RIGA GRADUATE SCHOOL OF LAW

An Analysis of the Liability Rule in Latvia in Case of a Transfer of an Undertaking in the Context of Freedom of Contract Principle

MASTER'S THESIS

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DECLARATION OF HONOUR:

I declare that this thesis is my own work, and that all references to, or quotations from, the work of others are fully and correctly cited.

(Signed) …….

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SUMMARY

The objective of this Thesis is to answer whether Article 20 of the Commercial Law of Latvia is compatible with freedom of contract principle.

Embarking on the path towards the answer to this research question, Chapter 1 analyzes the limitation put on freedom of contract principle in case of a transfer of an undertaking set in Article 20 and the purpose of such limitation. Chapter 1 introduces the concept of a transfer of an undertaking as a way to structure asset purchase deal that may be accompanied by additional complications – liability rule set in Article 20 that limits freedom of contract of the transferor and the acquirer of an undertaking. After establishing the existence of the limitation on freedom of contract and its purpose, the Thesis moves research to freedom of contract principle.

Chapter 2 begins by defining freedom of contract principle and outlining its scope. Then it proceeds to analyze the way freedom of contract principle manifests in contemporary legal framework, both in Latvian normative acts and European Contract Law. Lastly, Chapter 2 analyses whether the European Contract Law, similarly as Latvian normative acts, contains provisions limiting freedom of contract for the protection of third parties, in particular, creditors.

The analysis undertaken in Chapter 2 determines that, while freedom of contract is a component of a fundamental right, it is not an absolute right. In certain cases, limitations on freedom of contract principle are justified. Therefore, the existence of the limitation on freedom of contract principle in Article 20 does not in itself make Article 20 incompatible with freedom of contract principle. What is crucial, is determining when freedom of contract principle and when governmental intervention needs to prevail.

Chapter 3 continues the research of freedom of contract principle. It traces the development of this principle through ages, firstly, studying its origins and philosophical underpinnings and then analyzing the most vivid historical case law related to this principle. A look into historical development of freedom of contract principle confirms that freedom of contract is an important concept supported by the majority of legal scholars, even though to varying extents. At the same time, historical case law indicates the need for balance between freedom of contract principle and the necessity of governmental interference. Analysis of the historical development of freedom of contract principle demonstrates that determining, when freedom of contract principle should prevail, and, when, on the other hand, governmental intervention is justified, requires in-depth examination.

For this purposes Chapter 4 introduces evaluation methodology used for assessing limitations on fundamental rights in Latvia. Chapter 4 begins by arguing that freedom of contract is a component of the fundamental right to freedom and therefore evaluation methodology used for assessing limitations on fundamental rights, can be used for assessing limitations put on freedom of contract principle as well.

Chapter 5 proceeds to apply introduced evaluation methodology to the limitation on freedom of contract set in Article 20. In the course of the analysis it is concluded that one out of three evaluation criteria is not met, in particular, Article 20 does not comply with proportionality criterion.

Based on the results of the evaluation, the Thesis concludes that Article 20 is incompatible with freedom of contract principle. Considering that freedom of contract, while a component

of fundamental, is not an absolute right, the existence of the limitation on freedom of contract principle in Article 20 does not itself make Article 20 incompatible with freedom of contract principle. Limitation is incompatible only if unjustly limiting freedom of contract. In this Thesis in order to determine whether limitation on freedom of contract set in Article 20 is justified, evaluation methodology used for assessing limitations on fundamental rights is applied. Based on the results of the evaluation, it is concluded that Article 20 is incompatible with freedom of contract principle.

INTRODUCTION

In the past years, all three Baltic States have experienced an increase in merger and acquisition activity. In 2017, the accumulated value of publicly available Baltic merger and acquisition deals reached almost two billion euro. Noteworthy, that in terms of announced merger and acquisition deals Latvia was almost at par with Estonia and ahead of Lithuania. This proves that Latvian companies get increasingly more attractive for investors.[1] Mergers and acquisitions are a crucial part of any healthy economy. It is widely accepted that they are beneficial not only for the companies and for their shareholders taking part in the transactions, but for the economy in general as well.

Having achieved such good results, now for Latvian economy it is important to maintain merger and acquisition market growth rates at least on the same level. In order to so, it is crucial to ensure attractive legal environment compatible with an open, market-oriented and competitive international economic order, which according to UNIDROIT Principles of International Commercial Contracts (hereinafter – UNIDROIT Principles) is based on freedom of contract principle.[2]

Therefore, existence of legal environment attractive for potential investors is conditional on compliance with freedom of contract principle. Without doubt, there are many legal provisions in Latvian normative acts concerning mergers and acquisitions that need to be assessed in order to ensure that they comply with freedom of contract principle. However, the objective of this Thesis is not to list all provisions in Latvian normative acts in respect of mergers and acquisitions that possibly infringe on freedom of contract principle. This Thesis analyses the compatibility with freedom of contract principle of one single provision – Article 20 of the Commercial Law of Latvia. This provision establishes the liability rule in case of a transfer of an undertaking or its independent part, from which no derogation is allowed.

Therefore, the primary research question this Thesis attempts to answer is whether Article 20 is compatible with freedom of contract principle.

All Chapters of the Thesis, each having different objective, contribute to finding an answer to the research question.

The main objective of Chapter 1 is to introduce limitation put on freedom of contract principle in case of a transfer of an undertaking set in Article 20 as well as purpose of this Article. Having introduced Article 20 as provision limiting freedom of contract principle, in order to determine whether such limitation on freedom of contract principle can be justified, the Thesis moves research towards understanding freedom of contract principle.

Understanding freedom of contract principle is the main objective of Chapter 2. Firstly, it attempts to define it and outline its scope. Then Chapter 2 proceeds to analyze the way freedom of contract principle and its various limitations manifest in contemporary legal framework, both in Latvian normative acts and European Contract Law.

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[1] Prudentia. M&A Folio. Baltic M&A Overview. January – December 2017. Available on: https://docs.wixstatic.com/ugd/d56a0d_0902d99c69ce4218bb62e8827b384a67.pdf. Accessed on 03 May 2018.
[2] UNIDROIT Principles of International Commercial Contracts. UNIDROIT International Institute for the Unification of Private Law, 2004, comment to Article 1.

Chapter 3 continues to study freedom of contract principle. In particular, its main objective is to take a look into historical development of this principle. Chapter 3 begins by studying origins and philosophical underpinnings of the freedom of contract principle. Then it proceeds to analyze the most vivid historical case law related to this principle.

After historical case law counsels caution in respect of freedom of contract principle, the Thesis establishes the need for in-depth analysis for determining when limitations on freedom of contract principle are justified and when, on the other hand, freedom of contract principle should prevail.

Established need for in-depth analysis results in the introduction of the evaluation methodology for assessing limitations on fundamental rights in Chapter 4. The objective of Chapter 4 is to outline this evaluation methodology and determine the possibility to apply it to Article 20.

Finally, Chapter 5, attempting to answer the research question, applies evaluation methodology for assessing limitations on fundamental rights to Article 20.

To address aforementioned questions Latvian, European and International primary and secondary legal sources are analyzed. In the framework of research, different research methods are used. Historical method is utilized, when introducing and studying the development of such concepts as transfer of an undertaking and freedom of contract. This method is particularly present in the analysis of freedom of contract principle as it is used to trace the development of this principle through ages. Particular attention is paid to the development of this principle and the most vivid historical case law in the USA. In turn, comparative method is used in order to compare legal rules in respect of allocation of liability in case of an asset purchase deal, in particular, in case of a transfer of an undertaking, in Latvia with legal rules in other legal systems, in particular, the USA. Comparative method is utilized also in the analysis of freedom of contract principle. In the Thesis it is compared how freedom of contract principle manifests in Latvian normative acts, on the one hand, and European Contract Law, on the other hand. Also, the Thesis adopts analytical method, when studying and comparing different sources and opinions of different scholars. Finally, to answer research question evaluation methodology used for assessing limitations on fundamental rights in Latvia is applied to Article 20.

1. THE LIMITATION ON FREEDOM OF CONTRACT IN CASE OF A TRANSFER OF AN UNDERTAKING

1.1. Allocation of liability in case of an asset purchase deal, in particular, in case of a transfer of an undertaking, in Latvia

There are different ways how to structure an acquisition deal. This Chapter introduces one typical acquisition technique – purchase of assets. It outlines advantages of this acquisition technique as well as risks associated with it. In particular, this Chapter analyses one main risk that arises in case if an asset purchase deal takes a form of a transfer of an undertaking in Latvia, namely, imposition of liability on the acquirer for the debts of the transferor.

In Latvia, acquisitions usually take a form of share purchase or asset purchase deals. The choice between these types of transactions usually depends on their advantages and disadvantages. Structuring transaction as an asset purchase deal has quite a few disadvantages. Firstly, there may be complications related to the transferability of particular assets (for example, licenses or registrations). Secondly, sometimes it is impossible to transfer assets without receiving certain third party consents (for example, in case of databases). Thirdly, there are numerous ambiguous legal issues related to asset purchase deals (for example, it is unclear, if it is possible to reregister prohibition notations in favor of the seller of the business in the Land Register to the name of the acquirer of the business).[3]

However, despite a number of listed disadvantages, business acquisitions are quite often structured as transfers of assets from one company to another. For example, General Motors and Chrysler used this method in their bankruptcy reorganization after the global financial crisis.[4] This indicates that asset purchase deals have not only disadvantages, but advantages as well.

G. W. Tetler, when writing about structuring business acquisitions in the USA, claims that the main inducement for a buyer to structure a transaction as an asset purchase deal is concern about the liability for the obligations of the seller. As a rule, structuring the transaction as an asset deal is the safest way for the buyer to avoid or at least minimize the risk of being responsible for unknown liabilities of the acquired business. In share purchase deals, the company retains all of its liabilities and obligations regardless of whether they are known or unknown to the buyer. This is the case because the acquired company does not change in form, changed are only the owners of its shares.[5]

In turn, as G. W. Tetler explains, when the transaction is structured as an asset purchase deal, the parties usually conclude an agreement listing assets that the buyer is willing to acquire, as well as liabilities that he is willing to assume. When negotiating the division of liabilities between the buyer and the seller, what is usually taken into consideration, is the reason why transaction is structured as an asset purchase deal. For example, if the seller and the buyer

[3] Tidwell, *International Asset Transfer: An Overview of the Main Jurisdictions: a Practitioner's Handbook*, p. 343.
[4] Matheson, «Successor liability», p. 371.
[5] Tetler, «Asset acquisitions: important considerations», p. 3; 6.

agree on the sale of the entire business of the seller, but structure the deal as an asset purchase deal for tax optimization and other technical reasons, it may be correct for the buyer to assume all or at least the majority of the liabilities of the seller. This way parties could avoid or at least minimize disruption to the operation of the business. For example, the buyer may assume liabilities of the seller arising out of agreements for the performance of services or the manufacture and delivery of goods. In turn, if the transaction is structured as an asset purchase deal because the buyer wants to eliminate risk of being responsible for certain liabilities of the seller, in particular unknown liabilities, the parties may expressly agree to limit the liability of the buyer in asset purchase agreement. One of the main advantages of structuring the transaction as an asset purchase agreement is this option available to the buyer of «picking and choosing» what liabilities he is willing to assume and what he expressly wishes to avoid.[6]

Subject to certain exceptions, in the USA the legal presumption is that in contrast to share purchase deals in case of an asset purchase deal the buyer is not responsible for liabilities that he has not expressly agreed to assume in the asset purchase agreement.[7]

In respect of the general rule that the buyer does not assume any of the seller's liabilities in case of transfer of assets the Supreme Court of the USA declared over 120 years ago that: «[t]his doctrine is so familiar that it is surprising that any other can be supposed to exist».[8]

Explaining the consequences of imposing on the buyer the liability for the debts of the seller, John H. Matheson provides simple example. For example, person A wishes to sell his car, worth approximately 10'000 EUR to person B. The car in question is still under the loan and the loan has 9'000 EUR balance. Person B wants to buy the car and pays to the person A 9'500 EUR for it. The deal seems beneficial for both person A and person B. Person B now owns the car, but person A has money to pay the loan and leave the rest to himself. However, what happens if person A does not repay the loan? Will person B be liable for the debt of the seller? As a rule the answer is no. If person B thought that he would be liable for the debt of person A, most likely he would not pay him for the car 9'500 EUR. The price would be much lower.[9]

However, while the answer to this question seems obvious, in fact it is not always so straightforward. In certain cases, even in case of an asset purchase deal the buyer may end up being liable for the debts of the seller even if he did not expressly assume them. In particular, in Latvia such is the case if an asset purchase deal takes a form of a transfer of an undertaking. In such a case Article 20 of the Commercial Law of Latvia (hereinafter – Article 20) that allocates liability in case of transfer of an undertaking or its independent part is applicable.

Of course, not all sale of assets constitutes transfer of an undertaking. If in the framework of asset purchase deal genuine piece-by-piece asset transfer takes place, then it is not transfer of an undertaking.[10] For determining, when transfer of an undertaking takes place, meaning of the term «undertaking» is crucial. Article 18 of the Commercial Law of Latvia defines an undertaking as an organizational economic unit, which includes both tangible and intangible

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[6] *Supra note* 5, pp. 6-7.
[7] *Ibid*.
[8] *Fogg v. Blair*, 133 U.S. 534, 538 (1890).
[9] *Supra note* 4, p. 371.
[10] *Supra note* 3, p. 343.

things belonging to a merchant, as well as other economic benefits (value), which are used by the merchant to perform commercial activities.[11] The Commentary to the Commercial Law of Latvia clarifies that the aim of the undertaking is performance of the commercial activity, *i.e.* profit making. An undertaking is not legal subject, but rather an object – an instrument, which is used for the performance of commercial activity.[12] Further, in accordance with the Commentary to the Commercial Law of Latvia in order to conclude that transfer of an undertaking has taken place, it is necessary to establish that an undertaking or an independent part thereof was transferred to the acquirer and he can use it without significant changes. If the acquirer can continue the relevant commercial activity using an undertaking, then it is considered that transfer of an undertaking has taken place regardless if some insignificant part of an undertaking was left to the transferor. It is also noted that Article 20 relates not only to transfer of the title (sale, gift, exchange, inheritance, etc.), but also to any other transfer of an undertaking to the possession of another person, for example, lease of the undertaking.[13]

However, while there is a definition of what constitutes an «undertaking», applying this definition to factual situation is quite challenging, which gives rise to legal uncertainty. Until recently, case law in relation to the transfer of an undertaking was very limited and ambiguous. There were cases, when Latvian courts, analyzing whether transfer of an undertaking has taken place, came to opposing conclusions in respect of similar situations.[14] For example, in the decision of March 10, 2014 in case No. C29715111Rīga District Court recognized transfer of an undertaking, when SIA «Latvijas Keramika A» invested in equity capital of AS «Latvijas Keramika» its real estates as well as some movable assets.[15] Rīga District Court has made such a decision even though the previous year, the Supreme Court of Latvia in the decision of November 5, 2013 in case No. C04367311 established that transfer of an undertaking did not take place even though SIA «Mežlejas» similarly as in previous case transferred to SIA «Cerība Pluss» both real estates and movable assets.[16] This ambiguity resulted in many individuals not knowing whether what they were doing was in fact transfer of an undertaking. Consequently, individuals did not know whether liability rules set in Article 20 applied.

