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Lexis Nexus Complexus: Comparative Contract Law and International Accounting Collide in the IASB-FASB Revenue Recognition Exposure Draft

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Lexis Nexus Complexus: Comparative Contract Law and International Accounting Collide in the IASB-FASB Revenue Recognition Exposure Draft

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ABSTRACT

U.S. and international accounting-standard setters plan to launch a new, global revenue accounting standard, Revenue from Contracts with Customers, in 2013. Poised at the nexus of comparative contract law and international accounting, the proposal's contract-based revenue recognition model creates new legal risks and opportunities for accountants, lawyers, clients, and financial statement users. Despite its focus on legally enforceable contracts, the proposed standard was drafted

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without input from the legal community. This Article models the proposal's complex contract-analysis process, demonstrating that its revenue outcomes may vary materially because of seemingly minor interjurisdictional differences in law applicable to "open-price" contracts; offers practice pointers for attorneys, accountants, and auditors; recommends changes to the proposal, including the substitution of self-enforcing Nash equilibria for legally enforceable contracts; and encourages more collaboration between the legal and accounting professions in the joint deployment of legal and accounting expertise for better value creation, value allocation, and risk mitigation.

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I. INTRODUCTION

The wheels of commerce would turn more smoothly if lawyers better understood accounting and accountants better understood the law. Exhibit A in support of this proposition is the international revenue accounting exposure draft (ED), *Revenue from Contracts With Customers*,¹ now under final review by the U.S. Financial Accounting Standards Board² (FASB) and the International Accounting Standards Board³ (IASB) in preparation for global implementation.

1. The ED is available in International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) versions. See Exposure DRAFT: REVENUE FROM CONTRACTS WITH CUSTOMERS, ED/2011/6 (Int'l Acct. Standards Bd. 2011) (Proposed Exposure Draft 2011) [hereinafter EXPOSURE DRAFT] (IASB version), available at http://www.ifrs.org/Current-Projects/IASB-Projects/Revenue-Recognition/EDNov11/Documents/RevRec_EDII_Standard.pdf; EXPOSURE DRAFT: REVENUE FROM CONTRACTS WITH CUSTOMERS, ED/2011/6 (Fin. Accounting Standards Bd. 2011) (Proposed Exposure Draft 2011) (FASB version), available at <http://www.fasb.org/cs/BlobServer?blobkey=id&blobwhere=1175823559369&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs>. Hereinafter, unless otherwise noted, citations to ED paragraphs will be to the IASB version. The original ED/2010/6 will be referred to hereinafter as ED 2010.

2. Effective September 15, 2009, the FASB promulgates U.S. generally accepted accounting principles (U.S. GAAP) exclusively in the ACCOUNTING STANDARDS CODIFICATION, subtopic 105-10-05 (Fin. Accounting Standards Bd. 2012) [hereinafter FASB CODIFICATION], available at <http://asc.fasb.org>, which must be followed in the preparation and auditing of U.S. GAAP-compliant financial statements of all for-profit companies. The Codification and Securities Exchange Commission (SEC) regulations, issued by the SEC under its rule-making authority, comprise the accounting principles binding on publicly traded, U.S.-headquartered companies. *Id.* Prior to September 15, 2009, U.S. GAAP was found in materials promulgated by the FASB and the American Institute of Certified Public Accountants archived at *Pre-Codification Standards*, FIN. ACCT. STANDARDS BOARD, <http://www.fasb.org/jsp/FASB/Page/PreCodSectionPage&cid=1218220137031> (last visited Feb. 15, 2013). These materials were ranked hierarchically, in terms of their relative authoritative force. STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 162: THE HIERARCHY OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES ¶ 3 (Fin. Accounting Standards Bd. 2008) [hereinafter SFAS 162], available at <http://www.fasb.org/pdf/fas162.pdf>.

3. The IASB promulgates International Financial Reporting Standards (IFRS). *Preface* to INTERNATIONAL FINANCIAL REPORTING STANDARDS ¶¶ 5, 7 (Int'l Accounting Standards Bd. 2010), available at <http://eifrs.iasb.org/eifrs/bstandards/en/preface.pdf>. Prior to January 1, 2001, the IASB's predecessor, the International Accounting Standards Committee, issued IAS, which continue in force unless superseded by subsequently issued IFRS. INTERNATIONAL ACCOUNTING

Hovering at the nexus of comparative contract law and international accounting, the ED's contract-based revenue recognition model offers a prime context for accountants and lawyers to work together. Legal and management scholars in Europe and the United States have previously encouraged lawyers and other professionals to apply their expertise collaboratively to maximize business success.⁴ So far, however, little, if any, collaboration has occurred in connection with the ED.

Despite its singular focus on legally enforceable contracts, the ED was drafted largely without input from the legal community, which plays a leading role in the negotiation, drafting, interpretation, and enforcement of contracts. Arguably, the ED's resulting redundancy, internal inconsistency, and superfluous legal complexity will increase both the costs of preparing and auditing financial statements and the risks of revenue-related misunderstanding, litigation, and regulatory-enforcement actions. This Article is, in part, a call for collaboration between accountants and lawyers in an effort to reduce or mitigate these costs and risks.

Accounting standards are a form of regulatory law governing financial reporting. The ED, in particular, is a proposed regulation governing how, when, and in what amounts market players are entitled to claim credit, in the eyes of other market participants, for having persuaded others to buy goods or services. Under the ED, as currently written, revenue may be claimed or "recognized" only in the context of legally enforceable contracts with customers.⁵ Yet, as discussed in greater detail below, some transactions or relationships

STANDARDS (Int'l Accounting Standards Bd. 2012), available at <http://www.ifrs.org/IFRSs/IAS.htm>; see also *Preface* to INTERNATIONAL FINANCIAL REPORTING STANDARDS, *supra*, ¶ 5. IAS are interchangeably referred to herein as "IFRS" or "IAS" depending on the context.

4. See Constance E. Bagley, *Winning Legally: The Value of Legal Astuteness*, 33 ACAD. MGMT. REV. 378, 378–79 (2008) (analyzing the opportunities that are inherent in management taking advantage of legal tools and knowledge as part of their market strategy); Gerlinde Berger-Walliser, Robert Bird & Helena Haapio, *Promoting Business Success Through Contract Visualization*, 17 J.L. BUS. & ETHICS 55, 61–62 (2011) (describing a collaborative proactive approach to contracting); Robert C. Bird, *Law, Strategy, and Competitive Advantage*, 44 CONN. L. REV. 61, 71–81 (2011) (discussing how businesses can gain a competitive advantage through legal strategizing); Omar Ochoa, *Filling the "GAAP": Why Generally Accepted Accounting Principles Should Inform U.C.C. Article 9 Decisions*, 89 TEX. L. REV. 207, 207, 210 (2010) (lamenting the artificial separation of accountants and lawyers and advocating the use of accounting rules to "fill holes within commercial law"); Damaris Rosich-Schwartz, *Accounting Expertise and Attorney Compliance with the Sarbanes-Oxley Act of 2002*, 24 T.M. COOLEY L. REV. 533, 535–38 (2007) (stressing that corporate counsel must understand financial accounting or enlist the help of accounting experts in order to fulfill their professional duties to clients under Sarbanes-Oxley Act § 307 and SEC Rule 205); George J. Siedel & Helena Haapio, *Using Proactive Law for Competitive Advantage*, 47 AM. BUS. L.J. 641, 659–60 (2010) (discussing this type of collaboration in the context of the Proactive Law Movement in Europe).

5. EXPOSURE DRAFT, *supra* note 1, ¶¶ 8, 12–15.

that superficially appear to be enforceable contracts are revealed, on closer examination under applicable local law, *not* to be contracts or *not* to be enforceable. In contrast, some noncontractual relationships with customers are legally enforceable. Meanwhile, in most relationships, the parties perform their commitments because they must do so out of commercial necessity, not because of the threat of legal action in the event of a breach. Thus, it may be argued that the scope of the ED is narrower than the commercial and legal reality it seeks to portray.

Not surprisingly, in light of its contract focus, the ED relies on contract-law terms, such as *contract*, *consideration*, *enforceable*, *legal title*, *modification*, *control*, and *transaction price*. These terms appear in the ED 279, 150, 5, 7, 17, 55, and 81 times, respectively, and differ in definition and cultural authority across jurisdictions,⁶ as do contract *formation* and *validity*,⁷ which are essential prerequisites to legal enforceability. While the ED does not discuss contract formation or validity, this Article illuminates a subset thereof: the extent to which the price of goods or services must be specified in order to form a valid, enforceable contract.

More specifically, this Article (a) models the ED's contract-analysis and revenue recognition process, demonstrating in microcosm how outcomes may vary even because of seemingly minor interjurisdictional differences in contract law applicable to "open price" contracts; (b) offers practice pointers for attorneys, accountants, and auditors; (c) recommends changes to the ED;⁸ and

6. See John H. Matheson, *Convergence, Culture and Contract Law in China*, 15 MINN. J. INT'L L. 329, 345 (2006) (describing how in China, written contracts are often viewed as either the beginning of a negotiation process or, more negatively, as a last resort when personal relations and verbal agreements fail). See generally Reinhard Zimmermann, *The Present State of European Private Law*, 57 AM. J. COMP. L. 479 (2009) (examining European private-law documents to determine the extent of commonality among them). The ED does not define *consideration*, despite its 150 mentions, leaving the interpretation to user discretion.

7. See, e.g., United Nations Convention on Contracts for the International Sale of Goods arts. 8, 11, Apr. 11, 1980, 1489 U.N.T.S. 3 [hereinafter CISG], available at http://www.uncitral.org/uncitral/en/uncitral_texts/sale_goods/1980CISG.html (referencing unwritten agreements that are binding and may be proven with reference "to all relevant circumstances," including negotiations and subsequent conduct between the parties); *MCC-Marble Ceramic Ctr., Inc. v. Ceramica Nuova D'Agostino, S.P.A.*, 144 F.3d 1384, 1388–89 (11th Cir. 1998) (discussing the CISG's reliance on the parties' subjective intent and conduct in determining contractual validity and comparing it to the U.S. parol evidence rule). In contrast, the Uniform Commercial Code (UCC) and common law prohibit the use of contemporaneous external or "parol" evidence to prove or interpret contracts and require that certain contracts be written. See *id.* at 1389 (describing the UCC's writing requirement and indicating that few courts have adopted the more flexible CISG approach).

8. The ED will not be effective until at least 2015. See *infra* note 41 and accompanying text.

(d) encourages collaboration between legal and accounting professions in accounting-standard setting, especially in relation to the ED.⁹

The remainder of the Article is structured as follows. Part I.A defines and contextualizes revenue, highlighting its importance in the financial reporting and analysis environment. Part I.B summarizes related research and commentary in the fields of comparative law and accounting. Part II describes the ED's revenue recognition process and summarizes the ED's contract-relevant provisions. Part III applies the ED's contract-analysis and revenue recognition provisions to an historical transaction involving the proposed international sale of jet engines, comparing the likely results across six different contract-law regimes. Part IV concludes with summary observations and recommendations.

A. Revenue Primer

Revenue may be viewed as fuel that powers a business enterprise and has been defined as the periodic "gross inflow of economic benefits" from the ordinary activities of the business.¹⁰ Also called *sales* or *turnover*,¹¹ revenue is typically found on the first or top line of the income statements of U.S.- and European-listed firms.¹² Revenue's significance derives partly from its status as the central element of *operating income*, which is a component of *net income* or *net earnings*.¹³ These relationships may be stated algebraically as follows:

9. Georgetown Law Library's Accounting Research page, *Accounting Research Guide*, GEORGETOWN L. LIBR., <http://www.ll.georgetown.edu/guides/accounting.cfm> (last visited Feb. 15, 2013), is a sign that accounting is beginning to receive attention in the legal community.

10. See INTERNATIONAL ACCOUNTING STANDARDS, *supra* note 3, standard 18 ¶ 7.

11. See Christopher Nobes, *On the Definitions of Income and Revenue in IFRS*, 9 ACCT. EUR. 85, 91–92 (2012) (referring to the British Companies Act's use of the term *turnover*); Susan M. Sorensen & Donald L. Kyle, *Found in Translation*, 203 J. ACCT. 38, 41 exhibit 3 (2007) (comparing the UK term *turnover* to the U.S. equivalent *sales*). In English-speaking countries, the income statement is also sometimes called the "statement of operations" or "results." Accounting terminology and standards used to prepare income statements vary among countries and through time. See generally WORLD ACCOUNTING (John D. Gould & Kurt S. Schulzke eds., 2011) (documenting local accounting standards in more than thirty countries); Deloitte, *Jurisdictions*, IASPLUS, <http://iasplus.com/en/jurisdictions> (last visited Feb. 15, 2013) (summarizing accounting standards and applicability of IFRS by jurisdiction worldwide).

12. See, e.g., MERCK, CONSOLIDATED INCOME STATEMENT (2011), available at <http://merck.online-report.eu/2011/ar/financialstatements/incomestatement.html>; see also Nobes, *supra* note 11, at 92 ("[Revenue] is conventionally presented as the first line of the income statement.").

13. Net income may also be styled "profit." See, e.g., MERCK, *supra* note 12.

Operating income¹⁴ = revenue – operating expenses,

and

Net income = operating income – nonoperating expenses.

While net income is widely regarded as a key indicator of firm value,¹⁵ recent research indicates that revenue itself also acts as a highly significant financial-performance indicator.¹⁶ Furthermore, revenue has been found to be a predictor of firm value independent of net income,¹⁷ and has increased in firm-value relevance over time, as the value relevance of net income has decreased.¹⁸

The importance of revenue is further corroborated by the existence of Staff Accounting Bulletin No. 104, published by the Securities and Exchange Commission's (SEC's) chief accountant, which is focused solely on revenue recognition.¹⁹ The frequent

14. Operating income may also be called "results of operations" or "operating result." *Id.*

15. See Uday Chandra & Byung T. Ro, *The Role of Revenue in Firm Valuation*, 22 ACCT. HORIZONS 199, 199–200 (2008) (discussing the merits of using revenue and earnings in firm valuations); Letter from the Hundred Grp. of Fin. Dirs. to the Int'l Accounting Standards Bd. [IASB] 1 (Apr. 3, 2012), available at <http://www.fasb.org/cs/BlobServer?blobkey=id&blobwhere=1175823852005&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs> ("Revenue is an important measure of business performance and in some industries is used as an indicator of the value of businesses.").

16. See Chandra & Ro, *supra* note 15, at 220–21 (summarizing findings that imply that revenue is a good indicator of value-relevant information and other variables); Am. Accounting Ass'n Fin. Accounting Standards Comm. [FASC], *Response to the Financial Accounting Standards Board's and the International Accounting Standards Board's Joint Discussion Paper Entitled Preliminary Views on Revenue Recognition in Contracts with Customers*, 24 ACCT. HORIZONS 689, 691 (2010) (analyzing an attempt to standardize revenue recognition standards given that this measure is "extremely important to investors"); Letter from the Inst. der Wirtschaftsprüfer to the IASB 2 (Oct. 13, 2010), <http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175821482858&blobheader=application%2Fpdf> ("Revenue is a crucial part of financial reporting and plays an important role in the assessment of an entity's performance.").

17. Chandra & Ro, *supra* note 15, at 201–02.

18. *Id.*

19. SEC Staff Accounting Bulletin No. 104, 17 C.F.R. § 211 (2003) [hereinafter SAB No. 104], available at <http://www.sec.gov/interps/account/sab104rev.pdf>. Staff Accounting Bulletin (SAB) No. 104 was preceded by SAB No. 101. See SEC Staff Accounting Bulletin No. 101, 17 C.F.R. § 211 (1999), available at <http://www.sec.gov/interps/account/sab101.htm>. Comparing the relative importance of revenue and net income, it is worth noting that while SAB No. 104 is dedicated to revenue, no SAB is focused on net income. *SEC Staff Accounting Bulletin: Codification of Staff Accounting Bulletins*, SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/interps/account/sabcode.htm> (last visited Feb. 16, 2013). Recognition has been defined as recording "in the balance sheet or income statement an item that meets the definition of [a financial statement] element and satisfies the [paragraph 4.38] criteria

appearance of revenue recognition in financial reporting fraud provides additional evidence that revenue is independently material to preparers, readers, and regulators of financial statements. A 2010 study by the Committee of Sponsoring Organizations of the Treadway Commission²⁰ found that revenue recognition accounted for 61 percent of SEC fraud cases in the 1998–2007 interval, up from 50 percent in 1987–1997, and was the single most common source of financial reporting fraud in both periods.²¹

Legal counsel and accountants must understand how the interplay between revenue and the law affects associated risks and returns, in order to effectively serve stakeholders, such as owners, creditors, officers, directors, and auditors. With respect to revenue recognition, mutual understanding between lawyers and accountants is essential to the achievement of three objectives at the intersection or nexus of law and accounting: value creation, value allocation, and risk mitigation.

First, a cross-disciplinary, business-oriented approach to contract drafting, as advocated by the Nordic School,²² can create firm value by favorably altering the fact, amount, and timing of revenue. These, in turn, affect financial position (through assets or liabilities reported in the balance sheet) and operating results (through revenue in the income statement), thereby impacting stock price, access to financing, and strategic position in the market. Second, revenue is frequently written into legal agreements involving loans, incentive compensation, corporate mergers and acquisitions, buy–sell clauses, wills and trusts, and other transactions²³ as a benchmark for

for recognition.” IASB, THE CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING ¶ 4.37 (2010), available at <http://eifrs.ifrs.org/eifrs/bnstandards/en/2012/framework.pdf>.

20. The Committee of Sponsoring Organizations of the Treadway Commission (COSO) is a joint initiative of the American Accounting Association, American Institute of CPAs, Financial Executives International, Institute of Management Accountants, and Institute of Internal Auditors. See COSO, <http://www.coso.org/> (last visited Feb. 16, 2013). COSO is best known as the institutional author of the COSO Internal Control Framework used by all U.S. public companies to evaluate and report in their SEC filings on the effectiveness of financial internal controls. See, e.g., DELTA AIR LINES, INC., 10-K: ANNUAL REPORT PURSUANT TO SECTION 13 AND 15(D), at 86 (Feb. 10, 2012), available at http://images.delta.com.edgesuite.net/delta/pdfs/annual_reports/DeltaAirLines_10K_2011.pdf.

21. COMM. OF SPONSORING ORGS. OF THE TREADWAY COMM’N, FRAUDULENT FINANCIAL REPORTING: 1998–2007: AN ANALYSIS OF U.S. PUBLIC COMPANIES 4 (2010), available at http://www.coso.org/documents/COSOFRAUDSTUDY2010_001.pdf.

22. See Siedel & Haapio, *supra* note 4, at 659 (“The Nordic School is a network of researchers and practitioners from Denmark, Finland, Iceland, Norway, and Sweden, each of whom has an interest in Proactive Law.”). See generally Gerlinde Berger-Walliser, *The Past and Future of Proactive Law: An Overview of the Development of the Proactive Law Movement*, in PROACTIVE LAW IN A BUSINESS ENVIRONMENT 13 (Gerlinde Berger-Walliser & Kim Østergaard eds., 2012) (describing the proactive law philosophy and the Nordic school).

23. See Chandra & Ro, *supra* note 15, at 202 (“[A] primary objective of accounting data is to provide verifiable summary measures of performance for use in

allocating value among business owners or between the business and other stakeholders, such as employees, suppliers, customers, or creditors. Third, revenue embodies significant legal risk because of the role it often plays in financial statement restatements, SEC investigations,²⁴ and securities-fraud claims against firms, executives,²⁵ and auditors.²⁶

Despite the centrality of revenue to financial reporting, to date, the FASB has promulgated neither a general definition of revenue nor a generally applicable rule for timing or measuring revenue.²⁷

debt and compensation contracts . . . [C]ompensation committees would like to know in which situations they should include revenue in management contracts.”).

24. See SEC, REPORT PURSUANT TO SECTION 704 OF THE SARBANES-OXLEY ACT OF 2002, at 2 (2003), available at <http://www.sec.gov/news/studies/sox704report.pdf> (determining that 126 of 227 SEC enforcement matters in the five years ending in 2002 involved revenue recognition issues); Dana R. Hermanson, Daniel M. Ivancevich & Susan H. Ivancevich, *SOX Section 404 Material Weaknesses Related to Revenue Recognition*, 78 CPA J. 40, 40–41 (2008) (explaining that revenue recognition may be the biggest single source of material errors in U.S. financial reporting). Some readers may wonder about the income tax ramifications of revenue accounting in general and of the ED in particular. The scope of this Article is limited to so-called *financial accounting*, meaning general purpose accounting rules used in preparing and auditing financial statements used primarily by equity investors and creditors in making investment and lending decisions, because the ED itself will be binding only for financial accounting purposes except in jurisdictions where financial accounting income forms an element of the tax base.

25. See, e.g., SEC v. Nacchio, 704 F. Supp. 2d 1099, 1105 (D. Colo. 2010) (explaining that the primary focus of the SEC’s case is Qwest’s public reporting of revenue); SEC v. Nacchio, No. 05-cv-00480-MSK-CBS, 2008 U.S. Dist. LEXIS 76138, at *3–4 (D. Colo. Jul. 14, 2008) (establishing that the SEC’s complaint alleged that senior company executives perpetrated a “massive financial fraud” in part by reporting \$3 billion in false revenue).

26. See, e.g., PUBLIC CO. ACCOUNTING OVERSIGHT BD. [PCAOB], REPORT ON OBSERVATIONS OF PCAOB INSPECTORS RELATED TO AUDIT RISK AREAS AFFECTED BY THE ECONOMIC CRISIS, PCAOB RELEASE NO. 2010-006, at 18 (2010), available at http://pcaobus.org/Inspections/Documents/4010_Report_Economic_Crisis.pdf (indicating that financial-statement fraud often involves inappropriate revenue recognition due to increased pressure on companies to meet internal and market expectations).

