

TRANSFORMATIONS IN THE NOTION OF CONTRACTUAL EQUILIBRIUM BETWEEN PARTIES WITH EQUAL BARGAINING POSITION

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Abstract

Purpose – the purpose of this article was to analyse the conception of contractual equilibrium which had dominated in the classical period of contract law and define the problems of the application of such concept in the contractual relationship of parties with equal bargaining position.

Methodology – theoretical methods (analytic, systematic and historical) had been applied in the research.

Findings – the author concludes that the limits of intervention into the contractual relationship of parties with equal bargaining position (especially, business to business contracts) has to be reasoned taking into consideration the concept of contractual equilibrium applied in the period of the classical contract law. What is more, it has been concluded that the court judging on the basis of unequal bargaining power must take into consideration not only the experience and position of the party, but also it must determine, whether a party has used its advantageous position, therefore, the weaker party could not conclude the contract on better terms. In these cases it is important to determine which party has the burden of proof – the party invoking its weaker bargaining position must not only prove the real advantageous bargaining position of counterparty, but also - unsuccessful attempts to conclude the contract with more beneficial provisions.

Research limitations – in this paper the research has been limited to the analysis of the concept of contractual equilibrium which had been dominating in classical period of contract law and the analysis of problems in applying such concept in the contemporary legal relationship between parties with equal bargaining power.

Practical implications – the findings of the research can be applied by judges in determining the criteria which could be the basis for the intervention into contractual relationship between parties with equal bargaining power.

Originality – although Zapolskis, P., Klimas, E., Jurgaitis, V., Jakaitė, A. and some other scholars have analysed particular aspects of contract law which are important for the ensuring the contractual balance in the relationship between the parties with equal bargaining position, the problems of intervention into such contractual relationship has been mentioned only indirectly and the attention has been paid to other aspects. Taking into consideration the absence of legal

doctrine in Lithuanian Republic regarding intervention into legal relationship between parties with equal bargaining power, the research is original.

Keywords: contractual equilibrium, contract freedom, bargaining power, weaker party.

Research type: general review.

Introduction

The notion of contractual equilibrium is considered to be one of the main purposes of contract law – it is a relationship which formally should be reflected in every contract concluded between parties having equal bargaining power. This idea is inseparably related to the principal of contract freedom. Accordingly, changes in this fundamental contract law principal undoubtedly should be considered as changes in the process of ensuring the contractual equilibrium.

The ones who should be mostly concerned with the balance between rights and obligations are the parties of precise precontractual relationship - every person bargains for the most advantageous terms of contract and does not conclude unbeneficial contracts on his own free will. In case the parties are unable to reach the assurance of such contractual balance on their own the state has to interfere by passing the laws (legislative) or by implementing the justice (judiciary). If the contract concluded with the weaker party is taken into consideration the intervention is justified by the solidarity policy of the state and those social purposes which are being achieved using the contract law rules do not raise doubts for most of us. However, such intervention is carried out not only in cases of the relationship with the weaker party. For this reason the question has to be raised, to what extent such interference of the state (especially – the judiciary) into the contractual relationship of the parties with equal bargaining power should be considered as justified.

What is more, it is obvious that the notion of contractual freedom which dominated in the classical period of contract law could not be applied to its full extent because of the dramatic changes in the society and the solidarity policy of modern state. Despite that, sometimes the interference into the contractual relationship between the parties of equal bargaining power can be considered as unjustified and unreasonable, even if the party demands it. The contractual balance of relationship between parties with equivalent bargaining power should be reflected by their concluded contract. Even more - the unreasonable solidarity in respect of one of the parties should be considered as the obstacle of market certainty. For this reason, the intervention into contractual relationship between the parties with equal bargaining power should be executed only in exceptional cases.

I. The content of contractual freedom in the period of classical contract law

The principle of contractual freedom prospered in the classical period of contract law, the golden age of which was the XIX century. During this period the rules of economics were considered to be the background and the essence of law. The assimilation