However, it must be noted that during the time this Thesis was written the case law in respect of a transfer of an undertaking was supplemented, as the Supreme Court of Latvia issued important judgements clarifying what criteria need to be assessed when analyzing if transfer of an undertaking has taken place. The Supreme Court of Latvia in the decision of November 09, 2017 in case No. SKC 340/2017 ruled that the following components could indicate that transfer of an undertaking took place: transfer of employees to the acquirer, transfer of assets and stocks, takeover of bank liabilities, transition of the board members of the transferor to the acquirer.[17]

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[11] The Commercial Law of Latvia, 13 April 2000. Available on: https://likumi.lv/doc.php?id=5490. Accessed on 10 April, 2018, Article 18.
[12] Strupišs, *Komerclikuma komentāri. A daļa. Komercdarbības vispārīgie noteikumi (1.-73. panti)* (Commentaries on Commercial Law. Part A. General conditions of commercial activity), p. 101.
[13] *Supra note* 12, pp. 113; 115.
[14] Spriedums lietā Nr. (Decision in case No.) C29715111, Rīga District Court (2014); Spriedums lietā Nr. (Decision in case No.) C04367311, the Supreme Court of Latvia (2013).
[15] Spriedums lietā Nr. (Decision in case No.) C29715111, Rīga District Court (2014).
[16] Spriedums lietā Nr. (Decision in case No.) C04367311, the Supreme Court of Latvia (2013).
[17] Spriedums lietā Nr. (Decision in case No.) C33355814, the Supreme Court of Latvia (2017).

Legal certainty in respect of determining what constitutes transfer of an undertaking is crucial, because if an asset purchase deal is recognized as a transfer of an undertaking, additional legal rules apply. For example, in case of a transfer of an undertaking, under both Latvian and European law the employees of such an undertaking are automatically transferred with the undertaking. However, while safeguarding of employees' rights in case of a transfer of an undertaking is fascinating and widely discussed topic, it falls outside the scope of this Thesis. This Thesis concerns another legal rule – previously mentioned liability rule set in Article 20, which applies only in case of a transfer of an undertaking.

In Latvia, if an asset purchase deal takes a form of a transfer of an undertaking Article 20 is applicable. This Article establishes solidary liability of the transferor and acquirer of an undertaking in respect of liabilities, which originated before the transfer of the undertaking and are to be fulfilled in the five year period after the transfer. For all of the other liabilities of such an undertaking, Article 20 imposes a liability on the acquirer.

In particular, Article 20 Part one stipulates that:

> [i]f an undertaking or an independent part thereof is transferred to the ownership or use of another person, the acquirer of the undertaking shall be liable for all the obligations of the undertaking or its independent part.[18]

While special procedure set in the same Article 20 Part 1 stipulates that:

> in respect of those obligations which arose prior to the transfer of the undertaking or its independent part to the ownership or use of another person, and the terms or conditions for the fulfilment of which come into effect five years after the transfer of the undertaking, the transferor of the undertaking and the acquirer of the undertaking shall be solidary liable.[19]

Having established this liability rule, Article 20 in Part three proceeds to state that «[a]n agreement, which is in contradiction to the provisions of this Section, shall be void as to third parties».[20]

This means that even if the acquirer and the transferor agree on different liability scheme than what is set in Article 20, such agreement shall be void as to third parties. So, the transferor and the acquirer have the right to agree on another liability scheme, for example, they can agree that the acquirer is not liable for the debt that originated prior to transfer of an undertaking at all. However, while Article 20 allows to conclude such an agreement, it also explicitly states that it shall be void as to third parties. It means that if the transferor and the acquirer conclude an agreement releasing the acquirer from the liability for obligations that arose before transfer of an undertaking, the creditor can still choose to ask for satisfaction from / bring a claim against the acquirer. In such a case, the acquirer cannot object on the basis of the agreement concluded with the transferor. The acquirer is obligated to fulfill the obligation in accordance with the law. However, it still must be noted, that after the acquirer has fulfilled an obligation to the creditor, he can raise a claim to recover the respective amount from the transferor on the basis of concluded agreement.[21] However, while there is a possibility to recover paid amount from the transferor, in this case Article 20 Part three still adversely affects the acquirer. If the creditor requests so, the acquirer is obligated to pay him

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[18] *Supra note* 11, Article 20, Part 1.
[19] *Ibid*, Article 20, Part 1.
[20] *Ibid*, Article 20, Part 3.
[21] *Supra note* 12, p. 116.

the debt. This means that he has to pay the money that he could otherwise invest somewhere, so they could bring him interest, or use it for the expansions of his business, or use it for any other purpose. In turn, recovering paid amount from the transferor may result in lengthy court proceedings. Therefore, it is clear that Article 20 restricts freedom of contract of the transferor and the acquirer to agree on different liability scheme than what is set in Article 20, as such an agreement shall be void as to third parties.

To sum up, this Section introduced asset purchase deal as an acquisition technique with its advantages and disadvantages. As one of the main inducements the option available to the buyer of «picking and choosing» what assets he is willing to acquire and what liabilities he is willing to assume was mentioned. However, it turns out that such an option is not available if an asset purchase deal takes a form of a transfer of an undertaking in Latvia. Article 20 contains mandatory rule allocating liability in case of a transfer of an undertaking. Next Section aims to take a look at how another national legal system addresses the issue of liability in case of an asset purchase deal, in particular, the USA.

1.2. Allocation of liability in case of an asset purchase deal in the USA

Previous Section established the existence of the liability rule in case of a transfer of assets, in particular, transfer of an undertaking, in Latvian legal system. In turn, this Section aims to take a brief look at another legal system, trying to determine whether there are similar legal rules.

As already mentioned, in the USA the general rule is that of the non-liability of the buyer for the debt of the seller. When one company transfers all of its assets to another company, acquiring company does not assume the liabilities of the transferor, solely because of its succession to ownership of the assets. However, there are exceptions to the general rule of non-liability of the buyer. There are four main traditional exceptions to the rule of non-liability. In the Cargill, Inc. v. Beaver Coal & Oil Co. case the following exceptions are listed 1) the acquirer expressly or impliedly assumes liability of the seller, 2) the transaction is a *de facto* merger or consolidation, 3) the acquirer is a continuation of the seller, or 4) transaction is fraudulent entered into with the aim to evade liabilities.[22]

The first exception applies when the parties to the transaction agree on the allocation of liability themselves, concluding an agreement specifying what party shall take responsibility for a specific liability.[23] So, the parties are free to negotiate and agree on the allocation of liabilities, reflecting the result of negotiations in the price for the acquisition.

The second exception arises, when the court establishes that, despite the transaction being structured as an asset purchase deal, what in fact took place was a consolidation or merger. Originally, this exception developed with the purpose of safeguarding dissenter's rights of shareholders, i.e. right of shareholders provided under certain jurisdictions to receive payment for the fair value of their shares, in case of merger (other major decisions) with which the shareholders do not agree. Lately, however, this exception was mainly used to protect creditors, in particular unsecured creditors, from their debtors trying to evade liability. The USA court has established the following elements indicating that transfer of assets amounts to *de facto* merger. First element is continuation of the enterprise of the seller, i.e. a continuity of

[22] *Supra note* 5, pp. 7-8.
[23] *Ibid*, p. 8.

management, personnel, physical location, assets, and general business operations. Second element of *de facto* merger is a continuity of shareholders that may be the result of the price for the acquired assets being the shares of the acquirer's company. Third element is stop in the operation of seller's business and subsequent liquidation or dissolution. The fourth element indicating *de facto* merger is acquirer taking over those obligations of the seller that are required for the uninterrupted continuation of business operations of the seller.[24]

In this context noteworthy is Milliken & Co. v. Duro Textiles case that arose in the context of foreclosure sale. In this case, an unsecured creditor filed a claim seeking to recover trade debt from the defendant that was not its *de facto* debtor, but was established with the aim of bidding at the foreclosure sale and subsequently acquired the majority of its debtor's assets. Unsecured creditor claimed that the defendant was the corporate successor to its initial debtor. The defendant argued against imposing successor liability pointing out that predecessor company had not been liquidated and continued to exist. Also, the predecessor did not sell all of its assets and continued to own certain ones, including real estate. The court disregarded this argument claiming it to be form over substance. However, the defendant also claimed that transaction did not harm unsecured creditors as secured debt exceeded the collateral and the secured creditor had the right to foreclose. The court recognized the right of the secured creditor to foreclose and admitted that if assets had been transferred to unrelated third party, the unsecured creditor would not have an opportunity to recover the debt. However, considering the circumstances in that case the court acknowledged the *de facto* merger and imposed successor liability on the defendant, because the transaction was a «reconstituted version of itself (...) in an effort to retain its textile business as a going concern with the potential for future profits, while shedding its debt obligations to unsecured creditors».[25]

Another similar case, where the court imposed successor liability on the acquirer is Renaissance Worldwide Inc. v. Converged Access Inc. case. In that case, the purpose of the transaction was to continue business operation without any interruptions and simultaneously avoid liability to unsecured creditors. All of the assets, including intellectual property and other intangibles, and business operations were transferred to a new company with the same owners, management, and business operation.[26]

Another exception to the general rule of non-liability takes place, when the purchasing company is merely a continuation of the selling company. While this exception is similar to previously discussed one of de facto merger, this exception focus more on continuity of ownership or corporate structure, as opposed to the continuation of the business operation. Main signs indicating the continuation are the following: the buyer's use of the seller's name, location, employees, a common identity of shareholders and directors, existence of only one company after the transfer of assets.[27] What is encompassed under this exception, in fact, seems to be quite similar to what is understood under the definition of «transfer of an undertaking» in Latvia.

Lastly, the forth main exception to the rule of non-liability is fraudulent transfers, i.e. transaction concluded with the aim to defraud. While recently in the USA some more exception to the rule of non-liability emerged, they are not recognized by all the courts, as

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[24] *Cargill, Inc. v. Beaver Coal & Oil Co.*, 424 Mass. 356, 360 (1997).
[25] Milliken & Co. v. Duro Textiles, LLC, 451 Mass. 560 (2008).
[26] *Supra note* 5, p. 9.; Renaissance Worldwide Inc. v. Converged Access Inc., Lawyers Weekly No. 12-201-09
[27] *Ibid*.

opposed to four traditional exceptions discussed above.[28] One such recently developed exception is continuity of enterprise. In contrast to *de facto* merger or mere continuity exceptions, this one does not require continuity of owners or corporate structure or assets being acquired for shares. What it focuses on is, whether there is continuity of the seller's business and whether seller stops its business operations.[29]

To sum up, this Section demonstrated that in the USA the general rule of the non-liability of the buyer for the debt of the seller is subject to numerous exceptions. One of these exceptions, namely, an exception that arises if the acquirer is a continuation of the seller, is quite similar to what is understood as «transfer of an undertaking» in Latvia. While this Section has established the existence of liability rule in case of a transfer of assets in another legal system, the next Section will try to determine the purpose of such legal rules.

1.3. The purpose of the liability rule in case of a transfer of an undertaking

In accordance with the Commentary to the Commercial Law of Latvia, the purpose of Article 20 is the protection of the rights of third persons. It establishes the indivisibility of obligations contained in the undertaking from the rights.[30]

The main risk that third persons – creditors face in respect of a transfer of an undertaking is the possibility that the debtor alienates belonging to him undertaking, from which he was supposed to get revenue. The revenue, in turn, was supposed to be used to settle debtor's debt to the creditor. Therefore, Article 20 aims to protect the creditors. Firstly, it protects the creditors by ensuring that the creditors have right to claim in respect of the acquirer, which basically means that the debt follows the undertaking. Secondly, Article 20 ensures that for the period of time the creditor also retains right to claim in respect of the transferor also.[31] In respect of liabilities, which originated before the transfer of the undertaking and are to be fulfilled in the five year period after the transfer, Article 20 ensures that the creditors do not need to look for the acquirer of the undertaking in order to receive performance of the obligation. They have an option to choose from whom to receive satisfaction.[32]

Yedidia Z. Stern, when discussing possible adverse effects that acquisitions may have on creditors, also claims that acquisitions may have an adverse effect on the main interest of the creditors – the interest to redeem the debt. Firstly, the acquisition may result in the change in the degree of leverage of the companies involved in transaction. Secondly, the main activity of the companies involved in the acquisition deal may also change as well as associated risk levels. As an illustration imagine that there is a loan agreement between the company and the creditor. Interest rate is set low due to conservative, *i.e.* low risk nature of the company. This company (an undertaking) gets acquired by much more speculative, risk-taking company. Consequently, this acquisition has adverse effect on the possibility of the creditor to redeem his debt. Similarly, creditors are adversely effected, if the debtor company (an undertaking), which itself has only few debts, gets acquired by the company with numerous debts. In this

[28] *Ibid*.
[29] *Ibid*.
[30] *Supra note* 12, p. 113.
[31] *Ibid*, p. 116.
[32] *Ibid*, p. 114.

case, the significant increase in total debt of the debtor company reduces the chances of the creditors to redeem their individual debts.[33]

Article 20 containing a provisions aiming to ensure that creditors are able to receive performance of their debts, is the result of the development of the commercial law over the last centuries. The contract law has developed from *nexum* institute in Roman law, which involved complete subjection of the debtor to the creditor in case if an obligation was not fulfilled, to prohibition to imprison for failure to pay. For centuries, debtors were personally liable for non-payment. In accordance with that approach, the principal object of liability was the debtor himself, but assets that creditors could use were those belonging to the debtor when obligation was being fulfilled.[34] Only the most progressive legal systems had mechanisms, whose purpose was to ensure legal protection against fraudulent transfers of assets intended to defraud creditors (*in fraudem creditorum*), *e.g. Actio Pauliana*.[35] So, for centuries obligations could not follow the property in cases other than inheritance (*mortis causa* institute in Roman law). Only relatively recently, an undertaking was acknowledged as a legal entity. Due to this recognition, Germany being the first implemented the concept of non-personal commitment of the debtor in German Commercial Act adopted in 1897. At the time, Germany introduced this concept mainly to strengthen the confidence in a company. Later, other states, following Germany's example, introduced similar concepts in their own legal systems.[36]

However, while in case of an asset purchase deal creditors certainly need to be considered, their interests are not the only ones in need of protection. For example, Ilaria Pretelli, when analyzing *Actio Pauliana* as a technique aimed at protecting creditors in cases when the debtor transfers his assets in order to avoid paying his debts, admits the existence of conflicting interests that need to be balanced. She indicates that there is not only a need to protect investment (creditors), but also a need to protect legal certainty and the freedom of contract.[37]

Similarly, John H. Matheson claims that the basis for non-liability principle is a need to ensure the free alienability of corporate assets. Non-liability principle, in turn, includes two other independent principles. Firstly, a need to protect the buyer from liabilities of the predecessor that were not expressly assumed[38] and, secondly, a need to promote predictability in corporate transactions.[39]

In turn, Sharon L. Cloud, when claiming that corporations planning business expansion require the law of successor liability to be predictable, explains that:

> [f]acing potentially unlimited and unpredictable exposure for future products liability claims which they had no part in creating forces companies interested in acquisitions to reconsider. Corporations for sale face a correspondingly shrinking market. In purely economic terms, the free flow of assets to their most efficient uses is severely

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[33] Yedidia, «A General Model for Corporate Acquisition Law», pp. 695-696.
[34] Strazds, «Mechanisms of Protection of Third Persons in Case of Transfer of an Undertaking and Potential Improvement Possibilities. Thereof in Latvian Commercial Law», p. 649.
[35] Bayitch, «Transfer of Business. A Study in Comparative Law», p. 284.
[36] *Supra note* 34, pp. 649-650.
[37] Pretelli, «Cross-border credit protection against fraudulent transfers of assets. Actio Pauliana in the conflict of laws», p. 600.
[38] Phillips, «Products Liability of Successor Corporations: A Corporate and Commercial Law Perspective», p. 258.
[39] *Supra note* 4, p. 374.

