

The law applicable to contractual obligations (Rome I Regulation) - a summary and practical guidance on its impact on contractual obligations concluded by Cyprus companies

From 17 December 2009 Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations ("Rome I Regulation") is directly applicable in Cyprus and all other Member States of the European Union, apart from Denmark. The importance of this Regulation is highlighted by the fact that many Cyprus companies frequently enter into agreements with counterparts based in different jurisdictions regarding matters which have relevance to foreign countries.

The following paragraphs provide a summary of the rules by which the law applicable to contractual obligations is determined in accordance with the Rome I Regulation and a practical guidance on its impact on contractual obligations concluded by Cyprus companies as from 17 December 2009.

1) Freedom of choice – the primary principle

One of the cornerstones of the system of conflict-of-law rules in matters of contractual obligations is the freedom of the parties to choose the applicable law.¹ Cyprus companies which enter into contracts are free to choose the law applicable to their contracts,² subject to the limitations discussed below.

The law chosen by the parties will govern issues such as interpretation of the contract, performance of the contract, prescription and limitation of actions, consequences of breach of obligations or nullity of the contract and will apply also if a contractual dispute arises.³ Moreover, in connection with the issues of existence and validity of a contract and its terms, formal requirements, capacity of persons and burden of proof, the Rome I Regulation allows the parties to invoke, or have regard to, other legal regimes.⁴

Form of choice of law

A choice of law governing a contract must be made expressly or must be clearly demonstrated by the terms of the contract or the circumstances of the case.⁵

The choice of the governing law must not be mistaken with the choice of court. The former refers to the selection of law which will govern contractual obligations of the

¹ Recital 11 of the Rome I Regulation

² It is to be noted that certain categories of obligations are expressly excluded from the scope of the Rome I Regulation. These include, inter alia, the constitution of trusts and the relationship between settlors, trustees and beneficiaries, questions governed by the law of companies (such as the creation, legal capacity, internal organisation, winding-up of companies or personal liability of their officers and members), obligations arising out of dealings prior to the conclusion of a contract, or obligations of negotiable character arising out of bills of exchange, cheques, promissory notes and other negotiable instruments.

³ Article 12 of the Rome I Regulation

⁴ Articles 10, 11, 13 and 18 of the Rome I Regulation

⁵ Article 3 (1) of the Rome I Regulation

parties to a contract whilst the latter refers to the determination of the court which will be the forum for resolution of any dispute that may arise between the parties under such a contract. Nevertheless, the choice of court might serve as an indicator when considering whether a choice of governing law has been clearly demonstrated.⁶

The parties can choose the law applicable to the whole or to part only of the contract. The parties are also free at any time to change their choice of law governing the contract. Any such change will not prejudice the formal validity of the contract or adversely affect the rights of third parties.⁷

While choosing the applicable law, the parties can additionally incorporate by reference into their contract an international convention or a non-State body of law.⁸

Is there a requirement of connection with the country whose law has been chosen?

The answer is - not necessarily. The parties can choose the law of a particular country as the governing law of the contract even if all elements relevant to the situation at the time of choice are located in a different country. Nevertheless, there are certain limitations in such instances.

Firstly, the choice made by the parties will not exclude the application of provisions of the law of the relevant country which cannot be derogated from by agreement⁹ and, secondly, where the relevant country is a Member State of the European Union, the parties' choice of applicable law other than that of a Member State cannot prejudice the application of provisions of Community law, where appropriate as implemented in the Member State of the forum, which cannot be derogated from by agreement.¹⁰

Consequently, two Cyprus companies entering into a contract which relates only to Cyprus or the other Member States could decide that the contract would be governed by the law of a country other than Cyprus or other than a Member State. However, any applicable mandatory provisions of Cyprus law and Community law, such as competition legislation, which cannot be derogated from by agreement will apply in any case.

What happens if the parties do not choose the law applicable to their contract?

In situations where the parties do not choose the law applicable to their contract, for whatever reason, the law which will apply will be determined in accordance with rules set out in Article 4 of the Rome I Regulation. The law governing the most common contracts will be determined as follows:

- (a) a contract for the sale of goods will be governed by the law of the country where the seller is habitually resident;