of general principles of contract law and the market economy grounds determined that the contractual relationships were based on some main rules: the parties dealt with each other “at arm’s length“ and this legal concept meant that every party relies on his own skills and judgments, no one had any fiduciary obligations towards the other. Parties negotiated over the price and terms of the transaction. Offers were submitted, accepted, rejected and counter-offers were presented. The offer could be withdrawn even if it could be relied on it. Neither party had the obligation to disclose all information, also, with rear exceptions, neither party was entitled to rely on the other party. Everyone had to analyse the terms, evaluate the subject-matter of the contract and the general market situation, the future possibilities and had to rely on his sources of information. A party was entitled to advise experts and acquire information from third parties for money. If he did not, it was considered that the party acted at his own risk. The only exception – there had to be no fraud and misrepresentation, however, those rules were interpreted very narrowly. The transaction was considered to be concluded when the parties reached and expressed their agreement. Mistakes and subjective intentions were not important, unless they could influence the free will (consent) of the party, which was essential for the conclusion of the contract. The contract had to be concluded freely and without pressure, despite that, those notions were also interpreted very narrowly, because they could not contradict the rules of market place where certain „not exaggerated“ pressure was held to be a normal phenomenon. The content of the contract, the price and the subject-matter were exclusively the concern of the parties. It was presumed that the parties realize the level of their experience and knowledge and that they are the best judges who are able to evaluate their needs and the possibility that they had estimated the risks and essential terms of the contract. This was considered to be the normal process of bargaining. The prevalence of those essential ideas determined that from the moment of conclusion the parties of the contract could not rely on the unfairness, the gross inadequacy or excess price¹.

The presumption of equal benefit gained from the contract was applied during the classical period of contract law, which meant that deal was considered fair despite the real value of exchange. This presumption was grounded on reasoning that “it is impossible for courts to assess the fairness of exchanges because of the *subjectivity of values*: since individuals value things differently, a contract freely entered into is fair by definition; courts should not second – guess the parties’ preferences and refuse to enforce their contracts. Second, consistent with social Darwinism, exchanges which are grossly unbalanced are regarded as instances of foolishness and carelessness from which parties should not be protected, lest it removes their incentive to be more careful in future“².

„The classical model of contract, which relied upon a utopian of equality of bargaining power and symmetric information between the parties, has declined as a result of dramatic shifts in the technological, political and social organisation of society

¹ Beale, H. G.; Bishop, W. D.; Furmston, M. P. 2006. *Contract. Cases & Materials. 5th Edition*. Oxford: Oxford University Press, p. 47-48.

² Chen-Wishart, M. 2008. *Contract law*. Oxford, New York (N.Y.): Oxford University Press, p. 16.

heralded by unprecedented growth in the production of goods and services and the dominance of standardised business contracts throughout the twentieth century. <...> New European welfarists justify not only judicial interventionism in agreements and policing standard terms, but in addition, the notion that the parties should similarly consider the needs and legitimate interests of their co-contracting partners. Contractual solidarity is now entrenched as a principle of Dutch, French and Spanish contract law¹. It could not be doubted, that economical, technological and social changes have influenced the systems of contract law and obviously – the development of process of ensuring the contractual equilibrium. In spite of that, contract freedom (also – the *pacta sunt servanda* rule) remained to be an important principle of contract law and has not been eliminated².

It is widely acknowledged nowadays, that contract law is best understood as grounded by two fundamental - and conflicting – ideas: autonomy and solidarity. The notion of autonomy is politically related to liberalism and its typical dogmas – contract freedom and *pacta sunt servanda* rules. The idea of solidarity is politically related to socialism and its main rules – good faith and the protection of weaker party’s interests³. Obviously, the balance between those fundamental notions is a hard task of legislation and judiciary.

II. Peculiarity of relationship between parties of equal bargaining position

The need to limit the contractual freedom is obvious in the relationship of parties with unequal bargaining power – those are cases when the contract is concluded with a weaker party, the most often example of which is a consumer contracts. The priority protection of such parties is undoubtedly recognized by the European Union institutions⁴.

¹ Doris, J. M. 2008. *Dispute Avoidance and European Contract Law. Dealing With Divergence*. Groningen: Europa Law Publishing, p. 83-84.

² The principle of contract freedom is enclosed in the Article 6.156 of Civil Code of Lithuanian Republic, *pacta sunt servanda* rule – Article 6.189 subclause 1 (Civil Code of Lithuanian Republic. *Official Gazette*. 2000, No. 74-2262).

³ Hesselink, M. W. 2002. *The new European Private Law*. The Hague: Kluwer Law International, p.187.