> impaired if there is no way to know at the outset how much an acquisition will truly cost.[40]

So, in case of an asset purchase deal there are not only creditors that need to be protected. There are other interests in need of protection as well, *inter alia*, legal certainty and the freedom of contract. However, Ilaria Pretelli admits that to a certain extent, the freedom (of contract) as well as confidence in the certainty of legal transactions must be sacrificed in order to protect the rights of creditors. However, each national legal system determines the balance between protection of opposing interests itself.[41] It is not possible to achieve simultaneous equal protection of competing interests. The states need to find balance between safeguarding competing interests. The question is whether legal norms implemented in national legal systems are truly balanced, whether they do not unjustly sacrifice certain interests in the name of protecting other interests.

This Section established that the purpose of Article 20 was the protection of the rights of third persons – creditors. The main risk that creditors face in case of a transfer of an undertaking is that their chances of redeeming the debt will be undermined. The most progressive legal systems had mechanisms for protection of creditors against fraudulent transfers of assets (*in fraudem creditorum*) already in the deep past. However, this Section established the existence of other competing interests that needed to be protected in case of an asset purchase deal as well.

Conclusion

To conclude, Article 20 illustrates one of the complications that arise if an asset purchase deal takes a form of a transfer of an undertaking. In particular, Article 20 establishes liability rule in case of a transfer of an undertaking, from which no derogation is allowed. It clearly limits freedom of contract of the transferor and the acquirer of an undertaking as even if they conclude a contract establishing different liability scheme, it is void as to third parties. The purpose of such limitation is the protection of the rights of third persons – creditors. In the absence of this provision, in case of a transfer of an undertaking creditors' chances of redeeming the debt would be undermined. Without doubt, protection of creditors is a legitimate goal. However, does protection of creditors in this case justify sacrificing protection of other values by limiting one of the fundamental principles of contract law – freedom of contract principle? In order to answer this question, in the following Chapters the Thesis proceeds to explore freedom of contract principle and its scope.

[40] Cloud, «Purchase of Assets and Successor Liability: A Necessarily Arbitrary Limit», p. 793.
[41] *Supra note* 37, p. 600.

2. UNDERSTANDING FREEDOM OF CONTRACT PRINCIPLE

2.1. Defining freedom of contract principle

While seemingly a simple task, defining freedom of contract principle might be a challenge. When talking about freedom of contract P. S. Atiyah says that: «it is by no means easy to say what exactly the nineteenth-century judges meant, when they used this phrase».[42] Nevertheless, P. S. Atiyah affirms that at least it might be said that freedom of contract embodies two interlinked, but still distinct concepts. The first concept is that contracts are based on mutual agreements. In turn, the second concept is that contracts are formed based on free choice, unlimited by external control such as governmental or legislative interference.[43]

This explanation of the freedom of contract principle is in line with the definition provided in Black's Law Dictionary. Black's Law Dictionary defines freedom of contract as:

> the doctrine that people have the right to bind themselves legally, a judicial concept that contracts are based on mutual agreements and free choice, and thus should not be hampered by external control such as governmental interference. This is the principle that people are able to fashion their relations by private agreements, especially as opposed to the assigned roles of the feudal system.[44]

This is a brief formal definition of the freedom of contract principle. However, this definition does not explain what exactly freedom of contract principle is and how it manifests. In order to understand it, scholarly opinions must be analyzed.

K. Balodis claims that freedom of contact principle is the most important expression of private autonomy. He says that freedom of contract principle is legal precondition for the existence of capitalist oriented economic system. In a free market, exchange of goods happens in accordance with supply and demand, where parties freely agree on the subject and price of an agreement.[45] However, he also explains the necessity to limit absolute freedom of contract. He says that while parties to a civil agreement formally are equal under the law, in reality one party is often significantly financially or economically stronger than the other party. Thus, in circumstances of absolute freedom of contract, unequal material position of the parties would produce situations, where one party would be put under disproportionate pressure from the other party. Therefore, as K. Balodis explains, since the turn of 19th and 20th centuries

[42] Atiyah, *An introduction to the law of contract*, p. 5.
[43] *Supra note* 42, p. 5.
[44] Garner, *Black's Law Dictionary*, p. 735.
[45] Balodis, *Ievads civiltiesībās (Introduction to Civil Law)*, p. 176.

legislators of civilized states have gradually reformed the civil law, introducing laws aiming at the protection of the weaker parties of an agreement.[46]

K. Torgāns, J. Kārkliņš and A. Bitāns also affirm that freedom of contract is an important element of market economy as well as an expression of private autonomy of the parties to a civil relationship. However, similarly as K. Balodis, they also argue against absolute freedom of contract. They compare freedom to a double edged knife as the way in which it is expressed may conflict with other fundamental concepts of civil relationships, especially with justice, good faith and equivalence. They say that freedom is not a personal concept only. Freedom is exercised in the society, where interests of other members of the society need to be also respected. K. Torgāns, J. Kārkliņš and A. Bitāns provide historical examples, when the conduct of individuals and groups of people, selfishly exercising their freedom, has resulted in social shocks and protests. As an example, they mention French Revolution, which started with the motto «Liberty, Equality, Fraternity», but in the end led to the civil war. Further, they state that Latvia also experienced both positive and negative expressions of freedom. Latvian people were of course happy, when Latvia swiftly moved to a free market economy after the collapse of the Soviet Union. However, this almost absolute freedom rapidly resulted in battles for market share with guns and brute force and marketing of counterfeit and stolen goods. Further, during this time Latvia experienced the collapse of small and big banks, which resulted in the loss of citizens' deposits. This has shown that to some extent the state needs to interfere in order to regulate so-called free market.[47]

Concluding, K. Torgāns, J. Kārkliņš and A. Bitāns affirm that freedom of contract principle and recognition of this principle in the laws is much more beneficial to the society than administrative regulation (Soviet type economic planning) or control and regulation systems existing in totalitarian states. However, they again emphasize that freedom also obligates to have due regard to the interests of the society in general. Therefore, according to them, state can interfere and limit freedom of contract on the following grounds. 1) Performance of state social functions (prohibition of agreements compromising social order, environment, health and security of people. 2) Prohibition of agreements contrary to the law and good virtues. 3) Protection of the weaker party against unjust, unfair provisions of the agreement. 4) Generation of possibilities to adjust the agreement to new circumstances if they have significantly changed.[48]

Further, widely accepted limitation on the freedom of contract principle arises out of respect for the freedom and rights of non-consenting third parties. The majority of contracts have twofold nature. They create two types of effects. Firstly, they bind parties to the contract, *i.e.* impose certain contractual obligations upon the parties. Secondly, contracts affect pre-existing legal order, thus affecting third persons. This way unlimited freedom of contract can infringe on the rights of the third parties, who have not agreed to be bound by any contract. So, in order to preserve the rights of third parties, states put limits to absolute freedom of contract. At the same time, the majority of states do not have provisions in their legal acts, stipulating that parties to the contract are forbidden from undermining the rights of third parties. This is so, because the basis for safeguarding the rights of third parties is a fundamental principle

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[46] *Supra note* 45, p. 177.
[47] Torgāns, Kārkliņš, Bitāns, *Līgumu un deliktu problēmas Eiropas Savienībā un Latvijā (Problems of contracts and delicts in European Union and in Latvia)*, pp. 45-46.
[48] *Supra note* 47, p. 85.

accepted by all legal systems – no one can harm another. However, while possibly not having such provision, each state has its own methods for ensuring protection of the rights of third parties to the contract.[49] Latvia, in particular, also has provisions safeguarding rights of non-consenting third parties. One vivid example of such provision is found in previously considered Article 20.

So, while freedom of contract is a significant concept, it still needs to be limited in the interest of the whole society, as some agreements may compromise its safety and order.[50] B. Blum expresses similar opinion. He says that while freedom of contract is a fundamental value – a component of person's freedom, there are also other values in need of protection. Therefore, there must be limits, such as prohibition of criminal companies, provisions for the protection of environment as well as prevention of unfair competition.[51]

H. N. Scheiber similarly as B. Blum considers freedom of contact as a fundamental right, which is often celebrated as the primary reason for the establishment of functional, market-based economy.[52] Further, H. N. Scheiber claims that:

> [t]he institution of contract has become in modern society the principal instrument for organizing the private marketplace; indeed, it is coextensive with the market in its scope.[53]

D. P. Weber also confirms that freedom of contract principle is a fundamental right deserving of additional protection, however not an all-encompassing right.[54]

H. G. Hutchison, on the other hand, has more radical opinion in relation to the freedom of contract principle. He claims that for freedom of contract principle to become a meaningful concept, citizens, politicians, and judges must demonstrate modesty in relation to the ability of a state to solve the human problem and immodesty in relation to an individual's right and responsibility to solve his own problems through negotiations with others.[55]

On the other hand, B. Fauvarque-Cosson and D. Mazeaud similarly as H. N. Scheiber, B. Blum and D. P. Weber, while stating that freedom of contract undeniably is a fundamental principle of contract law, emphasize that it is limited by mandatory rules. Freedom of contract principle does not authorize the parties to the contract to violate mandatory rules. This principle is to be exercised only within the framework of respect for mandatory rules.[56]

This Section attempted to define freedom of contract principle and outline its scope. Pursuant to Black's Law Dictionary freedom of contract is a concept according to which contracts are based on mutual agreements and free choice and should not be hampered by external control. It was demonstrated that among scholars, there was a wide consensus that freedom of contract was an important element of market economy as well as an expression of private autonomy. Further, pursuant to various scholars, freedom of contact is the fundamental right. However, while, scholars agree on the importance of freedom of contract, they also agree that freedom of contract is not an absolute right. This Section listed grounds, on which freedom of contract

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[49] Fauvarque-Cosson and Mazeaud, *European Contract Law: Materials for a Common Frame of Reference: Terminology, Guiding Principles, Model Rules*, p. 438; 443.
[50] *Supra note* 47, p. 65.
[51] Blum, *Contracts: Examples & Explanations*, p. 1.
[52] Scheiber, *The state and freedom of contract*, p. 3.
[53] *Supra note* 52, p. 3.
[54] Weber, «Restricting the Freedom of Contract: A Fundamental Prohibition», p. 54.
[55] Hutchison, «Lochner, Liberty Of Contract, and Paternalism: Revising the Revisionists?», p. 465.
[56] *Supra note* 49, p. 423.

could be limited. One such ground is the protection of the rights of third persons. Exactly this reason is used to justify limitation put on freedom of contract principle set in Article 20. Having defined freedom of contract principle and having outlined its scope in this Section, the Thesis moves to the analysis of the way freedom of contract principle manifests in contemporary legal framework as well as how it coexists with limitations put on this principle.

2.2. Contemporary legal framework – absolute freedom of contract?

After introducing freedom of contract principle as well as its limits in the previous Section, the Thesis proceeds to outline the ways freedom of contract principle and its limits are expressed in contemporary legal framework, both in Latvian law and in European Contract Law.

2.2.1. Freedom of contract principle and its limits in Latvia

It can be claimed that freedom of contract principle, namely, that parties freely decide who with whom enters into agreement and on what terms, in Latvia arises from Article 1511 of the Civil Law of Latvia. This Article says that:

> [a] contract within the widest meaning of the word is any mutual agreement between two or more persons on entering into, altering, or ending lawful relations. A contract in the narrower sense applied here is a mutual expression of intent made by two or more persons based on an agreement, with the purpose of establishing obligations rights.[57]

Other than that, in the Civil Law of Latvia there is no Article that would explicitly proclaim freedom of contract principle. Rather, freedom of contract principle and its limits arise from the whole set of norms found in the Civil Law of Latvia, which on the one hand, proclaim freedom of contract principle in all four its manifestations, but on the other hand, set limits to this principle.[58]

In Latvia freedom of contract principle has four manifestations. Firstly, there is freedom to conclude an agreement, meaning that each person can freely choose whether to conclude an agreement or not. Secondly, there is freedom to choose partner to an agreement, which means freedom to choose with whom to enter into an agreement. Third manifestation is freedom to choose the content of an agreement. Lastly, there is freedom to choose form of an agreement, *e.g.* oral, written, notarial.[59]

It is exactly one of these manifestations of freedom of contract principle that Article 20 limits. While Article 20 does not have any effect on person's freedom to conclude an agreement, choose partner to an agreement or choose form of an agreement, Article 20 limits person's freedom to choose the content of an agreement. This Article expressly allocates liability in case of a transfer of an undertaking. While the acquirer and the transferor of an undertaking are not prohibited from agreeing on different allocation of liability, such agreement is void as to third parties. So, while Article 20 allows the acquirer and the transferor to conclude an

[57] The Civil Law of the Republic of Latvia, January 28, 1937. Available on: https://likumi.lv/doc.php?id=225418. Acessed on 10 April, 2018, Article 1511.
[58] *Supra note* 47, pp. 46-47.
[59] *Supra note* 45, p. 177.; Torgāns, *Saistību tiesības. I daļa. (Contract Law. I Part)*, p. 41.

agreement allocating liability in case of a transfer of an undertaking, it prohibits them from including in the agreement provision making such agreement binding for third parties, thus limiting freedom to choose the content of an agreement. This limitation means that if the transferor and the acquirer conclude an agreement releasing the acquirer from the liability for obligations that arose before transfer of an undertaking, the creditor can still choose to ask for satisfaction from the acquirer. In such a case, the acquirer cannot object on the basis of the agreement concluded with the transferor. The acquirer is obligated to fulfill the obligation in accordance with the law. Of course, in such a case, after the acquirer fulfills an obligation to the creditor, he can raise a claim to recover the respective amount from the transferor on the basis of concluded agreement. However, as must be emphasized, the acquirer may do so only after he settles the debt to the creditor. This means that he has to pay the funds that he could otherwise invest somewhere, so they could bring him interest, or use it for the expansions of his business, or use it for any other purpose. In turn, recovering paid amount from the transferor may result in lengthy court proceedings, or in fact funds may not be recovered at all (for example, if the transferor is declared bankrupt).

Continuing the discussion on freedom of contract principle, it must be also emphasized that freedom of contract is a fundamental value – a component of person's freedom. While the Constitution of Latvia does not explicitly mention freedom of contract, it contains various Articles protecting various freedoms, for example, freedom of thought, conscience and religion, freedom of expression, freedom of previously announced peaceful meetings, street processions, pickets, freedom of trade unions, freedom of scientific research, artistic and other creative activity.[60]

However, while Latvian normative acts recognize freedom of contract principle and its four manifestations, even if in some cases implicitly, they also put limits on it.

For example, freedom to choose the content of an agreement exists so far it is not limited by imperative legal norms.[61] Article 1415 of the Civil Law of Latvia illustrates this approach. It provides general limit to the freedom to choose the content of an agreement. It states that:

> [a]n impermissible or indecent action, the purpose of which is contrary to religion, laws or moral principles, or which is intended to circumvent the law, may not be the subject-matter of a lawful transaction; such a transaction is void.[62]

Further, there are numerous laws limiting freedom to choose the content of an agreement in such legal areas, where stronger party due to its position has the power to dictate conditions that adversely affect weaker parties. For example, many such provisions aim to protect employees and consumers.[63] There is Latvian Unfair Commercial Practices Prohibition Law, whose aim is to protect consumer rights and economic interests. Consumer Rights Protection Law also has similar agenda. [64]

Furthermore, many provisions limiting freedom of contract principle are found in Latvian Competition law. Their primary aim is to ensure that influential legal entities do not abuse their position in the market and limit competition as lack of competition would result in lower

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[60] The Constitution of the Republic of Latvia, 15 February 1922, Available on: https://likumi.lv/doc.php?id=57980. Accessed on 2 April, 2018, Articles 99, 100, 103, 108, 113.
[61] *Supra note* 45, p. 179.
[62] *Supra note* 57, Article 1415.
[63] *Supra note* 45, p. 179.
[64] *Supra note* 47, p. 55.

product offering, higher prices and it would be more difficult for new members to enter the market.[65] There are also other laws limiting freedom of contract principle. For example, Freedom to Provide Services Law, Law On Extrajudicial Recovery of Debt, Public Procurement Law, Credit Institution Law, etc.[66]

In property law, freedom to choose content of the agreement is mostly limited in order to protect interests of third persons. This is because property rights are absolute rights that are in force for any third person and in case of necessity can be used in respect of any third person.[67]

To conclude, freedom of contract principle has a clear presence in Latvian normative acts. This principle and its four manifestations are recognized in the Civil Law of Latvia. Further, it can be argued that in Latvia freedom of contract principle indirectly exists also as a component of fundamental right to freedom. However, in line with previous discussion on freedom of contract principle, while Latvian normative acts recognize this principle, the same acts also establish limitations on this principle.