⁶ Recital 12 of the Rome I Regulation

⁷ Article 3 (1) and 3 (2) of the Rome I Regulation

⁸ Recital 13 of the Rome I Regulation

⁹ Article 3 (3) of the Rome I Regulation

¹⁰ Article 3 (4) of the Rome I Regulation

- (b) a contract for the provision of services will be governed by the law of the country where the service provider is habitually resident;
- (c) a contract relating to a right *in rem* in immovable property or to a tenancy of immovable property will be governed by the law of the country where the property is situated (with the exception of a tenancy concluded for temporary private use for a period of no more than six consecutive months which will be governed by the law of the country where the landlord is habitually resident, provided that the tenant is a natural person who is habitually resident in the same country);
- (d) a franchise contract will be governed by the law of the country where the franchisee is habitually resident and, similarly, a distribution contract by the law of the country where the distributor is habitually resident;
- (e) a contract for the sale of goods by auction will be governed by the law of the country where the auction takes place, if such a place can be determined; and
- (f) a contract concluded within a multilateral system facilitating multiple third-party buying and selling interests in financial instruments in accordance with non-discretionary rules and governed by a single law will be governed by that law.

Contracts not falling into these categories and contracts which contain elements which would be covered by more than one category will be governed by the law of the country where the party required to effect the characteristic performance of the contract has his habitual residence.¹¹ In the case of a contract consisting of a bundle of rights and obligations capable of being categorised as falling within more than one of these specified types of contracts, the characteristic performance of the contract should be determined having regard to its "centre of gravity".¹²

It is important to note that there is an overriding principle of the closest connection. Pursuant to this principle, in situations where it is clear from all the circumstances of the case that the contract is manifestly most closely connected with a different country from that indicated by applying the rules set out above, then the law of that country will apply.¹³ Similarly, in all residual cases which do not fall within the ambit of the rules, the contract will be governed by the law of the country with which it is most closely connected.¹⁴

The courts are given a degree of discretion to determine the country that is most closely connected with the contract. In making the determination the court should take account, *inter alia*, of whether the contract in question has a very close relationship with another contract or contracts.¹⁵ Critical voices have been raised that the

¹¹ Article 4 (2) of the Rome I Regulation

¹² Recital 19 of the Rome I Regulation

¹³ Article 4 (3) of the Rome I Regulation

¹⁴ Article 4 (4) of the Rome I Regulation

¹⁵ Recitals 16, 20 and 21 of the Rome I Regulation

discretionary nature of the court's power to decide what is "most closely connected" could result in increased uncertainty in cross-border transactions.¹⁶

Habitual residence

As can be seen, the Rome I Regulation in many instances associates the determination of the applicable law with the country of habitual residence of one of the parties to the contract. It also defines such a habitual residence. The decisive time for the purposes of determining the habitual residence is the time of the conclusion of the contract.

According to Article 19, the habitual residence of companies, including those incorporated under the laws of Cyprus, and other bodies, corporate or unincorporated, will be the place of their central administration. Where the contract is concluded as a part of the operations of a branch, agency or any other establishment, the place where the branch, agency or establishment is located will be treated as the place of habitual residence. Habitual residence of natural persons acting in the course of their business activity will be their principal place of business.

2) Specified types of contracts (contracts of carriage, consumer contracts, insurance contracts and individual employment contracts)

The Rome I Regulation expressly stipulates specific rules for contracts for the carriage of goods and passengers, consumer contracts, insurance contracts and individual employment contracts.

Contracts for carriage

Freedom to choose the applicable law as the first and foremost option also applies in respect of contracts for the carriage of goods and, subject to a limitation, in respect of contracts for the carriage of passengers.

Contracts for the carriage of goods

In the absence of such a choice, in contracts for the carriage of goods the law of the country of habitual residence of the carrier¹⁷ will apply, as long as the place of receipt or the place of delivery of goods or the habitual residence of the consignor is also situated in that country. Otherwise, the applicable law will be the law of the country in which the delivery of goods as agreed by the parties is to take place.¹⁸

Contracts for the carriage of passengers

Parties to contracts for the carriage of passengers can freely opt only for the law of the country where the passenger or the carrier has his habitual residence, or where the carrier has his place of central administration, or where the place of departure or destination is situated. If the parties do not make a choice of governing law, the governing law will be the law of the country where the passenger is habitually

¹⁶ See E Chvika, 'Rome I: uncertainty on the horizon of cross-border finance transactions', (2009) Butterworths Journal of International Banking and Financial Law 153.

¹⁷ Pursuant to Recital 22 of the Rome I Regulation, the term "carrier" refers to the party to the contract who undertakes to carry the goods, whether or not he performs the carriage himself and the term "consignor" refers to any person who enters into a contract of carriage with the carrier.

