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# Limits of mandatory rules in contract law: an example in agency law

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## Abstract

*This paper uses Article 17 of the Commercial Agent (Council Directive) Regulations 1993 as an example to illustrate the regulatory limits of a mandatory rule in contract law. Article 17 aims to protect commercial agents by forcing the principal to a commercial agency contract to make a mandatory end payment to the agent on termination of the contract. This paper argues that Article 17 cannot benefit the commercial agent. Rather, it makes both the agent and the principal worse off. Based on the analysis, the paper provides four general implications for understanding the limits of the mandatory rule in policing abuse of bargaining power. First, the mandatory rule will generate a new compliance cost for the stronger party, who can pass it on to the weaker party. Second, the mandatory rule cannot benefit all of the parties aimed to be protected. It inevitably creates both winners and losers. Third, the mandatory rule cannot be used to force the stronger party to make a direct payment of money to the weaker party. Fourth, the mandatory rule may exacerbate the problem of information asymmetry in a contracting process.*

**Keywords:** mandatory rule; commercial agency; compliance cost; information problem; termination fee.

## 1 Introduction

Freedom of contract is the cornerstone of contract law.[1] One manifestation of this principle is the legal control of abuse of bargaining power. Since at least the twentieth century, the phenomenon of unequal bargaining power has been recognised in many types of transactions, such as consumer contracts, employment contracts and franchise contracts.[2] Where the abuse generates a risk of significant losses to society or a large group of individuals, strong regulatory interventions, such as competition law or administrative

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1 P S Atiyah, *The Rise and Fall of Freedom of Contract* (OUP 1985) ch 22.

2 M J Trebilcock, *The Limits of Freedom of Contract* (Harvard University Press 1994) ch 1.

law, will be deployed.[3] These techniques belong to the domain of public law, the enforcement of which is normally entrusted to public agencies. Where the abuse impairs only the individual party to a contract, modest interventions such as contract law or tort law will be used. Often, these rules are enforced by the aggrieved party.[4]

One such technique is the mandatory rule in contract law, which is a legal rule that the parties must obey. If a mandatory rule is in conflict with a contract term, the mandatory rule will prevail. From a regulatory perspective, the mandatory rule can control abuse of bargaining power in two ways. Firstly, it can impose on the stronger party a positive duty in favour of the weaker party. Secondly, it can impose on the stronger party a negative duty to prohibit him or her from exploiting the vulnerability of the weaker party.

The mandatory rule is an important regulatory means in protection of the vulnerable.[5] However, it also has its own limits. This paper illustrates these limits by an example in commercial agency law, namely Article 17 of the Commercial Agent (Council Directive) Regulation 1993 (hereafter referred to as Article 17). Article 17 aims to benefit the commercial agent by forcing the principal to make a mandatory end payment to the agent on termination of the contract. This paper suggests that Article 17 cannot benefit the commercial agent. Rather, it makes both the agent and the principal worse off.

Furthermore, the analysis of Article 17 reveals four general implications for understanding in general the regulatory limits of a mandatory rule in contract law. First, the mandatory rule will generate a new compliance cost for the stronger party, who can pass it on to the weaker party. Second, the mandatory rule cannot benefit all of the parties intended to be protected. It inevitably makes some better off and others worse off. Third, the mandatory rule cannot be used to force the stronger party to make a direct payment of money to the weaker party. Fourth, the mandatory rule may exacerbate the problem of information asymmetry in a contracting process.

The paper proceeds as follows. Section 2 provides a brief review of Article 17. Section 3 evaluates a rational principal's responses to Article 17. Section 4 examines the effect of Article 17 on the information problem. Finally, section 5 draws some general implications from the analysis for understanding the regulatory limits of a mandatory rule in contract law.

## 2 Mandatory termination fees in Article 17

Commercial agency is a common business strategy which is often used to develop a new market. In a commercial agency contract, the principal hires the agent to sell products on the principal's behalf. In return, the principal pays the agent a commission, which is calculated as a percentage of the retail price. The agent's remuneration grows with the increase in the volume of the sale. The more products the agent sells, the more commission the agent earns. Traditionally, agency contracts in England were governed largely by common law. Commercial agents were not treated differently from other agents, nor were they offered special legal protection. But the law was changed by the Commercial Agent (Council Directive) Regulations 1993, which implemented the EU Council Directive on the Co-ordination of the Laws of the Member States Relating to Self-Employed Commercial Agents. The directive aims both to harmonise agency law in the member states and to

3 A Ogus, R*egulation: Legal Form and Economic Theory* (Hart 2004) ch 3; R Baldwin, M Cave and M Lodge, *Understanding Regulation: Theory, Strategy, and Practice* (3rd edn OUP 2011) ch 2; R Van Den Bergh and P D Camesasca, *European Competition Law and Economics: A Comparative Perspective* (2nd edn Sweet & Maxwell 2006) ch 1.