2.2.2. Freedom of contract principle and its limits in the European Contract Law

Previous Section considered the way freedom of contract principle and its limits were expressed in Latvia. In turn, this Section analyses how freedom of contract principle is expressed in European Contract Law.

However, before considering European Contract Law, firstly, it must be clarified what is encompassed under this term. European Contract Law has two main directions. Firstly, European Contract Law is codified in secondary legislation of the European Union (hereinafter – the EU), which consists of international conventions, agreements and EU legal acts. EU legal acts in turn consist of five types of legal acts, *i.e.* regulations, directives, decisions, recommendations and opinions, which depending on their nature can have a binding force. Secondly, European Contract Law consists of academic documents, such as previously mentioned UNIDROIT Principles, the Principles Of European Contract Law (hereinafter – the PECL), European Code of Contract – Preliminary Draft etc. While the majority of these academic documents lack legal force and cannot be used as a source of law, they were drafted by highly authoritative academics, whose primary aim was the harmonization of national laws of the EU states and they give insight into dominant, even prevailing concepts.[68]

When talking about secondary legislation of the EU, in particular, conventions, it must be noted, that the United Nations Convention on Contracts for the International Sale of Goods (hereinafter – the CISG) does not explicitly proclaim freedom of contract principle. However, Article 6 of the CISG provides for the right of the parties to exclude the application of the CISG, derogate from or vary the effect of any of its provisions. UNCITRAL Secretariat's explanatory note on the CISG recognized this Article as a proclamation of the fundamental principle of freedom of contract.[69]

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[65] *Ibid*, pp. 62-63.
[66] *Ibid*, p. 63.
[67] *Supra note* 45, p. 179.
[68] *Supra note* 47, p. 25.
[69] *Supra note* 49, p. 423; United Nations Convention on Contracts for the International Sale of Goods, Article 6.

Further, freedom of contract principle is recognized in almost all previously listed significant academic documents that constitute part of the European Contract Law.

This principle is codified in current version of the PECL. Article 1:102 of the PECL states that:

> [p]arties are free to enter into a contract and to determine its content, subject to the requirements of good faith and fair dealing, and the mandatory rules established by these Principles.[70]

However, while the PECL explicitly recognizes freedom of contract principle, it still limits its scope by mandatory rules. While Article 1:103 of the PECL permits parties to avoid application of national laws, as it allows parties to choose to have their contract governed by the PECL with the effect that national rules are not applicable, derogation from mandatory rules is not allowed under any circumstances. Mandatory rules of national, supranational and international law, which are applicable according to the relevant rules of private international law, need to be complied with irrespective of the law governing the contract.[71] As stated in the commentary to the PECL, these mandatory rules from which no derogation is permitted, are rules which

> are expressive of a fundamental public policy of the enacting country and to which effect should be given when the contract has a close connection to this country.[72]

To sum up, while the PECL seemingly provides an opportunity to elude the application of certain national rules, mandatory rules that are applicable regardless, still limit freedom of contract principle.

The same approach towards freedom of contract principle is taken in the European Code of Contract – Preliminary Draft. Article 2&1 of the European Code of Contract – Preliminary Draft explicitly proclaims this principle by stating that: «[t]he parties can freely determine the contents of the contract».[73]

However, at the same time, it specifies that this principle is to be understood

> within the limits imposed by mandatory rules, morals and public policy, as established in the present code, Community law or national laws of the Member States of the European Union, provided always that the parties thereby do not solely aim to harm others.

If this is not observed, in accordance with Article 140 of the European Code of Contract Preliminary Draft the contract is considered to be null.[74]

Similar approach is taken in UNIDROIT Principles. Article 1.1 of UNIDROIT Principles states that: «[t]he parties are free to enter into a contract and to determine its content».[75] Further, the commentary to this Article adds that principle of freedom of contract, which entails the right of people to freely choose the parties to the transaction and the right to freely

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[70] Cf. Ole Lando and Hugh Beale (eds.) The Principles Of European Contract Law 2002 (Parts I, II, and III), 2002, Article 1:102.
[71] *Supra note* 70, Article 1:103 (2).
[72] *Supra note* 49, p. 425.
[73] Academy of European Private Lawyers. European Contract Code - Preliminary draft. Universita Di Pavia, 2001, Article 2&1.
[74] *Supra note* 73, Article 140.
[75] *Supra note* 2, Article 1.1.

choose the terms of transaction (the content of the agreement) is the basis of «an open, market-oriented and competitive international economic order».[76]

However, even having acknowledged the significance of the freedom of contract principle, UNIDROIT Principles limit it by mandatory rules. Article 1.4 of UNIDROIT Principles affirm that mandatory rules, whether of national, international or supranational origin, prevail, and nothing can restrict their application.[77]

Having established, that freedom of contract principle is recognized also on the European level, it must be considered, what expressions of freedom of contract are recognized.

Similarly, as Latvian normative acts, European Contract Law also recognizes that freedom of contract principle can take different forms. Firstly, there is the right to freely choose the party to the contract, *i.e.* with whom to enter into the contract. The Commentary to Article 1.1 of UNIDROIT Principles recognizes

> the right of business people to decide freely to whom they will offer their goods or services and by whom they wish to be supplied.[78]

Secondly, UNIDROIT Principles also recognize the right to choose the form of the contract, *e.g.* written, oral, notarial. This right is found in Article 1.2 of UNIDROIT Principles. According to this Article, no special form of contract is required. The existence of the contract may be confirmed by any means available, including witnesses.[79] Similar provision can be found also in Article 1127 of the Proposals for Reform of the Law of Obligations and the Law of Prescription. This Article states that:

> [a]s a general rule, contracts are completely formed by the mere consent of the parties regardless of the form in which this may be expressed.[80]

Thirdly, there is the right to choose the content of the contract. This right is established in Article 2&1 of the European Code of Contract Preliminary Draft.[81] Similarly, this right is explicitly recognized in Article 1:102 of the PECL[82] and Article 1.1 of UNIDROIT Principles.[83]

These three listed manifestations of freedom of contract principle are analogous to the ones found in Latvian legal acts. However, the European Contract Law recognizes one more manifestation not explicitly recognized in Latvian legislature. It is the right to freely negotiate and to break off negotiations.[84] This right is included in the first sentence of article 1104 of the Proposals for Reform of the Law of Obligations and the Law of Prescription, which states that: «[t]he parties are free to begin, continue and break off negotiations».[85] UNIDROIT

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[76] *Ibid*, comment to Article 1.
[77] *Ibid*, Article 1.4.
[78] *Supra note* 2, Article 1.1.
[79] *Ibid*, Article 1.2.
[80] John Cartwright, Simon Whittaker ed. Proposals for Reform of the Law of Obligations and the Law of Prescription (2005), Article 1127.
[81] *Supra note* 73, Article 2&1.
[82] *Supra note* 70, Article 1:102 (1).
[83] *Supra note* 2, comment to Article 1.
[84] *Supra note* 49, p. 437.
[85] *Supra note* 80, Article 1104.

Principles also have similar provision, *i.e.* Article 2.1.15 states that: «[a] party is free to negotiate and is not liable for failure to reach an agreement».[86]

So, as has been outlined, the European Contract law explicitly recognizes freedom of contract principle and its expressions. Further, not only European Contract Law explicitly recognizes it. All EU member states have acknowledged freedom of contract principle, in particular, freedom to choose the content of the contract.[87] The majority of the states have included it in their laws, *e.g.* this principle is found in legal acts of Germany, Denmark, Spain, France, Belgium and Luxembourg, the Netherlands, Austria.[88] However, while all EU member states recognize freedom of contract principle, they all also acknowledge that freedom of contract principle operates within the framework of respect for mandatory rules. For example, under Article 1322 of the Italian Civil Code freedom of contract principle operates «within the limits laid down by the law». Similarly, Article 1255 of the Spanish Civil Code while proclaiming freedom of contract principle, stipulates that: «contracts cannot be contrary to statute, to morality or to public policy (…) ».[89]

In some EU member states, freedom of contract principle, while being acknowledged as a fundamental principle, is not explicitly included in legal acts. For example, in Switzerland there is no national rule that explicitly proclaims freedom of contract principle. However, this principle is unanimously recognized as one of four fundamental freedoms on which Swiss civil law rests.[90]

To sum up, this Section of the Thesis established that similarly as in Latvian normative acts, freedom of contract and its various expressions were recognized also under the European Contract Law as well as in various normative acts of EU member states. However, this Section again confirmed that there was no absolute freedom of contract. All considered legal acts, while acknowledging freedom of contract, also specified that it was subject to *inter alia* mandatory rules. Having once again confirmed that there was no absolute freedom of contract and that it was subject to various restrictions, in next Section the Thesis proceeds to analyze whether the European Contract Law contains limitations on freedom of contract set for the protection of third parties. In particular, the next Section attempts to answer whether protection of rights of third persons – creditors, similarly as in Latvia, justifies limiting freedom of contract principle under European Contract Law.

2.2.3. The limitation on freedom of contract for the protection of third parties

This Section attempts to answer whether protection of rights of third persons, in particular, creditors, similarly as in Latvia, justifies limiting freedom of contract principle under European Contract Law.

Firstly, it must be noted, that general provisions safeguarding third parties from relative effect of the contract are present in numerous legal documents. For example, Article 1165 of the Proposals for Reform of the Law of Obligations and the Law of Prescription states that:

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[86] *Supra note* 2, Article 2.1.15(1).
[87] *Supra note* 49, p. 437.
[88] *Ibid*, p. 426.
[89] *Ibid*.
[90] *Supra note* 49, p. 428.

> [c]ontracts bind only the contracting parties: they have no effect on third parties except in the situations and subject to the limitations explained below.[91]

Similarly, the European Code of Contract Preliminary Draft contains provision that limits freedom of contract for the protection of third party rights. Article 2&1 states that parties are free to choose the content of the contract *inter alia* if they do not aim to harm others with this contract.[92]

Secondly, certain legal documents include provisions intended specifically for the protection of creditors. The Proposals for Reform of the Law of Obligations and the Law of Prescription emphasize that there is a difference between «third parties, who are entirely foreign to the contract» and «third party creditors». One of the protective measures available to creditors under this legal document is the possibility to challenge any legal act made by the debtor with the intention to defraud the creditor. In particular, Article 1167 states that: «a creditor can challenge in his own name any judicial act made by his debtor in fraud of his rights».[93] Further, the Proposals for Reform of the Law of Obligations and the Law of Prescription expressly state that if the court declares the act fraudulent, it does not have an effect on the creditors, so the creditors are not prejudiced by it or its consequences.[94]

The European Code of Contract Preliminary Draft similarly as the Proposals for Reform of the Law of Obligations and the Law of Prescription have provision specifically intended for the protection of creditors against fraud. In accordance with Article 154, contracts drafted with the intent to defraud a creditor of one of the parties are not opposable to third parties (creditors).[95]

Further, provisions safeguarding creditors from fraud are found also in normative acts of various EU member states. For example, such are found in the French Civil Code (*fraude paulienne*). Article 1167 states that creditors: «may also, on their own behalf, attack transactions made by their debtor in fraud of their rights».[96]

Similarly, Italian law also has protective measures against fraudulent acts. Articles 2901 to 2904 of the Civil Code regulate *action révocatoire* in case of fraudulent acts. Similar provisions are present also in Dutch law, Spanish law, Belgian law *et al*.[97]

This Section established that the European Contract Law also contained provisions limiting freedom of contract principle for the protection of third parties. Further, both European Contract Law and normative acts of EU member states include provisions safeguarding creditor rights. So, it means that protection of creditor rights justifies limitations being put on freedom of contract principle not only under Latvian normative acts, but also under European Contract Law and laws of various EU member states.

Conclusion

To sum up, freedom of contract is an important element of market economy as well as an expression of private autonomy and a great benefit to society. Furthermore, in accordance

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[91] *Supra note* 80, Article 1165.
[92] *Supra note* 73, Article 2&1.
[93] *Supra note* 80, Article 1167.
[94] *Supra note* 80, Article 1167.
[95] *Supra note* 73, Article 145 (c).
[96] Rider, *Research Handbook on International Financial Crime*, p. 341.
[97] *Supra note* 49, p. 446.

with various scholars freedom of contract is an element of a fundamental right. However, while, scholars agree on the importance of freedom of contract, they also agree that freedom of contract is not an absolute right. Chapter 2 listed various grounds, that could justify limiting the scope of the freedom of contract. One such ground is the protection of the rights of third persons. Exactly this reason is used to justify limitation put on freedom of contract principle set in Article 20. Having defined freedom of contract principle and having outlined its scope, Chapter 2 proceeded to analyze the way freedom of contract principle was expressed in contemporary legal framework. It was found, that freedom of contract principle was recognized both under Latvian normative acts as well as under European Contract Law and normative acts of various EU member states. However, this Chapter also confirmed that currently there was no absolute freedom of contract. All considered legal acts, while acknowledging freedom of contract, also specified that it was subject to various restrictions. So, more than a century after they were said, words of Chief Justice Charles Hughes that «freedom of contract is a qualified, and not an absolute, right»[98] still ring true. Lastly, Chapter 2 established that European Contract Law similarly as Latvian normative acts contained provisions limiting freedom of contract principle for the protection of third parties. Both European Contract Law and normative acts of EU member states have provisions, whose purpose, similarly as the purpose of Article 20, is safeguarding of creditor rights. Having outlined the contemporary legal framework, where freedom of contract principle and its limitations operate, in order to better understand freedom of contract principle, in Chapter 3 the Thesis continues the discussion on the freedom of contract principle, tracing the development of this principle through ages.

[98] *Chicago, Burlington and Quincy Railroad Company v. McGuire*, 219 U.S. 549 (1911).

3. FREEDOM OF CONTRACT PRINCIPLE THROUGH AGES

3.1. Origins and philosophical underpinnings of the freedom of contract principle

Origins of the freedom of contract principle can be traced to the classical period, *i.e.* the seventeenth and eighteenth centuries. This era brought the development of philosophical movement known as liberalism. Liberalism, in turn, influenced the development of the theory of natural rights and individual freedom. Individual freedom and restriction of governmental interference in private sector with the aim to allow greater freedom of individuals were some of the main concepts of the era. These notions were greatly supported by great political economist Adam Smith, social philosophers such as Thomas Hobbes, Jean-Jacques Rousseau, John Locke, John Stuart Mill, Charles-Louis de Montesquieu, and Thomas Jefferson, and great judicial thinkers such as Hugo Grotius and Samuel Pufendorf.[99] Among these theories, freedom of contract principle developed.

Development of freedom of contract principle was greatly influenced by social philosopher John Locke with his philosophy of natural law. Pursuant to him:

> the natural liberty of man is to be free from any superior power on earth, and not to be under the will or legislative authority of man, but to have only the law of nature for his rule.[100]

John Locke's philosophy was based on the notion that people have natural rights derived from the law of nature such as rights to life, liberty, and estate and the objective of the government has to be the protection of these natural rights.