⁴ This can be proved by the exceeding EU legislation: Council Directive 85/577/EEC of 20 December 1985 to protect the consumer in respect of contracts negotiated away from business premises. [1985] OJ L 372; Council Directive 90/314/EEC of 13 June 1990 on package travel, package holidays and package tours, OJ L 158; Council Directive 93/13/EEC of 5 April 1993 on unfair terms in consumer contracts. [1993] OJ L 95; Directive 94/47/EC of the European Parliament and the Council of 26 October 1994 on the protection of purchasers in respect of certain aspects of contracts relating to the purchase of the right to use immovable properties on a timeshare basis. [1994] OJ L 280; Directive 97/7/EC of the European Parliament and of the Council of 20 May 1997 on the protection of consumers in respect of distance contracts. [1997] OJ L 144; Directive 98/6/EC of the European Parliament and of the Council of 16 February 1998 on consumer protection in the indication of the prices of products offered to consumers. [1998] OJ L 80; Directive 1999/44/EC of the European Parliament and of the Council of 25 May 1999 on certain aspects of the sale of consumer goods and associated guarantees. [1999] OJ L 171; Directive 2011/83/EU of the European Parliament and of the Council of 25 October 2011 on consumer rights, amending Council Directive 93/13/EEC and Directive 1999/44/EC of the European Parliament and of the Council and repealing Council

The solidarity policy of the state and European Union is reflected in the consumer law and the reasons of such policy are mostly not the subject-matter of contract law.

However, when such state „help“ is implemented regarding contractual relationship between parties of equal bargaining position, it can be not only unreasonable, but even harmful, especially, in the business to business contracts. The certainty of the market is one of the most important criteria for business environment. Experienced businessmen appreciate not only the possibility of profit and the tax system of the country, when deciding if it is worth entering into business relationship there. Legal system and its certainty are very important parameters motivating to start and/or continue business practice in a particular country. The possibility to prognosticate the likelihood of future disputes and the perspective of them with respect to concluded contracts is essential criteria for evaluating the risks of your business.

The question has to be raised: whether the rules which had dominated in the classical period of contract law (defined in section I of this Article) should not be applied in the relationship between the parties of equal bargaining power, especially – the businessmen? How should the notion of contractual equilibrium be interpreted and applied in the commercial relationship?

There is an opinion expressed in legal doctrine that the contract should be considered equivalent if it is substantially fair. According this idea, the commodity or service should be sold for a fair price - market price – and only such transaction does not infringe the balance of contractual rights and obligations. This means that the contractual price of subject-matter which does not correspond to the market value could be reasonable ground for the contract to be declared voidable or amended by the court. This could sound logical at first glance. However, this idea could be criticized. One of the reasons – the conception of „fair price“ is meaningless in market economy. Value is subjective. What is more, the principle of substantive fairness hardly corresponds with the notion of contract freedom, according to which every person is entitled to decide whether to conclude contract or not, and what should be the terms of the contract¹. Classical contract law theory was grounded on the idea that no person could agree with terms which are disadvantageous², so the conclusion of contract itself had to justify the fact that the party evaluated the terms of the contract and agreed to them.

On the basis of the idea that interests of neither party of the commercial contract should be protected more, the equilibrium of such relationship should be reflected namely by the concluded contract. Presuming that both parties negotiated actively for the most beneficial terms and that they would not agree to disadvantageous one, the mere conclusion of the contract is a proof that parties have reached a compromise. It could be objected that not always parties are active in the negotiations for dozens of reasons. Sometimes a party considers itself as the weaker party and is sure, that the other party

Directive 85/577/EEC and Directive 97/7/EC of the European Parliament and of the Council. [2011] OJ L304.

¹ Smith, A. S. 2008. *Contract Theory*. Oxford: Oxford University Press, p. 354.

² Muray, R. 2008. *Contract Law. The Fundamentals*. London: Sweet & Maxwell, p. 6.

shall not agree to the proposed terms. In other cases the particular situation, for example, the lack of time, makes them conclude the contract without proper analysis or without proper negotiations. However, it is doubted that when the relationships of parties with equal bargaining power are concerned such reasoning could be applied. If the counterparty is passive during the negotiations not because he had no possibility to negotiate (i. e., his proposals were rejected by using advantageous bargaining position), but for reasons which do not depend on the active party, this inactivity should be considered as his own risk. If a party who proposed the term does not receive any counterargument or even an opinion, naturally that this party reasonably believes that the passive party agrees to the term. If later it turns out that the term is unbeneficial for the passive party, the interests of the active party should not suffer, because the inactivity of the counterparty has not been influenced by the active party.