4 G Wagner, 'Mandatory Contract Law: Functions and Principles in Light of the Proposal for a Directive on Consumer Rights' in A Ogus and W H Van Boom (eds), *Juxtaposing Autonomy and Paternalism Law* ( Hart 2011) 9.

5 G Wagner, 'Mandatory Contract Law: Functions and Principles in Light of the Proposal for a Directive on Consumer Rights' (2011) 3(1) Erasmus Law Review 47.

enhance legal protection of commercial agents.[6] The 1993 regulations came into effect in 1994 and brought a number of changes to English agency law.[7]

One of the most significant changes is Article 17, which stipulates the entitlement of commercial agents to indemnity or compensation on termination of an agency contract. According to Article 17, when a commercial agency contract is terminated, the principal should pay the agent either an indemnity or compensation. This is a mandatory rule, which cannot be derogated to the detriment of the agent.[8]

Article 17(3) provides that, where the parties have agreed an indemnity clause, the agent should be entitled to the indemnity if the following conditions are met:

(1) the agent must have brought new customers to the principal or must have significantly increased the volume of the business with existing customers, which continues to generate substantial benefits for the principal;

(2) the payment of indemnity is equitable;

(3) the amount of the indemnity shall not exceed the agent's average annual remuneration over the preceding five years; if the contract goes back less than five years, the indemnity shall not exceed the average remuneration for the period in question.[9]

Arguably, a clause may only stipulate a method to calculate the indemnity, but not payment of a fixed sum on termination of the contract, because the latter may be treated as a void penalty clause. In *Duffen v FRA BO SpA*,[10] the claimant was appointed as the exclusive UK and Irish agent by the defendant on 1 August 1994 for a minimum period of four years. In the agency contract, a clause provides:

> Upon the termination of this agreement by the principal pursuant to clause 6.3 the principal shall immediately become liable to the agent for and shall pay to the agent forthwith the sum of £100,000 by way of liquidated damages which sum is hereby agreed by the parties to be a reasonable pre-estimate of the loss and damage which the agent will suffer on termination of this agreement by failure of the principal to pay the sums which but for the principal's breach thereof would have been payable to the agent under the terms hereof.[11]

The court ruled that the clause was void by relying on the decision in a famous case on penalty clauses, *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd*.[12] Otton LJ said:

> The sum payable is not graduated. £100,000 is payable irrespective of the unexpired duration of the term. It would still be payable if termination occurred

6 P Watts and F M B Reynolds, *Bowstead and Reynolds on Agency* (19th edn Sweet & Maxwell 2010) 679; S Saintier, 'France, Germany and the United Kingdom's Divergent Interpretations of Directive 86/653 and 93/13s: Exclusionary Provisions: An Overlooked Threat to Coherence?'(2011) 5 European Review of Private Law 519, 521.

7 For general discussion of the regulations, see S Saintier, *Commercial Agency Law: A Comparative Analysis* (Ashgate 2002); F Randolph and J Davey, *The European Law of Commercial Agency* (Hart 2010); R Munday, *Agency Law and Principles* (OUP 2010) 16–33; Watts and Reynolds (n 6) 679–718.

8 Article 19 of the Commercial Agents (Council Directive) Regulations 1993; *Ingmar GB Ltd v Eaton Leonard Technologies Ltd* (C-381/98) [2000] ECR I-9305; [2001] 1 All ER 329.

9 See F Randolph and J Davey, *The European Law of Commercial Agency* (Hart 2010) 98–106. The rule of indemnity comes from German law (*Ausgleich*): see Article 89b of the German Commercial Code; Watts and Reynolds (n 6) 710.

10 *Duffen v FRA BO SpA* [1999] ECC 58.

11 Ibid 62.

12 *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* [1915] AC 79.

> in the last month of the contract's life. The plaintiff could thus recover a substantial windfall. This, to my mind, would be both extravagant and unconscionable.[13]

Where the contract does not stipulate an indemnity clause or the indemnity clause is void, the agent is entitled to compensation.[14] After many years of uncertainties in the case law,[15] the rule on the assessment of compensation was finally clarified by the landmark case, *Lonsdale v Howard & Hallam Ltd*.[16] In this case, the principal, a shoe manufacturer, appointed Lonsdale as the sales agent in 1990. By 2000, the sales declined; accordingly the agent's commission also fell year by year. In 2003, the principal ceased trading and sold the company to a competitor. The agent was given six months' notice and paid commission on the sales which he had generated. Because the parties did not agree an indemnity clause, the agent was entitled to compensation under Article 17. The agent was paid compensation of £7500. He argued that the amount was insufficient and that the court should follow the rule in French law, which normally allows the agent to claim two years' average gross commission. The agent, therefore, claimed £19,670 instead. In the House of Lords' decision, the agent's claim was rejected. Lord Hoffman clarified the rule on the calculation of compensation under Article 17 by stating:

> This elegant theory explains why the French courts regard the agent as, in principle, entitled to compensation. It does not, however, identify exactly what he is entitled to compensation for. One possibility might have been to evaluate the total goodwill of the principal's business and then to try to attribute some share to the agent. But this would in practice be a hopeless endeavour and the French courts have never tried to do it. Instead, they have settled upon compensating him for what he has lost by being deprived of his business. That is the '*prejudice subi*'. The French case law makes it clear that this ordinarily involves placing a value upon the right to be an agent. That means, primarily, the right to future commissions 'which proper performance of this agency contract would have procured him': see *Saintier and Scholes*, op. cit, pp. 187–188. In my opinion this is the right for which the directive requires the agent to be compensated.
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> Having thus determined that the agent is entitled to be compensated for being deprived of the benefit of the agency relationship, the next question is how that loss should be calculated. The value of the agency relationship lies in the prospect of earning commission, the agent's expectation that 'proper performance of the agency contract' will provide him with a future income stream. It is this which must be valued.[17]

According to the decision in the *Lonsdale* case, the compensation should be calculated by reference to the value of the agency on the assumption that the agency relationship had continued. The value mainly depends on the circumstances which actually existed at the time of termination, such as the agent's earning prospects and the price which people might

13 *Duffen* (n 10) 65.

14 Article 17(3) of the 1993 regulations; the rule of compensation originates from French Law – see Article L 134-15 French Commercial Code; see S Saintier, 'Remedial Schemes: Directive 86/653 and the French Method for Calculating Compensation of Commercial Agents' in L DiMatteo, Q Zhou, S Saintier and K Rowley (eds), *Commercial Contract Law: Transatlantic Perspectives* (CUP 2013).

15 *Tigana v Decoro* [2003] EWHC 23; *Graham Page v Combined Shipping and Trading Co Ltd* [1997] 3 All ER 656; *King v Tunnock* [1999] 1 All ER.

16 *Lonsdale v Howard & Hallam Ltd* [2007] UKHL 32.

17 Ibid 10 and 11.

have been prepared to pay.[18] Before the *Lonsdale* case, the agent may prefer compensation to an indemnity because, unlike the rule of indemnity, there is no cap for the maximum amount of compensation which the agent can claim. But, after the *Lonsdale* case, this may not be true anymore. The ruling in *Lonsdale* limits the compensation by linking the calculation to the value of the agency. The higher the value of the agency at the time of termination, the higher the compensation awarded. If the agency has no value anymore, the agent may not be awarded compensation at all.

From a practical perspective, Article 17 requires the principal to make an end payment to the agent on termination of the contract, although the actual sum varies with the legal nature of the agent's entitlement – whether it is an indemnity or compensation. For the sake of convenience, this payment is called 'the mandatory termination fee' in this paper.

Why should the law make the principal pay the mandatory termination fee to the agent? There are two justifications. First, the agent is vulnerable to the principal's opportunistic behaviour. After the agent has developed a profitable new market for the principal, the principal may terminate the agency contract. Instead of relying on the agent, the principal will deal directly with customers in order to save the commission paid to the agent. Second, it must be assumed that the agent has no bargaining power to negotiate a termination fee with the principal. Otherwise, there would be no need to make the payment of the termination fee mandatory.

The justifications for Article 17 are debatable. At least, the second justification has been questioned in the UK. For example, in response to the call for views on the 1993 regulations, the Association of British Chambers of Commerce stated:

> The [1993 regulations] are particularly keen to impose protection where a principal in one country appoints a selling agent in another country. [We] believe that this relationship will most frequently occur when a comparatively small manufacturer wishes to break into an export market and, having neither the resource nor the immediate sales potential for setting up a full time distributor or his own office in the country, hires an agent with specialised and local knowledge to do the job on his behalf. In this type of situation, there is very little likelihood of the principal being in such a strong negotiating position that the agent is in need of special protection.[19]

This paper will not engage in the debate on the justifications for Article 17. Instead, it contests the effectiveness of Article 17. It is argued that, even if commercial agents do need special legal protection, Article 17 cannot make them better off: in contrast, it makes both principals and agents worse off.

## 3 Compliance costs and the principal's responses

Any mandatory rule will impose on the regulatee a new compliance cost which is the cost the party has to bear to comply with the new law. The principal's compliance cost incurred by Article 17 is the termination fee. The principal will try to minimise the termination fee and, as a consequence, may be reluctant to use commercial agents. Commercial agency is only one business strategy of developing a new market. Instead of using agents, the firm can hire distributors, set up branch offices, or establish new subsidiary companies.

18 *Lonsdale* (n 16); S Saintier, 'Final Guidelines for Compensating Commercial Agents' (2008) 124 Law Quarterly Review 31; L Macgregor, 'Compensation for Commercial Agents: An End to Plucking Figures from the Air?' (2008) 12 Edinburgh Law Review 86.

19 House of Lords Select Committee, *Fifty-First Report*, Wednesday 27 July 1977, para, 6, the report is reproduced in Séverine Saintier and Jeremy Scholes, *Commercial Agents and the Law* (LLP 2005) 299–303.