Adam Smith also greatly influenced the development of freedom of contract principle. Freedom of contract principle with its antipathy towards governmental interference with the

[99] McCaskey, «Thesis and antithesis of liberty of contract: excess in Lochner and Johnson controls», p. 410.
[100] *Supra note* 99, p. 413.

rights of individuals to freely negotiate and enter into agreements of their choice is very well illustrated by his words:

> [e]very man, as long as he does not violate the laws of justice, is left perfectly free to pursue his own interest his own way, and to bring both his industry and capital into competition with those of any other man, or order of men. The sovereign is completely discharged from a duty, in the attempting to perform which he must always be exposed to innumerable delusions, and for the proper performance of which no human wisdom or knowledge could ever be sufficient; the duty of superintending the industry of private people, and of directing it towards the employments most suitable to the interest of the society.[101]

This approach towards freedom of contract principle is in line with laissez-faire doctrine[102], which Adam Smith was the progenitor of. Laissez-faire doctrine advocates minimum governmental intervention. At the basis of it is the claim that perfect freedom of exchange is advantageous for everyone in the society, because in this case no one is obliged to exchange something that he wants more for what he wants less. According to laissez-faire doctrine market itself resolves its problems without any outside intervention being required. Laissez-faire doctrine operates under the assumption that parties know their own interests and have the power to defend them and outside forces should not prevent them from doing so.[103]

Both Adam Smith and John Stuart Mill argued that the right of individuals to freely bargain with each other was a vital precondition for the progress of society. Further, they even claimed that free enterprise and freedom of contract principle was an answer to society's industrial and social challenges.[104]

So, as can be seen, the meaning of freedom of contract principle in the seventeenth and eighteenth centuries significantly differed from what is understood as freedom of contract principle currently. As was discussed in Chapter 2, currently legal scholars understand freedom of contract as fundamental, but not an absolute right. On the other hand, John Locke and Adam Smith advocated almost absolute freedom of contract. However, what is noteworthy is that in the seventeenth and eighteenth centuries, despite wide support for absolute freedom of contract, theory of natural rights, and laissez-faire doctrine, some scholars still argued that the government should be allowed to interfere in private matters, in order to keep people from harming other people.

Noteworthy that such an opinion was expressed by advocate of the freedom of contract principle John Stuart Mill, who supported the notion of minimal governmental interference. He claimed that the only exception, when government should be allowed to interfere in private matters, is to keep people from harming other people. According to him, people should be allowed to freely enter into agreements of their choice as long as the objective of the agreement is not to harm others, it involves persons of full age and does not involve coercion, fraud, or deceit. One of the arguments used by John Stuart Mill against governmental interference is that according to him «when it does interfere, the odds are that it interferes wrongly, and in the wrong place».[105]

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[101] *Ibid*, p. 409.
[102] The policy of laissez-faire (from French: «allow to do»), *i.e.* policy in favour of minimum governmental intervention, which was strongly supported by an economist and philosopher Adam Smith.
[103] *Supra note* 49, p. 429.
[104] *Supra note* 99, p. 411.
[105] *Ibid*, p. 419.

To sum up, this Section demonstrated that freedom of contract principle developed during the seventeenth and eighteenth centuries among such concepts as liberalism, natural rights and laissez-faire doctrine. Freedom of contract principle was greatly supported by prominent political economists and great judicial thinkers. What is noteworthy, that even at that time, when absolute freedom of contract was widely supported, there were arguments coming from freedom of contract advocates themselves that limitations on freedom of contract were justified if intended to keep people from harming other people. Such approach is in line with contemporary legal framework. As was demonstrated in Chapter 2, European Contract Law has various provisions intended for the protection of third parties. Further, Article 20 also has the same aim. Having outlined origins and philosophical underpinnings of the freedom of contract principle in this Section, in the next Section the Thesis proceeds to follow the development of the freedom of contract principle, looking at the most vivid cases illustrating the development of this principle.

3.2. Freedom of contract principle – what has history taught us?

During the last centuries, the governments were experiencing the constant tension between the freedom of contract principle and the right of the government to restrict its scope. This tension was especially apparent in the context of labor rights. Interests of employers and the government (the society in general) in respect of worker protection and wage requirements constantly collided.

Special attention deserve periods of time, when freedom of contract principle received the most support. Corresponding public policy of those times is very well illustrated by the judicial pronouncement that:

> [p]ublic policy requires it that men of full age and competent understanding shall have the utmost liberty of contracting, and that their contracts ... shall be held sacred.[106]

In this context the most prominent case, rightly considered the pinnacle of the freedom of contract principle is Lochner v. New York case, which started new era in the history of the USA – so-called Lochner Era.[107]

3.2.1. The Lochner Era and its end

In the USA, support for freedom of contract principle was at its strongest during so-called Lochner Era. Throughout Lochner Era, the USA courts proceeded to invalidate various legal acts, *inter alia* laws setting restrictions on minimum wage,[108] maximum hour requirements,[109] union participation,[110] federal child labor laws,[111] and the mining industry[112] based on the freedom of contract principle.

So-called Lochner Era started in 1897 with the decision of the Supreme Court of the USA in Lochner v. New York case. This case is justly considered as the pinnacle of the freedom of

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[106] *Printing and Numerical Registering Co v. Sampson* 19 Eq. 462 (1875).
[107] *Lochner v. New York*, 198 U.S. 45 (1905).
[108] Adkins v. Children's Hospital, 261 U.S. 525 (1923).
[109] *Supra note* 107, 64.
[110] Adair v. United States, 208 U.S. 161 (1908).
[111] *Hammer v. Dagenhart*, 247 U.S. 251 (1918).
[112] *Carter v. Carter Coal Company*, 298 U.S. 238 (1936).

contract principle, illustrating absolute freedom from governmental interference. In this case, the Court invalidated a law limiting working hours of bakers to 60 as this law was considered to be in violation of freedom of contract principle.[113]

In Lochner v. New York case the Court, assuming nearly equal bargaining power of the employer and the employee, found laws favoring one party (in this case the employee) anomalous.[114] The Court claimed that the employees (bakers in that case) were in no sense wards of the state. The Court stated:

> [t]here is no reasonable ground for interfering with the liberty of person or the right of free contract (…) and there is no contention that bakers as a class are not equal in intelligence and capacity to men in other trades (…) or that they are not able to assert their rights and care for themselves without the protecting arm of the state, interfering with their independence of judgment and of action. They are in no sense wards of the state.[115]

As follows from provided citation, the Supreme Court of the USA reached the decision to invalidate the law, *inter alia* in order to ensure the right of the employees to enter into contracts relying on their own judgement, even if contracts are disadvantageous.

After the judgement in Lochner v. New York case a number of other similar judgements followed. The judgment in Lochner v. New York case started so called Lochner Era, lasting about thirty years. During Lochner Era the USA courts invalidated laws if they considered that these laws infringed on freedom of contract principle.

In Adair v. United States, the Court by analogy with Lochner v. New York case declared unconstitutional laws prohibiting employees from entering into labor unions («yellow-dog» contracts). Similarly as in Lochner v. New York case, the Court claimed that:

> the employer and the employee have equality of right, and any legislation that disturbs that equality is an arbitrary interference with liberty of contract which no government can legally justify in a free land.[116]

Another Lochner Era case illustrating the rule of freedom of contract principle is Hammer v. Dagenhart case. In this case the Court evaluated the right of the Congress to enact legal act prohibiting the shipment of goods in interstate commerce produced in factories employing children. Evaluating the case on the basis of the harmless items doctrine, the Court stated that the Congress was allowed to enact legal acts banning the interstate shipment only of intrinsically harmful goods, *e.g.* immoral lottery tickets and impure food. However, according to the Court the Congress was not allowed to prohibit interstate shipment of goods that themselves were not harmful. The way the goods were produced was ruled to be irrelevant. So, considering that products of child labor in themselves were not harmful, the Court ruled that the Congress did not have the right to ban it from being the subject of interstate commerce. This meant that the freedom of contract principle was to be applied in all the cases in relation to free movement of goods with inherently harmful items being the exception.[117]

This case demonstrates that during Lochner Era, protection of the rights of third persons, even children, did not have much weight, at least certainly not as much as it has now. In this case,

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[113] *Supra note* 107.
[114] *Supra note* 54, p. 58.
[115] *Supra note* 107.
[116] *Supra note* 110, 175.
[117] *Supra note* 111.

in the name of the freedom of contract, the Court failed to address protection of the rights of children, who could be adversely affected by invalidation of legal acts prohibiting the shipment of goods in interstate commerce produced in factories employing children. This case especially vividly demonstrates, to what extremes supporting unlimited freedom of contract can lead and cautions contemporary society to be very careful, when considering freedom of contract principle.

The Lochner Era ended in 1937 with the decision of the Supreme Court of the USA in West Coast Hotel Co. v. Parrish case, where the Court declared the establishment of minimum wages for women constitutionally legitimate. In this case, the Court considered the right of legislators to enact such law as a question of liberty rather than freedom of contract. The Court claimed that liberty was subject to legal restrains enforced to protect the health, safety, morals, and welfare of the people. Further, the Court added that the same principle applied also to freedom of contract principle.[118]

In this case, the Court, opposing the decision in Lochner v. New York case, claimed that:

> [t]here is no absolute freedom to do as one wills or to contract as one chooses. The guaranty of liberty does not withdraw from legislative supervision that wide department of activity which consists of the making of contracts, or deny to government the power to provide restrictive safeguards.[119]

In West Coast Hotel Co. v. Parrish case the Court provided also economic arguments for its decision. The Court claimed that female employees being the lowest paid class, with relatively weak bargaining power, were the «ready victims» of those who were in the position to take advantage of their unequal bargaining power. In turn, the exploitation of employees with unequal bargaining power, leaving them without a living wage, not only damages the health and well-being of these employees, but also creates a burden on society.[120]

So, as was demonstrated, there was a period of time in the history of the USA, when freedom of contract principle had very different implications than what it has now. During so-called Lochner Era, in the name of the freedom of contract the USA courts proceeded to invalidate legal acts that were intended for protection of weaker parties, legal acts that without doubt were beneficial for the society in general. During that time in the name of the freedom of contract the USA courts, *inter alia* invalidated laws setting restrictions on minimum wage, maximum hour requirements, union participation, and the mining industry. Even laws connected with prohibition of shipment of goods produced in factories employing children, were not an exception. However, with the judgement in West Coast Hotel Co. v. Parrish case the Lochner Era ended with its main arguments being overturned by the statement that is relevant also nowadays. According to this statement «[t]here is no absolute freedom to do as one wills or to contract as one chooses».[121] Having outlined the most vivid historical cases in relation to freedom of contract principle, the Thesis proceeds to analyze scholarly opinions on Lochner Era cases.

3.2.2. Opinions on Lochner Era

[118] *West Coast Hotel Co. v. Parrish*, 300 U.S. 379 (1937), 581.
[119] *Supra note* 118, 392.
[120] *Ibid*, 399.
[121] *Supra note* 118, 392.

Lochner Era cases indeed generated a lot of controversy. Even among its contemporaries. For example, Justice Harlan in his dissent criticized this judgement as, in his opinion, it did not adequately address legitimate interest of the government in the health and safety of its citizens.[122] In turn, Justice Holmes dissented in Adair v. United States case, claiming that the right to make contract at will was stretched to its extremes. According to Justice Holmes the word «liberty» in the Constitutional amendments from which the right to make contract at will was derived simply aimed to prohibit the stronger party from taking advantage of the weaker party by exacting certain undertakings or unjustly discriminating.[123]

Lochner Era judgments continued to attract academic attention many years after they were first issued. They are widely discussed even now. For example, D. P. Weber, when considering Lochner v. New York case claimed that such approach of the Court, where it aimed to ensure even playing field free from restrictions, was only seemingly neutral. In fact, lack of regulative norms benefited the party with greater bargaining power.[124] At the same time, he stated that while certainly not advocating for the return of Lochner Era jurisprudence, he still supported freedom of contract as the basic right to conclude agreements in order to acquire or dispose of possessions and services, or change legal relationships in any other way.[125]

D. P. Weber's opinion is in line with the statements made by the Court in Moore v. East Cleveland case. The Court claimed that even though Lochner Era judgments demonstrated that in certain cases legislative intervention was required, freedom of contract principle still without a doubt was one of the pillars of modern commercial society.[126] The Court stated that Lochner Era jurisprudence «counsels caution and restraint (…) [i]t does not counsel abandonment».[127]

There are also modern academics, who consider Lochner v. New York case even more favorably than D. P. Weber. For example, D. N. Mayer considers Lochner v. New York case as a legitimate attempt on the part of judiciary to protect a constitutional rule that ensures that individuals have the right to conclude contracts freely from the government willing to arbitrarily exercise its power. D. N. Mayer claims that the Supreme Court of the USA in Lochner v. New York case was safeguarding the principle of freedom of contract as a fundamental right and not promoting the laissez-faire constitutionalism as claimed by Justice Holmes and his supporters.[128]

Another modern academic A. S. McCaskey brings another perspective on freedom of contract principle. Presenting Lochner v. New York case as a thesis for the defense of the freedom of contract principle and Auto Workers v. Johnson Controls case[129] as an antithesis for this principle, A. S. McCaskey supports neither of these approaches. He claims that both of them have shortcomings. He considers the dangers of not only unlimited freedom of contract, but also of unlimited governmental interference with the freedom of contract principle. Pursuant to A. S. McCaskey unlimited power of the legislative branch of government to pass legal acts

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[122] *Supra note* 107, (Harlan, J., dissenting).
[123] *Supra note* 110, (Holmes, J., dissenting).
[124] *Supra note* 54, p. 59.
[125] *Supra note* 54, pp. 56-57.
[126] *Moore v. East Cleveland*, 431 U.S. 494, 502 (1977).
[127] *Supra note* 126, 502-03.
[128] Mayer, *Liberty of Contract: Rediscovering a Lost Constitutional Right*, p. 1.
[129] *Auto Workers v. Johnson Controls*, 111 S.Ct. 1196 (1991).

resulted in an astounding increase of state and federal regulations in the USA, which «contributes to the stagnant growth in business and lagging productivity marked by today's economy as well as other adverse consequences».[130] Therefore, A. S. McCaskey supports neither approach, but rather their synthesis.

This Section demonstrated that Lochner Era judgements indeed generated a lot of controversy, when they were first issued and they still continue to attract attention of academics now. Noteworthy, that while the majority of academics recognize the dangers of Lochner Era jurisprudence with its corresponding unlimited freedom of contract, at the same time, the majority of academics still consider freedom of contract to be an important concept.

Conclusion

A look into historical development of the freedom of contract principle revealed experiences of the past that need to be remembered in order not to repeat mistakes already once made. During so-called Lochner Era, in the name of the freedom of contract, the USA courts proceeded to invalidate legal acts that were intended for protection of weaker parties. In the name of the freedom of contract, the courts failed to preserve even minimal safeguards essential for the society. While these decisions were taken with the objective to ensure even playing field free from restrictions, in fact Lochner Era judgements manifested as representation of unequal bargaining power of different classes, *i.e.* superior bargaining position of the empowered class and the economic insecurities of the working class.[131] However, despite dangers of Lochner Era jurisprudence with its unlimited freedom of contract, many academics still consider freedom of contract, while definitely not an absolute, an important right. Very relevant is already mentioned statement made by the Court in Moore v. East Cleveland case. The Court stated that Lochner Era jurisprudence «counsels caution and restraint (…) [i]t does not counsel abandonment».[132] Taking all this into consideration, it is crucial to find a balance between freedom of contract and the necessity for governmental intervention. In other words, it is crucial to determine in what circumstances freedom of contract principle shall prevail and when, on the other hand, governmental intervention is justified. This can be achieved only through in-depth analysis.