Illustrative examples that the intervention into contractual relationship can be very problematic are the cases of contractual penalty reduction. Although parties agree to it in the contract, according the Article 6.73 (2) of Lithuanian Republic Civil Code, the amount of penalty stipulated may be reduced by the court when it is manifestly excessive. This rule is often used by court emphasising the compensatory function of penalty clauses. Although the analysis of court practice of the Supreme Court of Lithuania shows that it is admitted that the relationship between parties with equal bargaining power should be treated differently and it is even more obvious in commercial relationship. In one of the judgements the Supreme Court of Lithuania noted that the penalty should not be reduced to the extent which would deny the principle of contractual freedom¹. What is more, it has been mentioned more than once that the position of the parties is important criteria. The court motivated it's decision on the fact that the parties of the contract were private businessmen, who had the experience in commercial relationship, freely expressed their will regarding taken responsibility for breaches of contract and ruled that without any exceptional ground the penalty reduction in such case would mean the breach of freedom of contract and the will of parties. What is more, the Supreme Court of Lithuania stated that entrepreneurs can freely agree regarding the nature and amount of contractual liability, what is more, such agreement must be respected, so the court should not deny their will on formal grounds. The agreements of businessmen are not the subject-matter of public law, so the courts should not interfere without the existence of exceptional circumstances which would be the reason to declare the breach of essential rules of law. And in that case such circumstances had not been determined².

In several of its rulings considering the interference into commercial relationship the Supreme Court of Lithuania emphasised that it is essential to take into consideration the fact that the parties are private entrepreneurs, having experience in business practice and negotiations, able to forecast the consequences of the contractual breaches

¹ The Supreme Court of Lithuania, Civil Division 2 November 2010 ruling of the board of judges in the civil case UAB „Miaras“ v. A. Daujoto individuali įmonė „Aldaujana (case No. 3K-7-409/2010).

² The Supreme Court of Lithuania, Civil Division 14 March 2011 ruling of the board of judges in the civil case AB „Kauno energija“ v. UAB Kauno termofikacijos elektrinė (case No. 3K-3-104/2011).

and who can choose the terms of contracts¹. For this reason, judicial intervention into such relationship is an exceptional measure and that the opposite interpretation of legal rules would force not to rely on concluded contracts and this would definitely damage the stability of civil relationships².

Although those examples prove the recognition of a concept stating that the intervention into commercial relationship is considered to be an exception, it could not be stated that solving the disputes between businessmen Lithuanian courts always take into consideration the fact that the contract is commercial and that the interference should be allowed only in exceptional cases or at least clearly discuss all reasons why this rule should not be applied in the case³. Due to the limited scope of this article such cases shall be discussed in other publications.

Such regulation of Lithuanian Republic can be compared with the regulation of Germany where the Article 348 of Commercial Code⁴ expressly states that “a penalty agreed to be paid by a mercantile trader in the course of his mercantile business cannot be reduced on the ground of sect. 343 of the Civil Code (i)”⁵.

The arguments presented in this section of the article show that in the relationship between the parties with equal bargaining power, especially, the businessmen, the principal of contract freedom and the notion of contractual equilibrium should be interpreted in the light of classical contract law.

III. Other problems

As mentioned earlier, the assurance of contractual equilibrium is problematic enough even in the relationship of parties with equal bargaining power. In some cases the most difficult issue is the qualification of parties – whether they should be considered as having equal bargaining power. Does the fact that both parties are entrepreneurs shall

¹ The Supreme Court of Lithuania, Civil Division 25 August 2008 ruling of the board of judges in the civil case *UAB „Kaduva“ v. UAB „Okadeta“* (case No. 3K-3-401/2008).

² The Supreme Court of Lithuania, Civil Division 18 June 2009 ruling of the board of judges in the civil case *UAB „Progresyvus verslas“ v. UAB „Baltisches Haus“* (case No. 3K-3-274/2009).

³ In some cases courts reduce the sums of penalties defined in the commercial contracts without explaining why it has been decided not to take into consideration the commercial type of relationship or even without mentioning the fact that the parties are entrepreneurs. For example, the Supreme Court of Lithuania, Civil Division 19 June 2006 ruling of the board of judges in the civil case *UAB „Šilo takas“ v. A. S. I.I.* (case No. 3K-3-409/2006), the Court of Appeal of Lithuania, 28 June 2012 ruling of board of judges in the civil case *UAB “Vaineta” v. UAB “Airinė”* (case No. 2A-1314).

⁴ German Commercial Code. [interactive]. 1900, [accessed 2013-05-10] <http://www.archive.org/stream/germancommercial00germuoft/germancommercial00germuoft_djvu.txt>.