Article 17 increases the cost of using commercial agents. Other things being equal, it makes other business strategies more appealing. In the extreme, firms may not use commercial agents anymore. If this happened, the whole commercial agency industry would be depressed. Statistics have indicated that Article 17 has significantly increased the cost of using commercial agents. According to one source, in 2007 the Professional Sales Agents Association, which funds the claims under Article 17 for its members, obtained settlements totalling £4m without solicitors and £1.5m after solicitor intervention.[20] Nonetheless, the actual impact of Article 17 on firms' decisions on hiring commercial agents is still unclear. Certainly, more empirical studies are needed.

Article 17 aims to benefit the agent by forcing the principal to pay the agent a mandatory termination fee in addition to the commission. It will achieve this objective if the agent's remuneration under Article 17 is higher than the remuneration would be if Article 17 did not exist. Unfortunately, this apparently laudatory aim cannot be achieved in this context because the principal will simply pass the compliance cost on to the agent. In fact, the principal can readily achieve this by lowering the commission paid to the agent.

Take the following example. Assume that the parties enter into a commercial agency contract where Article 17 does not exist. The principal agrees to pay the agent a commission of 10 per cent for selling each product at the price of £100. So, the agent earns £10 from selling one product. By the time the principal terminates the contract, the agent has already sold 10 products. The agent's total commission is £100, which is the agent's remuneration where the law does not make the principal pay a mandatory termination fee.

Assume now the same scenario, but with Article 17. How will the principal respond to this 'new' mandatory rule? Consider first the case where the parties agreed a method to calculate the indemnity. Let us further assume that the value of the indemnity based on the parties' agreed method is £30. The principal could pass on the £30 indemnity to the agent by lowering the commission from 10 per cent to 7 per cent. The agent's total remuneration is still £100. The only difference is that under Article 17 the agent receives a commission of £70 for selling 10 products and an indemnity of £30 while, where there is no Article 17, the agent receives a commission of £100 for selling 10 products but with no indemnity. Article 17 does not increase the agent's total remuneration.

Turning to the case where the agent is entitled to compensation, Article 17 may make the agent even worse off. Unlike the indemnity, which is agreed by the parties at the time of making the contract, the sum of compensation is decided by the judge at the end of the contract. More importantly, it depends on the value of the agency at the time of termination which the principal cannot discern the actual figure of when making the contract. In addition, there is no cap for the maximum amount of compensation. Because the compensation depends on the value of the agency, the more profitable the business that the agent has developed, the higher the compensation will be.[21] This generates uncertainty for the principal over the calculation of the compensation. Given the fact that the principal has a stronger incentive to terminate the contract where the new market developed by the agent is more profitable, the principal may tend to overestimate the amount of compensation. Factoring this into the decision setting the commission, the principal will offer a commission even lower than the one in the case of the indemnity. If the actual compensation awarded to the agent is lower than the principal's estimation, the agent will receive a lower remuneration in total. Supposing the principal mistakenly believes that the court will award compensation of £40. Under the same scenario, the principal would be

20 S Singleton, *Commercial Agency Agreement: Law and Practice* (3rd edn Bloomsbury Professional 2010) 114.

21 *Lonsdale v Howard & Hallam Ltd* [2007] 1 WLR 2055.

willing to pay only a commission of 6 per cent.[22] But if the court later awards compensation of £30, the agent's total remuneration is £90, which comprises of a commission of £60 for selling 10 products and the compensation of £30. It is lower than the agent's total remuneration in the case of indemnity.

One may challenge the preceding analysis by arguing that the agent will not accept any commission less than 10 per cent. This is possible. Perhaps any commission less than 10 per cent falls short of the agent's expectation. But the key question is whether the agent can negotiate a 10 per cent commission with the principal. If the agent can do this, there is no need for Article 17. If the agent cannot, Article 17 will not help. In either case, Article 17 is unnecessary.

Undoubtedly, the reality is far more complicated than the preceding analysis. In reality, the principal may not have sufficient information to calculate precisely the termination fee whereby the *ex ante* calculation may be different from the *ex post* award by the court. Therefore, it may be argued that Article 17 can benefit the agent because Article 17 provides insurance to cover the risk of being left uncompensated on termination of the contract. The *ex ante* reduction in the commission can be seen as a 'premium' for the insurance. If Article 17 did not exist, the principal would not agree to pay a termination fee.

At first glance, this argument seems to be correct, but a careful analysis can reveal its limits. Even if Article 17 is viewed as insurance, it can only benefit some agents because not all agents are willing to have such insurance. It depends on many factors, such as the agent's risk preference, the principal's reputation and the relationship between the principal and the agent. Probably, it benefits only more risk-averse agents.

More importantly, Article 17 is very unlikely to be insurance in favour of the agent.