[130] *Supra note* 99, p. 410, 422.
[131] *Supra note* 54, p. 57.
[132] *Supra note* 126, 502-03.

4. ASSESSING LIMITATIONS ON FUNDAMENTAL RIGHTS IN LATVIA

Chapter 3 established the need for in-depth analysis for determining, when freedom of contract principle should prevail, and, when, on the other hand, governmental intervention is justified. When assessing the limitation on the freedom of contract, it is especially important to apply the optimal evaluation methodology available. In this context, Chapter 4 introduces elaborate evaluation methodology used by the Constitutional Court of Latvia for assessing limitations on fundamental rights. Chapter 4 undertakes to establish that freedom of contract is a component of a fundamental right to freedom and therefore evaluation methodology used for assessing limitations on fundamental rights, can be used for assessing limitations on freedom of contract also.

4.1. Freedom of contract as a component of a fundamental right to freedom

Argument that freedom of contract is a component of general right to freedom finds support in the works of prominent scholars. For example, K. Torgāns, J. Kārkliņš and A. Bitāns state that in the state governed by the rule of law freedom of contract is a component of human freedom in its general meaning.[133] Similarly, B. Blum also confirms that freedom of contract is a fundamental value – a component of person's freedom.[134] Further, H. N. Scheiber also claims that freedom of contact is a fundamental right that is often celebrated as the primary reason for the establishment of functional, market-based economy.[135]

Furthermore, additional argument supporting the assumption that freedom of contract is a component of general right to freedom is found in previous discussion of post Lochner Era

[133] *Supra note* 47, p. 45.
[134] *Supra note* 51, p. 1.
[135] *Supra note* 52, p. 3.

cases. As was already mentioned in Chapter 3, in West Coast Hotel Co. v. Parrish case, the Court analyzing the minimum wage requirement for women, approached it as a question of liberty rather than freedom of contract.[136]

In turn, if freedom of contract is a component of general right to freedom, similarly as other freedoms (such as political, social, economic and other freedoms), it is protected under the Constitution of Latvia, the European Convention on Human Rights, the Charter of Fundamental Rights of the European Union etc. This protection allows people to take the initiative in civil relationships, to choose course of action most suitable for them and solve their welfare issues. However, freedom is not solely the personal category, it is implemented in the society, where interest of other individuals also need to be respected.[137] Therefore general right to freedom is also not absolute.

In Sky Österreich GmbH v. Österreichischer Rundfunk case the European Court of Justice expressly confirms that Article 16 of the Charter of Fundamental Rights of the European Union that proclaims «[t]he freedom to conduct a business in accordance with Union law and national laws and practices» covers also the protection of freedom of contract.[138] In one of the following cases Mark Alemo-Herron and Others v. Parkwood Leisure Ltd. case concerning the approximation of the laws of the member states relating to the safeguarding of employees' rights in the event of transfers of undertakings, businesses or parts of undertakings or businesses, the European Court of Justice confirmed its previous conclusion. It affirmed its position that freedom of contract is a fundamental right protected under Article 16 of the Charter of Fundamental Rights of the European Union. Furthermore, in this case the European Court of Justice used freedom of contract principle in order to prohibit the domestic court from interpreting transposing European Union Directive in a way more beneficial to employees and trade unions.[139] However, fundamental rights provided under the Charter of Fundamental Rights of the European Union are also not absolute. Article 52 of the Charter of Fundamental Rights of the European Union determines their scope. It lists criteria that must be met for the limitation on the exercise of the rights and freedoms recognized by the Charter to be legitimate. Firstly, any limitation must be provided for by law and it must respect the essence of rights and freedoms being limited. Secondly, limitations must be proportionate. Thirdly, limitations must be necessary and genuinely meet objectives of general interest recognized by the European Union or the need to protect the rights and freedoms of others.[140]

The Constitution of Latvia expressly protects various freedoms, e.g. it protects freedom of thought, conscience and religion, freedom of expression, freedom of previously announced peaceful meetings, street processions, and pickets, freedom of trade unions, the freedom of scientific research, artistic and other creative activity.[141] While it does not expressly provide for freedom of contract, it is the case in respect of the majority of Constitutions of member states. Still, in many member states freedom of contract is understood as fundamental right covered under other constitutional provisions. For example, such is the case in Germany, where freedom of contract principle is derived from provisions protecting property, freedom

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[136] *Supra note* 118, 581.
[137] *Supra note* 47, p. 45.
[138] *Österreich GmbH v. Österreichischer Rundfunk*, C 283/11, European Court of Justice, OJ C 71/05 (2013), 42.
[139] *Mark Alemo-Herron and Others v. Parkwood Leisure Ltd.*, European Court of Justice, C-426/11, OJ C 260/06 (2013), 32, 38.
[140] Charter of Fundamental Rights of the European Union, 26 October 2012, OJ C 326, Article 52.
[141] *Supra note* 60, Articles 99, 100, 103, 108, 113.

of occupation and general freedom of action.[142] In turn, in Italy freedom of contract is considered a part of the freedom of economic initiative.[143] So, while the Constitution of Latvia does not expressly provide for freedom of contract, it is reasonable to assume that similarly as in other member states this principles is covered under other constitutional provisions.

Furthermore, Article 89 of the Constitution of Latvia proclaims that:

> [t]he State shall recognize and protect fundamental human rights in accordance with this Constitution, laws and international agreements binding upon Latvia.[144]

One such legally binding instrument that establishes fundamental rights that must be respected both by the European Union and the member states when implementing European Union law is the Charter of Fundamental Rights of the European Union. In turn, as already mentioned freedom of contract is expressly recognized by the European Court of Justice as a fundamental right covered by Article 16 of the Charter of Fundamental Rights of the European Union.

So, it follows that freedom of contract also falls under the definition of fundamental rights protected under the Constitution of Latvia.

This Section established that freedom of contract is a component of the fundamental right to freedom. Therefore, evaluation methodology for assessing limitations on fundamental rights can be used also in assessing limitations put on freedom of contract principle. Taking this into consideration, next Section introduces evaluation methodology for assessing limitations on fundamental rights used in Latvia.

4.2. Evaluation methodology for assessing limitations on fundamental rights

In Latvia, evaluation methodology for assessing limitations on fundamental rights started to develop in 2000, when case No. 2000-03-01 was considered. In this case, evaluating the legitimacy of the legal act, the Constitutional Court of Latvia applied criteria found in the European Convention on Human Rights. Namely, to be legitimate, limitations, firstly, must be provided for by law, secondly, must have legitimate aim, thirdly, must be necessary in a democratic society. In addition, the Constitutional Court of Latvia also evaluated whether limitations are proportionate to the legitimate aim.[145] This evaluation methodology has further evolved and has been refined in further case law. Currently, the Constitutional Court of Latvia applies evaluation methodology that was first used in 2003 in case No. 2002-21-01.[146] In accordance to this case the Constitutional Court of Latvia, when evaluating if a limitation on fundamental right is justified, needs to determine the following. Firstly, if a limitation on fundamental right is provided for by properly adopted law. Secondly, if a limitation has a

[142] Flessner, «Freedom of Contract and Constitutional Law in Germany», pp. 88-89.
[143] Colombi, «Party Autonomy as a Fundamental Right in the European Union», p. 313.
[144] *Supra note* 60, Article 89.
[145] Spriedums lietā Nr. (Decision in case No.) 2000-03-01, the Supreme Court of Latvia (2000).
[146] Spriedums lietā Nr. (Decision in case No.) 2002-21-01, the Supreme Court of Latvia (2003).

legitimate aim. Thirdly, if a limitation complies with proportionality principle or if selected means are proportionate to legitimate aim of a limitation.[147]

For contested legal norm / act, that limits fundamental rights, to be recognized as compatible with the Constitution of Latvia, all listed criteria must be met. If the Constitutional Court of Latvia finds that at least one criteria is not met, the contested legal norm / act is recognized as unconstitutional.[148] In order to better understand, when legal norm / act can be declared unconstitutional, current criteria for evaluation of limitations on fundamental rights, must be analyzed in detail.

Conclusion

Chapter 4 established that freedom of contract was a component of the fundamental right to freedom and therefore evaluation methodology used for assessing limitations on fundamental rights, can be used for assessing limitations put on freedom of contract principle. Then Chapter 4 outlined this evaluation methodology and its main criteria. In turn, Chapter 5 will proceed to discuss each criterion in detail and apply them to the limitation on freedom of contract in case of transfer of an undertaking set in Article 20.

5. APPLICATION OF EVALUATION METHODOLOGY TO LIMITATION ON FREEDOM OF CONTRACT IN CASE OF A TRANSFER OF AN UNDERTAKING

Previous Chapters of the Thesis have demonstrated that freedom of contract, while a component of a fundamental right, is not an absolute right. In certain cases, limitations on freedom of contract principle are justified. So, the existence of the limitation on freedom of contract principle in Article 20 in itself does not make Article 20 incompatible with freedom of contract principle. What is crucial, is determining when freedom of contract principle and when governmental intervention needs to prevail. In order to answer this question, Chapter 4 introduced evaluation methodology used for assessing limitations on fundamental rights. In turn, Chapter 5 endeavors to apply each introduced evaluation criterion to the limitation on freedom of contract principle set in Article 20. In doing so, ultimately, Chapter 5 seeks to answer the research question, *i.e.* whether Article 20 is compatible with freedom of contract principle.

5.1. Criterion I – properly adopted law

The first criterion that is analyzed, is whether limitation on fundamental rights is set in properly adopted law. The Constitutional Court of Latvia clarified criteria for assessing whether law is properly adopted, *inter alia* in judgement No. 2008-12-01 of February 04, 2009. For the contested legal norm / act to meet this criterion it needs to comply with the following requirements. Firstly, the law had to be adopted in compliance with the procedures established in normative acts. Secondly, the law had to be promulgated and publically

[147] Balodis, «Pamattiesību ierobežojumu pieļaujamība demokrātiskā valstī» («Permissibility of limitations of fundamental rights in a democratic state»). Available on: http://www.satv.tiesa.gov.lv/articles/pamattiesibu-ierobezojuma-konstitucionalitates-izvertesana-satversmes-tiesas-prakse/#_ftn12. Accessed April 10, 2018.
[148] *Supra note* 147.

available in accordance with the requirements of normative acts. Thirdly, it needs to be expressed in a sufficiently clear manner. So, the individual can understand the content of the right and obligation arising out of the legal norm as well as envisage the consequences of its application.[149]

To note, legal norms / acts are rarely recognized as unconstitutional on this basis. Usually, it happens only in cases, when the legislator has violated the authorization provided for by the law.[150] Similarly, Article 20 meets this requirement. The Commercial Law itself as well as all its amendments were properly adopted and there is no indication that the procedure established in normative acts was breached in any way. Similarly, there is no indication that Article 20 was not promulgated and publically available in accordance with requirements of normative acts. So the second requirement is not contested.

Third requirement, however, requires more in-depth analysis. Third criterion assesses if the law is expressed in a sufficiently clear manner. Similarly, the ECHR has repeatedly indicated that law limiting fundamental rights needs to be expressed in a sufficiently clear manner and be foreseeable. Namely, the legal norm needs to be expressed in such a way that an individual would be able to regulate his behavior.[151] This ensures adequate safeguard for an individual.[152]

At the time, this Thesis was started, it would have been argued that the law was not expressed in a sufficiently clear manner. Understanding what exactly was meant under the term «transfer of an undertaking» and whether transfer of an undertaking was taking place could be quite a challenge.[153] Until recently, case law in relation to the transfer of an undertaking was very limited and ambiguous. For example, in the decision of March 10, 2014 in case No. C29715111, Rīga District Court recognized transfer of an undertaking, when SIA «Latvijas Keramika A» invested in equity capital of AS «Latvijas Keramika» its real estates as well as some movable assets.[154] Rīga District Court has made such a decision even though the previous year, the Supreme Court of Latvia in the decision of November 5, 2013 in case No. C04367311 established that transfer of an undertaking did not take place even though SIA «Mežlejas» similarly as in previous case transferred to SIA «Cerība Pluss» both real estates and movable assets.[155] This ambiguity resulted in many individuals not knowing whether what they were doing was in fact transfer of an undertaking. Consequently, individuals did not know whether liability rules set in Article 20 applied.

However, it must be noted, that during the time this Thesis was being written, the Supreme Court of Latvia issued important judgements clarifying what criteria need to be assessed when

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[149] Spriedums lietā Nr. (Decison in case No.) 2008-12-01, the Constitutional Court of Latvia (2009).
[150] Spriedums lietā Nr. (Decison in case No.) 2013-21-03, the Constitutional Court of Latvia (2014), at 12.6.
[151] Spriedums lietā Nr. (Decision in case No.) 2010-55-0106, the Constitutional Court of the Republic of Latvia (2011); *Sunday Times v. The United Kingdom*, 50/1990/241/312, Council of Europe: European Court of Human Rights (1991), at 49; *Larissis et al v. Greece*, 140/1996/759/958–960, Council of Europe: European Court of Human Rights, (1998), at 40.
[152] Spriedums lietā Nr. (Decision in case No.) 2010-55-0106, the Constitutional Court of the Republic of Latvia (2011); *Hashman and Harrup v The United Kingdom,* 25594/94, Council of Europe: European Court of Human Rights, (1999), at 31.
[153] Girne, «Uzņēmuma pāreja – praktiskie aspekti – ifinanses» *ifinanses* (2011), available on: http://ifinanses.lv/raksti/vadiba/saimnieciska-darbiba/uznemuma-pareja-praktiskie-aspekti/2924. Acessed April 20, 2017, p. 1.
[154] *Supra note* 15.
[155] *Supra note* 16.

analyzing if transfer of an undertaking takes place. The Supreme Court of Latvia in the decision of November 09, 2017 in case No. SKC 340/2017 ruled that the following can indicate that transfer of an undertaking takes place: transfer of employees to the acquirer, transfer of assets and stocks, takeover of bank liabilities, transition of the board member of the transferor to the acquirer.[156]

While, it is possible that in practice there can still be some uncertainties as to when transfer of an undertaking takes place and when it does not, mentioned decision of the Supreme Court of Latvia clarified a lot of uncertainties in relation to the ambiguous wording of Article 20. Taking this into consideration, it can be concluded that currently third requirement for the law to be considered properly adopted is met as well.

This Section established that Article 20 met all three requirements of properly adopted law. It did not provide arguments suggesting that Article 20 was not adopted in compliance with the procedures established in normative acts or was not promulgated and publically available in accordance with requirements of normative acts. On the other hand, in respect of the third requirement it was suggested that until recently there was much confusion in respect of understanding the meaning of the «transfer of an undertaking». However, considering that recently the Supreme Court of Latvia issued important judgement, clarifying this term, third requirement of properly adopted law is met as well.

5.2. Criterion II – a legitimate purpose

Second criterion for assessing limitation on fundamental rights set in Article 20, is whether this limitation has a legitimate purpose.

The Constitutional Court of Latvia has repeatedly affirmed that at the basis of limitations on fundamental rights must be circumstances and arguments, justifying their necessity. The limitation may be imposed only for important reason – to achieve legitimate purpose.[157] As legitimate purpose, the Constitutional Court of Latvia recognizes protection of other constitutional values.[158] Article 116 of the Constitution of Latvia as legitimate aims, which can justify limitations of fundamental rights lists protection of the rights of other people, the democratic structure of the State, and public safety, welfare and morals. So, the purpose of Article 20, *i.e.* protection of creditors, falls under the protection of the rights of other people. Therefore, Article 20 has a legitimate purpose.