27. Katherine A. Schipper et al., *Reconsidering Revenue Recognition*, 23 ACCT. HORIZONS 55, 57 (2009). However, in an apparent effort to informally mitigate this lack of authoritative revenue recognition guidance, on September 15, 2009, paragraphs 83(a) and 83(b) of FASB Concepts Statement No. 5, which discuss revenue at a general level, were added to the FASB Codification, Subtopic 605-10-25-1, without the notice-and-comment process required for FASB standard setting. See FASB CODIFICATION, *supra* note 2, subtopic 605-10-25-1; see also RULES OF PROCEDURE 17 (Fin. Accounting Standards Bd. 2012), available at <http://www.fasb.org> (follow “About FASB”; then “Our Rules of Procedure”). Contradicting Subtopic 605-10-25-1, Subtopic 105-10-05-3, also effective September 15, 2009, states that FASB Concepts Statements (such as No. 5) are nonauthoritative. FASB CODIFICATION, *supra* note 2, Subtopic 105-10-05-3; see also FIN. ACCOUNTING STANDARDS BD. [FASB], ORIGINAL PRONOUNCEMENTS AS AMENDED: STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 5, at CON5-4 (2008), available at <http://www.fasb.org/cs/BlobServer?blobkey=id&blobwhere=1175820900391&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs> (“Statements of Financial Accounting Concepts do not establish

This gap in U.S. general revenue recognition guidance has spawned more than two hundred separate pieces of industry- and transaction-specific guidance,²⁸ now included in the FASB Codification under Topic 605.²⁹ Their multiplicity is cited as a justification for the development of a generally applicable revenue accounting standard.³⁰

In the absence of generally applicable U.S. revenue accounting rules, financial-statement preparers and auditors now typically follow SEC Staff Accounting Bulletin (SAB) No. 104,³¹ which presents views of the SEC's chief accountant and Division of Corporation Finance.³² While SABs are technically nonbinding because they are not issued through due process rulemaking by the SEC itself,³³ they have been cited by the SEC and federal courts as persuasive authority on how companies should apply existing U.S. generally accepted accounting principles (GAAP) in the SEC reporting context,³⁴ as "guidance" issued by the SEC,³⁵ or even as full-on SEC rules.³⁶

standards prescribing accounting procedures or disclosure practices . . . which are issued by the Board as Statements of Financial Accounting Standards."); *Concepts Statements*, FIN. ACCT. STANDARDS BOARD, <http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176156317989> (last visited Feb. 16, 2013) ("A Statement of Financial Accounting Concepts does not establish generally accepted accounting standards."). Nevertheless, according to the FASB Codification, in appropriate circumstances in the absence of applicable authoritative GAAP, nonauthoritative materials may be used as guidance. FASB CODIFICATION, *supra* note 2, subtopic 105-10-05-1.

28. Schipper, *supra* note 27, at 55.

29. See, e.g., FASB CODIFICATION, *supra* note 2, subtopic 954-605-25 (regarding revenue from health care services); *id.* subtopic 926-605-25 (regarding revenue from film sales); *id.* subtopic 605-35 (regarding revenue from construction-type and production-type contracts).

30. See Schipper, *supra* note 27, at 55 ("The earnings process is complete . . . and revenue is recognized, when the selling firm has provided the goods or services and the buying party has accepted . . . and agreed to pay."); see also FASC, *Accounting for Revenues: A Framework for Standard Setting*, 25 ACCT. HORIZONS 577, 577-78 (2011) (discussing the need for a uniform type of revenue accounting standard that applies to all contexts).

31. SAB No. 104, *supra* note 19, at 9-10.

32. *Id.* at 2; SFAS 162, *supra* note 2, at n.1 (noting that SABs "represent practices followed by the staff in administering SEC disclosure requirements").

33. See SAB No. 104, *supra* note 19, at 1-2 ("[S]taff accounting bulletins are not rules or interpretations of the Commission, nor are they published as bearing the Commission's approval. They represent interpretations and practices followed by the Division of Corporation Finance and the Office of Chief Accountant in administering the disclosure requirements of the Federal securities laws."); see also Paul S. Atkins, SEC Comm'r, Remarks at the "SEC Speaks in 2008" Program of the Practising Law Inst. (Feb. 8, 2008), transcript available at <http://www.sec.gov/news/speech/2008/spch020808psa.htm> ("The process of issuing [SABs] is organized to avoid 'complications' with the Administrative Procedure Act. . . . The Commission never voted on the views espoused within any SAB, so it does not and cannot represent the views of the SEC. Worse yet, SEC staff developed SAB 99 without public input.").

34. See, e.g., *Allen v. Admin. Review Bd.*, 514 F.3d 468, 478 (5th Cir. 2008) (finding that unlike rules promulgated by the SEC, SABs are not accounting rules and do not carry the force of law, but provide guidance to companies in applying SEC rules and GAAP); *New Orleans Emp. Ret. Sys. v. Celestica, Inc.*, No. 10-4702-cv, 2011 U.S.

In 2002, the FASB and IASB began developing a joint, international revenue recognition standard as part of their larger effort to globally harmonize accounting standards.³⁷ The first FASB and IASB attempt at a harmonized revenue standard was exposed for comment in June 2010 and subsequently withdrawn in response to constituent concerns.³⁸ On November 14, 2011, the boards published a revised ED whose comment period closed on March 13, 2012.³⁹ The boards have since made clear their intention to implement the revision, with an effective date not earlier than January 1, 2015,⁴⁰ substantially without addressing the issues discussed in this Article.⁴¹

App. LEXIS 25921, at *13 (2d Cir. Dec. 29, 2011) (citing SAB No. 99, *inter alia*, to define materiality in reversing dismissal for failure to state a claim); *see also* Strom v. United States, 583 F. Supp. 2d 1264, 1270–71 (W.D. Wash. 2008) (questioning, on summary judgment, the legal import of SABs and observing that SAB No. 65 is not an SEC rule or interpretation but an SEC staff guideline for application of accounting rules), *rev'd on other grounds*, 641 F.3d 1051, 1071 (9th Cir. 2011) (noting that SAB No. 65 is not binding but nevertheless supports reversal of summary judgment); *In re Bio-Tech. Gen. Corp. Sec. Litig.*, 380 F. Supp. 2d 574, 580 (D.N.J. 2005) (noting that SAB No. 101 is an SEC staff interpretation of GAAP); *SEC v. Geswein*, No. 5:10-cv-1235, 2011 U.S. Dist. LEXIS 111906, at *34 (N.D. Ohio Aug. 5, 2011) (discussing SAB No. 104 and how SABs generally provide persuasive guidance). In fairness to the courts, accounting scholars have also mischaracterized SABs as U.S. GAAP standards, even in one of the most prestigious peer-reviewed accounting journals, *The Accounting Review*. *See, e.g.*, Dain C. Donelson, John M. McInnis & Richard D. Mergenthaler, *Rules-Based Accounting Standards and Litigation*, 87 ACCT. REV. 1247, 1263, 1264–65 (2012) (identifying SAB No. 101 as a U.S. GAAP standard).

35. *See* *Barrie v. Invoice-Brite, Inc.*, 397 F.3d 249, 257 (5th Cir.) (stating that the SEC “issued Staff Accounting Bulletin No. 101 . . . to guide companies in applying SEC Rules and GAAP to revenue recognition issues”), *opinion modified on other grounds*, 409 F.3d 653 (5th Cir. 2005).

36. *See, e.g.*, *In re Scientific Atlanta, Inc. Sec. Litig.*, 754 F. Supp. 2d 1339, 1358 (N.D. Ga. 2010) (relying on accounting expert’s citation to SAB No. 101 as GAAP); *In re U.S. Office Prods. Sec. Litig.*, 326 F. Supp. 2d 68, 77 (D.D.C. 2004) (referring to SAB No. 96 as “an SEC rule”); *In re Dohan + Co. CPAs* (2011) (SEC final order) (relying in part on SAB No. 104 in support of an administrative order censuring an audit firm and disbarring from SEC practice two individual auditors), *available at* <http://www.sec.gov/litigation/admin/2011/34-63740.pdf>.

37. *See* Frank E. Ryerson III, *Major Changes Proposed to GAAP for Revenue Recognition*, 5 J. FIN. & ACCT. 1, 2 (Dec. 2010) (“The stated objective of the Revenue Recognition Project is to develop coherent conceptual guidance for revenue recognition and a comprehensive statement on revenue recognition based on those concepts.”).

38. EXPOSURE DRAFT, *supra* note 1, ¶ IN5.

39. *Id.* at 2; *see supra* text accompanying note 2.

40. EXPOSURE DRAFT, *supra* note 1, ¶ IN35, app. ¶ C1. The boards currently plan to promulgate the finalized ED as a binding standard during the first half of 2013. *Current Technical Plan and Project Updates*, FIN. ACCT. STANDARDS BOARD, <http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1218220137074> (last visited Feb. 16, 2013).

41. *Project Updates, Revenue Recognition, Summary of Decisions Reached to Date*, FIN. ACCT. STANDARDS BOARD, http://www.fasb.org/cs/ContentServer?site=FASB&c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=1175801890084#summary (last updated Feb. 8, 2013).

Once effective, the ED will be authoritative for companies required or allowed to publish financial statements in accordance with U.S. GAAP or International Financial Reporting Standards (IFRS). Jurisdictions that currently require U.S. GAAP or IFRS financial statements include the United States,⁴² the European Union,⁴³ and Canada, in addition to numerous other countries.⁴⁴ IFRS financial statements are currently not permitted in a variety of jurisdictions, including China, Singapore, and Thailand, where national accounting standards continue in force.⁴⁵

Because of its customer-contracts scope, the ED will not be a generally applicable revenue recognition standard. However, it will be the most broadly applicable revenue accounting standard in U.S. history and will supersede more than three-dozen extant industry-focused U.S. GAAP revenue standards.⁴⁶ Similarly, in the IFRS arena, the ED will supersede the six core current IFRS revenue

42. The SEC permits companies listed in but headquartered outside the United States to choose one of three options for preparing their financial statements: U.S. GAAP, IFRS as promulgated by the IASB, or any other "comprehensive set of accounting principles" accompanied by a separate reconciliation of income and equity to U.S. GAAP. 17 C.F.R. § 210.4-01(a)(2) (2012).

43. The European Union requires listed companies organized under the laws of any EU member state to follow IFRS, as adopted by the European Parliament and the Council, in preparing consolidated financial statements. EC Regulation 1606/2002 on the Application of International Accounting Standards, 2002 O.J. (L 243) 1, available at http://www.esma.europa.eu/system/files/Reg_1606_02.pdf. For nonconsolidated financial statements (and financial statements for nonlisted companies), each EU state is permitted to independently determine whether companies must follow IFRS or local, home-country GAAP. *Id.* at 3. The European Union allows U.S.-domiciled companies listed in the European Union to report financial statements in accordance with U.S. GAAP. Commission Regulation 1289/2008, art. 1, 2008 O.J. (L 340) 17, available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2008:340:0017:0019:EN:PDF>.

44. See *The Move Towards Global Standards*, IFRS, <http://www.ifrs.org/Use-around-the-world/Pages/Use-around-the-world.aspx> (last visited Feb. 16, 2013) ("All major economies have established time lines to converge with or adopt IFRSs in the near future."); *Use of IFRS by Jurisdiction*, IASPLUS, <http://www.iasplus.com/en/resources/use-of-ifrs> (last visited Feb. 16, 2013) ("Many jurisdictions that maintain their own local GAAP claim that their local GAAP is 'based on' or 'similar to' or 'converged with' IFRSs.")

45. See Deloitte, *Use of IFRS by Jurisdiction*, IASPLUS, <http://www.iasplus.com/en/resources/use-of-ifrs> (last visited Feb. 17, 2013); see also WORLD ACCOUNTING, *supra* note 11, at PRC-1, PRC-4 to -8 (discussing how the Chinese Ministry of Finance requires companies to follow Chinese accounting standards which, though harmonized to a large extent with IFRS, retain significant local peculiarities).

46 EXPOSURE DRAFT: PROPOSED AMENDMENTS TO THE FASB ACCOUNTING STANDARDS CODIFICATION: REVENUE RECOGNITION (TOPIC 605): REVENUE FROM CONTRACTS WITH CUSTOMERS 3-4 (Fin. Accounting Standards Bd. 2012), available at <http://www.fasb.org/cs/ContentServer?site=FASB&c=Page&pagename=FASB%2FPage%2FSectionPage&cid=1176157086783> (proposing that revenue accounting standards superseded by the ED include those for airlines, films, music, U.S. federal government contractors, health care, and software).

accounting standards, most notably International Accounting Standard (IAS) 18 (Revenue) and IAS 11 (Construction Contracts).⁴⁷

B. Related Research and Commentary

1. Comparative Contract Law

Comparative law literature establishes that contract law and its enforcement vary among,⁴⁸ and even within,⁴⁹ jurisdictions. In addition, a contract that is theoretically enforceable may be practically unenforceable or may yield more or less cash flow in some jurisdictions than others because of jurisdiction- or forum-specific law, or enforcement and implementation anomalies.⁵⁰

Beyond mere interjurisdictional contract law variability, some legal commentators have observed that contract drafting choices, including the choice of governing law, can be used strategically to obtain commercial advantage⁵¹ and create value.⁵² However, despite the clear connection between contract law and revenue recognition, available data suggest that the legal community either does not fully

47. See EXPOSURE DRAFT, *supra* note 1, ¶ C6 (listing the six standards that the draft supersedes).

48. See, e.g., Claire A. Hill & Christopher King, *Law and Language: How Do German Contracts Do as Much with Fewer Words?*, 79 CHI.-KENT L. REV. 889, 910 (2004) (giving the example that the German contract concept *cic* “might render a seller liable for ‘insufficient’ disclosures to a buyer when U.S. law would have given the buyer no recourse”); Antonio Lordi, *Towards a Common Methodology in Contract Law*, 22 J.L. & COM. 1, 2 (2002) (proposing that civil- and common-law contract lawyers adopt a harmonized approach to contract analysis); Matheson, *supra* note 6, at 335 (asserting that knowledge of Chinese contract law and how it differs from Western norms is essential for Westerners doing business in China); Siedel & Haapio, *supra* note 1, at 668; Zimmermann et al., *supra* note 6, at 479–82 (discussing the status of efforts to harmonize European contract law). See generally Kalvis Torgans & Amy Bushaw, *Some Comparative Aspects of Contract Law in Civil and Common Law Systems*, 12 INT’L LEGAL PERSP. 37 (2002) (noting that the U.S. common-law contract concept is more narrow than that of Latvian law).

49. See generally Arthur Rosett, *Critical Reflections on the United Nations Convention on Contracts for the International Sale of Goods*, 45 OHIO ST. L.J. 265 (1984) (considering general issues presented by the UN Convention and its attempt to standardize contract law).

50. See, e.g., Matheson, *supra* note 6, at 375–82 (describing the comparative “current chaos of Chinese law” featuring judicial decrees overturned by nonjudicial government entities and appeals entered by nonparties, leading to problematically lower outcome predictability for investors); see also Rosett, *supra* note 49, at 285 (discussing how the arbiter’s interpretation of agreements and facts, not the mere rules, typically determines the outcome of legal contests).

51. See, e.g., Larry A. DiMatteo, *Strategic Contracting: Contract Law as a Source of Competitive Advantage*, 47 AM. BUS. L.J. 727, 767 (2010) (outlining the strategic use of contract terms).

52. See, e.g., Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 293 (1984) (suggesting that “business lawyers serve as transaction cost engineers and that this function has the potential for creating value”).

appreciate the importance of revenue recognition or is willing to allow nonlawyers to control the debate. In scholarly legal commentary, one article—ironically published just months before the collapse of Enron and demise of mega-certified public accounting firm Arthur Andersen—associated revenue recognition with contract law,⁵³ but did not discuss how comparative contract law might impact revenue. Practicing attorneys have been similarly silent, at least in their public comments; none of the combined 1,345 comment letters submitted in response to the ED⁵⁴ and ED 2010⁵⁵ was written by a practicing attorney or legal academic writing as such.

Further evidence of the legal community's noninvolvement in drafting the ED was offered by FASB member Tom Linsmeier who, in an October 2011 interview, stated his understanding that neither the FASB nor the IASB had formally involved legal experts (either practicing attorneys or legal scholars) in the drafting process.⁵⁶

2. Accounting and Revenue Recognition

Accounting research recognizes that legal differences among countries may materially impact financial results and disclosures, yet so far has not directly examined the relationship between comparative contract law and revenue recognition.

Bikki Jaggi and Pek Yee Low compared financial disclosures of firms in common-law countries with disclosures of firms in so-called code-law countries, using corporate disclosure data obtained from the

53. See Robert A. Prentice, *The Case for Educating Legally-Aware Accountants*, 38 AM. BUS. L.J. 597, 615, 617 (2001) (noting that financial statement auditors must understand contract law to properly audit revenue assertions).

54. The 359 comment letters submitted in response to the ED can be accessed at *FASB Comment Letters*, FIN. ACCT. STANDARDS BOARD, http://www.fasb.org/jsp/FASB/CommentLetter_C/CommentLetterPage&cid=1218220137090&project_id=2011-230&page_number=1 (last visited Feb. 16, 2013).

55. The 986 comment letters submitted in response to the ED 2010 can be accessed at *FASB Comment Letters*, FIN. ACCT. STANDARDS BOARD, http://www.fasb.org/jsp/FASB/CommentLetter_C/CommentLetterPage&cid=1218220137090&project_id=1820-100&page_number=1 (last visited Feb. 16, 2013).

56. Interview with Thomas J. Linsmeier, Board Member, FASB, in Kennesaw, Georgia (Oct. 13, 2011). Prabhakar Kalavacherla, the IASB member in charge of the revenue recognition project, echoed Linsmeier, stating that he could think of no comment letters from law firms and that the IASB had not actively reached out to attorneys, in part because IASB members and staff were occupied with other groups that had demonstrated significant interest in the ED. Interview with Prabhakar Kalavacherla, Board Member, IASB, in Kennesaw, Georgia (Sep. 10, 2012). The views of Linsmeier and Kalavacherla are corroborated by a May 2012 FASB-IASB staff memorandum indicating that no attorney or law firm acting as such was formally approached by either board in relation to the ED. FASB & IASB, FASB-IASB REVENUE RECOGNITION STAFF PAPER: SUMMARY OF OUTREACH (2012), available at <http://www.fasb.org/cs/BlobServer?blobkey=id&blobwhere=1175824041164&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs>.

International Financial Reporting Index for Industrial Companies.⁵⁷ They found common-law countries associated with more extensive financial disclosure than code-law countries.⁵⁸

Similarly, Robert M. Bushman and Joseph D. Piotroski analyzed the influence of legal systems on incentives for accounting conservatism, finding that companies in jurisdictions with stronger investor protections and well-functioning judicial systems communicate negative earnings information more quickly than companies in countries where investor protections are weak and the judicial systems are of low quality.⁵⁹

Elaine Henry, Stephen Lin, and Ya-wen Yang found that net income and shareholders' equity reconciliation amounts filed with the SEC by IFRS-compliant issuers on Form 20-F varied significantly according to the issuer's legal origin, leading the authors to question whether IFRS is internationally homogeneous.⁶⁰

Christopher Nobes examined UK, German, French, and Italian regulators' interpretations of the terms *present fairly* and *give a true and fair view*, finding variation among and within the studied countries, in part because of legal and linguistic differences among them.⁶¹ In a separate paper, without reference to the relationship between revenue recognition and contract law, Nobes opined that IAS 18's definition of revenue contains four errors that persist in the ED.⁶²

Steven M. Mintz examined the ED's contract emphasis but did not mention the word *law* or seriously address contract-law

57. Bikki Jaggi & Pek Yee Low, *Impact of Culture, Market Forces, and Legal System on Financial Disclosures*, 25 INT. J. ACCT. 495, 505 (2000). The final sample included 401 firms composed of 263 from common-law countries (represented by Canada, the United States, and the United Kingdom) and 138 from code-law countries (represented by France, Germany, and Japan), where *code law* and *common law* refer, respectively, to the Napoleonic civil-code tradition (which emphasizes the preeminence of the legislature and eschews judicially created case law) and the English common-law tradition (which, conversely, embraces judicial case law). *Id.*

58. *Id.* at 516.

59. Robert M. Bushman & Joseph D. Piotroski, *Financial Reporting Incentives for Conservative Accounting: The Influence of Legal and Political Institutions*, 42 J. ACCT. & ECON. 107, 108 (2006).

60. Elaine Henry, Stephen Lin & Ya-wen Yang, *The European-U.S. "GAAP Gap": IFRS to U.S. GAAP Form 20-F Reconciliations*, 23 ACCT. HORIZONS 121, 124 (2009). The study examined the financial statements of IFRS-reporting EU companies with both U.S. listings and 20-F reconciliations, categorizing them as having common or civil-law legal origins, among civil-law countries, as pertaining to French, German, or Scandinavian legal "families." *Id.* at 126.

61. See Christopher Nobes, *The Importance of Being Fair: An Analysis of IFRS Regulation and Practice—A Comment*, 39 ACCT. & BUS. RES. 415, 417–20 (2009) (explaining that the question of whether the "give a true and fair view" requirement is identical to the "present fairly" requirement should be analyzed based on jurisdiction "because the legal and linguistic context will affect the answer").