Article 17 generates a 'new' compliance cost for the principal although the actual sum is uncertain to the parties at the time of making the contract. If the principal has dominant bargaining power, the principal will and can pass on the compliance cost to the agent. In addition, the principal will also shift the risk in the miscalculation of the termination fee to the agent. Given the uncertainty over the calculation of the *ex post* award by the court, there are three possible outcomes. First, the principal's *ex ante* calculation is just equal to the *ex post* award by the court. In this case, the reduction in the commission is just equal to the termination fee awarded by the judge. Article 17 does not benefit the agent. Second, the *ex ante* calculation is higher than the *ex post* award. If so, Article 17 makes the agent worse off because the reduction is higher than the termination fee. Only in the third possibility, where the principal's *ex ante* calculation is lower than the *ex post* award, can Article 17 make the agent better off. The agent in this case receives a termination fee higher than the reduction in the commission. But this result is very unlikely to happen. If the rational principal has dominant bargaining power, he or she is more likely to overestimate than to underestimate the compliance cost in order to shift the risk in the miscalculation to the agent.

## 4 Effects on information problems

What is the real effect of Article 17? If Article 17 did not exist, the principal could pay either a high commission with no termination fee or a low commission with a termination fee. The choice is at the principal's discretion. Article 17 makes the principal pay a mandatory termination fee. The principal has to lower the commission to gain the same profit as where Article 17 did not exist. Therefore, although Article 17 makes the principal pay a mandatory termination fee, it cannot increase the agent's total remuneration. The real effect of Article 17 is the restriction on the principal's options of payment. The principal is

22 (6%×£100×10)+£40=£100.

coerced into paying a low commission with a termination fee. This effect harms both the principal and the agent.

To see the side effect, we should ask: why would the principal prefer to pay a high commission with no termination fee, rather than a low commission with a termination fee? It is because the principal encounters the problem of moral hazard. The payment of a high commission with no termination fee is a strategy to mitigate the problem.

The term 'moral hazard' is used to denote the phenomenon that the behaviour of one party to the contract after the formation of the contract may increase the risk of the other party.[23] The typical example is the insurance contract. If the insurer agrees to compensate the insured for full losses resulting from burglary, the insured may take fewer precautions against burglary. The insured may not be willing to install a burglar alarm or to check if the doors and windows are properly locked on leaving the property. This irresponsible behaviour increases the risk to the insurer. To solve this problem, the insurer will not compensate for the full loss, but shares the risk with the insured. For example, the insurance contract often includes an excess clause, which provides that the insurer only compensates for a loss higher than the excess. The excess clause shifts part of the risk back to the insured, making the insured bear any loss lower than the excess. So, the insured will behave more responsibly. The arrangement of risk-sharing is a strategy for the insurer to overcome the problem of moral hazard.

In the commercial agency contract, the principal also faces the problem of moral hazard, although it takes a different form. The principal entrusts the agent with the tasks of developing the new market, of building relationships with new customers and of selling products. The agent enjoys a great deal of discretion on how to perform the above tasks. If the agent shirks from performing their contractual obligations after the contract is made, the principal will suffer a variety of losses such as the investment made in developing the market, the lost opportunity of dominating the market and the expected profit brought from the new market. The principal can mitigate, if not completely overcome, this problem by linking the agent's remuneration to performance. The payment of a high commission with no termination fee can serve this purpose. Under this arrangement, the more products the agent sells, the more commission will be earned. If no product at all is sold, the agent receives no commission. So, the payment of a high commission with no termination fee encourages the agent to sell more products.

By contrast, under the payment of a low commission with a termination fee, the agent's remuneration is less dependent on performance. The agent may have less incentive to sell products because the agent's payment consists of two parts. The first part is the commission, which depends on performance, namely the number of products that the agent sells. The second part is the termination fee, which depends less on performance but more on the state of the agency at the time of the termination. In the case of an indemnity, the termination fee depends on the increase in new customers or the growth in the volume of business with the existing consumers.[24] However, it is difficult in practice to judge accurately whether the increase is attributable to the agent's effort, or to the reputation of the principal's brand, or to both. It is also possible that the increase is led by some factors that are out of both parties' control. For example, in *Duncan Moore v Piretta*,[25] the principal hired the agent to sell fashion clothing to independent retail outlets in the UK. The agent

23 K Arrow, 'Uncertainty and the Welfare Economics of Medical Care' (1963) 53 American Economic Review 941; J Stiglitz, 'Risk, Incentives and Insurance: The Pure Theory of Moral Hazard' (1983) 8 Geneva Papers on Risk and Insurance 4; T Baker, 'On the Genealogy of Moral Hazard' (1996) 75(2) Texas Law Review 237.

24 Article 17(3) of the Commercial Agent (Directive) Regulation 1993.

25 *Duncan Moore v Piretta* [1999] 1 All ER 174.

commenced work in 1988 and was given a customer list. Customers also came through contact with the principal at exhibitions and in other ways. It was very hard to decide which customers were brought to the principal by the agent's effort only and which were brought by the joint effort of both the principal and the agent. The principal argued that the customers who attended a fair in response to a circular or advertisement issued by the principal should not be considered as the customers brought by the agent. The court rejected this argument and said:

> a new customer may in practice be induced to place business with a principal by a variety of means – for example, the quality and price of the goods offered for sale by the principal, the reputation of the principal, the general marketing efforts of the principal, the salesmanship of the individual agent, or the introduction, by an agent on whom the customer is accustomed to rely, of the principal to that customer. [180]

This case indicates that the requirement for an indemnity under Article 17(3)(a) will be satisfied as long as new customers come to the principal. It is not necessary for the agent to show that the new customers are the result of the agent's own effort. Under this rule, the agent may rely more on the principal to improve the reputation of the brand name and work less hard in bringing new customers.