However, while the purpose of Article 20 is legitimate, its general nature – protection of creditors brings additional questions. What is intended as legitimate purpose of Article 20 – is it protection of creditors in general or is it protection of creditors from fraudulent transfers (*in fraudem creditorum*) in particular. Such question appeared after taking a look at the European Contract Law. Chapter 2 of the Thesis demonstrated that in both European Contract Law and normative acts of the EU member states there were provisions limiting freedom of contract principle in particular for the protection of creditors against fraudulent transfers of assets intended to defraud creditors

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[156] *Supra note* 17.
[157] Spriedums lietā Nr. (Decision in case No. 2004-18-0106), the Constitutional Court of Latvia (2005), at 16; Spriedums lietā Nr. (Decision in case No.) 2007-08-01, the Constitutional Court of Latvia (2007), at 14.
[158] Spriedums lietā Nr. (Decision in case No.) 2005-19-01 9, the Constitutional Court of the Republic of Latvia (2005), at 9.

While, regardless of the answer, the purpose of Article 20 remains legitimate, it may affect examination of other evaluation criteria used for assessing limitation on fundamental rights. In particular, it is can be important for assessing the second requirement of proportionality, *i.e.* if there is less restricting method available for achieving legitimate purpose. As will be demonstrated, assessment of this criterion depends also on the scope of the legitimate purpose of the limitation. Whether the legislators introduced this limitation generally for the protection of creditors or for the protection of creditors from fraudulent transfers, in particular.

Having established legitimate purpose of Article 20 as falling under Article 116 of the Constitution of Latvia, *i.e.* protection of the rights of other people, another question arises. Does protection of rights of other people justify governmental intervention in all circumstances? Does all potential harm to third parties justify governmental intervention? In order to attempt to answer this question, introduction of certain economics terms is required. In economics terms, harm to third parties resulting from the contract to which they are not parties, is understood as externalities that impose costs.[159] Welfare economists also recognize that there are costs produced by market transactions that parties to the transaction never pay. This creates a problem as because of externalities it is possible that concluded contracts result in greater social costs than benefits. Further, in most cases parties to the contract are not required to compensate third parties shouldering the burden of externalities. In order to remedy this market failure, the government in certain cases finds it necessary to interfere by limiting costs shouldered by third parties.[160]

However, the majority of contracts result in some sort of third-party effect. For example, if person A concludes a contract for the sale of the rare painting with person B, person C, who wanted to add this painting to his collection, may end up very disappointed. Another example occurs if person A opens the bakery next to person's B bakery and by offering lower prices and wider variety of goods proceeds to drive person B away from business. In such a situation, each transaction between person B and his customers adversely affects person A. In turn, person A concluding a contract for buying a new car causes an increase of pollution in the environment, which imposes costs on the society in general. Also, if person A buys the most tasteless garish outfit from the shop and then wears it, it may offend sense of taste of person B, thus adversely affecting him. These are just a few examples of contracts imposing costs on non-consenting third parties. However, if freedom of contract principle was to be restricted in order to avoid listed externalities, there would not be freedom of contract at all.[161] There are of course examples when third-party effects clearly have to limit freedom of the contract. One of the most vivid examples is an agreement between person A and person B to rob a bank. Also, clearly State Revenue Service may not appreciate an agreements between the employer and the employee, where parties undertake to hide the precise amount of employee's income.[162] So, as can be seen in certain cases governmental intervention is certainly required, while in other cases it would serve only to unnecessary restrict freedom of contract.

So, solely the existence of externalities does not justify limiting freedom of contract. What is important, is what kind of externalities and under what circumstance justify limitations being

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[159] Cserne, *Freedom of Contract and Paternalism: Prospects and Limits of an Economic Approach. Perspectives from Social Economics*, pp. 34-36.
[160] Desautels-Stein, «The Market as a Legal Concept», p. 406.
[161] Trebilcock, *The Limits of Freedom of Contract*. Harvard University Press, pp. 58-59.
[162] *Supra note* 159, pp. 34-36.

imposed on freedom of contract. Without doubt, the essential, but insufficient condition, is that the externality adversely affects certain person and causes him material harm. However, this is just a minimum threshold that alone does not justify limitation on freedom of contract. Meeting this threshold is not sufficient. Freedom of contract limitation is justified only, when, in addition, externalities cause the particular contract to become economically inefficient. This approach is based on the assumption that the main purpose of contracting is efficiency. The society benefits if parties contract in ways that are efficient even if these contracts produce externalities. For instance, if parties conclude a contract for building a major sport base, it has adverse effects – incessant noise, dust, and traffic impairment. On the other hand, the whole town will benefit from such a contract as it will make a city more vibrant and attractive to tourists.[163] So, for the restriction on freedom of contract to be justified, existence of externalities is not sufficient. There must be such externalities that cause contract to be economically inefficient.

So, the existence of the legitimate aim or in this case adverse-effects from which third party needs to be protected, is not enough. Question of efficiency must be also considered. This conclusion is in line with the evaluation methodology for assessing limitations on fundamental rights, even though in it the question of efficiency is approached from a different angle. In particular, evaluation of the third proportionality criteria also involves assessment, whether the measures taken by the legislators correspond to the particular issue, meaning whether the benefit to society from limitation imposed by the government on the freedom of contract principle outweighs adverse effects suffered by the individuals.[164] So, assessment of the question of efficiency will be considered in relation to that criterion, and its evaluation is not required in connection to the legitimacy of the purpose.

This section established that Article 20 had a legitimate purpose. Its purpose is the protection of creditors, which falls under the protection of the rights of other people. In turn, the Constitution of Latvia lists protection of the rights of other people as a legitimate purpose. However, while this Section established that purpose of Article 20 was legitimate, it also questioned its scope. While not affecting the legitimacy of the purpose, whether Article 20 was intended to protect creditors in general or protect them from fraudulent transfers in particular, is important for assessing other evaluation criteria, in particular, second requirement of proportionality. Further, this Section also demonstrated that existence of potential adverse-effects to people did not always justify governmental intervention. Governmental intervention is justified only if it is efficient. This conclusion, in turn, brings the Thesis to the discussion of the third evaluation criterion for assessing limitation on fundamental rights – proportionality.

5.3. Criterion III – proportionality

The last criterion that needs to be analyzed is proportionality of the limitation on fundamental rights. The limitation is considered to be proportionate if three following requirements are met. If at least one criterion is not met, it means that the contested legal norm /act does not comply with the proportionality principle. First requirement establishes that method designated by the legislator must be appropriate for achievement of the particular legitimate

[163] Schwarcz, «Collapsing Corporate Structures: Resolving the Tension between Form and Substance», pp. 115-116.
[164] *Supra note* 147.

purpose. Under the second requirement, it is assessed if there is other less disruptive method, with which the legitimate purpose may be achieved. Lastly, under the third requirement it is assessed whether the measures taken by the legislators correspond to the particular issue.[165]

5.3.1. Chosen method appropriate for achieving legitimate purpose

In respect of the first criterion, it is evaluated if the method designated by the legislator is appropriate for achieving particular legitimate purpose. Meaning, it is evaluated whether legitimate purpose is in fact achieved through chosen method.[166] This criterion is analyzed taking into consideration practical application of the contested legal norm / act.[167]

Applying this criterion to the case of a transfer of an undertaking, it is assessed whether Article 20 achieves its legitimate purpose. Does it ensure protection of creditors?

Article 20 certainly provides some safeguards to creditors in case of a transfer of an undertaking. It ensures that the main interest of the creditors, *i.e.* to redeem a debt, is not undermined in case of a transfer of an undertaking. Article 20 certainly improves chances of creditors to receive satisfaction in case of a transfer of an undertaking. Article 20 protects creditors by ensuring that in case of a transfer of an undertaking creditors get right to claim in respect of the acquirer, while for the period of time retaining right to claim in respect of the transferor also.[168]

However, while Article 20 certainly protects creditors to some extent, there are also arguments that it does not fully achieve its purpose. For example, A. Strazds argues that regulation established in Article 20 does not fully achieve legislator's intent – protections of the rights of third persons. He claims that there is no objective justification for the different treatment of obligations that arise prior to the transfer of the undertaking with the term for fulfilment being within five years after the transfer, for which solidary liability of the transferor and the acquirer is prescribed, and all other obligations, for which the acquirer has sole liability. Under this regulation the acquirer is solely liable for those obligations, whose term for fulfilment has set in before the transfer of an undertaking. As creditors' consent to the transfer is not required, this provision may significantly prejudice creditors' chances of repayment if the new debtor is worse off financially than the previous debtor.[169]

Further, A. Strazds argues, that even though in accordance with Article 20 Part one the creditor is entitled to request from the acquirer of an undertaking the performance of an obligation, this right of the creditor is useless if a creditor is unaware of the transfer of an undertaking and in particular about the transfer of an obligation. This means that the ultimate goal of the legislators, *i.e.* protection of creditors' rights is not fulfilled.[170]

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[165] Spriedums lietā Nr. (Decision in case No.) 2013-08-01, the Constitutional Court of the Republic of Latvia (2014), at 12; Spriedums lietā Nr. (Decision in case No.) 2014-34-01, the Constitutional Court of the Republic of Latvia (2015), at 16.
[166] Spriedums lietā Nr. (Decision in case No.) 2011-02-01, the Constitutional Court of the Republic of Latvia (2011), at 15.
[167] *Supra note* 166, at 15.
[168] *Supra note* 12, p. 116.
[169] *Supra note* 34, p. 651.
[170] *Supra note* 34, p. 654.

While Article 20 certainly improves creditors chances at redeeming their debts in case of transfer of an undertaking, it does not fully achieve its legitimate purpose – protection of creditors.

5.3.2. Less restricting method available for achieving legitimate purpose

In respect of the second criterion, it must be analyzed if there is at least one less restricting method, with which the legitimate purpose can be achieved at least in the same amount.[171]

The protection of creditors can be achieved through the variety of ways.[172] One of alternative solutions for safeguarding creditor interests mentioned by Yedidia Z. Stern is disclosure requirement. Adverse effects to creditors may be limited by requiring shareholders of the debtor company to disclose all information about any potential wealth transfers that may have adverse effects on creditors to them.[173]

For example, disclosure obligation is the core requirement in the framework of transfer of an undertaking under Lithuanian law. Under Lithuanian law, creditors must be informed before the transfer of an undertaking has taken place of future transfer. In Lithuania the transfer can take place only with consent of the creditor.[174]

Disclosure obligation in case of a transfer of an undertaking is prescribed also in Article 562 of the Civil Code of Russian Federation. It also prescribes that creditors have to be informed about the transfer prior to the conclusion of the agreement. If the creditor does not agree with the transfer of the debt to the acquirer he has options: 1) to request the up-front fulfillment of obligation, 2) to request termination of contract and reimbursement of loses or 3) to request to acknowledge the sale-purchase agreement or its part void within three months.[175]

S. Grundmann also writes in support of mandatory disclosure rules. While, his work mostly concerns disclosure obligation with the aim to protect consumers, his arguments can be used in other contexts as well. S. Grundmann argues that mandatory disclosure rules do not limit parties' autonomy but in fact promote it as they do not limit contractual conditions available. Pursuant to S. Grundmann such disclosure rules help market failure in the case of unavoidable information asymmetries, but simultaneously do not needlessly restrict market mechanisms.[176]

Governmental intervention in economics is often justified by reference to market failure. S. Grundmann points to one type of market failure especially important for European Contract Law, namely, information asymmetries. He claims that information on relevant issues is required in order to reach rational wealth maximizing decision, consequently information is required for the functioning of markets.[177]

However, it needs to be admitted that examples of disclosure procedures being implemented in Lithuanian and Russian legal systems, are even more restrictive than liability rule

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[171] Spriedums lietā Nr. (Decision in case No.) 2008-42-01, the Constitutional Court of the Republic of Latvia (2009), at 17.2; Spriedums lietā Nr. (Decision in case No.) 2009-85-01, the Constitutional Court of the Republic of Latvia (2010), at 16.
[172] *Supra note* 33, p. 698.
[173] *Supra note* 33, p. 687.
[174] Jakutytė-Sungailienė, «Protection of Creditors' Rights in Asset Deal, p. 203.
[175] The Civil Code of Russian Federation. Part One (November 30, 1994), Article 562.
[176] Grundmann, «Information, party autonomy and economic agents in European Contract Law», p. 269.
[177] *Supra note* 176, pp. 277-280.

prescribed in Article 20. In the case of Lithuania, the disclosure obligation goes hand in hand with the legal rule making transfer of an undertaking conditional on creditor's consent. In turn, in the context of Russia, disclosure obligation goes together with the right to request to acknowledge the sale-purchase agreement or its part void. Both these options are even more restrictive than Latvian liability rule prescribed in Article 20. This rule just allocates liability, while the rules prescribed in Lithuanian and Russian legal systems give the creditor the power to break off the deal between the transferor and the acquirer. Taking this into consideration, less restricting method for protecting creditors in this case was not found. It means that the second criterion of proportionality is met.

However, as was stated previously, there is another factor that affects assessment of this criterion. In order to assess if there is less restricting method available for achieving legitimate purpose, it is important, what exactly is the legitimate purpose of Article 20. Is it the protection of creditors in general or is it protection of creditors from fraudulent transfers in particular. If the legitimate purpose of Article 20 indeed is the general protection of creditors, then previous discussion does not reveal less restricting method available for achieving legitimate purpose. On the other hand, if the legitimate purpose of Article 20 is protection of creditors from fraudulent transfers in particular, then less restricting methods can be found both in European legal instruments as well as in national laws of EU member states. For example, this legitimate aim can be achieved by already existing right of the creditor to challenge any legal act made by the debtor with the intention to defraud the creditor. This way the creditors are protected from fraudulent contracts, but freedom of contract of honest transferors and acquirers is not violated. Examples of such provisions are included in a number of European legal instruments as well as in provisions of national law of EU member states.

Article 1167 of the Proposals for Reform of the Law of Obligations and the Law of Prescription contains provision granting creditors the right to challenge any legal act made by the debtor with the intention to defraud the creditor. Also, Article 154 of the European Code of Contract Preliminary Draft stipulates that contracts drafted with the intent to defraud a creditor of one of the parties are not opposable to third parties (creditors). Similarly, provision aimed to protect creditors from fraud is found in the French Civil Code (*fraude paulienne*). Article 1167 states that creditors «may also, on their own behalf, attack transactions made by their debtor in fraud of their rights».[178] Similarly, Italian law also has protective measures against fraudulent acts. Articles 2901 to 2904 of the Civil Code regulate *action révocatoire* in case of fraudulent acts. Similar provisions intended for safeguarding creditor rights are present *inter alia* also in Dutch law, Spanish law, Belgian law, Quebec law *et al.*[179]

To conclude, whether the second criterion of proportionality is met, depends on the scope of the legitimate purpose of Article 20. If the legitimate purpose of Article 20 is the general protection of creditors then this criterion is met. The discussion has not revealed less restricting method available for achieving legitimate purpose. While disclosure obligation was suggested as less restrictive method, it was established that disclosure obligation alone was not sufficient. Usually it goes together with provisions making transfer of an undertaking conditional on creditor's consent. In turn, such provisions are even more restrictive than liability rule set in Article 20. On the other hand, if the legitimate purpose of Article 20 is

[178] *Supra note* 96, p. 341.
[179] *Supra note* 49, pp. 445-6.

protection of creditors from fraudulent transfers in particular, then there are less restrictive methods for achieving this legitimate purpose. One example of such less restrictive measure is provision granting the creditors the right to challenge any legal act made by the debtor with the intention to defraud the creditor. Examples of such provisions can be found both in European legal instruments as well as in national laws of EU member states. Such provisions protect creditors from fraudulent contracts, but do not infringe on freedom of contract of honest transferors and acquirers.