⁵Section 343 of BGB “Reduction of the penalty”: “(1) If a payable penalty is disproportionately high, it may on the application of the obligor be reduced to a reasonable amount by judicial decision. In judging the appropriateness, every legitimate interest of the obligee, not merely his financial interest, must be taken into account. Once the penalty is paid, reduction is excluded. (2)The same also applies, except in the cases of sections 339 and 342, if someone promises a penalty in the event that he undertakes or omits an action”. German Civil Code [interactive]. 1900, [accessed 2013-05-10] <http://www.gesetze-im-internet.de/englisch_bgb/englisch_bgb.html#p1192>.

mean that they definitely enjoy equal bargaining power? Business entities are classified into large, medium and small, and it is often noted that contractual relationship between a large corporation and a small or medium size business can be considered as the relationship with a weaker counterparty. However, does the protection of the interests of such businessmen - formally the weaker party - always is rational and fair?

It is obvious that the same legal entity, which is considered as the stronger contract party in one legal relationship, could be the weaker in another and such argument is quite common in legal doctrine. This only proves that the size of the legal entity may not be undoubted criteria. In spite of that, the problems of ensuring the contractual equilibrium may evidence in different situations.

How should a judge solve the case, when the weaker party did not negotiate and concluded the contract on less advantageous terms, although the stronger party had been willing to compromise? Here it should be asked, what could be the reasons of such willingness? Why shouldn't the stronger party use its bargaining position and why should it agree on giving up even the smallest part of the benefits? However, there could be even some causes. First of all, a party with a stronger bargaining position may rationally evaluate that in case of future legal dispute in court the counterparty would be considered as a weaker party and its interests would be probably protected on priority basis. For this reason, by agreeing on compromise terms it ensures that there won't be any future legal disputes on the ground of contractual inequality or at least reduces the risk of them. Second, the purpose may be strictly commercial – if the stronger party has one or more competitors in the same market and the competition is tense, almost every transaction is important, even if the counterparty is a small or medium enterprise. Every contract is a “small” victory, especially if the market itself is not large. What is more, it should not be forgotten, that legal entity is just a fiction (creation of law) and the decision is made by natural person. For this reason, such decision sometimes is based not only on the professional reasons.

Previously mentioned reasons prove that the bargaining position of the party should not be the ground to decide undoubtedly that the interests of the weaker party have to be defended in a particular case. First of all, it must be identified whether the stronger party actually used its bargaining position and whether the weaker party even tried to propose better terms and conclude more advantageous contract. It is rational, that in such cases, when the weaker party did not put any efforts and concluded the contract without even trying to negotiate, the interests of such party should not be defended more that the interests of the counterparty. What is more, the rules on allocation of burden of proof become very important. According to the principle that the fact must be proven by the party of the dispute which relies on such fact (the Article 178 of Lithuanian Code of Civil procedure¹), it must be recognized that the party which invokes the unequal bargaining position must not only prove such weaker position of it, but also – the unsuccessful efforts to conclude the contract on better terms.

¹Civil Procedure Code of the Republic of Lithuania. Official Gazette. 2002, No. 36-1340.

It is obvious that the qualification of contract parties and the evaluation of contractual equilibrium shall mostly be the task of the court in case the dispute between the parties arises and the parties are not able to solve it peacefully. It is important that judges who decide in favour of a weaker contract party on grounds of contractual unbalance would determine whether the parties in fact had unequal bargaining position and the weaker party had no possibility to conclude the contract on better terms.

Conclusions

Contractual equilibrium is inseparable from the concept of contractual freedom. Therefore the changes in this concept have influenced the processes of ensuring the contractual balance. It is no doubt that the interpretation of contractual freedom principle which prevailed in the classical period of contract law cannot be applied in its full extent nowadays as it does not always correspond with the social values and aims of modern state. Despite that, the reasoning of contractual freedom of classical period should not be rejected one hundred present. This notion should still be applied in the contractual relationships between the parties with equal bargaining power, especially the businessmen, and such application would ensure the certainty of legal system of the state which is a significant criteria.

A very important issue for the ensuring the balance of contractual rights and obligations is the qualification of the parties. Acknowledging the difference of application of contractual freedom notion in the relationships of parties with equal bargaining power, there is a need to define how should such equality be understood and determined. And this question shall probably be answered by the judge solving particular legal dispute and evaluating the bargaining position of the parties. It is essential, that the judge would rule in favour of one party on the basis of its weaker bargaining position only if he has actually evaluated not only the experience and the status of the party (whether it is large corporation or small single person business), but also the fact that the party actually used its stronger bargaining position, therefore, the weaker party could not conclude the contract on more beneficial terms. In such cases the question of burden of proof is relevant - the party, relying on its weaker bargaining position must not only prove the advantageous position of the counterparty, but also – the unsuccessful efforts to conclude the contract on better terms.

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