62. Nobes, *supra* note 11, at 92.

implications.⁶³ Similarly, Katherine A. Schipper et al. compared two alternative revenue recognition models then under consideration by the FASB and IASB and, while emphasizing that both models were based on contractual assets and liabilities, used the term *law* in their article only once in passing.⁶⁴

Accounting regulators have sometimes stretched to find alternatives to the term *contract*. For example, SAB No. 104⁶⁵ uses *arrangement*, defined as the “final understanding between the parties as to the specific nature and terms of the agreed-upon transaction.”⁶⁶

Similarly, the word *contract*, when it appears in accounting literature, does not necessarily imply operation of law. For example, IAS 32 defines *contract* as “an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law,” implicitly defining as “contracts” legally unenforceable agreements.⁶⁷

Constituent commentary on the contract-law aspects of the ED has been sparse and contradictory. While some commentators expressed concerns regarding the contract-law focus of the ED and

63. See Steven M. Mintz, *Proposed Changes in Revenue Recognition Under U.S. GAAP and IFRS*, CPA J., Dec. 2009, at 34, 34–39; see also Ryerson, *supra* note 37 (noting the ED’s enforceable contract criterion but omitting reference to law as the required enforcement mechanism).

64. See generally Schipper, *supra* note 27.

65. SAB No. 104, *supra* note 19, at 1–2.

66. *Id.* at 10 n.3.

67. INTERNATIONAL ACCOUNTING STANDARDS, *supra* note 3, standard 32 ¶ 13 (2012).

ED 2010,⁶⁸ references to those contract-law concerns are scarce in the boards' published summaries of constituent comments.⁶⁹

Some commentators acknowledge the law-accounting relationship but seem unsure about how to address it. For example, a June 2009 Financial Accounting Standards Committee (FASC) letter argued that the new FASB-IASB revenue recognition standard should define the term *contract* as a legally enforceable agreement.⁷⁰ Paradoxically, the FASC also asserted that (a) agreements are often noncontractual or legally unenforceable, (b) other means of enforcement (such as retaliatory expulsion from diamond-trading co-ops) might bind counterparties where courts cannot, and (c) those "contracts" should also be accounted for under the ED.⁷¹ A later, scholarly version of the same FASC letter dropped the word *legally*, while retaining the footnote reference to other means of enforcement, thereby implying that enforceability by whatever means should be enough to justify revenue recognition.⁷² That the FASC felt compelled

68. See, e.g., Letter from the Inst. der Wirtschaftsprüfer to the IASB, *supra* note 16, at 18 (suggesting that the IASB adopt a single definition of *contract*); Letter from the Fed. of European Accountants to the IASB ¶¶ 16–19 (Apr. 17, 2012), available at <http://www.fasb.org/cs/BlobServer?blobkey=id&blobwhere=1175823880881&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs> (favoring a "reasonable expectation" test in place of the "too legalistic approach" of ED paragraph 35(b)(iii)); Letter from the Australian Accounting Standards Bd. to the IASB 28 (Nov. 1, 2010), available at <http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175821647623&blobheader=application%2Fpdf> (suggesting that the ED address how contract terms and performance obligations interact with local law); Letter from Grant Thornton Int'l Ltd. & Grant Thornton LLP to the IASB 5 (Oct. 21, 2010), available at <http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175821597817&blobheader=application%2Fpdf> (asking whether an entity would be required by contract terms or local law to refund progress payments if the entity terminates the contract); Letter from the Swedish Enter. Accounting Grp. to the IASB 4 (Oct. 18, 2010), available at <http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175821608026&blobheader=application%2Fpdf> (asserting that the ED's focus on legal title and its passage will undermine comparability because title passes at different times in different jurisdictions).

69. The word *law* appears only once in the summary of comments on ED 2010. IASB & FASB, IASB-FASB STAFF PAPER: COMMENT LETTER SUMMARY—MAIN ISSUES 20 (2010), available at <http://www.ifrs.org/Documents/RRAp3to3c.zip>. Similarly, for the ED, FASB & IASB, FASB-IASB STAFF PAPER: FEEDBACK SUMMARY FROM COMMENT LETTERS AND OUTREACH (2012), available at <http://www.ifrs.org/Documents/RR0512b07A.PDF>, highlights only two issues related to this paper: (1) whether contract payment terms must be "specified" in the contract or, alternatively, whether "general business practices and/or the legal environment in which the contract was signed" may be considered in recognizing revenue, *id.* ¶ 35; and (2) how to account for revenue from transactions or relationships that are not contracts with customers, *id.* ¶ 72.

70. Letter from the FASB to the IASB 6, 12 (June 19, 2009), available at <http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175819237972&blobheader=application%2Fpdf>.

71. *Id.* at 6 n.6.

72. FASC, *supra* note 16, at 691 n.6.

to argue for recognition in those circumstances supports the contention that the ED's omission of those transactions or relationships is a drafting deficiency.

In 2011, the FASC published a scholarly commentary critiquing the ED 2010 as too vague and proposing a revenue standard-setting framework that would entirely replace it.⁷³ While the FASC's proposal refers repeatedly to contracts and contractual performance, it does not address in a meaningful way the interplay between comparative contract law and revenue accounting.

Comments by the Chartered Financial Analyst (CFA) Institute's Centre for Financial Markets Integrity suggest similar intellectual conflict regarding the causal relationship between contract negotiation and formation (on the one hand) and revenue recognition and cash flow (on the other). The Institute recommended that the ED explicitly define *contract* as a constructive obligation rather than as a legally enforceable contract,⁷⁴ reasoning that constructive obligations correspond to economic liability more closely than legally enforceable contracts.⁷⁵ However, the Institute's letter does not define constructive obligation, explain how constructive obligation is better than a legally enforceable contract as an economic-liability surrogate, or explain how delinking constructive obligation from legal enforceability would improve the quality of financial reporting or reduce confusion in the minds of financial statement readers.

One plausible interpretation of the constructive-obligation concept is offered by game theory, which describes buyer-seller relationships that are self-enforcing Nash equilibria. In Nash equilibria, which may be fairly described as constructive obligations, buyer and seller have individual economic incentives to honor their contract, independent of judicial or other external enforcement.⁷⁶

In contrast to the expansive viewpoints of the FASC and CFA Institute, the European Financial Reporting Advisory Group argued that only with unilateral *legal* power to direct the use of and receive

73. FASC, *supra* note 30, at 577–78.

74. Letter from the CFA Inst. to the IASB 12 (Oct. 22, 2010), available at <http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175821813585&blobheader=application%2Fpdf>.

75. *Id.*

76. See JOEL WATSON, STRATEGY: AN INTRODUCTION TO GAME THEORY 139–41 (2008) (explaining basic game theory in the legal context). Substituting “Nash equilibrium” for “legally enforceable contract” in the ED would arguably improve the internal consistency of IFRS by reconciling the ED's narrow revenue recognition rule with the more liberal IFRS Conceptual Framework, which authorizes recognition when “(a) it is *probable* that *any* future economic benefit associated with the item will flow to or from the entity; and (b) the item has a cost or value that can be measured with reliability.” THE CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING ¶ 4.38 (Int'l Accounting Standards Bd. 2010) (emphasis added).

the benefit from a good or service⁷⁷ does a customer control that good or service, thereby allowing the seller to meet a threshold ED requirement for revenue recognition.⁷⁸ In other words, in the European Financial Reporting Advisory Group's view, a purported account receivable emanating from an obligation without legal force should not be recorded in the financial statements.

The FASB-affiliated Private Company Financial Reporting Committee (PCFRC) observed that ED paragraphs 13 and 24 state, respectively, that (a) only *legally enforceable* contract rights and obligations are recognizable but, conversely, (b) performance obligations of the revenue-reporting entity need only create a *valid expectation* in the customer's mind in order to be treated as separate revenue recognition milestones.⁷⁹ The PCFRC queried why a mere valid expectation should be good enough to establish paragraph 24 recognition milestones, while supposedly more robust legal enforceability is required for overall recognition under paragraph 13.⁸⁰

Meanwhile, the International Auditing and Assurance Standards Board questioned whether, because the ED's definition of *contract* includes some unwritten agreements, auditors will be able to obtain sufficient evidence to support management assertions regarding revenue to be received.⁸¹ Counter-logically, the Board also questioned how, in the absence of written agreements, auditors will be able to verify the existence or nonexistence of undisclosed side agreements.⁸²

77. See Letter from the European Fin. Reporting Advisory Grp. to the IASB 9 (Oct. 22, 2010), available at <http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175821620447&blobheader=applicati on%2Fpdf> (noting that a customer's control over goods and services is a function of contractual rights enforceable under relevant law).

78. *Id.*

79. Letter from the Private Co. Fin. Reporting Comm. to the FASB 1-2 (Feb. 10, 2012), available at <http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175823755909&blobheader=application%2Fpdf>.

80. This seeming contradiction was written into the ED because some respondents to ED 2010 argued that some promises should be treated as performance obligations even if unenforceable. See BASIS FOR CONCLUSIONS EXPOSURE DRAFT: REVENUE FROM CONTRACTS WITH CUSTOMERS, ED/2011/6 ¶¶ BC33, BC63 (Int'l Accounting Standards Bd. 2011) [hereinafter BASIS FOR CONCLUSIONS], available at http://www.ifrs.org/Current-Projects/IASB-Projects/Revenue-Recognition/EDNov11/Documents/RevRec_EDII_BC.pdf (describing contractual obligations). While not technically part of the ED, the Basis for Conclusions (BC) summarizes the considerations and reasoning that the FASB and IASB used in drafting it. See *id.* at 6 (explaining considerations taken during drafting); see also EXPOSURE DRAFT, *supra* note 1, at 17; BASIS FOR CONCLUSIONS, *supra* ¶ BC1 (explaining that certain factors were given more weight in drafting the ED).

81. See Letter from the Int'l Auditing and Assurance Standards Bd. to the FASB 8 (Mar. 19, 2012), available at <http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175823829827&blobheader=application%2Fpdf> (discussing how the increased use of significant judgments makes it more difficult to obtain audit evidence).

82. *Id.*

In fact, side agreements are sometimes deliberately hidden from auditors even when they are memorialized in writing.⁸³ Therefore, it appears that their existence or (especially) nonexistence should be equally difficult to discover and document with or without implementation of the ED.

II. REVENUE RECOGNITION PROCESS

A. Overview

The stated objectives of the ED include (a) clarification of revenue recognition principles,⁸⁴ (b) development of a common IFRS and U.S. GAAP standard⁸⁵ applicable to most contracts with customers,⁸⁶ and (c) enhanced comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets.⁸⁷ More specifically, the ED seeks to clarify when to recognize revenue,⁸⁸ how to measure revenue,⁸⁹ and what contract information must be disclosed in the financial statements and how to disclose it.⁹⁰ When to recognize revenue, in relation to contract formation, is a major focus of this Article. The following discussion divides the ED's revenue recognition process into two stages referred to here as Stage 1 (contract analysis) and Stage 2 (recognition and measurement).

83. See, e.g., SEC v. Koninklijke Ahold N.V. (2004) (SEC final order) (explaining that defendants allegedly delivered forged side letters to external auditors to support consolidation of nonsubsidiaries while concealing actual side letters, which contradicted the forgeries, from the auditors), available at <http://www.sec.gov/litigation/litreleases/lr18929.htm>.

84. See EXPOSURE DRAFT, *supra* note 1, ¶ IN2 (stating the goals of the ED).

85. *Id.*

86. Beyond the scope of the ED are (a) lease contracts covered by IAS 17, (b) insurance contracts covered by IFRS 4, (c) contractual rights or obligations covered by IFRS 9 and IAS 39, and (d) nonmonetary exchanges, between entities in the same lines of business, executed for the purpose of facilitating sales to customers not parties to the contract. *Id.* ¶ 9.

87. *Id.* ¶ IN2(c).

88. *Id.* ¶¶ 12–48 (explaining how to read a contract to determine the revenue). While the Codification provides no generally applicable definition of *financial statements*, the term typically refers to a collection of documents comprising a balance sheet, income statement, and statement of cash flows, plus accompanying explanatory notes. FASB CODIFICATION, *supra* note 2, subtopic 272-10-45-1.

89. See EXPOSURE DRAFT, *supra* note 1, ¶¶ 49–89 (explaining factors that must be considered when measuring revenue, including transaction price, time value of money, and noncash considerations).

90. See *id.* ¶¶ 104–130 (detailing what information is required in the presentation of the contract).

B. Stage 1: Contract Analysis

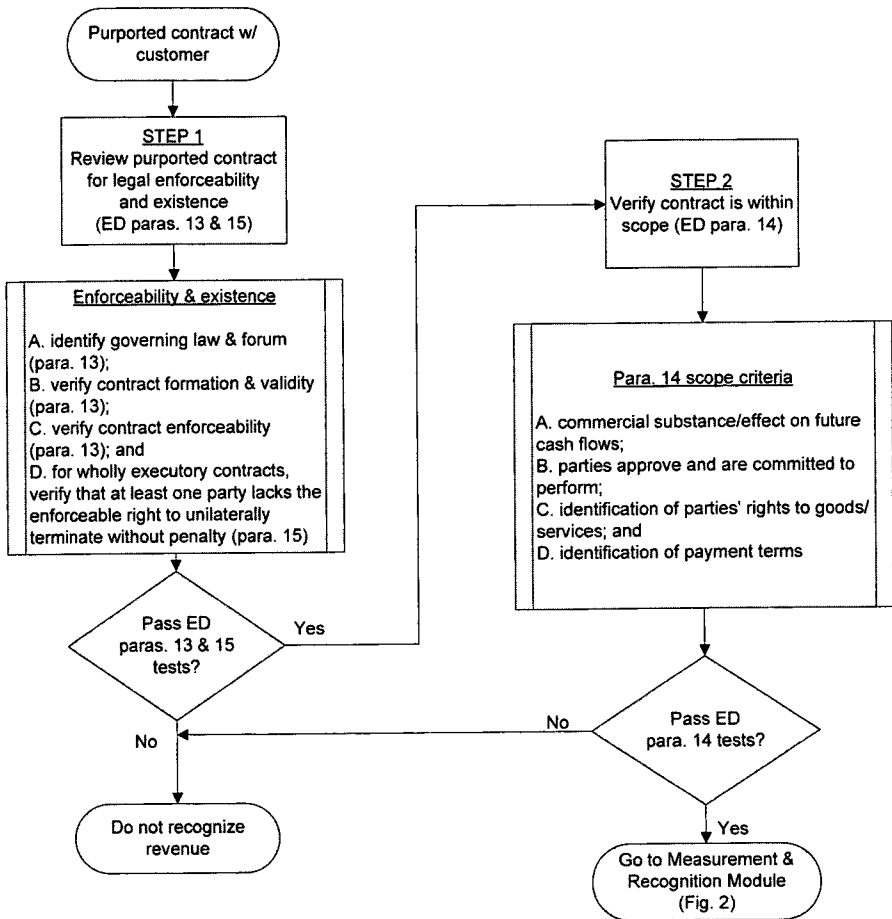
1. Contract Analysis Overview

The first stage of the ED's revenue recognition process, flow charted in Figure 1, requires two related analytical steps: (a) verification that a legally enforceable agreement exists within the meaning of ED paragraphs 13 and 15⁹¹ and (b) verification, under paragraph 14, that the legally enforceable agreement falls within the scope of the ED.⁹²

91. *Id.* ¶¶ 13,15.

92. *Id.* ¶¶ 14.

Figure 1
ED/2011/6 Revenue Recognition
Stage 1 - Contract Analysis



2. Contract Existence

The existence of a legally enforceable contract presupposes a contract validly formed under applicable law. Thus, paragraph 13 defines a contract as an agreement, whether written, oral, or implied by the entity's customary business practices, that creates enforceable rights and obligations.⁹³ It describes enforceability as a matter of law, with the understanding that practices and processes for establishing

93. See *id.* ¶ 13 (defining a contract for the purposes of the ED); see also BASIS FOR CONCLUSIONS, *supra* note 80, ¶ BC33 (defining *contract* in the ED).

enforceable contracts vary among jurisdictions, industries, and entities.⁹⁴ Paragraph 13 thus appears internally inconsistent: it limits implied contracts to those implied by the entity's customary business practice while noting, more liberally, that practices and processes for establishing enforceable contracts may also vary by jurisdiction or industry.

Paragraph BC32 of the ED's Basis for Conclusions affirms the primacy of legal enforceability:

[T]he IASB decided not to adopt a single definition of a contract for both IAS 32 and [the ED] because the IAS 32 definition implies that contracts can include agreements that are not enforceable by law. Including such agreements would be inconsistent with the boards' decision that a contract with a customer must be enforceable by law⁹⁵

The ED's emphatic legal enforceability requirement contrasts with current SEC staff views and IASB guidance on the role of contract enforceability in revenue recognition. SAB No. 104 endorses a four-pronged revenue recognition test that requires *persuasive evidence of an arrangement* between seller and buyer.⁹⁶ To illustrate the meaning of this phrase, SAB No. 104 describes a scenario, discussed in the following paragraph, in which the term *arrangement* resembles but does not necessarily equate to a legally binding contract.⁹⁷

Just before the seller's fiscal quarter end, a buyer places a product order with a seller.⁹⁸ Before the quarter's end, the seller ships the product and signs a sales agreement to which the buyer's purchasing department orally agrees but, pending final legal department approval, does not sign.⁹⁹ While the purchaser's

94. See EXPOSURE DRAFT, *supra* note 1, ¶ 13; see also BASIS FOR CONCLUSIONS, *supra* note 80, ¶ BC33.

95. BASIS FOR CONCLUSIONS, *supra* note 80, ¶ BC32. Paragraph BC32 also states that the definition of contract is "based on common legal definitions of a contract in the United States." This reference to U.S. "definitions" appears to merit little analytical weight because of its vagueness and because it is contradicted by the plain language of ED paragraph 13 and BC paragraph BC33. *Id.* ¶ BC33; EXPOSURE DRAFT, *supra* note 1, ¶ 13; see also *supra* note 67 and accompanying text (discussing IAS 32's expansive definition of contract). However, it does raise questions regarding the international bona fides of the ED and may create confusion in the minds of financial statement preparers, auditors, readers, or regulators who lack expertise in U.S. contract law.

96. See SAB No. 104, *supra* note 19, at 10–11 (explaining how to determine when revenue has been realized or is realizable). The remaining three prongs of SAB No. 104 require delivery of goods or provision of services, fixed or determinable transaction price, and reasonably assured collectability. *Id.*

97. See *id.* at 12–14 (describing the difference between an arrangement and a contract).

98. See *id.* at 12 (providing a timeline for the scenario used to explain the difference between an arrangement and a contract).

99. *Id.*

signature is said to be “highly likely” at the beginning of the next quarter,¹⁰⁰ the seller’s “normal and customary business practice for this class of customer” requires a sales agreement signed by the seller and buyer.¹⁰¹ On these facts, SAB No. 104 opines, despite the oral agreement and the delivery of the product, that revenue recognition should be postponed until the buyer signs because the seller’s customary business practice requires a customer-signed agreement for revenue recognition, not because the agreement is not legally binding.¹⁰²

Perhaps because SAB No. 104 does not have the force of law, no published SEC decision or other authoritative precedent has explicitly interpreted persuasive evidence of an arrangement. However, at least one SEC decision came close to doing so. In a 2007 enforcement action, the SEC found \$5.5 million in revenues improperly recorded where two purported contracts bound a reseller to endeavor to resell software.¹⁰³ According to the SEC, merely endeavoring to resell did not constitute a commitment sufficient to justify revenue recognition.¹⁰⁴

In the IFRS arena, IAS 18 does not refer to *contracts* or *arrangements*, but authorizes revenue recognition when it is probable that the reporting entity will receive the economic benefits associated with a *transaction*.¹⁰⁵ The remaining prongs of IAS 18 differ between goods and services transactions. Both require that the amount of revenue and associated costs be reliably measureable.¹⁰⁶ For goods sales, the seller must transfer to the buyer the risks and rewards of ownership and relinquish managerial involvement and effective control over the goods.¹⁰⁷

The ED does not resolve debates among accounting practitioners, regulators, and scholars as to the definition of *contract* or the role contracts should play in revenue recognition. However, the ED seems clear that contract enforceability is to be analyzed with reference to the law governing the purported contract, except for legally

100. *Id.*

101. *Id.* While the SAB’s language is imprecise, it would appear that SEC staff expect readers to intuit that the seller’s “customary business practice” is to *recognize revenue* only once this class of customer signs a written sales agreement.

102. *See id.* at 13 (arguing that business practices require written, rather than oral, agreements).

103. *In re Ernst & Young Chartered Accountants*, 8–9 (2007) (SEC final order) (finding that Ernst & Young inadequately audited arrangements and agreements), available at <http://www.sec.gov/litigation/admin/2007/34-56104.pdf>.

104. *Id.*

105. *See* INTERNATIONAL ACCOUNTING STANDARDS, *supra* note 3, standard 18 ¶ 18 (explaining what conditions are necessary to recognize revenue).

106. *Id.* ¶¶ 18, 20.

107. *See id.* ¶ 18 (describing sales transactions). Service transactions require that the transaction’s stage of completion be reliably measureable. *Id.* ¶ 20.

enforceable contracts implied by facts other than the reporting entity's own customary practices.

Beyond legal enforceability, ED paragraph 14 purports to further limit the scope of the ED to enforceable contracts that meet the following four additional tests:

- (a) the contract has commercial substance (ie the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract);
- (b) the parties to the contract have approved the contract (in writing, orally or in accordance with other customary business practices) and are committed to perform their respective obligations;
- (c) the entity can identify each party's rights regarding the goods or services to be transferred; and
- (d) the entity can identify the payment terms for the goods or services to be transferred.¹⁰⁸

Subparagraph 14(a) may reflect concerns about how jurisdictional legal diversity may impact the cash-flow prediction properties of revenue, one of the primary functions of revenue reporting.¹⁰⁹ Additionally, though it does not do so expressly, it may signal, probabilistically, that even a legally enforceable contract may ultimately produce no cash flow because of legal-process anomalies or other factors. Meanwhile, Nash equilibria seem ideally suited to the "committed to perform" language of subparagraph 14(b).