In the case of compensation, the agent's termination fee depends on the value of the agency at the time of the termination; it is even less related to the agent's performance. For example, perhaps the value of the agency increases because the market demand for the product rises. It has nothing to do with the agent's effort. Although the agent is not absolutely guaranteed an end payment on termination of the contract, by making the payment of a termination fee mandatory Article 17 exacerbates the problem of moral hazard.

Furthermore, Article 17 also worsens the problem of 'adverse selection'. The term adverse selection refers to the problem of the buyer of a product being unable to discern the product's quality at the time of purchasing. So, the buyer will factor the uncertainty into the price that he or she is willing to pay. Other things being equal, this price is lower than the price which the buyer is prepared to pay for a high quality product. As a result, the sellers of high quality products have a problem. In extreme cases, the famous problem of the 'market for lemons' occurs, where the low quality products drive all of the good quality products out of the market.[26]

When buying the services of a commercial agent, the principal cannot distinguish a diligent agent from an idle agent. Service is a type of 'experience goods', the quality of which can only be evaluated after purchase.[27] Article 17 worsens this problem. It is reasonable to assume that the idle agent prefers a low commission with a termination fee because she can receive an end payment which depends less on performance. Conversely, the diligent agent may prefer a high commission with no termination fee, not only because he is prepared to work hard, but, more importantly, because he intends to distinguish himself from the idle agent. To compete with the idle agent, the diligent agent needs to show that he is more productive. However, the information as to productivity is unverifiable to the principal. If the diligent agent chooses to accept a high commission with no termination fee, he implicitly conveys a piece of information to the principal that he is not an idle agent because, under this payment scheme, his remuneration depends entirely on

26 G Akerlof, 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism' (1970) 84(3) Quarterly Journal of Economics 488; M Spence, 'Job Market Signaling' (1973) 87(3) Quarterly Journal of Economics 355; G Stigler, 'The Economics of Information' (1961) 69(3) Journal of Political Economy 213.

27 P Nelson, 'Information and Consumer Behavior' (1970) 78 Journal of Political Economy 311.

performance. By accepting the high commission with no termination fee, the diligent agent can distinguish himself from the idle agent.[28] Unfortunately, Article 17 prohibits the diligent agent from using this strategy. The mandatory nature of Article 17 not only forces the principal to pay the agent a termination fee, but also forces the agent to accept it, even though the agent may prefer something else. Consequently, Article 17 makes both the principal and the diligent agent worse off, but the idle agent better off. This is certainly an unwanted outcome.

The fundamental problem with Article 17 is not the payment of the termination fee, but its mandatory nature. In some cases, both the principal and the agent may prefer a low commission with a termination fee. This arrangement can relieve the agent of the concern over the hold-up by the principal.[29] The risk of a hold-up may materialise when the agent has made an advance investment in performing the contract. Assume the same scenario as our above example. The contract stipulates that the agent should invest in marketing, which costs the agent £30. After the agent has made the investment, the principal may force the agent to accept a lower commission than agreed in the contract by threatening to terminate the contract. Because the investment cannot be retrieved once it has been made, the agent will be reluctant to invest in the first place. If the principal pays the agent a high commission, 10 per cent with no termination fee, the agent earns £10 from selling each product. The agent can recover the marketing cost of £30 after selling three products. Only by selling the fourth product can the agent start to make a profit. However, if the principal pays the agent a lower commission, 7 per cent with a termination fee of £30, the £30 termination fee covers the agent's marketing cost. The agent can start to make a profit from selling the first product and does not need to worry about the hold-up. So, the payment of a low commission with a termination fee is more efficient in the case where the agent is required to make an advance investment.

Nonetheless, this is certainly not a justification for Article 17. First, the problem of hold-up does not occur in every commercial agency contract. It only happens and becomes serious when the contract requires the agent to make a substantial advance investment. When the agent makes no investment, or a very small investment, the problem is negligible. Second, even in those cases where the agent makes an advance investment, there is still no need for Article 17. Surely, the principal should be aware of the agent's concern. If the principal intends to encourage the agent's investment, the principal will voluntarily pay the agent a sum to cover the cost of the advance investment. Article 17 is unnecessary. Third, despite a guaranteed termination fee for the agent, Article 17 may not induce the agent to make the optimal level of investment. To induce the agent to invest optimally, the termination fee should be equal to the optimal level of investment, which maximises the return for both the principal and the agent. If the termination fee is lower than the optimal level, the agent may underinvest; while if the termination fee is higher than the optimal level, the agent may overinvest.[30] Either result is inefficient. Article 17 cannot induce the agent to invest optimally because neither the indemnity nor the compensation is calculated by reference to the agent's optimal level of investment. Finally, the legal rules already existed to prevent the principal from unduly reducing the commission. Under English contract law, the reduction in the commission amounts to variation of the contract: the principal must show that by reducing the commission, he or she provides the agent with a new

28 Spence (n 26).

29 B Klein, 'Why Hold-Ups Occur: The Self-Enforcing Range of Contractual Relationships' (1996) 34(3) Economic Inquiry 444; J Demski and D Sappington, 'Resolving Double Moral Hazard Problems with Buyout Agreement' (1991) 22(2) RAND Journal of Economics 232.

