention on Human Rights.

#### *Germany*

Article 2(1) of the Federal Constitution (*Grundgesetz*, GG) of 1949 reads: 'Every person shall have the right to free development of his personality insofar as he does not violate the rights of others or offend against the constitutional order or the moral law.' This provision was defined in 1957 by the German Federal Constitutional Court (Bundesverfassungsgericht, BVerfG) as a catch-all fundamental right<sup>9</sup> to general freedom of action, embracing all manifestations of freedom which are not covered by other, more specific, fundamental rights.<sup>10</sup> Among the manifestations of freedom which

<sup>7</sup> J. H. Niewenhuis, 'Contractvrijheid, een weerbarstig beginsel', in T. Hartlief and C. J. J. M. Stolker (eds.), *Contractvrijheid* (Deventer: Kluwer, 1999) 25–6; C. Mak, *Fundamental Rights in European Contract Law. A Comparison of the Impact of Fundamental Rights on Contractual Relationships in Germany, the Netherlands, Italy and England* (Alphen aan den Rijn: Kluwer Law International, 2008) 26, 28.

<sup>8</sup> See below. <sup>9</sup> *Auffanggrundrecht*.

<sup>10</sup> BVerfG 16 January 1957, BVerfGE 6, 32 (known as 'Elfes' case). An English translation of this judgment is available at [www.iuscomp.org/gla/](http://www.iuscomp.org/gla/).



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are not covered by other specific fundamental rights there is freedom of contract. Indeed, in German case law and literature this principle has been generally considered protected by the Constitution in the framework of Article 2 (1) GG.<sup>11</sup>

However, more than thirty years passed after the establishment of the constitutional dimension of freedom of contract in 1957, before a *substantive* understanding of this freedom was acknowledged. The first BVerfG decision which relied on a substantive understanding of freedom of contract was the 'Commercial Agent' judgment of 1990.<sup>12</sup> The case dealt with an agency contract which excessively restricted the agent's professional freedom after termination of the contractual relationship. The BVerfG stated (my translation):

[P]rivate autonomy is based on the principle of self-determination, and thus requires that the conditions of free self-determination be in fact actually present. If the bargaining power of one of the contracting parties is so heavily disproportionate that the contractual regulation becomes factually one-sided, this makes the contract heteronomous. Where there is an absence of approximate equality of bargaining power between the parties, then a fair balancing of their interests cannot be reached by the means of contract law alone. Even when the legislator refrains from creating mandatory contract law for certain aspects of life, that in no way means abandoning the field of contract practice to the free play of power. Rather, the general clauses of private law, which have the effect of prohibiting excessive power, first and foremost those in §§ 138, 242, 315 BGB,<sup>13</sup> are to be applied as integrative instruments. It is precisely in the elaboration and application of these general clauses that fundamental rights are to be observed. The corresponding protective mandate of the

<sup>11</sup> See W. Höfling, *Vertragsfreiheit. Eine grundrechtsdogmatische Studie* (Heidelberg: Müller, 1991); M. Bäuerle, *Vertragsfreiheit und Grundgesetz: Normativität und Faktizität individueller Vertragsfreiheit in verfassungsrechtlicher Perspektive* (Baden-Baden: Nomos, 2001) with further references.

<sup>12</sup> BVerfG 7 February 1990, BVerfGE 81, 242 ('*Handelsvertreter*') (1990) *Juristenzeitung* 691, comment Wiedemann; AP No. 65 to Article 12 GG, comment Canaris. For further discussion see (in chronological order) P. Derleder, 'Unterlegenenschutz im Vertragsrecht. Ein Modell für das Arbeitsrecht?' (1995) *Kritische Justiz* 320–39; C.-W. Canaris, *Grundrechte und Privatrecht* (Berlin, New York: de Gruyter, 1999) 49; G. Brüggemeier, 'Constitutionalisation of Private Law – The German Perspective', in T. Barkhuysen and S.D. Lindenbergh (eds.), *Constitutionalisation of Private Law* (Leiden: Nijhoff, 2006) 59; Cherednychenko (n. 5 above) 245–6; Mak (n. 7 above) 70–5, 281–2.

<sup>13</sup> § 138 *Bürgerliches Gesetzbuch* (BGB, German Civil Code) provides the nullity of immoral contracts or other acts of private autonomy, § 242 BGB requires the debtor to behave according to good faith, § 315 BGB states that if the contractual performance is to be unilaterally determined by one party, this determination shall be fair and equitable.

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Constitution is directed here to the judge, who has to enforce the objective basic decisions of fundamental rights in cases of imbalanced contractual parity, using the means of private law.

In the 'Commercial Agent' case, the civil judgment impugned by the agent's constitutional complaint was declared unconstitutional by the BVerfG on ground of violation of the agent's fundamental right to professional freedom under Article 12 GG.<sup>14</sup> In this decision, the BVerfG established the doctrine of substantive freedom of contract, but it did not expressly devise this substantive freedom as a constitutional right. A definition of substantive freedom of contract as a constitutional right was provided by the BVerfG only three years later, with the famous 'Suretyship' judgment of 1993.<sup>15</sup>

[A]t least for the sake of legal certainty, a contract may not be challenged or adjusted in every instance in which the equality of bargaining power is disturbed. However, if there is a typical case scenario, which reveals a structural inferiority of one contracting party and in which the consequences of the contract for the inferior party are unusually onerous, then the civil law must react and enable corrective measures. That follows from the fundamental guarantee of private autonomy (Article 2 (1) GG)<sup>16</sup> and the principle of the social state (Articles 20 (1), 28 (1) GG) . . . For the civil courts, it follows that they are under a duty to interpret and apply the general clauses so as to ensure that contracts shall not serve as a means to hetero-determination [*Fremdbestimmung*].

In this decision, the BVerfG treated the substantive dimension of freedom of contract as an integral aspect of the fundamental right to the free development of personality and the general freedom of action under Article 2 (1) GG. Precisely because of the violation of the surety's fundamental right to private autonomy and freedom of contract under Article 2 (1) GG, the BVerfG allowed the surety's constitutional complaint and

<sup>14</sup> *Grundgesetz für die Bundesrepublik Deutschland*, in force since 1949.

<sup>15</sup> BVerfG 19 October 1993, BVerfGE 89, 214 ('*Bürgschaft*'). See M. Habersack and R. Zimmermann, 'Legal Change in a Codified System: Recent Developments in German Suretyships Law' (1999) 3 *Edinburgh Law Review* 272; Brüggemeier (n. 12 above); P. Rott, 'German Law on Family Suretyships: An Overrated System', in A. Colombi Ciacchi (ed.), *Protection of Non-Professional Sureties in Europe: Formal and Substantive Disparity* (Baden-Baden: Nomos, 2007) 51–69; C. U. Schmid, 'Private Suretyships as a Socio-Legal Crucible of Modern Private Law', *ibid.*, 31–40; Cherednychenko (n. 5 above) 232–48, 256–7, 281–9, 306–31; Mak (n. 7 above) 75–82, 169, 180, 242–6, 276.

<sup>16</sup> Article 2 (1) GG reads: 'Everyone has the right to the free development of his personality insofar as he does not violate the rights of others or offend against the constitutional order or the moral code.'