While paragraphs 13 and 14 might seem sufficient to screen out questionable but legally enforceable contracts, ED paragraph 15 goes further, imposing a sixth test on what it terms *wholly unperformed contracts*:

[A] contract does not exist if each party... has the unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party (parties). A contract is wholly unperformed if both of the following criteria are met:

- (a) the entity has not yet transferred any promised goods or services to the customer; and
- (b) the entity has not yet received, and is not yet entitled to receive, any consideration in exchange for promised goods or services.¹¹⁰

The meaning of ED paragraph 15 and the results of its interaction with ED paragraph 13 are unclear for three reasons. First, paragraph 15 states that a contract does not exist if each party has the unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party or

108. EXPOSURE DRAFT, *supra* note 1, ¶ 14.

109. *Id.* ¶ 8.

110. *Id.* ¶ 15.

parties.¹¹¹ From a purely logical standpoint, no contract that fails this paragraph 15 existence test can create enforceable rights or obligations as required by paragraph 13. A purported contract that frees each party from its so-called obligations offers no enforceable rights to anyone and is, therefore, not a legally enforceable contract. Therefore, arguably, paragraph 15 describes a null set.

Second, paragraph 15 circuitously defines *wholly unperformed contract* as a contract in which the seller has transferred no goods or services to the customer *and* has not received, and is not yet entitled to receive, consideration in exchange.¹¹² This presents a dilemma in jurisdictions where mutual consideration is an essential contract element.¹¹³ In those jurisdictions, a so-called wholly unperformed contract, in which consideration to the seller is absent, has no legal validity; therefore, paragraph 15 is meaningless.

Third, assuming that paragraph 15 has some meaning, the ED does not define the compensation for unilateral termination that would bring an otherwise nonexistent, wholly unperformed contract into existence. This drafting oversight also renders paragraph 15 inoperative.

Whatever the practical meaning of paragraph 15, Table 1 provides a high-level summary of the ED, IAS 18, and SAB No. 104, highlighting differences among them. In reading Table 1, it should be understood that these three views of revenue recognition differ markedly in substance and style. Therefore, the topical equivalency of verbiage in cells located in different columns on the same row may be approximate, minimal, or nonexistent.

111. *Id.*; see also Prentice, *supra* note 53 (“[A]greements that give the buyer total discretion to return the product and consignment arrangements do not produce binding contracts.”).

112. EXPOSURE DRAFT, *supra* note 1, ¶ 15 (emphasis added).

113. See, e.g., CAL. CIV. CODE § 1550 (1982) (describing the essential elements of a contract); GA. CODE ANN. § 13-3-1 (2010) (stating the essentials of a contract).

Table 1—ED, SAB No. 104 and IAS 18 Compared

ED	IAS 18	SAB 104
Legally enforceable contract rights and obligations ¹¹⁴	Probable that the enterprise will receive the economic benefits of the transaction	Persuasive evidence of an arrangement between buyer and seller
Commercial substance (the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract) ¹¹⁵	Seller has relinquished managerial involvement and control over goods	Delivery of goods or provision of services
Parties have approved the contract and are committed to perform ¹¹⁶	Amount of revenue can be reliably measured	Fixed or determinable transaction price
Enforceable rights of the parties are identifiable ¹¹⁷	No similar concept	Reasonably assured collectability
Identifiable terms and manner of payment ¹¹⁸	Transaction-related costs can be reliably measured	No similar concept
For wholly unperformed contracts only, at least one party lacks the unilateral right to terminate the contract without compensating the other(s) ¹¹⁹	For services, stage of transaction completion can be measured reliably; for goods, risks, and rewards of ownership transferred to buyer	No similar concept

That ED paragraphs 13 and 14 explicitly require legal enforceability, when IAS 18 and SAB No. 104 do not, raises questions about revenue accounting for noncontractual relationships that are economically committed or legally binding and recognizable under

114. EXPOSURE DRAFT, *supra* note 1, ¶¶ 12–13.

115. *Id.* ¶ 14(a).

116. *Id.* ¶ 14(b). Paragraph 14(b) appears to conflict with paragraph 13 in that the former accepts unwritten contract approval “in accordance with other customary business practices,” whereas the latter limits implied contracts to those arising from “the entity’s customary business practices.” *Id.*

117. *Id.* ¶ 14(c).

118. *Id.* ¶ 14(d).

119. *Id.* ¶ 15.

current standards or guidance to be superseded by the ED.¹²⁰ Whatever the outcomes for such relationships, implementation of the ED may influence sellers to game the revenue recognition system by emphasizing legal enforceability over other aspects of customer relationships.

Having verified the contract's validity and enforceability under the ED, the revenue recognition and measurement process begins in earnest, as explained in Part II.C. However, before moving to Part II.C, this Article highlights relationships not involving express contracts, most of which lie beyond the scope of the ED and for which no other accounting literature will provide authoritative guidance after the ED becomes effective.

3. Implied and Noncontract Obligations

In a variety of situations, counterparties may become legally obligated or otherwise committed to perform in the absence of an express, legally enforceable contract. These situations may be divided into two general categories: contracts implied in fact and noncontractual obligations.

For example, in some jurisdictions, pre- or extra-contractual damages may be assessed under various good faith-related doctrines.¹²¹ In German jurisprudence, when one party induces detrimental reliance by falsely leading another to believe there will be a contract between them, the inducing party may be held liable, *via culpa in contrahendo*, to make the other whole.¹²² In like manner,

120. See *supra* notes 46–47 and accompanying text (detailing guidance to be superseded by the ED); *infra* notes 137–139 and accompanying text (discussing possible accounting options for transactions and relationships beyond the ED's scope).

121. See also Hill & King, *supra* note 48, at 910 (discussing the codification of a duty to act in good faith in the German Civil Code); R.J.P. Kottenhagen, *Freedom of Contract to Forcing Parties into Agreement: The Consequences of Breaking Negotiations in Different Legal Systems*, 12 IUS GENTIUM 58, 74–77 (2006) (discussing various good-faith doctrines in the United States, the United Kingdom, and Europe); Robert A. Riegert, *The West German Civil Code, Its Origin and Its Contract Provisions*, 45 TUL. L. REV. 48, 94–97 (1970) (explaining the historical application of duty of care in German law). See generally Friedrich Kessler & Edith Fine, *Culpa in Contrahendo, Bargaining in Good Faith, and Freedom of Contract: A Comparative Study*, 77 HARV. L. REV. 401 (1964) (discussing the German good-faith doctrine of *culpa in contrahendo*). Under China's Uniform Contract Law Article 42(1), parties are prohibited from conducting negotiations in bad faith under the false pretense of entering a contract. See Matheson, *supra* note 6, at 348–49 (explaining the difference between Chinese and American contract law regarding good faith); see also C. Stephen Hsu, *Contract Law of the People's Republic of China*, 16 MINN. J. INT'L L. 115, 123 (2007) (explaining that good-faith duties apply during preliminary negotiations and post-contractual rights and duties, in addition to contract formation and performance). Similarly, under the Italian Civil Code, negotiating parties must behave in good faith during the precontractual bargaining and contract drafting. C.C. art. 1337 (It.).

122. See Hill & King, *supra* note 48, at 910 n.66 (stating that the first effective date of BGB § 311 II was Jan. 1, 2002); Hoffman, *Interpretation Rules and Good Faith*

the German *Bürgerliche Gesetzbuch* imposes restitutionary liability on a negotiating party who withdraws a manifestation of intent (either offer or acceptance) after a counterparty has detrimentally relied on that manifestation.¹²³ A similar doctrine is gaining traction in the United States.¹²⁴ Similar results may also be achieved in some U.S. jurisdictions through promissory estoppel or the quasi-contract arm of *quantum meruit*.

Promissory estoppel sounds in *culpa in contrahendo*: a promise is binding if injustice can be avoided only by its enforcement, when the promisor should reasonably expect the promise to induce action or forbearance by the promisee or a third person, and the promise does, in fact, induce such action or forbearance.¹²⁵

In theory, *quantum meruit* comprises two distinct but related doctrines: (1) *quasi-contract* (also called unjust enrichment or contract implied in law), a noncontract remedy calling for restitutionary damages equal to the value received by the defendant; and (2) *contract implied in fact*, in which a valid contract is formed, not by the parties' words, but by their conduct, for the breach of which the appropriate measure of damages is the price intended by the parties, or a reasonable market value when no price is expressed by them.¹²⁶

A contract implied in law arises where the defendant receives a benefit, and appreciates or knows of the benefit, under circumstances making it unjust for the defendant to retain the benefit without

as Obstacles to the UK's Ratification of the CISG and to the Harmonization of Contract Law in Europe, 22 PACE INT'L L. REV. 145, 160 (2010) (explaining that German courts applied the good-faith principle as a bar against claims); Kessler & Fine, *supra* note 121, at 402 (indicating that the essence of *culpa in contrahendo* is that a "careless promisor has only himself to blame when he has created for the other party the false appearance of a binding obligation"); Kottenhagen, *supra* note 121, at 74-77 (discussing the historical origins of *culpa in contrahendo* and citing BÜRGERLICHES GESETZBUCH [BGB] [CIVIL CODE], Aug. 18, 1896, § 241 II and § 311 II (Ger.), for the proposition that *culpa in contrahendo* is now codified in the German Civil Code).

123. BÜRGERLICHES GESETZBUCH [BGB] [CIVIL CODE], Aug. 18, 1896, § 122 (Ger.).

124. Alan Schwartz & Robert E. Scott, *Precontractual Liability and Preliminary Agreements*, 120 HARV. L. REV. 661, 664-65 (2007) (noting the recent emergence of a legal rule requiring parties to preliminary agreements with open terms to bargain over such terms in good faith or pay reliance damages to the other party).

125. See RESTATEMENT (SECOND) OF CONTRACTS § 90 (1981) (defining promissory estoppel); see also, e.g., Hoffman v. Red Owl Stores, Inc., 133 N.W.2d 267, 274-75 (Wis. 1965) (applying promissory estoppel where defendants induced plaintiffs to sell their grocery store, fixtures, and inventory by falsely promising to build a new store).

126. See, e.g., Davies v. Olson, 746 P.2d 264, 269 (Utah 1987) (citing RESTATEMENT (SECOND) OF CONTRACTS § 5 cmt. a (1981)); see also Candace S. Kovacic, *A Proposal to Simplify Quantum Meruit Litigation*, 35 AM. U.L. REV. 547, 553-58 (1986) (explaining sources of confusion in *quantum meruit* litigation).

paying for it,¹²⁷ but only so long as the benefit is not gratuitously conferred.¹²⁸

Typically, a contract implied in fact arises where (1) the defendant requests the plaintiff to perform work, (2) the plaintiff expects the defendant to compensate plaintiff for the work, and (3) the defendant knows or should know that the plaintiff expects compensation.¹²⁹ If these elements are present, the transaction would be a contract within the scope of the ED, but only if recognizing revenue in such a scenario is consistent with the seller's customary business practices¹³⁰ and the governing law adheres to this contract-implied-in-fact model. However, neither the ED nor the Basis for Conclusions indicates whether a legally enforceable, implied-in-fact contract would be recognizable if recognition proves inconsistent with the seller's customary business practices. Either way, if the governing law does not recognize a contract implied in fact under the circumstances presented,¹³¹ then the transaction would lie outside the ED's scope.

In practice, courts often misinterpret quasi-contract and contract implied in fact by confusing the two¹³² or conflating them into a monolithic *quantum meruit* hybrid.¹³³ For example, some jurisdictions have imposed generic *quantum meruit* restitutionary damages where: (1) valuable services are delivered to the defendant, who either requests or knowingly accepts them, (2) the plaintiff expects compensation at the time the services are rendered, and (c) failure to compensate the plaintiff would be unjust.¹³⁴ Thus, in *Nextel*

127. See Kovacic, *supra* note 126, at 554–55 (explaining legal actions in restitution); see also, e.g., Berrett v. Stevens, 690 P.2d 553, 557 (Utah 1984) (using “unjust enrichment” in place of “quasi-contract” or “contract implied in fact”).

128. See Kovacic, *supra* note 126, at 554–55 (explaining that the plaintiff must not confer the benefit gratuitously if seeking restitution).

129. See, e.g., Davies, 746 P.2d at 268–69 (stating that the theory of *quantum meruit* presupposes that no enforceable written or oral contract exists).

130. See EXPOSURE DRAFT, *supra* note 1, ¶ 13 (“Contracts can be written, oral or implied by an entity’s customary business practices.”).

131. See, e.g., Michael C. Walch, *Dealing with a Not-So-Benevolent Uncle: Implied Contracts with Federal Government Agencies*, 37 STAN. L. REV. 1367, 1373–74 (1985) (noting that federal courts have rejected implied-in-fact contract claims on “wooden, technical” grounds because, for example, a federal agency failed to follow its own contracting procedures, omitted a required contract term, or accepted terms different from published bid requests).

132. See Kovacic, *supra* note 126, at 547 n.23 (citing illustrative decisions by California, New York, North Carolina, and Texas courts).

133. See *id.* at 560–61 (explaining sources of confusion for courts and litigants regarding the theory of *quantum meruit*).

134. See, e.g., United States *ex rel.* Cortolano & Barone, Inc. v. Morano Constr. Corp., 724 F. Supp. 88, 99 (S.D.N.Y. 1989) (describing how a subcontractor is entitled to *quantum meruit* value of benefits provided to the prime contractor where both parties expected the subcontractor would get part of a construction contract); *Nextel S. v. RA Clark Consulting*, 596 S.E.2d 416, 419 (Ga. Ct. App. 2004) (describing how an executive search firm sued an employer for breach of contract and *quantum meruit*).

South v. RA Clark Consulting, the Georgia Court of Appeals upheld a *quantum meruit* award of \$15,000 to an executive search firm when the parties did not sign a fee agreement, but the search firm placed advertisements for the position and screened, evaluated, and interviewed over three hundred candidates, including the winning candidate who eventually resigned after working just over a month.¹³⁵

The concepts underlying implied or noncontractual obligations dovetail with the CFA Institute's proposal to substitute constructive obligation in place of legally enforceable contract,¹³⁶ evoking the following IASB meeting colloquy between Henry Rees, then-IASB Technical Principal on the Revenue Recognition Project, and James Leisenring, then representing the United States at the IASB:

Leisenring: There's a couple of things about this [contract concept] that trouble me. . . . [W]e spent an awful lot of time talking about situations like the painter . . . where I don't think there was a contract. So if you mean only when there is this contract that I can see I signed . . . I don't even know how to make that distinction.

Rees: [B]y contract . . . we did not mean a formal, signed document. We did discuss whether the word arrangement would be better but . . . I think we sort of agreed that contract translates better. . . . [S]o by contract we just meant promises that would be enforceable [W]e didn't mean, necessarily, that they have to be a written contract [M]ost people don't think of a cash sale as being a written contract.

Leisenring: But I'm afraid, I come from a jurisdiction that'll translate contract—and I think some FASB board members—will translate it very narrowly¹³⁷

Rees was not a member of the FASB or IASB and was not speaking for either board. His statement that by contract, "we just meant promises that would be enforceable," was uttered two years before the issuance of ED 2010 and should not color the meaning of the ED, which requires legally enforceable contracts on its face. However, the colloquy highlights two competing interpretations of the term *contract* prevalent in accounting circles.

At face value, revenues derived through promissory estoppel, *culpa in contrahendo*, and quasi-contract fall outside the ED's enforceable-contract scope. In contrast, SAB No. 104 and IAS 18 both appear to accommodate at least some noncontract customer relationships. When, how, or how much revenue to recognize from transactions outside the ED's scope remains an open question.

135. *Nextel S.*, 596 S.E.2d 416 at 418.

136. See *supra* note 74 and accompanying text (recommending that an explicit articulation of a contract be a constructive obligation to avoid confusion with legal obligations).

137. Audio MP3: IASB Meeting (Jul. 22, 2008), available at <http://media.iasb.org/AP6RevenueRecognition22072008.mp3>.

Under U.S. GAAP, one possible solution is offered by Codification Subtopic 105-10-05-02, which states that when transaction-specific guidance does not exist in the Codification (or, for SEC registrants, SEC rules), the reporting entity must first consider authoritative guidance for similar transactions and then turn to “non-authoritative” sources.¹³⁸ With most transaction-specific guidance superseded by the ED, the search for authority will likely loop back to the broad, high-level theory of FASB Concepts Statement No. 5 and, from there, to a déjà vu rendezvous with SAB No. 104, assuming that the SEC staff do not withdraw SAB No. 104.¹³⁹

IFRS, on the other hand, appears to offer no similar escape mechanism. The closest thing to it might be the so-called fair presentation override of IAS 1, paragraph 19, which requires firms to depart from or override detailed IFRS standards when management concludes that compliance with IFRS would be so misleading as to conflict with the IFRS Framework’s financial statement objectives.¹⁴⁰

Under either U.S. GAAP or IFRS, the financial statement results will likely vary depending on who searches for and interprets the nonauthoritative sources.

C. Stage 2: Recognition and Measurement

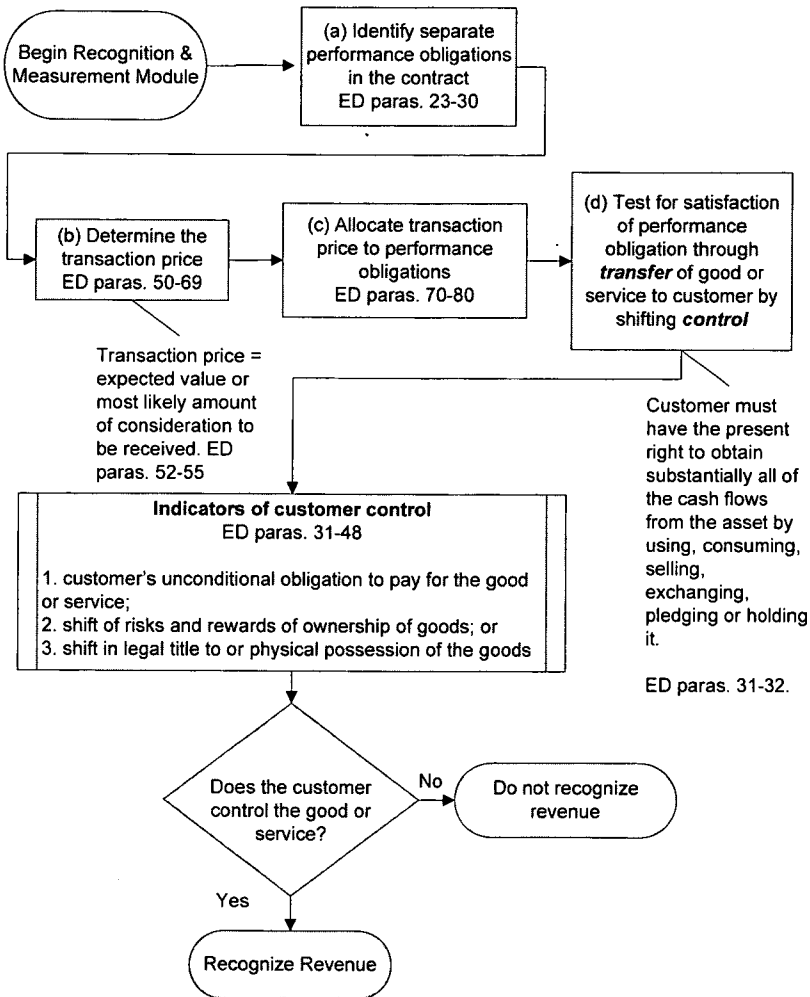
The primary aim in discussing Stage 2 is to assist readers in understanding the overall context in which the Stage 1 contract analysis takes place. Like Stage 1, Stage 2 (flowcharted in Figure 2) is intimately connected with contract law, as evidenced by the frequent appearance of terms such as *control*, *consideration*, *performance*, *pledging*, *obligation*, *satisfaction*, *title*, and *ownership*. Exhaustive analysis of these connections is beyond this Article’s scope. However, the following commentary provides helpful background.

138. FASB CODIFICATION, *supra* note 2, subtopic 05-10-05-2.

139. See *supra* note 27 (discussing FASB Concepts Statement No. 5) and *supra* note 19 (discussing SAB No. 104).

140. INTERNATIONAL ACCOUNTING STANDARDS, *supra* note 3, standard 1 ¶ 19.

Figure 2
ED/2011/6 Revenue Recognition
Stage 2 – Recognition & Measurement



Stage 2 performs two functions. First, it tests the transaction to ensure that revenue is recognized (meaning recorded in the financial statements) only upon satisfaction of performance obligations through transfer to the customer of the contracted goods or services.¹⁴¹ Second, Stage 2 determines the transaction price of the contract¹⁴² and, once transfer occurs, allocates the transaction price to separate performance obligations under the contract.¹⁴³

141. EXPOSURE DRAFT, *supra* note 1, ¶ 31.

142. *Id.* ¶ 50.

143. *Id.* ¶¶ 70–80.

Transfer occurs when control of the good or service shifts to the customer.¹⁴⁴ A customer obtains control of a good or service when the customer has the ability to direct the use of and receive related cash flows, and to prevent others from doing so.¹⁴⁵ Indicators of a shift in control include the customer's unconditional obligation to pay for the good or service, the transfer of legal title to or physical possession of the good, or transfer to the customer of the risks and rewards of ownership of the good.¹⁴⁶

Despite this required shift in control, which may indirectly impose accounting symmetry between buyer and seller, neither IFRS, nor U.S. GAAP, nor SEC regulations explicitly require symmetry. In other words, in a given transaction, the seller may be permitted or even required to recognize sales revenue under the seller's revenue accounting standards, even if the buyer does not record the purchase of the goods or services under the buyer's accounting standards.¹⁴⁷

Control has no accounting significance in the absence of a legally enforceable contract, without which contract revenue cannot be recognized. While it is not this Article's purpose to examine control in detail, the discussion below suggests that the ED fails to account for control-related contract-law complications in some jurisdictions.¹⁴⁸

The transaction price equals the amount of consideration to which the reporting entity expects to be entitled in exchange for transferring promised goods or services,¹⁴⁹ adjusted for discounts, rebates, incentives, performance bonuses, contingencies, and similar items.¹⁵⁰ For contracts that include a significant financing component, the transaction price must be discounted to present value.¹⁵¹ The transaction price should not, however, be adjusted for customer credit risk,¹⁵² which the ED describes as a collectability question to be accounted for under other accounting standards.¹⁵³

144. *Id.* ¶ 31.