30 R Cooter, 'Unity in Tort, Contract and Property' (1985) 73(1) California Law Review 1.

consideration or a practical benefit, neither of which seems to exist in the case where the principal requests a reduction in the commission.[31] In addition, when calculating the agent's damages as a result of the principal's termination of the contract under Article 17, the court will consider whether the agent has recouped his or her investment if the contract was terminated just after the agent had started performing.[32]

## 5 Regulatory limits of mandatory rules

Article 17 aims to benefit the commercial agent by forcing the principal to pay a mandatory termination fee. As this paper shows, it does not benefit the agent because a rational principal will pass on the compliance cost to the agent by lowering the commission. Moreover, Article 17 prohibits the parties from using contractual arrangements to overcome the information problem. Consequently, both the principal and the agent are made worse off. What can we learn from this analysis of Article 17 for mandatory rules in general in contract law?

First, the mandatory rule will inevitably generate a 'new compliance cost' for the regulatee. It is vital to investigate how the rational regulatee minimises that cost. From a regulatory perspective, the distinction should be made between the regulation of unilateral behaviour and the regulation of transactional behaviour. In the regulation of unilateral behaviour, the regulatee can comply with the new rule in two ways: bear the cost and continue the regulated activity; or alternatively stop the regulated activity. The rule requiring drivers to purchase a compulsory third-party liability insurance imposes on drivers a new compliance cost in terms of the insurance premium. If a driver believes that the benefit from driving exceeds the insurance premium, the driver will buy insurance and continue driving. On the other hand, if the driver thinks that the insurance premium is too high, he or she will stop driving and use alternative means of transport. However, in the regulation of transactional behaviour, the regulatee has a third option to complying with a new mandatory rule. The regulatee may continue the regulated activity but, rather than bearing the cost him or herself, the regulatee passes on the compliance cost to the other party. Our analysis shows that the principal can either stop using commercial agents or pass on the compliance cost to the agent by lowering the commission. The general implication is that, where the mandatory rule imposes a new compliance cost on the stronger party, the stronger party will pass it on to the weaker party via the price term in the contract. This implication can be equally applied to the regulation of other contracts.

In addition, the stronger party can also pass on the compliance cost to the weaker party via other contract terms. One example is Article 14(1) of the Chinese Employment Contract Act, which requires the employer to offer an open-ended/permanent contract after an employee has served 10 years under a fixed-term contract. Instead of lowering the salary in order to shift the compliance cost to the employee, the employer can offer a short-term contract to employees. The employer may never offer anyone a fixed-term contract up to 10 years. In reality, the regulated party's responses are more complicated. The regulated party may use both the price term and other terms to minimise the compliance cost. It is also possible that this party only passes on part of the cost to the other party. When using

31 *Williams v Roffery Brothers & Nicholls (Contractors)* [1990] 2 WLR 1153.

32 Article 17(7) provides: 'For the purposes of these regulations such damage shall be deemed to occur particularly when the termination takes place in either or both of the following circumstances, namely circumstances which: (a) deprive the commercial agent of the commission which proper performance of the agency contract would have procured for him whilst providing his principal with substantial benefits linked to the activities of the commercial agent; or (b) have not enabled the commercial agent to amortize the costs and expenses that he had incurred in the performance of the agency contract on the advice of his principal.'

a mandatory rule in protection of the vulnerable, it is vital both to estimate the costs created by the new rule and to investigate who will bear the cost.

Second, the mandatory rule cannot benefit all of the parties it intends to protect. It inevitably creates both winners and losers among both weaker and stronger parties. A mandatory rule does not necessarily distinguish among weaker parties, giving its benefit to 'deserving' weaker parties. Before using the mandatory rule, we should examine its distributional consequences. Our analysis shows Article 17 may benefit risk-averse agents, although the possibility is low. There are many similar examples. Take just one of them – the rule of the 'cooling-off' period in consumer law. Consumers in some transactions are entitled to cancel the contract without giving any reason within a short period, termed the cooling-off period.[33] This rule is justified on the ground that consumers are bounded rational actors and are more likely to make irrational decisions when having insufficient information or in certain environments, such as when purchasing goods on the internet.