5.3.3. Net effect of the limitation

Lastly, when evaluating whether limitation is proportionate, it is necessary to consider if measures taken by the legislators correspond to the particular issue. It requires contrasting adverse effects imposed on individuals due to restriction on their fundamental rights, with the benefit to the society in general. It is assessed, whether the benefit to society outweighs adverse effects suffered by individuals.[180]

Analysis of this criterion in fact involves the performance of efficiency analysis. In law and economics efficiency is generally understood as either Pareto or Kaldor-Hicks efficiency. Pareto efficiency is achieved if everyone is made better off without making anyone worse off. However, considering that in most cases it is impossible, achieving Pareto efficiency is also impossible. In turn, Kaldor-Hicks efficiency is achieved if the net benefit exceeds the net harm including externalities.[181] So, the evaluation of this criterion of proportionality involves evaluating whether Article 20 is Kaldor-Hicks efficient.

Benefit to society

Existence of such test ensures that government has the right to limit freedom of contract only if it is efficient. In order to determine if Article 20 is efficient it is necessary to compare benefit to society resulting from Article 20 with adverse effect suffered by the transferor and the acquirer due to their freedom of contract being restricted.

Firstly, it can be argued that the society in general benefits from Article 20 as it is advantageous for the economy of the state. It has been argued that improved creditor protection can increase output, investment, and credit penetration.[182]

Secondly, in this case, benefit to society resulting from Article 20 means benefit to creditors. This Article ensures that the main interest of creditors, *i.e.* to redeem a debt is not undermined in case of a transfer of an undertaking.

However, in order to correctly assess benefit to the creditors resulting from Article 20, the adverse effect that creditors could have suffered in the absence of it, needs to be looked at. As was previously mentioned, in the absence of Article 20 creditors' ability to redeem the debt could be undermined. Consequently, Article 20 ensures that the ability of creditors to receive satisfaction is not adversely affected. However, this seemingly great benefit is reduced significantly, if creditors themselves are able to ensure protection of their rights.

For example, Yedidia Z. Stern argues that already at the initial stages of negotiations creditors know about existing agency problem, meaning that shareholders of the debtor company have

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[180] *Supra note* 147.
[181] *Supra note* 163, pp. 117-118.
[182] Balmaceda, Fischer, «Economic Performance, Creditor Protection and Labor Inflexibility», p. 553.

different goals from that of creditors and their business decisions may have some adverse effect on creditors. Knowing this, creditors may take precautions already at the initial stage, when issuing the loan to the debtor. Creditors may carefully draft loan agreements including in them clauses ensuring protection in case of certain events. Creditors may also set an increased interest rate covering the potential future risks.[183]

However, Yedidia Z. Stern provides also opposing arguments. Firstly, the assumption that creditors are aware of the potential risks and can integrate them into the contact is true only for contract creditors. It does not apply to involuntarily creditors such as consumers, tax authorities, etc. Secondly, Yedidia Z. Stern argues that not all creditors have the possibility to adequately protect themselves from future risks. In many cases, only large and influential creditors, for example, such as banks, have an opportunity to draft complicated contracts with incorporated safeguards and have commercial power to set high compensating interest rates.[184]

Similarly, Aditi Bagchit states that contract creditors are not the group of third parties most deserving of protection, as creditors are able to assess the possibility of non-payment when first entering into contract and accordingly price this risk into the contract. However, similarly as Yedidia Z. Stern, she agrees that it is different for creditors, who are unable to price the risk of non-payment into the initial contract.[185]

So, when analyzing benefit to the creditors resulting from Article 20 it is important to distinguish between creditors who are able to protect themselves through carefully drafted loan agreements and increased interest rates and non-contract creditors, who have no way to protect themselves from possible adverse effects of transfer of an undertaking. Article 20 obviously results in great benefit to non-contract creditors as otherwise they would not have other means of protection. In turn, benefit of Article 20 to contract creditors is not so very great, as these creditors are able to take necessary precautionary measures themselves.

So, as was discussed, Article 20 indeed is beneficial to society in general and creditors in particular. Firstly, it has been argued that improved creditor protection can increase output, investment, and credit penetration and consequently stimulate economy. Secondly, Article 20 is beneficial to creditors themselves as well. However, resulting benefit is much greater for non-contract creditors, who cannot protect themselves from possible adverse effects of a transfer of an undertaking in any other way. In turn, benefit to contract creditors is not so very great, as these creditors are able to take necessary precautionary measures themselves already at the initial stages of negotiations.

Adverse effects

As was demonstrated, governmental interference in the form of Article 20 indeed has some benefits. However, it may has adverse effects as well.

In this context, R. Coase argues against the necessity of governmental intervention in case of externalities. He illustrates his opinion by providing an example of the rancher and the farmer, where rancher's cattle damages farmer's crop. The government reacts by imposing the fine on the rancher. However, what is noteworthy is that the decision to restrain the rancher by fining him may result in as much harm as the harm initially done to the farmer. So, here the main

[183] *Supra note* 33, p. 696.
[184] *Ibid*, pp. 696-697.
[185] Bagchi, «Other People's Contracts», p. 250.

social issue is not to find the best way to restrain the rancher, but rather, to determine what harm is greater in the context of allocation of productive resources. In this case, the choice is between the meet and the crops. However, only the farmer and the rancher themselves can adequately assess the value of each. So, if the rancher considers the value of cattle to be relatively high, he will find a way to come to an agreement with the farmer, for example, by paying him off, or by bargaining with the farmer some other way. Therefore, governmental intervention at best is ineffective and at worst damages the equilibrium that the market could achieve itself. While this example is based on the unrealistic assumption of competitive market free of transaction costs and supplied with perfect information, in more realistic world in certain circumstances governmental intervention may compensate for certain market failures. However, even so, the necessity of governmental intervention must be carefully assessed. In most cases governmental intervention creates new costs that were not present before.[186] However, R. Coase's example, does not concern measures taken by the government in order to protect third parties and therefore his argument about rancher and farmer being able to find market equilibrium themselves does not work in the context of measures intended for creditor protection. Creditors are not parties to the contract and therefore cannot influence the terms of the contract. However, R. Coase's example is still valuable as it illustrates that sometimes governmental intervention can result in as much harm / or even more harm than what was present initially.

In this case, governmental intervention for the protection of creditors embodied in Article 20 certainly has not only benefits, but adverse effects as well. Firstly, there are costs that this Article imposes on the transferor and the acquirer of an undertaking by limiting their freedom of contract. Secondly, this Article may also impose additional costs on the acquirer of an undertaking. While Article 20 focuses on the potential risks to the creditors, it completely ignores the potential risks to the acquirer of an undertaking that can arise due to the transfer. This Article imposes solidary liability of the transferor and the acquirer of an undertaking in respect of liabilities, which originated before the transfer of the undertaking. Therefore, if the transferor was not fully honest, the acquirer may end up being solidary liable for liabilities he knew nothing about. Further, Article 20 ensures that even if the transferor and the acquirer conclude an agreement releasing the acquirer from the liability for obligation that arose before transfer of an undertaking, the creditor can still choose to ask satisfaction from / bring a claim against the acquirer. In this case, the acquirer would be obligated to fulfill the obligation in accordance with the law.

Further, Article 20 imposes costs not only on the parties to the contract for transferring of an undertaking, but on the society in general as well.

It is widely accepted that legal environment has an impact on the financial development of a state and legal environment present in merger and acquisition market is not an exception. In order to expand the states economies and enhance business performances many states develop laws for the regulation of mergers and acquisition.[187] In turn, Article 20 may make Latvian asset purchase deals less attractive for potential investors. Firstly, even though after previously discussed judgement of the Supreme Court of Latvia some ambiguity related to distinguishing between genuine asset deal and transfer of undertaking was cleared, some uncertainty in relation to the interpretation of this provision remains. Article 20 can still make

[186] *Supra note* 160, pp. 406 – 407.
[187] Ciobanu, «Mergers and Acquisitions: Does the Legal Origin Matter?», p. 1236.

potential acquirers question whether what they are doing is transfer of an undertaking and whether they will be liable for certain connected obligations. Such legal confusion may certainly play a role in dissuading potential acquirers from concluding asset purchase deals.

Furthermore, even if the acquirer knows that what he is doing constitutes transfer of an undertaking, Article 20 imposing solidary liability, can result in acquirer deciding against concluding the contract. Such is the case if the acquirer is not ready to rely on the honesty of the transferor about obligations of the undertaking and deal with lengthy legal proceedings in case of dishonesty. In this context the opinion of American professor Marie T. Reilly is relevant, according to whom the rule of non-liability is said to promote alienability of property.[188] So, liability rule set in Article 20 may have detrimental effect on the willingness of potential acquirers to conclude contracts for the transfer of an undertaking and consequently on numbers of acquisition deals structured as transfers of an undertaking. This, in turn, has adverse effects on the society in general.

To sum up, Article 20 has a number of adverse effects. Firstly, this Article imposes costs on the transferor and the acquirer of an undertaking by limiting their freedom of contract. Secondly, this Article also imposes additional costs on the acquirer of an undertaking by failing to adequately protect him from possible fraud on the part of the transferor. Due to this Article the acquirer may end up being solidary liable for liabilities he knew nothing about. Thirdly, Article 20 imposes costs not only on the parties to the contract, but on the society in general as well. This Article may have detrimental effect on the willingness of potential acquirers to conclude contracts for the transfer of an undertaking. Firstly, there still is some ambiguity in relation to what exactly constitutes transfer of an undertaking and consequently whether an acquirer in particular case is liable for certain connected obligations. Secondly, the acquirer knowing that what he is acquiring is an undertaking, may not want to deal with any possible connected obligations. Further, he may not be ready to rely on the honesty of the transferor about obligations of the undertaking and deal with lengthy legal proceedings in case of dishonesty. Both these factors may have detrimental effect on the willingness of potential acquirers to conclude contracts for the transfer of an undertaking and consequently on the financial development of a state in general and merger and acquisition market in particular.

When assessing whether Article 20 meets last criteria of proportionality, it was established that Article 20 had both benefits and adverse effects. In order for Article 20 to meet last criteria of proportionality, the benefit must outweigh adverse effects. The result of comparison depends on the values one attaches to particular benefits and adverse effects and requires economic analysis, which was not the objective of this Thesis. However, what was demonstrated, was that each benefit of Article 20 was out-shadowed by the corresponding adverse effect. Benefit to creditors was out shadowed by costs being imposed on the transferor and the acquirer, especially acquirer. In turn, benefit to the economy of the state, resulting from possible increase in output, investment, and credit penetration was out-shadowed by the corresponding adverse effect on the same economy resulting from decreased number of acquisition deals structured as transfer of an undertaking. Adverse effect on the financial development of a state in general and merger and acquisition market in particular. Taking this into consideration, it cannot be concluded that the benefit resulting from Article 20 outweighs adverse effects. Therefore, last criterion of proportionality is not met.

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[188] Reilly, «Making sense of successor liability», p. 746.

Conclusion

In order to determine, whether limitation on freedom of contract set in Article 20 was justified, Chapter 5 applied evaluation methodology used for assessing limitations on fundamental rights to Article 20. Each criterion of this evaluation methodology was analyzed. Firstly, it was established that Article 20 met all three requirements of properly adopted law. Therefore, Article 20 meets the first evaluation criteria. Further, Chapter 5 demonstrated that Article 20 had a legitimate purpose and therefore complied with second evaluation criterion. However, having established the existence of legitimate purpose, Chapter 5 also questioned the scope of this purpose. The scope of the legitimate purpose turned out to be crucial for assessing second requirement of proportionality (third evaluation criterion). It was established that, whether the second criterion of proportionality was met, depended on the scope of the legitimate purpose of Article 20. The discussion has not revealed less restricting method available for achieving general protection of creditors. On the other hand, less restrictive measures for achieving protection of creditors from fraudulent transfers were demonstrated. Further, Article 20 did not meet the first requirement of proportionality, as it was demonstrated that Article 20 did not fully achieve protection of creditors. Finally, after performing cost-benefit analysis it was concluded that each benefit of Article 20 was out-shadowed by the corresponding adverse effect. Therefore, it could not be established that the benefit resulting from Article 20 outweighed its adverse effects. Therefore, last criterion of proportionality is not met. Therefore, considering that Article 20 does not meet some evaluation criteria, Article 20 is not justified.

CONCLUSION

This Thesis attempted to find an answer to the research question whether Article 20 was compatible with freedom of contract principle.

Chapter 1 started the discussion by analyzing the limitation put on freedom of contract principle in case of a transfer of an undertaking set in Article 20. Chapter 1 established that the purpose of such limitation was protection of creditors. Having established the existence of the limitation on freedom of contract and its purpose, the Thesis moved research to freedom of contract principle.

In Chapter 2, the Thesis proceeded to define freedom of contract principle and outline its scope. Then it proceeded to analyze the way freedom of contract principle manifested in contemporary legal framework, both in Latvian normative acts and European Contract Law. The analysis determined that, while freedom of contract was a component of a fundamental right, it was not an absolute right. In certain cases, limitations on freedom of contract principle are justified. So, the existence of the limitation on freedom of contract principle in Article 20 in itself does not make Article 20 incompatible with freedom of contract principle. What is crucial, is determining when freedom of contract principle and when governmental intervention needs to prevail.

Continuing the discussion on freedom of contract principle, Chapter 3 studied origins and philosophical underpinnings of freedom of contract principle and analyzed the most vivid historical case law related to this principle. A look into historical development of freedom of

contract principle indicated the need for balance between freedom of contract principle and the necessity of governmental interference. It also suggested the need for in-depth analysis for determining when limitations on freedom of contract principle were justified and when, on the other hand, freedom of contract principle should prevail.

For this purpose, Chapter 4 introduced elaborate evaluation methodology used by Constitutional Court of Latvia for assessing limitations on fundamental rights. Chapter 4 established that freedom of contract was a component of fundamental right to freedom and therefore evaluation methodology used for assessing limitations on fundamental rights, could be used for assessing limitations put on freedom of contract principle.

Chapter 5 proceeded to apply introduced evaluation methodology to the limitation on freedom of contract set in Article 20. All introduced evaluation criteria were analyzed. It was established that Article 20 complied with two evaluation criteria. Firstly, it is a properly adopted law. Secondly, it has a legitimate purpose. However, Article 20 does not comply with proportionality criteria. Firstly, Article 20 does not meet the first requirement of proportionality, as it was demonstrated that Article 20 did not fully achieve protection of creditors. Secondly, there is some ambiguity, whether second requirement of proportionality is met. It depends on the scope of the legitimate purpose of Article 20. The discussion has not revealed less restrictive method available for achieving general protection of creditors. On the other hand, less restrictive measures for achieving protection of creditors from fraudulent transfers were demonstrated. Finally, it was concluded that third requirement of proportionality was not met as well. After performing cost-benefit analysis it was demonstrated that each benefit of Article 20 was out-shadowed by the corresponding adverse effect. Therefore, it could not be established that the benefit resulting out of Article 20 outweighed its adverse effects.

To conclude, considering that freedom of contract, while a component of fundamental, is not an absolute right, the existence of the limitation on freedom of contract principle in Article 20 in itself does not make Article 20 incompatible with freedom of contract principle. Limitation is incompatible only if unjustly limiting freedom of contract. In this Thesis in order to determine whether limitation on freedom of contract included in Article 20 was justified, evaluation methodology used for assessing limitations on fundamental rights was applied. The analysis demonstrated that one out of three evaluation criteria was not met, therefore it was concluded that Article 20 was not compatible with freedom of contract principle.

Having reached the conclusion that Article 20 is not compatible with freedom of contract principle, the next step is to develop legal rule in respect of allocation of liability in case of transfer of an undertaking, if any, that in fact is compatible with freedom of contract principle and simultaneously provides sufficient protection to unrelated third parties as well. While, the objective of this Thesis was merely to analyses the compatibility of Article 20 with freedom of contract principle and not to find the ultimate legal solution to the allocation of liability in case of transfer of an undertaking, this topic is recommended for further research.

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