145. *Id.* ¶ 32.

146. *Id.* ¶ 37.

147. Readers seeking a citation to authority for this proposition will seek in vain. Because there is no authority *positively* requiring financial accounting symmetry, it is not necessary to expressly authorize its *negative*. Outside of the financial accounting arena, the "no symmetry required" rule fails, particularly in the context of U.S. tax law. *See, e.g.*, 26 U.S.C. § 267(a)(2) (2006) (requiring symmetry in the reporting of the income and deductions in some transactions between some counterparties).

148. For discussion of the German principle of separation and abstraction, see *infra* notes 223–226 and accompanying text.

149. EXPOSURE DRAFT, *supra* note 1, ¶¶ 3, 50.

150. *Id.* ¶ 54.

151. *Id.* ¶ 58.

152. *Id.* ¶¶ IN17, 68–69. Credit risk is the risk that the reporting entity will be unable to collect the transaction price from the customer. *Id.*

153. *Id.* However, collectability may factor in Stage 1 contract analysis. Doubts about collectability may indicate that the customer's commitment to perform is less than required for applicability under ED paragraph 14.

While the term *consideration* appears in the ED 150 times, the ED does not define it—either internally or by reference to external authority. Similarly, the ED does not specify whether the term *expects* is defined subjectively or objectively. However, on the surface, ED paragraphs 3 and 50 both appear to describe what the entity actually (subjectively) expects, not what a reasonable observer in the entity's position should (objectively) expect.¹⁵⁴

A performance obligation is a seller's contractual promise to transfer a good or service to the customer.¹⁵⁵ The transaction price must be allocated to separate performance obligations, if any, in proportion to their separate estimated or actual (if actually sold separately) stand-alone selling prices.¹⁵⁶

III. ED APPLIED TO PRATT & WHITNEY–MALEV

This Part of the Article presents an actual transaction involving a purported contract for the sale of jet engines, parts, related services, and financing. The Article tests the purported contract for revenue recognition purposes using the ED's analytical process presented in Part II.

A. Fact Scenario: Jet Engine Transaction

Pratt & Whitney's (P&W's) 1990¹⁵⁷ attempt to sell jet engines and related services to Hungary's national airline, Malev, illustrates how an open or uncertain price term may result in either a binding contract or no contract depending on applicable law and its judicial interpretation.

In the fall of 1990, P&W entered into negotiations with Malev for the purchase of jet engines for two or three new airliners to be manufactured by either Boeing or Airbus and replacement engines for

154. The ED's discussion of transaction price appears to be internally inconsistent. While ED paragraphs 3 and 50 used "expects to be entitled," EXPOSURE DRAFT *supra* note 1, ¶¶ 3, 50, ED paragraph 49 states that where the consideration is "variable," cumulative revenue should not be recognized beyond the amount to which the entity "is reasonably assured to be entitled," *id.* ¶ 49. Meanwhile, under the same variable circumstances, ED paragraph 54 uses "will be entitled." *Id.* ¶ 54.

155. *Id.* ¶ 24.

156. *Id.* ¶ 71.

157. Although it occurred over twenty years ago, the Pratt & Whitney–Malev transaction remains a highly relevant illustration of issues and fact patterns that continue to arise today in negotiating, drafting, and litigating international sales of bundled goods and services. While it involved a bundle of tangible goods, services, and financing, the scope of the ED also extends to sales of intangibles. Application of the ED to a pure services or pure intangibles transaction will differ in some details from a bundled goods and services transaction, but the core principles are the same for both.

Malev's aging, Russian-built Tupolev airliners.¹⁵⁸ On December 4, 1990, the parties signed a letter of intent for the replacement engine component of the transaction, contingent on the signing of the new airliner component.

During a meeting on December 14, 1990, P&W presented Malev officials a detailed, fifteen-page proposed "Purchase Agreement"¹⁵⁹ (the Proposal) according to which Malev would purchase (a) engines for two new airliners and a call option¹⁶⁰ on engines for a third; (b) one spare engine plus a call option on an additional spare; and (c) a related service, maintenance, and spare parts "support" package.¹⁶¹ The Proposal also detailed credit terms that would accompany Malev's engine purchase.¹⁶²

Because Malev had not yet chosen between Boeing and Airbus planes, the Proposal specified per-engine prices for each of three alternative engine configurations: (1) for Boeing planes, the PW 4056 at \$5,847,675 per engine; and (2) for Airbus planes, either the PW 4152 at \$5,552,675 per engine, or the PW 4156/A at \$5,847,675 per engine.¹⁶³ The quoted prices, however, omitted the engine nacelle¹⁶⁴ and other parts that would be required if Malev were to choose Airbus.¹⁶⁵ On December 21, 1990, P&W extended the PW 4056 quote to the PW 4060 engine, should Malev choose Airbus over Boeing.¹⁶⁶

Subsequently, on December 21, Malev responded to the Proposal with a detailed written declaration of acceptance to the effect that Malev would power its new airliners with PW 4000 series engines.¹⁶⁷ As of December 21, however, Malev had not decided between Boeing

158. Fővárosi Bíróság [Metropolitan Court] Jan. 10, 1992, 3.G.50.289/1991/32 (Hung.), translated in *Case II: Metropolitan Court Budapest*, 13 J.L. & COM. 49, 52 (1993) [hereinafter *Metropolitan Court*].

159. *Id.*

160. Malev was firm in its decision to purchase at least two new airliners but also intended to purchase a call option on a third airliner, regardless of whether the airliners were manufactured by Boeing or by Airbus. *Id.* at 64. A call option is an option contract granting the holder of the option the right to buy the good or service at the "strike price" stated in the option contract. *Call Option*, OPTIONS GUIDE, <http://www.theoptionguide.com/call-option.aspx> (last visited Feb. 17, 2013).

161. Paul Amato, *U.N. Convention on Contracts for the International Sale of Goods—The Open Price Term and Uniform Application: An Early Interpretation by the Hungarian Courts*, 13 J.L. & COM. 1, 12–13 (1993).

162. Fővárosi Bíróság, 3.G.50.289/1991/32, translated in *Metropolitan Court*, *supra* note 158.

163. Amato, *supra* note 161, at 13.

164. An engine nacelle is a housing in which the jet engine sits and by which it is attached to the fuselage of the aircraft. *Id.* at 13 n.56.

165. Legfelsőbb Bíróság (LB) [Supreme Court] Gf.I.31.349/1992/9 (Hung.), translated in *Case I: The Supreme Court of the Republic of Hungary*, 13 J.L. & COM. 31, 41 (1993) [hereinafter *Hungarian Supreme Court*].

166. Fővárosi Bíróság, 3.G.50.289/1991/32, translated in *Metropolitan Court*, *supra* note 158, at 66–67.

167. *Id.* at 70.

and Airbus.¹⁶⁸ Eight days later, on December 29, Malev announced its decision to buy Boeing planes.¹⁶⁹

Through February 1991, the parties continued to dialogue regarding sale-related advertising, choice of a Hungarian engine-maintenance partner, and spare parts.¹⁷⁰ On March 25, Malev abruptly reversed its P&W jet purchase decision, sending P&W a letter characterizing it as “not likely” that Malev would purchase P&W engines.¹⁷¹ After negotiations broke down, P&W sued to enforce the agreement.¹⁷²

The Proposal’s choice-of-law clause designated the Connecticut Uniform Commercial Code (UCC) as the law governing the contract.¹⁷³ This clause, coupled with Hungarian law upholding contractual choice-of-law clauses,¹⁷⁴ might seem to require application of the Connecticut UCC.¹⁷⁵ However, prior to a September 20, 1991, hearing before the Metropolitan Court of Budapest, P&W voluntarily abandoned the Connecticut UCC in favor of the UN Convention on Contracts for the International Sale of Goods (CISG).¹⁷⁶ Why P&W chose the CISG over the Connecticut UCC is unclear. Whatever the rationale, the choice appears to have doomed P&W’s breach-of-contract claim against Malev.

B. Contract Analysis: Legal Enforceability

Revenue recognition analysis of the P&W–Malev transaction must begin by determining whether it presents a contract enforceable under applicable law. In discussing applicable law, this Article will refer to both substantive and procedural law. *Substantive law* defines the contract rights and obligations of the parties. *Procedural law* defines the legal process by which the parties’ substantive rights and obligations may be enforced if a party breaches.

Most jurisdictions generally permit parties to choose the law governing their contract and the forum in which disputes should be

168. Amato, *supra* note 161, at 14.

169. *Id.*

170. *Id.*

171. Fővárosi Bíróság, 3.G.50.289/1991/32, translated in *Metropolitan Court*, *supra* note 158.

172. *Id.* at 49.

173. Amato, *supra* note 161, at 14 n.58.

174. Fővárosi Bíróság, 3.G.50.289/1991/32, translated in *Metropolitan Court*, *supra* note 158, at 53 (quoting 13/1979. (VII.1.) Korm. r. a nemzetközi magánjogról (Law Decree No. 13/1979 (VII.1.) on Private International Law) (Hung.)).

175. *Id.*

176. Amato, *supra* note 161, at 14 n.58; see also Fővárosi Bíróság, 3.G.50.289/1991/32, translated in *Metropolitan Court*, *supra* note 158, at 53 (explaining that the Hungarian translation of the UCC was dispensed with because the parties agreed on the applicable substantive law).

decided.¹⁷⁷ However, if the parties do not choose or if enforcement of their choice would be unreasonable, unjust, or would contravene a strong public policy of the dispute resolution forum, applicable law will typically be chosen for the parties by treaty, statute, court, or arbitrator using principles of private international law or conflicts of law.¹⁷⁸

In most jurisdictions, substantive legal enforceability requires presence of the basic elements of a valid contract¹⁷⁹ and absence of valid defenses against the contract's enforcement.¹⁸⁰ Once substantive legal enforceability is established, further questions arise in relation to procedural and practical enforceability. In jurisdictions lacking the necessary legal infrastructure, it is possible that a legally enforceable contract may be practically unenforceable because judicial or enforcement capacity or willpower is lacking.¹⁸¹ Similarly, a court judgment or arbitral award has no economic value if assets are unavailable to satisfy it. A detailed analysis of procedural and practical enforcement issues goes beyond this Article's scope; however, it is important to note that legal enforceability is only the first step along a winding, uncertain path toward contract enforcement through legal process.

177. See, e.g., *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585, 591–93 (1991) (upholding a forum-selection clause in a cruise line's routine commercial carriage contract with an individual passenger); *The Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 12–16 (1972) (stating that, in general, freely negotiated agreements—including forum-selection clauses—unaffected by fraud, undue influence, or overweening bargaining power should be honored absent a strong contrary showing).

178. See, e.g., *The Bremen*, 407 U.S. at 15–17.

179. See, e.g., CAL. CIV. CODE § 1550 (1982) (listing the elements of a valid contract under California law: (a) parties capable of contracting, (b) their consent, (c) lawful object, and (d) sufficient cause or consideration); GA. CODE ANN. § 13-3-1 (2010) (listing the contract elements under Georgia law: (a) parties able to contract, (b) a consideration moving to the contract, (c) assent of the parties to the terms, and (d) subject matter upon which the contract can operate); RESTATEMENT (SECOND) OF CONTRACTS § 17(1) (1981) (“[T]he formation of a contract requires a bargain in which there is manifestation of mutual assent to the exchange and a consideration.”); Danielle Kie Hart, *Contract Law Now—Reality Meets Legal Fictions*, 41 U. BALT. L. REV. 1, 9 (2011) (explaining that contract validity requires the meeting of “contract law’s formation requirements”).

180. See, e.g., CODE CIVIL [C. CIV.] arts. 1109, 1110, 1111, 1116 (Fr.), translated at http://www.legifrance.gouv.fr/content/download/1950/13681/version/3/file/Code_22.pdf (last visited Jan. 21, 2013) (providing that error, duress, and deception may be defenses to the consent element of a contract in appropriate circumstances).

181. For example, delays in hearing and resolving contract cases in Italy can have the practical effect of making theoretically enforceable agreements practically unenforceable. This phenomenon is illustrated by a case involving the sale of “artistic goods” in which the plaintiff first filed a complaint in the court of original jurisdiction on November 21, 1985, and the Italian Supreme Court (*Corte Suprema di Cassazione*) finally found the contract valid on May 8, 2006. Cass. civile, sez. III, 8 maggio 2006, n. 10503 (It.). See generally Matheson, *supra* note 6 (discussing the unpredictability of legal outcomes in China stemming from cultural and legal infrastructure anomalies).

For the contract-analysis portion of this Article, jurisdictions were chosen to demonstrate differences in contract law (a) among fellow states of the European Union (represented by France, Germany, and Italy), (b) between the European Union and the Americas (represented by the United States and Colombia), (c) between individual country laws and international law (represented by the CISG), and (d) between conflicting interpretations of international law rendered by different courts of the same country (represented by the opposing decisions of the Metropolitan Court of Budapest and the Hungarian Supreme Court).

The selected jurisdictions share a common political pedigree, as current members of the European Union or former colonies of current EU members. Nevertheless, their shared political heritage belies differences in substantive contract rights and obligations, as well as procedural law governing their judicial vindication. The differences stem from a variety of historical factors including (a) the English Civil War, the aftermath of which strengthened the legislative power of English courts; (b) the Napoleonic backlash against the judiciary, which stripped French courts of legislative power; (c) the dissemination of Napoleonic civil law over much of Continental Europe; and (d) the spread of English-style common law¹⁸² throughout the former British Empire.¹⁸³

An example of procedural law with potentially substantive consequences is the variously observed tradition among civil-law jurisdictions, unlike common-law ones,¹⁸⁴ that courts generally lack the authority to create law by establishing binding precedent.¹⁸⁵ For example, France's Supreme Court (*Cour de cassation*) technically does not possess precedent-setting authority.¹⁸⁶ Nevertheless, a decision by the *Cour de cassation* (especially the *rapport objectif* written by the justice chosen as case *rapporteur*) is viewed as

182. English common law is distinguished from *das gemeine Recht* (the Justinian Roman common law), which is the most important antecedent of German civil law. Riegert, *supra* note 121, at 49.

183. See generally Daniel Klerman & Paul G. Mahoney, *Legal Origin?*, 35 J. COMP. ECON. 278 (2007) (explaining the historical divergences that led to the current systemic differences between countries whose legal systems are based on English common law and those whose systems are based on French civil law).

184. Mitchel de S.-O.-l'E. Lasser, *The European Pasteurization of French Law*, 90 CORNELL L. REV. 995, 1003 (2005) ("[T]he American system traditionally grants its judges explicit honest-to-goodness lawmaking power—as evidenced by the term 'case law,' for which there is, quite tellingly, no French equivalent . . .").

185. Klerman & Mahoney, *supra* note 183, at 288 ("Napoleon enacted his Code in part to eliminate judges' power to make law. . . . Revulsion at judicial power was so strong after the Revolution that judges were initially forbidden even to interpret law. Instead, they were required to refer ambiguous cases to the legislature . . .").

186. Lasser, *supra* note 184, at 1008–09 ("[O]nly the political branches of government can produce law. Judges must not usurp this . . . lawmaking power, because to do so would violate the most fundamental premise of a republican form of government." (emphasis omitted)).

persuasive guidance that, despite its technically nonbinding status, lower courts tend to follow in order to avoid reversal on appeal.¹⁸⁷

Whatever their genesis, the presence of these legal differences among modern European countries and their political descendants suggests that even greater differences prevail between Euro-centric jurisdictions and non-European ones. Some of these differences will be discussed in the following paragraphs.

1. European Union

Comparative law scholars regard German and French law as the two pillars of the civil-law system,¹⁸⁸ around which the other members of the civil-law family have evolved.¹⁸⁹ While Germany and France are both known as civil-law jurisdictions, their laws have developed differently, sometimes even in opposition to each other.¹⁹⁰ German and French law, in contrast to English common law, are derived to some degree from Roman law.¹⁹¹ The French Civil Code

187. *Id.* at 1009, 1050–63 (explaining that “only an incompetent attorney” would fail to consider *rapport objectif* of the *Cour de cassation*, of which 150–200 have been published annually in response to the European Court of Human Rights decision in *Kress v. France*, 2001-VI Eur. Ct. H.R. 1). See generally JOHN BELL ET AL., PRINCIPLES OF FRENCH LAW 26, 30 (2d ed. 2008) (discussing the role of French courts in French law). *Rapport objectif* is the work product of the *conseiller rapporteur*. See *Lexique, COUR DE CASSATION*, http://www.courdecassation.fr/informations_services_6/charte_justiciable_2544/annexes_2551/lexique_10967.html (last visited Feb. 16, 2013) (defining *rapport*).

188. The idea of grouping countries in legal families originated with Montesquieu, see PETER DE CRUZ, COMPARATIVE LAW IN A CHANGING WORLD 26 (2d ed. 2004), and continues today, see RENÉ DAVID & JOHN E.C. BRIERLEY, MAJOR LEGAL SYSTEMS IN THE WORLD TODAY 22 (3d ed. 1985). See generally KONRAD ZWEIGERT & HEIN KÖTZ, AN INTRODUCTION TO COMPARATIVE LAW (Tony Weir trans., 3d rev. ed. 1998).

189. The French Civil Code and the BGB have served as the basis for statutory codifications in many other jurisdictions. See MICHAEL H. WHINCUP, CONTRACT LAW AND PRACTICE: THE ENGLISH SYSTEM, WITH SCOTTISH, COMMONWEALTH, AND CONTINENTAL COMPARISONS 37 (6th ed. 2006) (explaining that contract law in Belgium, Holland, Luxembourg, Switzerland, Italy, Spain, Portugal, Egypt, Louisiana, Quebec, and the states of South America is modeled after the Napoleonic Code of 1804); Riegert, *supra* note 121, at 58 (stating that the codes of Thailand, Japan, Greece, Brazil, and Peru are influenced by the BGB). Even the UCC followed in most U.S. jurisdictions borrows from the BGB. See Riegert, *supra* note 121, at 54 n.34 (noting that UCC § 2-403(2) partially adopts BGB §§ 932–935 in relation to good-faith acquisition of property from a person without title). The University of Ottawa JuriGlobe World Legal Systems Research Group provides a high-level classification of legal systems employed in countries around the world. See *Alphabetical Index of the Political Entities and Corresponding Legal Systems*, JURIGLOBE, <http://www.juriglobe.ca/eng/sys-juri/index-alpha.php> (last visited Feb. 16, 2013).

190. See James Whitman, *Commercial Law and the American Volk: A Note on Llewellyn's German Sources for the Uniform Commercial Code*, 97 YALE L.J. 156, 159 (1987) (describing a period of German opposition to Roman law).

191. See Riegert, *supra* note 121, at 49–50, 56 (“The most important antecedent of German civil law was undoubtedly the Roman common law . . .”); Catherine Valcke,

merged the *droit écrit* (written law derived from Roman law) and existing *coutumes* (customary law),¹⁹² and reflects strong moral and ethical values.¹⁹³ It is praised for its conceptual clarity and elegant style, in part because Napoléon Bonaparte wanted the Code written for the people in a manner that lay people could understand.¹⁹⁴

In contrast, the *Bürgerliches Gesetzbuch* (BGB) was written for experts by experts¹⁹⁵ steeped in the German legal tradition, which was influenced by the nineteenth-century Pandectist movement, which itself was rooted in Roman law.¹⁹⁶ The resulting law is conceptual, systematic, and largely free of ethical, moral, or religious considerations.¹⁹⁷ The BGB differs markedly from the French Civil Code in style, structure, and sometimes substance, as the following survey of the law on open-price terms illustrates.

a. France

Under the French Civil Code, Malev's acceptance letter would not have created an enforceable contract on December 21, 1990, but arguably would have done so on December 29, 1990. It would not have been enforceable on December 21 because the P&W Proposal on which Malev's acceptance was based did not adequately specify the price of the engine nacelle or other parts that would be required if Malev were to choose Airbus over Boeing. This pricing ambiguity was effectively cured on December 29, 1990, when Malev, without renouncing its December 21 acceptance, chose Boeing planes, thereby rendering the price of the transaction objectively determinable.

The French Civil Code requires four conditions for contractual validity: (1) consent of the party to be bound, (2) the bound party's capacity to contract, (3) a definite object or subject matter of the undertaking, and (4) a lawful cause of the obligation.¹⁹⁸ The contract must have for its object a thing determined, at least as to kind. While the quantity may be uncertain, it must be determinable.¹⁹⁹

Comparative History and the Internal View of French, German, and English Private Law, 19 CAN. J.L. & JURISPRUDENCE 133, 149 (2005) (explaining that the drafters of the BGB sought to "preserve both the facts of German history and the written Reason of Roman law").

192. See DE CRUZ, *supra* note 188, at 63.

193. *Id.* at 66.

194. See 1 P.A. FENET, RECUEIL DES TRAVAUX PREPARATOIRES DU CODE CIVIL 3 (1836) (Fr.) (affirming the need for the Civil Code to be easily understood, given that the legislature works for the people and should therefore speak directly to the people).

195. See DE CRUZ, *supra* note 188, at 86.

196. *Id.* at 81.

197. *Id.*

198. CODE CIVIL [C. CIV.] art. 1108 (Fr.), translated at http://www.legifrance.gouv.fr/content/download/1950/13681/version/3/file/Code_22.pdf (last visited Jan. 21, 2013).