¹⁸ Article 5 (1) of the Rome I Regulation

resident, as long as either the place of departure or the place of destination is also situated in that country. Otherwise, the law of the country where the carrier is habitually resident will apply.¹⁹

Furthermore, the overriding principle of the closest connection referred to earlier also applies to contracts for the carriage of goods and passengers. In other words, where the parties have not chosen a governing law and it is clear from all the circumstances of the case that the contract is most closely connected with a country other than the one indicated by an application of the rules set out above, then the law of the closely connected country will apply.²⁰

Consumer contracts

A choice of law is also permitted in consumer contracts but, as the consumer is considered to be the weaker party, the choice is limited by factors aiming to protect the consumer.

Consequently, the choice of law cannot deprive consumers of the protection afforded to them by mandatory provisions of the law of the country where they have their habitual residence, provided that the other party pursues commercial or professional activities in that country or, by whatever means, directs such activities to that country or to several countries including that country, and the contract falls within the scope of such activities.²¹

If no choice of law is made by the parties and the two conditions set out in the preceding paragraph are satisfied, the consumer contract will be governed by the law of the country where the consumer is habitually resident.²² It should be noted that certain categories of consumer contracts expressly listed under Article 6 (4) of the Rome I Regulation are excluded from this general rule.

The "consumer-friendly" rules outlined above do not apply to all consumer transactions. Indeed, the simple fact that the litigant is a consumer is not sufficient for these rules to apply and where the necessary conditions are not satisfied the consumer may be obliged to bring proceedings in a foreign court and on the basis of a foreign law instead of in a court of the country of his habitual residence under its law.²³

Individual employment contracts

In the same way, a choice of law is permitted in individual employment contracts, subject to safeguards in favour of the employee. Hence, by the choice of law employees may not be deprived of the protection afforded to them by provisions which cannot be derogated from by agreement under the law that would be otherwise applicable if no choice were made.²⁴

¹⁹ Article 5 (2) of the Rome I Regulation

²⁰ Article 5 (3) of the Rome I Regulation

²¹ Article 6 (1) and (2) of the Rome I Regulation

²² Article 6 (1) of the Rome I Regulation

²³ P Cachia, 'Consumer contracts in European private international law: the sphere of operation of the consumer contract rules in the Brussels I and Rome I Regulations', (2009) *European Law Review* 479.

²⁴ Recital 35 and Article 8 (1) of the Rome I Regulation

If no choice were made by the parties, the employment contract would be deemed to be governed by the law of the country in which or, failing that, from which the employee habitually carries out his work in performance of the contract. If such a country could not be determined, the contract would be deemed governed by the law of the country where the place of business through which the employee was engaged is situated. If however it appears from the circumstances as a whole that the contract is more closely connected with a different country, the law of that other country applies.²⁵

Insurance contracts

The rules under the Rome I Regulation for determination of the law governing insurance contracts vary according to whether the insurance contract covers a "large risk"²⁶ or not.

An insurance contract covering a large risk, irrespective of the location of the risk, will be governed by the law chosen by the parties and in the absence of such a choice, by the law of the country where the insurer is habitually resident or, where this is clear from all the circumstances of the case, by the law of a different country with which the contract is manifestly more closely connected.

An insurance contract covering a risk situated inside the territory of the Member States which is not a large risk will be also governed by the law chosen by the parties, subject to certain restrictions.²⁷ If the parties do not make a choice of governing law, the contract will be governed by the law of the Member State in which the risk is situated at the time the contract is concluded. If there are several risks, situated in more than one Member State, the insurance contract will be considered as constituting several contracts each relating to only one Member State.²⁸

Additional rules are set out for insurance contracts covering risks for which a Member State imposes an obligation to take out insurance.²⁹

²⁵ Paragraphs 2, 3 and 4 of Article 8 of the Rome I Regulation

²⁶ As defined in Article 5(d) of the First Council Directive 73/239/EEC of 24 July 1973 on the coordination of laws, regulations and administrative provisions relating to the taking-up and pursuit of the business of direct insurance other than life insurance, as amended.

²⁷ Pursuant to Article 7 (3) of the Rome I Regulation the parties may opt only between (a) the law of any Member State where the risk is situated at the time of conclusion of the insurance contract; (b) the law of the country where the policy holder has his habitual residence; (c) in the case of life insurance, the law of the Member State of which the policy holder is a national; (d) for insurance contracts covering risks limited to events occurring in one Member State other than the Member State where the risk is situated, the law of that Member State; or (e) where the policy holder of the insurance contract pursues a commercial or industrial activity or a liberal profession and the insurance contract covers two or more risks which relate to those activities and are situated in different Member States, the law of any of the Member States concerned or the law of the country of habitual residence of the policy holder. Where, in the cases set out in points (a), (b) or (e), the Member States referred to grant greater freedom of choice of the law applicable to the insurance contract, the parties may take advantage of that freedom.