The cooling-off period rule generates two types of cost for the trader, namely the diminution in value of the returned goods and the transaction cost for the rescinded contract. Following our reasoning, these costs will be passed from the trader to the consumer. In fact, the rule imposes on the parties a compulsory transaction in which the consumer pays the trader for a generous right to rescission. Obviously, this transaction makes some consumers better off and others worse off. The consumers who often undertake online shopping would prefer the rule and the consumers who rarely buy goods through the internet may not be willing to pay for this generous right to rescission. They are made worse off by being forced to pay for such a right.

This example shows that a mandatory rule inevitably benefits some people (and here it is the less diligent consumer) at the cost of others (the more diligent consumer). Distributional consequences of the mandatory rule should be analysed seriously. On the one hand, not all of the parties whom the mandatory rule aims to protect can benefit. Therefore, the lawmaker should know the winners and the losers created by the mandatory rule. On the other hand, by identifying the winners and the losers, the lawmaker can make a better cost–benefit assessment to evaluate the efficiency of the rule.

Third, the mandatory rule in itself can never force the stronger party to make a direct transfer of money to the weaker party because the stronger party can always regain it through manipulation of the contract price. From a theoretical perspective, there is a fundamental difference between a rule like the mandatory cooling-off period and the rule of a mandatory termination fee. The mandatory cooling-off period is a non-monetary obligation. Although the trader may pass on the compliance cost to the consumer by charging a higher price, at least the consumer obtains a generous right to rescission. In contrast, the mandatory termination fee is a monetary obligation, which literally makes the principal pay the certain sum of a termination fee at the end of the contract in exchange for the payment of the same amount from the agent via the reduction in the commission. It cannot benefit the agent. The mandatory rule actually imposes a compulsory transaction on the parties where the weaker party pays the stronger party to perform the obligation in the weaker party's favour. If the rule forces the stronger party to make a direct transfer of money to the weaker party, it amounts to imposing on the parties a compulsory exchange of money for money. It only leads to a redistribution of wealth, which benefits nobody.

33 Article 11(2) Consumer Protection (Distance Selling) Regulations 2000; Article 10(2) Financial Services (Distance Marketing) Regulations 2004; Article 9 Timeshare Regulations 1997; Article 8(1)(b) Supply of Extended Warranties on Domestic Electrical Goods Order 2005; I Ramsay, *Consumer Law and Policy: Text and Materials on Regulating Consumer Markets* (Hart 2007) 331–46.

Finally, the mandatory rule may exacerbate the information problem. Our analysis shows that, by forcing the principal to pay the agent a low commission with a termination fee, Article 17 worsens not only the moral hazard but also the adverse selection. An analogy can be drawn to the rule of penalty clause in English contract law, which prohibits the parties to agree on a penalty clause for breach of the contract.[34] From an economic perspective, the penalty clause can serve as a singling strategy for the party to show the credibility to perform.[35] For example, in the shipping industry, it is often the case that the shipping company charters the ship before the ship has been built. If the ship is delivered late by the shipbuilder, the shipping company has to pay damages for breach of the charterparty contract. Nonetheless, it is very difficult to judge if the shipbuilder can accomplish the project on time. If the law allows the shipbuilder to offer a high penalty on late delivery, which can indemnify the shipping company's damages in the case of breach of the charterparty, it is clearly an efficient outcome. Nonetheless, signalling strategies are not always desirable. Sometimes, legal prohibition of signalling may be efficient. Suppose that in a bid for a construction project an incompetent bidder promises a high penalty on late completion in order to win the contract. If, for some reason, other more competent bidders cannot offer the same penalty clause, they may be considered as less confident in completing the construction on time and are unduly disadvantaged. Consequently, the contract may be awarded to an incompetent company. In this case, the rule prohibiting penalty clauses is efficient. Actually, the mandatory rule is a double-edged sword. It can both improve and exacerbate the information problem. Therefore, it should be used with caution.[36]

In conclusion, the mandatory rule in contract law is certainly a very important regulatory means. It has both advantages and disadvantages in comparison with other regulatory techniques. This paper uses an example in agency law to illustrate its regulatory limits. It should be noted, however, that this paper is by no means suggesting that the mandatory rule is useless and should never be employed; rather it intends to show that the mandatory rule has its limits. Proper appreciation of these limits enables the lawmaker to understand its regulatory features better and to use it more efficiently.

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34 *Dunlop* (n 12).

35 S Walt, 'Penalty Clauses and Liquidated Damages' in G De Geest (ed), *Contract Law and Economics: Encyclopaedia of Law and Economics* vol 6 (Edward Elgar 2011) 178–224, 181–92; C J Goetz and R E Scott, 'Liquated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach' (1977) 77(4) Columbia Law Review 554.

36 Walt (n 35) 192–201; P Aghion and B Hermalin, 'Legal Restrictions on Private Contracts Can Enhance Efficiency' (1990) 6(2) Journal of Law, Economics and Organization 381; G Wagner, 'Mandatory Contract Law: Functions and Principles in Light of the Proposal for a Directive on Consumer Rights' in A Ogus and W H Van Boom (eds), *Juxtaposing Autonomy and Paternalism Law* (Hart 2011) 9, 54.