199. *Id.* art. 1129.

While French courts once required pricing certainty in nearly all contracts,²⁰⁰ the *Cour de cassation* determined in 1995²⁰¹ that parties to a *contrat cadre de distribution* (long-term supply contract) can validly set future prices under a contract by reference to the supplier's normal contract rate, as long as the rate is not abusive.²⁰² Since the 1995 decision, subsequent cases have confirmed that this jurisprudence endorsing indefinite prices also applies to some other long-term contracts, such as for the delivery of gasoline between an oil company and a gas station,²⁰³ delivery of beer to a restaurant,²⁰⁴ rental and maintenance of telephone equipment,²⁰⁵ and loans.²⁰⁶

The principle applicable to long-term agreements does not extend to the one-time delivery of goods.²⁰⁷ In those sales contracts, the price must be stated by the parties²⁰⁸ or, alternatively, left to the estimation of a third person designated by them.²⁰⁹ However, when the third person is unwilling or unable to estimate, the contract fails.²¹⁰ This implies that the price must either be *determined* or

200. *Id.* art. 1591; see also Edward A. Tomlinson, *Judicial Lawmaking in a Code Jurisdiction: A French Saga on Certainty of Price in Contract Law*, 58 LA. L. REV. 101, 102 (1997) (explaining that Article 1591 requires the price to be fixed and stated by the parties); *Arrêts du 1er Décembre 1995 Rendus par l'Assemblée Plénière: Extraits de la Note de Madame le Conseiller Fossereau* [Excerpts of the Notes of Madame le Conseiller Fossereau], COUR DE CASSATION, http://www.courdecassation.fr/publications_cour_26/bulletin_information_cour_cassation_27/bulletins_information_1996_755/no_422_766/jurisprudence_767/cour_cassation_770/arret_public_integralement_1672.html (last visited Feb. 16, 2013) (Fr.) (addressing in depth the development of French jurisprudence on open-price terms).

201. Cour de cassation [Cass.] [supreme court for judicial matters] ass. plén., Dec. 1, 1995, Bull. civ. A.P. No. 7, at 13, note Aynès (Fr.).

202. See *id.* (holding that a contract was not void for indeterminacy of price where there was no reason to believe that the contested fees could not be predicted based on benchmark values); see also BELL ET AL., *supra* note 187, at 316 (“[I]n 1995 the Assemblée plénière divorced these two issues and roundly declared that parties to a long-term supply contract could validly set its future prices by reference to the supplier's normal contract rate . . .”). In the immediate aftermath of the 1995 decision, one commentator speculated that its liberalization of indefinite price would extend to all sales contracts. Tomlinson, *supra* note 200, at 102–03.

203. Tomlinson, *supra* note 200, at 120.

204. *Id.* at 131.

205. Cour de Cassation, Bull. civ. A.P. No. 7, at 13 (Fr.).

206. Cour de cassation [Cass.] [supreme court for judicial matters] 1e civ., Jun. 14, 2000, Bull. civ. I, No. 184 (Fr.); Cour de cassation [Cass.] [supreme court for judicial matters] com., Jul. 9, 1995, JCP 1996, II, 22721, obs. Stoufflet (Fr.).

207. It might, however, apply to the related services and spare-parts elements of the purported P&W–Malev contract.

208. CODE CIVIL [C. CIV.] art. 1591 (Fr.), translated at http://www.legifrance.gouv.fr/content/download/1950/13681/version/3/file/Code_22.pdf (last visited Jan. 21, 2013).

209. *Id.* art. 1592.

210. *Id.*

determinable.²¹¹ In this connection, French law voids contracts subject to so-called *potestative* conditions,²¹² which condition the validity of an agreement on the occurrence of an event that one of the contracting parties has the unilateral power to make occur or prevent.²¹³

The purported December 21 P&W–Malev agreement does not state a fixed price. Whether the price could be determined is questionable because, as of Malev’s December 21 acceptance, it was still possible that Malev could choose Airbus planes for which P&W had provided an incomplete price term by omitting the price of the nacelle and other parts. While one could argue that the agreement stated an engine-only price tied to Malev’s choice between Boeing and Airbus, that price was nevertheless unilaterally determinable by Malev and was, therefore, a potestative condition rendering the P&W–Malev contract invalid.

Consequently, under French law, a valid contract would have been formed only as of December 29, 1990, when Malev announced its decision to buy Boeing planes, thus narrowing its engine alternatives to the unadorned PW 4056 or PW 4060, both of which were priced at \$5,847,675 per engine.

b. Germany

Taken together with Malev’s December 21 acceptance, Malev’s December 29 choice of Boeing planes would form a valid contract under German law. In fact, the December 21 acceptance alone probably would have been sufficient.

Compared to French law and Colombian law, the BGB takes an expansive view of contract formation, requiring nothing more than declarations of will from at least two persons who agree with each other.²¹⁴ In contrast to the French Civil Code and English common law, the BGB requires no consideration, object, or cause to form a valid contract.²¹⁵ Price is an essential element of sale-of-goods contracts.²¹⁶ However, non-sale-of-goods contracts need no price to be enforceable.²¹⁷

211. See LAMY, *DROIT DU CONTRAT* 215-21 (2010) (presenting examples where contracts were held to be valid because the price of the isolated sale could be determined using various objective indicia).

212. C. CIV. art. 1174.

213. *Id.* art. 1170.

214. See BÜRGERLICHES GESETZBUCH [BGB] [CIVIL CODE], Aug. 18, 1896, §§ 145–155 (Ger.) (defining what constitutes an offer and the circumstances that will make an acceptance binding).

215. See RAYMOND YOUNGS, *ENGLISH, FRENCH & GERMAN COMPARATIVE LAW* 512 (2d ed. 2007).

216. See BGB § 433 (stating that the purchaser must pay an agreed-upon purchase price).

217. On the price question, the BGB differentiates between contracts for the sale of goods and other contracts, including sales of services and donations. See HANS-

Even in sale-of-goods contracts, the price requirements are low: it is required only that the price can somehow be gathered from the formal agreement between the parties,²¹⁸ the underlying circumstances,²¹⁹ or objective criteria in connection with the agreement.²²⁰ The parties may also refer to external market information in setting the contract price.²²¹ Unstated price terms may be clarified through statutory gap fillers, amendments by the court consistent with what the parties would reasonably have intended if they had considered price, or the parties' own subsequent agreement.²²²

When the price is not clearly stated, the prevailing market price at the place and time of delivery is presumed—or, in the absence of a market price, a price at which the item would generally sell in the same geographical area at the time of delivery.²²³ Finally, German law expressly allows one party or the other to unilaterally determine the price promised, so long as the price is equitable.²²⁴ If the price so determined is inequitable, the court is authorized to set an equitable price.²²⁵

Applying these standards, Malev's December 21 acceptance letter established a binding contract because P&W's Proposal provided sufficient objective mechanisms for resolving any price ambiguity. The Proposal empowered Malev to unilaterally determine the price by choosing between Boeing and Airbus; therefore, the exact price was determinable. Even if Malev chose Airbus planes, for which P&W's offer did not price the engine nacelle or other parts, the

WERNER ECKERT ET AL., *HANDBUCH DES KAUFRECHTS* 373 (2007) (stating that a sales contract need not spell out an explicit price to be enforceable).

218. ECKERT ET AL., *supra* note 217, at 373 (stating that a sales contract will be enforceable so long as a price can reasonably be gleaned from the context of the transaction); J. VON STAUDINGER, *KOMMENTAR ZUM BÜRGERLICHEN GESETZBUCH, MIT EINFÜHRUNGSGESETZ UND NEBENGESETZEN* § 433, at 3 (12th ed. 2005) (quoting Beckmann).

219. See BGB §§ 133, 157 (mandating that contractual interpretation take account of the circumstances surrounding the disputed provision instead of relying on a literal interpretation of the text); see also HS. TH. SOERGEL & W. SIEBERT, *BÜRGERLICHES GESETZBUCH: MIT EINFÜHRUNGSGESETZ UND NEBENGESETZEN* 137 (13th ed. 1999) (quoting Huber).

220. See STAUDINGER, *supra* note 218, at 53 (quoting Beckmann); Bundesgerichtshof [BGH] [Federal Court of Justice] Dec. 13, 1989, 43 *NEUE JURISTISCHE WOCHENSCHRIFT* [NJW] 1902 (1903), 1990 (Ger.) (supporting a holding on a disputed contract by examining the text of the contract, relevant trade customs, witness testimony, and the financing arrangements surrounding the contract).

221. See Amato, *supra* note 161, at 20 (explaining that parties need not be bound by data contained within the contract when setting the price).

222. See *id.* at 19 (listing ways of legally supplying missing prices for a contract).

223. See *id.* at 20 (explaining how the price will be determined if the contractual price term is ambiguous).

224. See BGB §§ 315–316 (laying out the rules that apply when a contract allows one party to set a term of the contract, including the price term).

225. See *id.* § 315 (providing that if a party abuses its power to set a contract term, the courts will step in to set that term).

contract would be valid because German law, unlike French or Colombian law, would fill this gap with reference to P&W's normal pricing practices or market prices, either when Malev chose the plane manufacturer or upon delivery of the engines. Therefore, assuming that all other contract elements are present, the jet engine purchase agreement would be enforceable against Malev as early as December 21.

Here it is worth noting a German contract law principle, *separation and abstraction*, which relates to the ED's Stage 2 transfer and control test. Separation and abstraction strictly separates the contract for the sale of goods²²⁶ from the transfer of title to the goods themselves.²²⁷ The practical effect of separation and abstraction is that a customer may take title to a good even if the underlying sales contract is void.²²⁸ However, the customer's ownership of the goods may be challenged retroactively under restitutionary principles.²²⁹

The possibility that title may legally shift to a customer despite the void status of the sales contract raises questions regarding accounting treatment under the ED. The ED requires an enforceable contract as a prerequisite to revenue recognition. Therefore, in a buyer-seller relationship subject to the principle of separation and abstraction, it would be possible for the seller to be simultaneously divested of title to the goods, yet unable to recognize revenue from the sale because an enforceable contract is lacking. This Article does not examine the details of the principle of separation and abstraction; rather, it points to it as an illustration of how the ED might be improved by dialogue between accounting-standards setters and contract-law experts.

c. Italy

Under the Italian Civil Code, Malev's December 21 acceptance letter would most likely create an enforceable agreement because the missing price term, if any, could be filled by the price at which P&W normally sells the PW 4000-model engines or systems Malev later decides to buy.

226. See *id.* § 433 (setting forth the obligations incurred by the parties to a sales contract, including the obligation to transfer title).

227. See *id.* § 929 (explaining what a transfer of title involves; a valid contract is not part of the formula).

228. See CROSS-BORDER SECURITY OVER RECEIVABLES 94 (Harry C. Sigman & Eva-Maria Kieninger eds., 2007) (explaining that the state of a sales contract is completely irrelevant to the operation of a title transfer, though the sales contract might obligate a party to perform a title transfer).

229. See BGB §§ 812–822 (setting forth the rules applicable to restitution claims).

Case law or precedent, in the common-law sense, generally does not exist under Italian law,²³⁰ in that Italian judicial decisions have no formal authoritative force in subsequent cases.²³¹ The ultimate source of authority on sources of Italian law, Article 1 of the *Disposizioni sulla legge in generale*, pointedly omits judicial decisions, expressly including only statutes, regulations, and usages as sources of legal authority.²³² Under Italian law, a usage is a uniform behavior engaged in by a political, geographic, or industrial subgrouping for a time period sufficiently long to create the presumption of legality and is binding if not contradicted by another source of law.²³³ Usages are sometimes codified in collections edited by chambers of commerce or by the Italian Ministry for Industry and Trade.²³⁴

In applying statutes to specific cases, Italian courts must interpret the statutes as they are written, but are permitted to reason by analogy from the statutory language to resolve interstitial or peripheral questions.²³⁵ Additionally, despite their formal disregard of precedent, lower Italian courts tend as a practical matter to respect the decisions of higher courts, particularly those of the *Corte di Cassazione*, Italy's highest court for commercial matters.²³⁶ Thus, the Italian judiciary plays an informal role in shaping Italian law.²³⁷

230. See Erika Arban, Note, *The Doctrine of Strict Compliance in the Italian Legal System*, 23 ARIZ. J. INT'L & COMP. LAW 77, 79–80 (2005) (explaining the position of previously decided cases in the hierarchy of Italian legal authority).

231. See *id.* at 80 (explaining that Italian courts are not bound by prior decisions); Marinella Baschiera, *Introduction to the Italian Legal System. The Allocation of Normative Powers: Issues in Law Finding*, 34 INT'L J. LEGAL INFO. 279, 317 (2006) (“[T]he Italian legal system does not treat case law as a formal source of law.”).

232. See CODICE CIVILE [ITALIAN CIVIL CODE] [C.C.] art. 1 (It.), available at <http://www.ilcodicecivile.it> (setting forth the sources of legal authority under Italian law).

233. See Arban, *supra* note 230, at 80–81 (explaining the definition and legal authority of a usage under Italian law). An examination of industry or regional usages might reveal different perspectives on the issue of open-price terms.

234. See *id.* at 80 (explaining how usages come into written form).

235. Silvio Martuccelli, *The Right of Publicity Under Italian Civil Law*, 18 LOY. L.A. ENT. L. REV. 543, 546 (1998) (“[C]ourts can look to existing . . . [statutes] and ‘reason by analogy’ to apply [statutory] principles . . . to the present situation.”); see also C.C. art. 12 (laying out the method of statutory interpretation that courts must use).

236. See Arban, *supra* note 230, at 80 (explaining the role prior decisions play in the Italian judicial system). This respect, however, must be tempered by the realization that it typically takes so long for a case to wend its way through the Italian courts that the judge in the original case may be retired or dead by the time his or her opinion is reversed. See, e.g., Cass. civile, sez. III, 8 maggio 2006, n. 10503 (It.), which took the Italian courts twenty-one years to resolve.

237. See Baschiera, *supra* note 231, at 317 (noting that judiciary opinions constitute substantive law applicable to the case in question, but judges can effectively shape the law concerning the subject under consideration).

Under the Italian Civil Code, the essential elements of a contract²³⁸ are (a) the agreement of the parties; (b) cause; (c) a possible, lawful, and determinable contract objective;²³⁹ and (d) the specific form required by law, if any, as in transfers of real estate.²⁴⁰ Lacking any one of these elements, the contract is void.²⁴¹ Cause is interpreted as the socioeconomic basis of the contract.²⁴² In contracts for the sale of goods or other legal rights, the contract generally must also specify the sale price.²⁴³

Obligations under a contract extend beyond the parties' express writing to everything that by law, equity, or custom follows from the nature of the particular contract and common sense.²⁴⁴ Thus, a missing price may be found by reference to the price of identical or similar goods frequently sold by the seller, the market price (if any), or an independent third party such as an arbitrator.²⁴⁵

If the sales price is not stated in the contract and if the object of sale is a good that the seller sells frequently, it is presumed that the parties intend the price at which the seller normally sells the good or a good that is similar to it.²⁴⁶ Alternatively, if a market price is readily available, it is presumed that the price is the market price of the good at or near the place where the delivery is performed. When a market price is not available and the parties cannot agree on a price, then the price is to be set by an independent third party or arbitrator.²⁴⁷ Where no market price is available, the seller does not frequently sell the subject goods, and the parties cannot agree on an arbitrator, the lack of a price renders the contract invalid.²⁴⁸

Precisely where to draw the line between sold frequently and not is unclear. However, decisions of the *Corte di Cassazione* provide

238. See C.C. art. 1325 (setting forth the elements required of every contract).

239. *Id.* art. 1346.

240. See *id.* art. 1325 (listing the elements required of every contract and referencing the sections that lay out which types of contracts must take specific forms).

241. See *id.* art. 1418 (setting forth conditions that will nullify a contract). See generally FRANCESCO GALGANO, *IL CONTRATTO* (2007); ANDREA TORRENTE & PIERO SCHLESINGER, *MANUALE DI DIRITTO PRIVATO* 590–92 (18th ed. 2007) (describing the Article 1418 requirements for contract formation).

242. Antonio Giovannoni, *La Causa del Contratto fra Nozione Codicistica e Prassi Negoziale*, 7–8 *DIRITTO COM. D'OGGI*, July–Aug. 2006, <http://www.dircomm.it/2006/n.7.8/02.html>.

243. See C.C. art. 1470 (listing price as part of the definition of a sales contract).

244. *Id.* art. 1374 (“Il contratto obbliga le parti non solo a quanto e nel medesimo espresso, ma anche a tutte le conseguenze che ne derivano secondo la legge o, in mancanza, secondo gli usi e le equità.”).

245. See *id.* art. 1474 (explaining the methods to be used to fill in a missing price term in a contract).

246. See *id.*

247. See *id.*

248. See ORESTE CAGNASSO & GASTONE COTTINO, 9 *TRATTATO DI DIRITTO COMMERCIALE: CONTRATTI COMMERCIALI* 108–12 (Gastone Cottino ed., 2d ed. 2009) (discussing how a contract will have no legal effect when the parties cannot determine a price through available means).

broad parameters. For example, in a case involving the sale of flowers and plants, the *Corte di Cassazione* held that Article 1474's open-price term was properly filled by the price normally charged by the seller because plants sold in nurseries are commodities sold frequently in an active market.²⁴⁹

Article 1474 has also been used to complete open-price clauses in contracts for the sale of artistic goods²⁵⁰ and engine lubricating oil,²⁵¹ as well as to determine the replacement value of and, therefore, the price to replace an automobile destroyed in an accident.²⁵² By contrast, Article 1474 was found inapplicable to a purported contract for the construction of a sea platform.²⁵³

The P&W–Malev case involved the sale of jet engines, which, though not commodities like flowers or oil, are more like automobiles than sea platforms in purpose, customization potential, and frequency of sale. P&W sold jet engines frequently to other customers in much the same way that a car dealer sells cars and had ready prices for models that the buyer, Malev, could choose under the purported agreement. Therefore, a court applying Italian law to the P&W–Malev transaction might indeed find a valid contract by concluding, under Article 1474, that the parties intended the price P&W normally charges for the jet-engine model chosen by Malev.

2. North America: United States

Substantive U.S. contract law is articulated primarily at the state level²⁵⁴ in two forms: traditionally uncodified common law, now codified to varying degrees in different jurisdictions,²⁵⁵ and the UCC. This Article uses UCC Article 2 as representative of U.S. contract law with two caveats: UCC Article 2 applies only to sales of goods, and

249. Cass. civile, sez. II, 18 gennaio 2010, n. 648 (It.).

250. Cass. civile, sez. III, 8 maggio 2006, n. 10503 (It.).

251. Cass. civile, sez. III, 16 gennaio 2006, n. 719 (It.).

252. Cass. civile, sez. III, 1 giugno 2010, n. 13431 (It.).

253. See Cass. civile, sez. I, 23 luglio 2004, n. 13807 (It.) (determining that Article 1474 did not apply because there was insufficient continuity and homogeneity in trade practice to predict pricing).

254. Contract law in the United States is also found in federal common law applicable to contracts between U.S. government agencies and private parties. See generally Willard L. Boyd III & Robert K. Huffman, *The Treatment of Implied-in-Law and Implied-in-Fact Contracts and Promissory Estoppel in the United States Claims Court*, 40 CATH. U. L. REV. 605 (1991) (describing the way U.S. federal courts have handled certain types of contractual disputes in which the United States has been a party to the dispute); Jay Tidmarsh & Brian J. Murray, *A Theory of Federal Common Law*, 100 NW. U. L. REV. 585 (2006) (describing the contours of U.S. federal common law, including activities in which the United States itself is a participant); Walch, *supra* note 131 (analyzing certain types of contractual disputes in which a federal agency is one of the parties).

255. See, e.g., GA. CODE ANN. § 13-3-1 (2010). Under Georgia law, the common-law elements of a valid contract were first codified in 1863.

the results under Article 2 may vary across jurisdictions and from the results obtained under state common law,²⁵⁶ federal common law,²⁵⁷ or other UCC articles.²⁵⁸

Under the UCC, Malev's December 21 acceptance would almost certainly result in formation of a binding contract because UCC Article 2 expressly honors agreements without a settled price if the parties intend to agree despite the missing price term.²⁵⁹

Under the UCC, the term *goods* "means all things (including specially manufactured goods) which are movable at the time of identification to the contract for sale other than money paid, investment securities . . . and things in action."²⁶⁰ One illustration of the UCC's jurisdictional variability relates to whether a mixed goods-and-services contract is or is not a sale of goods subject to UCC Article 2.

In evaluating mixed contracts, courts tend to follow one of two tests: the *predominant purpose test* or the *gravamen test*.²⁶¹ Most jurisdictions apply the predominant purpose test,²⁶² examining the contract as a whole to determine whether goods or services predominate.²⁶³ In contrast, the gravamen test more narrowly

256. According to the Restatement (Second) of Contracts, "[T]he formation of a contract requires a bargain in which there is a manifestation of mutual assent to the exchange and a consideration." RESTATEMENT (SECOND) OF CONTRACTS § 17 (1981). The practical application of this common-law approach to open-price terms has produced differing results. *See, e.g.,* Goldstick v. ICM Realty, 788 F.2d 456, 461 (7th Cir. 1986) (holding a contract invalid under the common law of Illinois because of indefinite price); *In re Express Indus. & Terminal Corp. v. N.Y. State Dep't of Transp.*, 93 N.Y.2d 584, 590-91 (1999) (finding a government permit to lease dock space insufficiently definite to constitute an offer where the permit omitted the date by which the government could exercise an option to reoccupy 7 percent of the leased property and the amount of the rent reduction upon exercise of the option). *But see* Schwartz & Scott, *supra* note 124, at 664-65 (2007) (noting the recent emergence of a legal rule requiring parties to preliminary agreements with open terms to bargain over such terms in good faith or pay reliance damages).