²⁸ Article 7 (3) and 7 (5) of the Rome I Regulation

²⁹ Article 7 (4) of the Rome I Regulation

3) General restrictions - public policy and overriding mandatory provisions

Public policy considerations represent a reason for which a provision of the law otherwise applicable under the Rome I Regulation might not apply. Hence, in accordance with Article 21, the application of a provision of the law of any country specified by the Rome I Regulation may be refused if such application is manifestly incompatible with the public policy of the forum.

The parties' autonomy in choosing the law is generally restricted by the application of the overriding mandatory provisions of the law of the forum and by the possibility of giving the effect to the overriding mandatory provisions of the law of the country where the obligations arising out of the contract have to be (or have been) performed, in so far as those overriding mandatory provisions render the performance of the contract unlawful.³⁰

4) Certain aspects of creditor – debtor – third person relationships

The Rome I Regulation sets out specific rules for determination of law governing certain aspects of the relationship between creditors, debtors and third parties. As the Regulation is directly applicable in Cyprus, these rules will be applied by the Cyprus courts and are therefore significant.

If a creditor has a claim against several debtors who are liable for the same claim, and one of the debtors has already satisfied the claim in whole or in part, that debtor's right to claim recourse from the other debtors is governed by the same law as governs the debtor's obligation towards the creditor. The other debtors may rely on the defences they had against the creditor to the extent allowed by the law governing their obligations towards the creditor.³¹

Where a creditor has a contractual claim against a debtor and a third person has a duty to satisfy the creditor, or has in fact already satisfied the creditor in discharge of that duty, the question whether and to what extent the third person is entitled to exercise against the debtor the rights which the creditor had against the debtor under the law governing their relationship, will be determined by the law which governs the third person's duty to satisfy the creditor.³²

Furthermore, in the absence of agreement to the contrary between the parties, rights of set-off will be governed by the law applicable to the claim against which the right to set-off is asserted.³³ This new rule aims to resolve the more complex situation where a conflict arises because more than one obligation is involved, each obligation is governed by a different law, and the substantive laws contain different rules concerning set-off. But if the right to set-off has been agreed between or among the

³⁰ Article 9 of the Rome I Regulation; Overriding mandatory provisions are provisions the respect for which is regarded as crucial by a country for safeguarding its public interests, such as its political, social or economic organisation, to such an extent that they are applicable to any situation falling within their scope, irrespective of the law otherwise applicable to the contract under the Rome I Regulation.

³¹ Article 16 of the Rome I Regulation

³² Article 15 of the Rome I Regulation

³³ Article 17 of the Rome I Regulation

parties, the applicable law governing that agreement must govern in the same way as before.³⁴

Finally, questions relating to the assignability of claims, the relationship between the assignee and the debtor, the conditions under which the assignment can be invoked against the debtor and the question whether the debtor's obligations have been discharged will be determined by the law governing the assigned claim. The concept of assignment is extended to include outright transfers of claims, transfers of claims by way of security as well as pledges or other security rights over claims. The same rules apply also in respect of the contractual subrogation of a claim.³⁵

5) Concluding remarks

Put into a broader picture, the Rome I Regulation represents an integral part of an ever-growing initiative on the part of the European Union to create a harmonised system of rules in the sphere of private international law. In addition to the rules on choice of law applicable to contractual obligations, issues regulated on the European level include the rules on the determination of law applicable to non-contractual obligations³⁶ as well as rules determining which court has jurisdiction to hear a dispute and when a judgment made by a court of one state must be recognised and enforced by a court of another state.³⁷

The initiative on the European level goes even further - to the substantive law, including the possible development of a "European" contract law. Indeed, the Rome I Regulation³⁸ allows for the possibility of there being rules of substantive contract law, including standard terms and conditions.

Simultaneously, despite the broadly accepted advantages of the Rome I Regulation, it has been criticised on the grounds that a number of the rules lack clarity and that difficulties are likely to arise in applying certain of its provisions in practice.³⁹

In the future we therefore might be witnessing not only the sophistication of conflict of law rules based on experience with their application but also the expansion of the scope of harmonised substantive law leading, potentially, to a European civil code.

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³⁴ E Crawford, 'Applicable law of contract: some changes ahead', (2010) Scots Law Times 21.

³⁵ Article 14 of the Rome I Regulation

³⁶ Regulation (EC) No 864/2007 of 11 July 2007 on the law applicable to non-contractual obligations (Rome II) [2007] OJ L199/40

³⁷ Regulation (EC) No 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgements in civil and commercial matters [2001] OJ L12/1

³⁸ Recital 14 of the Rome I Regulation

³⁹ See E Chvika, n 16 above 152.