257. *See, e.g.,* Walch, *supra* note 131, at 1373-74 (discussing how courts have handled contractual disputes involving the federal government).

258. *See, e.g.,* U.C.C. § 2A-204(3) (2012) (indicating that a lease contract does not fail for indefiniteness if the parties intend to contract and a basis for an appropriate remedy is reasonably certain).

259. *See id.* § 2-305 (explaining when parties will and will not be bound by a contract missing the price term); *see also* Amato, *supra* note 161, at 18-19 (explaining the UCC approach to unsettled price terms in contracts).

260. *See, e.g.,* MICH. COMP. LAWS § 440.2105 (1970) (defining the term *goods* for the purposes of the statute); GA. CODE ANN. § 11-2-105 (2002) (same).

261. *See* Pass v. Shelby Aviation, Inc., No. W1999-00018-COA-R9-CV, 2000 Tenn. App. LEXIS 247, at *8-9 (Tenn. Ct. App. Apr. 13, 2000) (discussing the tests that courts use to determine how to treat mixed contracts).

262. *See* Neibarger v. Universal Coops., Inc., 439 Mich. 512, 534 (1992) (noting that the predominant purpose test is the predominate test for determining how to treat mixed contracts).

263. *Id.* at 533-38 (holding a purchaser's common-law claims for economic loss time-barred by UCC Article 2 because the milking equipment purchase contracts at issue did not mention installation or service); Pass, 2000 Tenn. App. LEXIS 247, at *8-

examines that portion of the transaction upon which the complaint is based to determine whether its focus, and therefore the gravamen of the complaint, is goods or services.²⁶⁴

Under the gravamen test, a court would most likely find the P&W–Malev transaction to be a UCC Article 2 sale of goods because the apparent focus of P&W’s complaint was that Malev breached its agreement to buy goods in the form of jet engines. In contrast, the outcome under the predominant purpose test seems less clear because P&W’s Proposal was for an assortment of goods and services in which services, including financing and maintenance, played a major role.

Taking a closer look at predominant purpose, a consensus has formed around the *Bonebrake v. Cox*²⁶⁵ test, under which the UCC applies only when the purchaser’s ultimate goal is to acquire a product with incidental services²⁶⁶—not, in contrast, to obtain services accompanied incidentally by product.²⁶⁷

For example, in *Busch v. Dyno Nobel, Inc.*,²⁶⁸ the court applied UCC Article 2 to a joint-venture agreement between an explosives manufacturer and an antifreeze-recycling firm for the design and construction of a manufacturing plant whose ultimate purpose was the production of ethylene glycol.²⁶⁹ While the plant construction was a major contract element, the court held that UCC Article 2 governed the joint-venture agreement because its entire focus was to create a source of a good—ethylene glycol—not to provide services.²⁷⁰

12 (explaining the nature and application of the predominant factor test); see also *Bonebrake v. Cox*, 499 F.2d 951, 960 (8th Cir. 1974) (stating that the applicability of the UCC depends on whether the contract’s predominant factor, thrust, and purpose is the rendition of service with goods incidentally involved, or a sale of goods with labor incidentally involved).

264. See *Dixie Lime & Stone Co. v. Wiggins Scale Co.*, 144 Ga. App. 145, 145 (1977) (holding the UCC inapplicable to an action based entirely on a contract provision calling for construction of a pit and installation of a scale where the complaint alleged no defect in the scale itself); *In re Trailer & Plumbing Supplies*, 133 N.H. 432, 436 (1990) (describing the nature and implementation of the gravamen test); *Pass*, 2000 Tenn. App. LEXIS 247, at *8–9 (describing the gravamen test).

265. See *Bonebrake*, 499 F.2d. at 960 (describing the predominant purpose test).

266. *Olé Mexican Foods, Inc. v. Hanson Staple Co.*, 285 Ga. 288, 289–92 (2009) (holding the UCC inapplicable, under Georgia law, to a product-warranty litigation settlement contract because the settlement was the primary focus of the contract as evidenced in part by its title which read “agreement reached in settlement”); see also *Bonebrake*, 499 F.2d. at 960.

267. See, e.g., *Busch v. Dyno Nobel, Inc.*, 40 F. App’x 947, 955 (6th Cir. 2002) (applying the *Bonebrake* test to a mixed contract and holding that the UCC applied to the contract since the ultimate purpose of the contract was the provision of a product); see also *Bonebrake*, 499 F.2d at 960.

268. *Busch*, 40 F. App’x at 947.

269. See *id.* at 949, 955 (describing the nature of the dispute and holding that the UCC would govern the contract).

270. See *id.* at 955 (explaining the court’s rationale for applying the UCC under the predominant factor test).

Applying *Busch* and *Bonebrake* to the instant case, a court would likely find the P&W transaction to be a UCC Article 2 sale of goods because, while financing and maintenance were important to the transaction, Malev's primary motive was the purchase of jet engines, to which financing and maintenance were appendages. To facilitate discussion of the open-price term, this Article adopts this likely finding.

Section 2-305 of the UCC permits the formation of a contract with an open or unstated price if the parties intend to form a contract.²⁷¹ Most U.S. jurisdictions agree that contractual intent requires a meeting of the minds sufficient to create a binding agreement,²⁷² demonstrated by the parties' own objective manifestations rather than by their subjective, hypothetical, or unexpressed intentions.²⁷³

Whether preliminary documents—such as a letter of intent, agreement to negotiate a final agreement, or a sequence of preliminary written communications short of a formal, signed agreement—are sufficient to establish the intent necessary to form a binding contract is a matter of disagreement among and within U.S. jurisdictions.²⁷⁴ Because this Article focuses on the comparative

271. U.C.C. § 2-305(1) (2012).

272. See, e.g., *Fisk v. Fisk*, 328 Mich. 570, 574 (1950) (explaining that “a meeting of the minds upon all essential terms” is necessary to constitute a valid contract); *Busch*, 40 Fed. App'x. at 953–54 (describing the existence of a contract as contingent on whether the parties “reached a meeting of the minds sufficient to create a binding agreement”).

273. See, e.g., *D'Avanzo v. Wise & Marsac, P.C.*, 223 Mich. App. 314, 319 (1997) (including “extrinsic facts” within the factors to consider during contractual interpretation); *Busch*, 40 Fed. App'x. at 953–54 (noting that a letter of intent can be just as valid as a contract under Michigan law); see also *Sprague v. Gen. Motors Corp.*, 843 F. Supp. 266, 306–07 (E.D. Mich. 1994) (explaining that “contractual intent is concerned with objective manifestations of intent”), *aff'd in relevant part*, 133 F.3d 388 (6th Cir. 1998); *Siegel v. Spinney*, 357 N.W.2d 860, 862–63 (Mich. Ct. App. 1985) (explaining that the existence of a meeting of the minds is determined by an objective standard).

274. See Royce de R. Barondes, *The Limits of Quantitative Legal Analyses: Chaos in Legal Scholarship and FDIC v. W.R. Grace & Co.*, 48 RUTGERS L. REV. 161, 181–94 (1995) (explaining the variety of relationships that can result from different preliminary instruments); Schwartz & Scott, *supra* note 124, at 664–65 (offering three general scenarios that could occur in preliminary negotiations and briefly analyzing whether a contract could exist in those scenarios); see also *Weinreich v. Sandhaus*, 850 F. Supp. 1169, 1177 (S.D.N.Y. 1994) (stating that under New York law, an agreement with open terms is too indefinite only if it cannot be rendered reasonably certain by reference to an extrinsic standard that makes its meaning clear); *Heritage Broad. Co. v. Wilson Commc'ns, Inc.*, 428 N.W.2d 784, 787 (Mich. Ct. App.) (1988) (stating that an agreement to subsequently agree may be valid if it specifies the material and essential terms, leaving none to future negotiations). However, if a party communicates intent not to be bound until an agreement is signed, no negotiation or oral agreement can form a binding contract. For example, the Second Circuit applies a four-factor test to determine whether, without a document executed by both sides, the parties intend to be bound:

impact of the open-price term, it does not examine interjurisdictional disagreements over intent. Rather, it proceeds under the assumption that the intent requirement of UCC § 2-305 was met by the combination of P&W's detailed December 14 proposal and Malev's December 21 acceptance letter.

When the price is open or unstated, the price constitutes a reasonable price at the time for delivery if the contract is silent as to price or the price is left to be agreed to by the parties and they fail to agree.²⁷⁵ Alternatively, under UCC § 2-305(3), if a price to be fixed other than by the parties' agreement is not fixed through fault of a party, the other may optionally treat the contract as canceled, or unilaterally set a reasonable price²⁷⁶ in good faith.²⁷⁷ A price set under UCC § 2-305(3) must be consistent with reasonable commercial standards of fair dealing in the trade.²⁷⁸ In this context, a posted price or a future seller or buyer's given price, price in effect, or market price normally satisfies the good-faith requirement.²⁷⁹

P&W's December 14 offer contained a considerable amount of information about price and, therefore, under UCC § 2-305(3), was clearly not "silent" as to price. However, it can be argued that either (a) after Malev's December 21 acceptance, the price of the engines was left to be agreed by the parties—in the sense that if Malev had chosen Airbus, the parties would have yet to agree on the final full price of the engine systems—and they failed to agree, or (b) through fault of one party, the price of the engines was not fixed as of December 21, in the sense that up to that time Malev had yet to choose between Airbus and Boeing planes, thereby keeping the transaction price uncertain. Under alternative (a) or (b), the contract would be legally enforceable, but the price might differ between them.

(1) whether there has been an express reservation of the right not to be bound in the absence of a writing; (2) whether there has been partial performance of the contract; (3) whether all of the terms of the alleged contract have been agreed upon; and (4) whether the agreement at issue is the type of contract that is usually committed to writing.

Winston v. Mediafare Entm't Corp., 777 F.2d 78, 80 (2d Cir. 1985). *But see* Knight v. Sharif, 875 F.2d 516, 525 (5th Cir. 1989) (stating that, under Mississippi law, a writing is enforceable only if it expresses the agreement of the parties on all material terms).

275. U.C.C. § 2-305(1)(a)–(b) (2012).

276. *Id.* § 2-305(3).

277. GA. CODE ANN. § 11-2-305 (2002); Neugent v. Beroth Oil Co., 560 S.E.2d 829, 835–37 (N.C. Ct. App.) (2002); U.C.C. § 2-305(2).

278. *See, e.g.*, Autry Petroleum Co. v. BP Prods. N. Am., Inc., 334 F. App'x 982, 985 (11th Cir. 2009) (finding that a seller's recapture of a prompt-pay discount in setting sales prices for fuel products was not commercially unreasonable and satisfied the good-faith requirement where the buyer based his allegation that the recapture was done in bad faith on his own subjective beliefs and not on objective commercial reality).

279. *See, e.g.*, Neugent, 560 S.E.2d at 836 (quoting N.C. GEN. STAT. § 25-2-305 official cmt. 3 (1965)).

If (a), the price would be a reasonable price at the time of delivery; if (b), the reasonable price could be set unilaterally by P&W. Either way, the transaction would constitute a valid contract under UCC Article 2.

3. South America: Colombia

The P&W–Malev transaction would arguably result in a valid agreement under Colombian law as of December 29, 1990, but not as of Malev's December 21 acceptance letter because the Proposal did not adequately price the engine nacelle or other parts required if Malev chose Airbus over Boeing.

Under Colombian law, the parties' agreement as to price is essential to the formation of an enforceable contract,²⁸⁰ except where the alleged buyer has already received the goods, in which case the price is presumed to be the average price on the day and in the place of delivery.²⁸¹

The agreement on price must be (a) an absolute price; (b) a price objectively determinable at the time of payment from any combination of factors, including market prices in active markets;²⁸² or (c) a price to be determined by a third-party arbitrator agreed upon or otherwise designated by the parties.²⁸³ Any of these three price-setting alternatives fulfills the price requirement for formation of an enforceable agreement so long as it is agreed upon by the parties at the time they enter into the agreement, not—in contrast to the more liberal German approach—afterwards.²⁸⁴

Applying these principles, the transaction price as of December 21, 1990, was indeterminate because Malev could choose Airbus planes, for which the price term was incomplete because the price of the nacelle and other parts was unstated. Viewed this way, Malev's purported acceptance on December 21 was incomplete. Nevertheless, as under French law, acceptance under Colombian law would arguably have been perfected subsequently on December 29 when Malev announced its decision to buy Boeing planes.

280. CÓDIGO CIVIL [C.C.] [CIVIL CODE] art. 1864 (Colom.); CÓDIGO DE COMERCIO [C. COM.] [COMMERCIAL CODE] art. 920 (Colom.).

281. C. COM. art. 920.

282. C.C. art. 1864; C. COM. art. 921.

283. C.C. art. 1865. If the designated arbitrator refuses to set the price, the parties may then jointly designate an alternate arbitrator. However, if the parties cannot agree on an alternate, the contract is null; in no case can the price be unilaterally determined by any party to the contract. *Id.*

284. ALVARO TAFUR GONZÁLEZ, CÓDIGO CIVIL 304 (20th ed. 2003) (on file with author) (translating and quoting 10 MARCEL PLANIOL & GEORGES RIPERT, *TRAITÉ PRATIQUE DE DROIT CIVIL FRANÇAIS* 36 (2d ed. 1952)).

4. International Law: UN Convention on Contracts for the International Sale of Goods

The multijurisdictional discussion of open-price terms has been hypothetical up to this point, attempting to tease out what might result if the P&W–Malev case were decided under the law of Italy, France, Germany, the United States, or Colombia. Under the CISG, the discussion moves beyond hypothetical to actual. The P&W–Malev dispute was, in fact, decided under controversial CISG Article 55²⁸⁵ by both the Metropolitan Court of Budapest²⁸⁶ and the Supreme Court of Hungary, which reached opposing conclusions.²⁸⁷

The CISG attempts to harmonize international-sales contract law, similar in some respects to the joint IASB–FASB efforts to internationally harmonize revenue recognition, through a multilateral, UN-sponsored treaty now ratified by nearly all of the world's significant trading nations.²⁸⁸ However, the practical extent of the CISG's international harmonization is limited,²⁸⁹ in part because the CISG is official in six languages²⁹⁰ and is enforced by local jurists who interpret and apply the CISG through their own cultural, linguistic, and economic filters.²⁹¹ As they interpret, courts must fill gaps in the CISG's coverage with the general principles on which the CISG is based or, in their absence, local law as dictated by the rules of private international law.²⁹² Not surprisingly, different

285. See *infra* notes 290–291 & 300–303 and accompanying text (explaining why Article 55 is considered controversial).

286. See generally Fővárosi Bíróság [Metropolitan Court] Jan. 10, 1992, 3.G.50.289/1991/32 (Hung.), translated in *Metropolitan Court*, *supra* note 158 (holding the offer sufficiently definite to support a valid agreement).

287. See generally Legfelsőbb Bíróság (LB) [Supreme Court] Gf.I.31.349/1992/9 (Hung.), translated in *Case I: The Supreme Court of the Republic of Hungary*, 13 J.L. & COM. 31 (1993) (finding an ambiguity in the price term that rendered a valid agreement impossible).

288. The list of CISG signatory countries can be accessed at *CISG: Table of Contracting States*, PACE L. SCH. INST. INT'L COM. L., <http://www.cisg.law.pace.edu/cisg/countries/cntries.html> (last updated Mar. 26, 2012). One notable nonsignatory is the United Kingdom. *Id.* For a robust discussion of possible reasons why the United Kingdom remains a CISG hold-out, see Hoffman, *supra* note 122.

289. Rosett, *supra* note 49, at 270 (“The Convention does not appear to recognize the reality that identical wording of a legal norm in various jurisdictions does not preclude uncertainty resulting from different understandings and applications in practice.”).

290. The “equally authentic” languages of the CISG are Arabic, Chinese, English, French, Russian, and Spanish. CISG, *supra* note 7, art. 101.

291. Frank Diedrich, *Maintaining Uniformity in International Uniform Law via Autonomous Interpretation: Software Contracts and the CISG*, 8 PACE INT'L L. REV. 303, 303–04 (1996) (indicating that the CISG “lacks a common legal theory and practice upon which judges and practitioners can rely,” resulting in a “homeward-trend” in favor of the *lex fori*”).

292. CISG, *supra* note 7, art. 7(2).

courts—even those in the same country—may reach differing decisions in factually similar CISG cases.

Except when the parties expressly opt out of the CISG and specify an alternate governing law,²⁹³ the CISG generally applies to contracts for sales of goods²⁹⁴ between parties whose places of business are in different countries when the countries are CISG signatories²⁹⁵ or when the rules of private international law lead to the application of the law of a CISG signatory.²⁹⁶

The CISG contains seemingly conflicting directions regarding open-price contracts. Under Article 14, a proposal for establishing a contract constitutes an offer only if it is sufficiently definite and indicates the intention of the offeror to be bound if the offeree accepts.²⁹⁷ To qualify as sufficiently definite, the proposal must identify the goods and expressly or implicitly set or make determinable the quantity and the price.²⁹⁸ However, CISG Article 55 appears to contradict Article 14, purporting to save otherwise valid open-price contracts:

Where a contract has been validly concluded, but does not expressly or implicitly fix or make provision for determining the price, the parties are considered, in the absence of any indication to the contrary, to have impliedly made reference to the price generally charged at the time of the conclusion of the contract for such goods sold under comparable circumstances in the trade concerned.²⁹⁹

293. *Id.* art. 6.

294. The CISG does not define *goods*, leaving interpretation of this term to national courts whose local laws may yield different results. *See* Diedrich, *supra* note 291, at 307–08 (explaining how the CISG does not differentiate between merchants and other persons). However, specifically excluded from the CISG’s scope are sales

(a) of goods bought for personal, family or household use, unless the seller, at any time before or at the conclusion of the contract, neither knew nor ought to have known that the goods were bought for any such use;

(b) by auction;

(c) on execution or otherwise by authority of law;

(d) of stocks, shares, investment securities, negotiable instruments or money;

(e) of ships, vessels, hovercraft or aircraft; [and]

(f) of electricity.

CISG, *supra* note 7, art. 2.

295. CISG, *supra* note 7, art. 1(1)(a).

296. *Id.* art. 1(1)(b). However, under CISG Article 95, the United States has declared that it will not be bound by CISG Article 1(1)(b). Therefore, in the absence of the parties’ express choice of the CISG as their governing law, U.S. courts will enforce the CISG only between parties whose contract-relevant places of business are *both* located in CISG signatory states. The term *rules of private international law* refers to “choice of law” or “conflicts of law” rules, which guide courts in determining which set of laws to apply in resolving contract-related disputes.

297. *Id.* art. 14(1).

298. *Id.*

299. *Id.* art. 55.

Some commentators have attributed the dichotomy between Article 14 and Article 55 to disagreements between Western, largely free-market CISG signatories and socialist ones, which, at least at the time the CISG was negotiated, required a high level of predictability in contracting because of their reliance on centralized economic planning.³⁰⁰

Whatever its genesis, the ambiguous relationship between Article 14 and Article 55 has been the subject of strong disagreement among commentators.³⁰¹ While acknowledging learned dissent on this point,³⁰² Loukas Mistelis argues that Article 55 applies only when a tribunal finds the offer does not otherwise fail under local law for lack of a definite price.³⁰³ Consistent with Albert H. Kritzer's view, tribunals that have considered the question have applied Article 55 to save CISG contracts when the offer, including its price term, is sufficiently definite to establish a valid³⁰⁴ contract under the tribunal's local contract law, which may³⁰⁵ or may not³⁰⁶ take into consideration local conflicts-of-law rules.

300. See Alejandro M. Garro, *Reconciliation of Legal Traditions in the U.N. Convention on Contracts for the International Sale of Goods*, 23 INT'L LAW. 443, 462 (1989) (explaining that delegates from socialist countries thought an acceptance must be in complete agreement with the author, while common-law delegates thought an acceptance was enforceable so long as it did not materially alter the terms of the offer); Rosett, *supra* note 49, at 288–89 (describing how socialist governments consider open-term contracts a threat to the security of the agreement).

301. See Helen Elizabeth Hartnell, *Rousing the Sleeping Dog: The Validity Exception to the Convention on Contracts for the International Sale of Goods*, 18 YALE J. INT'L LAW 1, 66–69 (1993) (summarizing some theoretical disagreements that have emerged about open-price terms); Loukas Mistelis, *Article 55 CISG: The Unknown Factor*, 25 J.L. & COM. 285, 286–88, 290–91 (2005) (explaining why the “first and main point of controversy” related to Article 55 is its “interplay” with Article 14).

302. See Mistelis, *supra* note 301, at 289 n.20 (framing the controversy of Article 55 by presenting the opposing views of E. Allan Farnsworth and John Honnold, respectively, that Article 55 applies only to a validly concluded contract and, by contrast, that a contract may be validly concluded under Article 55 even though it neither expresses nor implies a determinate price).

303. *Id.* at 289 n.21 (quoting ALBERT H. KRITZER, GUIDE TO PRACTICAL APPLICATIONS OF THE UNITED NATIONS CONVENTION ON CONTRACTS FOR THE INTERNATIONAL SALE OF GOODS 134–35 (Supp. 7 1993)).

304. Under the CISG, the scope of contract validity is deliberately vague and subject to local interpretation. See Hartnell, *supra* note 301, at 37–40 (1993) (discussing the relationship between the CISG and the International Institute for the Unification of Private Law in the context of different nations' domestic policies concerning contracts). However, validity is typically viewed with reference to features of the domestic law of the forum that might render a contract void, voidable, or even unenforceable. *Id.* at 44–45. These include, without limitation, capacity, formal validity, open-price terms, duress, fraud, mistake, illegality, immorality, and unconscionability. *Id.* at 63–86.

305. See, e.g., *Geneva Pharms. Tech. Corp. v. Barr Labs., Inc.*, 201 F. Supp. 2d 236, 283 (S.D.N.Y. 2002) (equating “domestic law” of the forum with “governing law” as identified through “traditional conflict of laws analysis”), *aff'd in part, rev'd in part on other grounds*, 386 F.3d 485 (2d Cir. 2004); Oberlandesgericht Rostock [OLG ROSTOCK] [Rostock Appellate Court] Oct. 10, 2001, 6 U 126/00 (Ger.), *translated at*

In the actual P&W–Malev case, in 1992, the Metropolitan Court of Budapest held that the price term in P&W’s December 14, 1990, offer was sufficiently definite to support a valid agreement.³⁰⁷ Later in that same year, the Hungarian Supreme Court reversed the Metropolitan Court, holding that the ambiguity of the price term in P&W’s purported offer made agreement between the parties impossible.³⁰⁸

In holding the price term fatally indefinite, the Hungarian Supreme Court found that P&W’s December 14 Proposal embodied two separate purported offers, each deficient as to price: (1) an offer applicable in case Malev chose Boeing planes, for the purchase of either of two alternative jet *engines* and related services; and (2) an offer applicable to Airbus planes, for the purchase of either of two jet-engine *systems* and related services.³⁰⁹ The Boeing offer, so found the court, stated the price of one engine model but not the other.³¹⁰ Meanwhile, the Airbus offer omitted the additional price associated with the full engine system.³¹¹ Neither of the two purported offers stated the price of the related services.³¹²

That two courts—sitting in the same city, speaking the same language, and applying the same law to the same facts—could arrive at diametrically opposing conclusions on an issue of apparent simplicity illustrates the unpredictability of legal contract enforceability on which the ED exclusively relies. In fairness to Hungary and the CISG, such unpredictability is endemic to contract litigation throughout the world. Breach-of-contract decisions by lower courts are often reversed at the end of appeals processes that may last decades.³¹³

<http://www.cisg.law.pace.edu/cisg/wais/db/cases2/011010g1.html> (invoking German law under Article 55 of the CISG to fill an unstated price, in a contract for sale of crawfish, with the market price upon execution of the agreement of comparable goods, in the same business, under similar circumstances).

306. See, e.g., *Berry v. Ken M. Spooner Farms, Inc.*, 2006 U.S. Dist. LEXIS 31262, *2–6 (W.D. Wash. 2006) (applying Washington law, without reference to conflict-of-laws analysis, to uphold the validity of a contractual limitation-of-liability clause in a CISG contract), *rev’d on other grounds*, 254 F. App’x 646 (9th Cir. 2007); Russian Fed’n Arbitration Proceeding 185/2000 (Trib. Int’l Com. Arb., Russian Fed’n Comm. & Indus. 2001), <http://cisgw3.law.pace.edu/cases/010530r2.html> (applying Russian Federation Civil Code Article 424, which allows formation of open-price contracts, under CISG Article 55 to save as valid a contract between a Russian seller and non-Russian buyer in which price was not stated).

307. Fővárosi Bíróság [Metropolitan Court] Jan. 10, 1992, 3.G.50.289/1991/32 (Hung.), translated in *Metropolitan Court*, *supra* note 158, at 51.

308. Legfelsőbb Bíróság (LB) [Supreme Court] Gf.I.31.349/1992/9 (Hung.), translated in *Hungarian Supreme Court*, *supra* note 165, at 44–46.

309. *Id.* at 43.

310. *Id.*

311. *Id.*

312. *Id.* at 44.

313. See, e.g., Cass. civile, sez. III, 8 maggio 2006, n. 10503 (It.) (reversing the lower court two decades after the suit was originally filed).

In conclusion, with respect to the open-price term issue under the CISG, the legal validity of the contract and, therefore, the contract's enforceability under the ED, is determined with reference to local contract law as interpreted and applied by the court with jurisdiction over the case. This reinforces the view that if accounting-standard setters want a timely, clear, and reliable revenue recognition benchmark, legal enforceability may not be the best choice.

5. Legal Analysis Summary

Table 2 summarizes the likely outcomes—in terms of enforceable agreement or not—for each of the chosen jurisdictions. At December 21 and 29, these outcomes vary between and even within jurisdictions:

Table 2—Likely Stage 1 Legal Results by Jurisdiction

Jurisdiction	Enforceable Contract on 12-21?	Enforceable Contract on 12-29?
United States (UCC)	Yes	Yes
Germany	Yes	Yes
Italy	Probably	Probably
France	No	Probably
Colombia	No	Probably
CISG	Tracks forum law	Tracks forum law

Generally speaking, contracts are more likely to be legally enforceable in Germany and the United States than in France and Colombia because in comparison to the laws of the latter, the laws of the former are biased in favor of contract formation. Italy falls between the extremes. Meanwhile, the CISG tracks the underlying tendency of the law of the forum with jurisdiction over the case. This CISG-specific rule introduces yet another complexity into the ED's contract-analysis process because it may be impossible to determine in advance, when accountants and auditors must make their accounting determinations, which court will decide a case that has not yet been filed.

Within jurisdictions, the parties' actions moving through time affect legally material facts, including the definiteness of the price term. As a result, the contract-analysis outcomes also vary within jurisdictions by point in time. Within this Article's factual context, time appears immaterial to contract formation under German law and the UCC. However, time is material under French, Italian, and Colombian law and, by derivation, under the CISG in these three jurisdictions.

This time-based contract diversity could result in revenue recognition timing differences when transaction negotiation, contract

formation, or contract performance occurs very close to or straddles the end of a financial reporting period. Beyond mere timing, in some jurisdictions—such as France, Italy, Colombia, and Hungary—the existence of recognizable revenue may be open to question because the law on open-price terms may permanently preclude the formation of a valid contract.

C. Contract Analysis: ED Paragraphs 14 and 15

ED paragraphs 14 and 15 employ five tests to verify the applicability of the ED and the existence of the contract for revenue recognition purposes.³¹⁴ Here, this Article applies the paragraph 14 and 15 tests to the purported P&W–Malev contract.

1. Paragraph 14(a): Commercial Substance

Viewed through a purely legal perspective, under ED paragraph 14(a), the commercial substance of the purported contract depends on its legal enforceability, which, in turn, varies with time and jurisdiction. This is because each party can theoretically invoke judicial power to force the other to either specifically perform a legally enforceable contract or, alternatively, pay compensation in the form of damages. Either approach can justify the expectation of cash flow. Thus, on December 21, the contract would pass the paragraph 14(a) test under German and U.S. law, might pass under Italian law, but would not pass under Colombian or French law. Later, on December 29, the likelihood of passing under French and Colombian law would increase substantially.

However, while contextualized by paragraph 13's legalistic definition of *contract*, paragraph 14 does not directly invoke legal enforceability, requiring only that the "risk, timing or amount of the entity's future cash flows [be] *expected to change* as a result of the contract."³¹⁵ Arguably, in the vast majority of commercial relationships, the parties can be expected to perform their commercial obligations, whether legally enforceable or not, because doing so forms a Nash equilibrium in the sense that, typically, each party has economic incentives to perform independent external enforcement.³¹⁶ Perhaps the most powerful performance incentive is that failure to fulfill commitments can result in exclusion from the market as word reaches other potential counterparties that this player should not be trusted.

314. EXPOSURE DRAFT, *supra* note 1, ¶¶ 14–15.

315. *Id.* ¶ 14(a) (emphasis added).

316. See WATSON, *supra* note 76, and accompanying text.

2. Paragraph 14(b): Parties' Commitment

At December 21 and 29, 1990, the available evidence—including P&W's December 14 Proposal, P&W's December 21 Proposal extension, Malev's detailed December 21 acceptance, and the parties' extended dialogue regarding advertising and implementation of their agreement—is persuasive that the parties had both approved of and were committed to Malev's purchase of P&W jet engines. Thus, at least as of December 21 and 29, the paragraph 14(b) commitment test was met. It was only months later, on March 25, 1991, that Malev signaled by letter that it might not be committed to following through with the agreement.

3. Paragraph 14(c): Parties' Rights

Legally speaking, the contract meets or misses paragraph 14(c) depending on the contract's legal enforceability, which itself turns on timing and jurisdiction. Because this Article has assumed the contract was legally enforceable as of December 21 (in the case of the United States, Germany, and possibly Italy) or December 29 (Colombia, Italy, and France), P&W would be legally entitled as of the applicable enforceability date to the sales price pertaining to Malev's chosen engine model on a schedule determined by the contract's terms. These terms might call for payment before or after delivery of the engines. In like manner, as of the same dates, Malev was itself legally entitled to receive the promised engines from P&W and legally bound to pay for them.

4. Paragraph 14(d): Terms and Manner of Payment

Paragraph 14(d) requires only that the entity "can identify the payment terms for the goods or services to be transferred."³¹⁷ The P&W–Malev transaction arguably met this test on December 14, 1990, in that the terms and manner of payment appear to have been clearly identified in the Proposal delivered on that date.

5. Paragraph 15: Termination Compensation

The termination compensation requirement was met, if at all, at the point in time when the contract became legally enforceable *as a contract*, because paragraph 15 theoretically disregards only those wholly unperformed contracts under which neither party can extract compensation from the other for terminating the contract.³¹⁸

317. EXPOSURE DRAFT, *supra* note 1, ¶ 14(d).

318. *Id.* ¶ 15.

If enforceable on December 21 or 29, the contract was wholly unperformed within the meaning of paragraph 15 in the sense that at that time it was apparently a mere exchange of promises; neither P&W nor Malev had yet performed any obligation under it. Because of the contract's wholly unperformed status, ED paragraph 15 would require P&W to verify that at least one of the two parties could not unilaterally terminate the contract without compensating the other.³¹⁹ If at any moment in time Malev's acceptance created an enforceable *contractual* obligation, then by definition neither party could terminate the contract without incurring some penalty in the form of damages or an order of specific performance. Thus, assuming the existence of an enforceable contract, the termination penalty requirement was arguably satisfied.

Even in the absence of a legally enforceable contract, each party might potentially have been liable to the other via *culpa in contrahendo*, promissory estoppel, quasi-contract,³²⁰ or a similar noncontract liability doctrine.³²¹ For example, P&W could have argued under German law that Malev was liable for *culpa in contrahendo* damages equivalent to the value of the costs P&W incurred in bidding on the jet engine deal and negotiating with Malev between December 1990 and March 1991. However, the ED does not account for pre- or extra-contractual obligations. Therefore, in the absence of a legally binding contract, those obligations have no role in relation to paragraph 15.

Table 3 summarizes the application of ED paragraphs 14 and 15 to the P&W–Malev scenario. In the table, letters “a” to “d” represent ED paragraph 14 subparagraphs, while the letter “e” represents paragraph 15. Upper-case letters (e.g., “A”) identify criteria clearly satisfied; lower-case letters (e.g., “a”) identify criteria probably, though not clearly, met. A missing letter indicates that the criterion represented by that letter is not satisfied.

319. *Id.*

320. *See supra* notes 121–135 and accompanying text (explaining implied and noncontract obligations generally).

321. *See* Alan Schwartz & Robert E. Scott, *Precontractual Liability and Preliminary Agreements*, 120 HARV. L. REV. 661 (2007), cited *supra* notes 124, 256, 274.

Table 3—Likely Results: ED paras. 14,15

Jurisdiction	ED paras. 14, 15 tests met on 12-21	ED paras. 14, 15 tests met on 12-29
France	B, D, E	a, B, c, D, E
Germany	A, B, C, D, E	A, B, C, D, E
Italy	a, B, c, D, E	a, B, c, D, E
United States	A, B, C, D, E	A, B, C, D, E
Colombia	B, D, E	a, B, c, D, E
CISG	Varies with jurisdiction	a, B, c, D, E, but varies with jurisdiction

D. Recognition: ED paragraphs 23-80

In the P&W–Malev case, under ED paragraphs 23–30, the first step in the Stage 2 revenue recognition process is to identify separate performance obligations in the contract. Access to factual details is limited, but it is apparent that the P&W Proposal offered a bundle of goods and services including engines or engine systems, spare parts, financing, maintenance, and an option to buy additional engines. Each of these would presumably be considered a separate performance obligation under the ED, except for the option contract, which would be accounted for as a financial derivative instrument under another accounting standard. Next, under ED paragraphs 50–69, P&W would determine the transaction price and then, under paragraphs 70–80, allocate that price among the previously identified performance obligations.

The final hurdle for revenue recognition is satisfaction of one or more performance obligations through transfer of a specified good or service. Transfer, as outlined in Figure 2, requires a shift in control over the good or service from seller to customer. A shift in control is indicated, under paragraphs 31–48, by the customer’s unconditional obligation to pay, in the transfer of risks and rewards of ownership of goods, or transfer of legal title to or possession of the goods. Nothing in the available P&W–Malev facts suggests that any control-shifting criterion was met under the law of any of the jurisdictions examined for this Article with respect to goods. Therefore, no transfer of goods occurred. Thus, regardless of the outcome of the Stage 1 contract analysis, no contract revenue associated with goods would be recognized under the ED on the P&W–Malev facts at any point on the transaction timeline.

Whether Malev might be obligated to P&W for a transfer of services or under a pre- or non-contract theory for P&W’s good-faith expenditures in expectation of the contract presents a different question. P&W may have made significant expenditures in preparing for what it apparently believed in good faith would be a contract. If P&W did make such expenditures, it might invoke promissory

estoppel, quasi-contract, *culpa in contrahendo*, or a similar doctrine. Similarly, if P&W effectively transferred financing-related services under a Stage 1-qualifying contract, it would be entitled to recognize contract revenue for those services.

As the ED is currently written, it is conceivable that a seller could transfer goods or services within the meaning of paragraphs 31–48—through, e.g., German separation and abstraction—and yet lack the contract necessary for recognition under ED paragraphs 13–15. Perhaps more likely is a timeline, similar to that of the P&W–Malev case, where months after events that establish a contract, a tribunal finds that a contract formed months ago and then holds then breaching buyer liable for damages.³²² The ED does not indicate how to account for delayed judicial determinations of legal enforceability, thus leaving accounting practitioners to search for nonauthoritative guidance³²³ or to draw their own conclusions.

IV. CONCLUSIONS AND RECOMMENDATIONS

In Part I, this Article defined revenue recognition, documented its independent importance as a firm-value and financial-performance metric, and placed it squarely at the accounting–contract law nexus in the context of a proposed accounting standard built on a contract-law foundation. This Article documented the legal community’s lack of involvement in the ED’s development, the disagreement among accounting professionals regarding the relationship between contracts and revenue recognition, and misperceptions in the legal community regarding authoritative accounting standards. It also called for greater collaboration between legal and accounting professionals in creating value, allocating value, and mitigating risk through effective use of contract law and revenue recognition.

Part II modeled the ED’s contract-law-centered revenue process, from verification of contract existence to recognition and measurement; highlighted differences among the ED, SAB No. 104, and IAS 18; and identified potential revenue-producing transactions and relationships that fall beyond the scope of the ED and other accounting guidance.

Part III applied the ED, internationally and comparatively, to an actual transaction, demonstrating the complexity of the process and the variability of results stemming, in part, from the ED’s reliance on legal enforceability as its sole recognition benchmark. The foregoing findings inform the recommendations below.

322. See *supra* notes 286–287 and accompanying text.

323. See *supra* notes 27, 138 and accompanying text (discussing when nonauthoritative sources may be relied upon).

First, accounting-standard setters should reconsider whether the benefits of requiring legal enforceability for revenue recognition outweigh the associated measurement costs and uncertainty. Arguably, within and across jurisdictions, the ED's legal enforceability criterion creates unnecessary, costly, and risk-inflating complexity that the accounting and auditing professions appear ill-prepared to address.

Under the ED, legal enforceability functions as a commitment surrogate. The ED uses the legally enforceable contract as externally verifiable evidence that the buyer and seller are so committed to perform that cash or other assets are expected to flow between them. Yet, legal enforceability may be both under- and over-inclusive as a cash-flow indicator. For example, the ED precludes recognition of revenue from a legally unenforceable yet self-enforcing Nash equilibrium that nevertheless justifies the expectation of future cash flow.³²⁴ Conversely, theoretically enforceable contracts may generate no cash flow because judicial enforcement fails for practical or procedural reasons.

While the ED's emphasis on enforceable rights and obligations may be consistent with behavioral realities, its focus on legally enforceable contracts is arguably not so. IAS 32,³²⁵ IAS 18,³²⁶ and SAB No. 104,³²⁷ as well as FASC³²⁸ and CFA Institute³²⁹ comment letters, all advocate a more expansive concept that includes both legally and nonlegally binding relationships. Along similar lines, the ED should account for non- or pre-contractual legal doctrines like promissory estoppel, *culpa in contrahendo*, *quantum meruit*,³³⁰ and separation and abstraction,³³¹ which can also drive cash flows even in the absence of legally enforceable contracts. Similarly, the ED should define all key terms—such as *consideration*—that appear to be borrowed from the legal lexicon. Failure to provide those definitions will likely exacerbate interjurisdictional diversity in applying the new revenue recognition standard.

Including all committed customer–seller relationships in the ED's scope could mitigate interjurisdictional variability of revenue results and might defuse the argument, important in some jurisdictions, that financial-statement recognition implies admission

324. See WATSON, *supra* note 76, at 139–41 (describing the use of the Nash equilibrium in the legal context).

325. See *supra* note 67 and accompanying text.

326. See *supra* note 105 and accompanying text.

327. See *supra* notes 65–66 and accompanying text.

328. See *supra* notes 70–72 and accompanying text.

329. See *supra* notes 74–75 and accompanying text.

330. See *supra* notes 121–134 and accompanying text (explaining implied and noncontract obligations generally); see also BÜRGERLICHES GESETZBUCH [BGB] [CIVIL CODE], Aug. 18, 1896, §§ 241–853 (outlining the German law of obligations).

331. See *supra* notes 223–229 and accompanying text (discussing the German principle of separation and abstraction).

of legal liability. Some might argue that Nash equilibria are harder to verify than legally binding contracts and, therefore, more difficult to audit. However, it is not clear that audit firms are equipped to competently and cost-effectively test purported contracts for legal or practical enforceability, or that formal, verifiable enforceability equates to reliability in predicting cash flows. In any event, because Nash equilibrium-based commitments are common in some cultures and markets (e.g., China),³³² a truly international revenue accounting standard should address them.

In this connection, the boards may wish to revisit apparent redundancies in ED paragraphs 13, 14, and 15. The additional contract filters imposed by paragraphs 14 and 15 may render paragraph 13 unnecessary. In place of the technically challenging paragraph 13 tests for legal enforceability, the boards might consider shifting the analytical emphasis to paragraph 14's commercial substance and Nash-like commitment criteria, of which legal enforceability might serve as one form of supporting evidence. Meanwhile, audit firms should engage legal counsel to assist them in preparing to deal with contract-law nuances of the ED in the audit context.

Currently, under the guidance of SAB No. 104, one practical effect of using the phrase *persuasive evidence of an arrangement* in place of *legally enforceable contract* is to shift revenue recognition judgment calls away from the legal profession and toward accounting. The ED is likely to send those calls in the opposite direction. Whether this reversal is good for the market and the professions is a question for further inquiry. Legal and accounting professions should take a closer look at whether the definition and interpretation of revenue should be collaboratively shared.

The likelihood of interjurisdictional revenue recognition disparities under the ED suggests that attorneys should draft contractual choice-of-law and choice-of-forum clauses only after carefully considering how these choices may interact with the ED to affect revenue recognition. Similarly, accountants and auditors who apply the ED in accounting for and auditing revenue should understand applicable contract law and should probabilistically assess whether and, if so, how that law is likely to be enforced in the specific circumstances. Some countries (e.g., Germany and the United States) take a more expansive view of contract formation than others (e.g., France, Colombia, and Italy). When given the choice, *ceteris paribus*, a seller wishing to increase the speed and probability of recognizing revenue should favor the law of the former over the latter.

332. See, e.g., Matheson, *supra* note 6, at 345 (highlighting the Chinese tendency to rely on relationships and ongoing negotiation in place of legalistic written contracts, which carry negative cultural connotations in China).

In the United States, defense counsel in securities and other accounting-related litigation should strive to better educate the judiciary regarding the meaning and authoritative hierarchy of accounting standards and guidance. Judicial decisions citing SABs as SEC rules, or otherwise as authoritative, signal shortcomings. In this context, the U.S. Congress and courts should consider requiring the SEC to issue regulatory accounting interpretations through notice-and-comment rulemaking in place of SABs promulgated without public input. Accounting academics should also use the phrase *U.S. GAAP* more precisely³³³ to avoid endowing non-GAAP literature with GAAP authority. The alternative may be that whatever international harmonization is intended by the ED is erased by staff interpretations that do not reflect SEC views, constituent input, or international consensus.

In light of how SABs (especially SAB No. 104) have been applied by the SEC and the courts, legal and accounting professionals dealing with SEC registrants should bear in mind that despite the ED's international scope, its application in the United States will be colored by SEC rules and staff interpretations, just as under current guidance. Similarly, outside the United States, the ED will be interpreted and applied with local flavor. This diversity of enforcement will almost certainly lead to disparate revenue expectations and results for which attorneys, accountants, and auditors should prepare.

Finally, the contract-law ambiguity present in the ED suggests that regulatory authorities, like the SEC or the European Commission, should consider ways to improve the interaction between accounting standards and law. One approach might be to require organizations that set accounting standards, like the FASB and IASB, to include among their membership legal experts who can assist in drafting accounting standards congruent with legal norms. Another possibility might be to encourage or require U.S. accounting professionals to receive additional training in the law. Meanwhile, legal professionals around the world should participate more actively in providing commentary on proposed accounting standards.

333. See, e.g., Donelson et al., *supra* note 34 (incorrectly identifying SAB No. 101 as U.S. GAAP).