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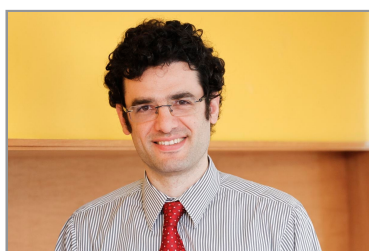
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Elasticity, Incompleteness, and Constitutive Rules



By Bruno Meyerhof Salama and Osny da Silva Filho July 30, 2013

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In *A legal theory of finance*, Katharina Pistor outlines a theory designed to deal with the law-finance paradox, that is, the observation that when “the full force of law is relaxed or suspended to take account of changes in circumstances” – precisely to avoid bringing down the financial system –, “the credibility law lends to finance in the first place is undermined” (Pistor, 2013: 323). In building her argument, Pistor advances the concept of *law's elasticity*, which she defines as “the probability that *ex ante* legal commitments will be relaxed or suspended in the future” (2013: 320). The present comment suggests that the concept of law's elasticity serves not only to ground a legal theory of finance, but also to highlight the limits of one of the most disseminated abstractions concerning the practice and the regulation of contracts in general, namely the theory of incomplete contracts.

The theory of incomplete contracts suggests that “[s]ince it may be prohibitively costly to specify, in a way that can be enforced, the precise actions that each party should take in every conceivable eventuality, the parties are in practice likely to end up writing a highly incomplete contract” (Hart & Moore, 1988: 755). Accordingly, the issue at stake is not information asymmetry among the parties – something that had occupied economists since at least the mid-70s (Williamson, 1975; Shavell, 1980) – but instead the costs involved in the specification of the uncountable possibilities of future contingencies: “the parties may have the same information; what prevents the use of a complete contingent contract is the cost of processing and using this information in such a way that the appropriate contingent statements can be included and implemented” (Hart & Moore, 1988: 756).

In spite of some severe criticism (e.g. Maskin & Tirole, 1999), the theory of incomplete contracts rapidly became very influential within law, giving rise to a vast literature concerning default rules, i.e. “rules that parties can contract around by prior agreement” (Ayres & Gertner, 1989). Thus came about what can be called the incompleteness paradigm, a model according to which the limits of the regulation of contracts would be twofold. The first limit would lie on the human ability to anticipate and specify the future; the second would lie on the offer of rules to deal with unanticipated and unspecified contingencies. Save for the inherent limitations of human autonomy (subjected to the constraints of limited rationality) and the vagueness of heteronomy (prey to the compromises of generality), under the incompleteness paradigm the world of contract would be shaped mainly by requisites of validity – i.e. rules such as basic formalities, capability and lawfulness of the commitments –, all of which statically set forth under the law or by customs.

The intuitions that underlie what we are calling the incompleteness paradigm can also be found in the tradition of Civil Law. Specifically, they can be located in the ambitions of completeness (i.e. the categorization of all brute facts) that characterized some interpretations of the Napoleonic codifications in the 19th century (even if said ambitions were not necessarily shared by the original codifiers: see, e.g., Portalis, 1801: 17). The rejection of the possibility of a “complete” codification was upheld through the recognition of the so-called “general clauses” (such as good faith, economic balance or social function), as well as on the recognition of “indeterminate legal concepts” (such necessity, fair price or *turpitudinem causa*), and ultimately the acceptance of the very notion of such a thing as judge-made law.

General clauses, indeterminate legal concepts, and judge-made law can be said to be consistent with the incompleteness paradigm exactly because they can be conceived as mechanisms to deal with the aforementioned limitations of human autonomy and the vagueness of heteronomy. Symptomatically, the Brazilian Civil Code of 2002, in its article 113, sets forth that “transactions should be interpreted in accordance with good faith and the customs of the place where they are entered into”. As can be seen, in one single article of the Code – one that constitutes a typical example of the legal technique that is now prevalent in Civil Law – one can find a general clause and an indeterminate legal concept, both of which serve as a criterion for a judge to interpret (and sometimes to fill gaps of) contracts autonomously agreed upon.

Evidently, the two limits that underlie and ultimately justify the incompleteness paradigm do not encompass all the problems faced by contract theory. For instance, aside from disciplining contingencies, contracts notoriously entail pedagogic, symbolic and expressive functions (Sunstein, 1996; Cooter, 1998; Collins, 2002: 14-15), and these functions have to be taken into account by contract law. Moreover, incompleteness cannot be said to represent an insurmountable barrier to contractual practice. After all, the parties can always renegotiate unanticipated or unspecified contingencies – and that had been,

in any case, the starting point of Hart & Moore's foundational paper (1988: 756). But above and beyond these questions, the notion of law's elasticity as developed by Katharina Pistor seems to deal with aspects that are neglected by what is here termed the incompleteness paradigm.

In fact, the narrative of the 2007-2008 financial crisis as well as its implications worldwide contain abundant examples of the elasticity of law. Suffices to notice that, in bailing out banks, governments worldwide acted on the basis of *ad hoc* considerations, also swiftly amending the law or temporarily suspending some of its effects where necessary. In short, altering the rules of the game while it was being played. The same can be said of the mechanisms created to bail out debtor countries, as exemplified by the establishment of the European Stability Mechanism in 2011. An additional, if perhaps self-evident, point is that law's elasticity is not a creature of the latest financial crisis: here, the invalidation of gold clauses worldwide in the early 30s offers an interesting example.

Although it has long been acknowledged that legal rules have an inherent constitutive aspect (Carcattera, 1974; MacCormick & Weinberger, 1986), there are few studies carried out to identify the boundaries of such a dimension (e.g. Lopes, 2004: 35-36). To delve deeper into this topic, one would have to recognize, firstly, that markets (all markets, and not only financial markets) are not simply spontaneous orders but *loci artificialis*, that is, aggregations of rules endowed with political meaning and historicity (Irti, 1998). A second step entails the recognition of two kinds of rules: those that constitute (in our case, constitutive rules of markets) and those that regulate (still in our case, regulative rules of markets). In the well known construction of John Searle, the main point of reference in the contemporary literature on the subject, "regulative rules regulate antecedently or independently existing forms of behavior [...]. But constitutive rules do not merely regulate, they create or define new forms of behavior. The rules of football or chess, for example, do not merely regulate playing football or chess, but as it were they create the very possibility of playing such games" (1969, 32-33; subsequently, 2010, 10). The distinction between constitutive and regulative rules helps clarify the differences between what we have been calling the paradigm of incompleteness and the paradigm of elasticity.

Indeed, the paradigm of incompleteness subsumes the preservation of markets to the flexibility of rules that are typically regulative. To borrow from Searle's vocabulary, general clauses and indeterminate legal concepts define the scope of movement within a "pre-existing activity" (1969, 33) – but statically so, that is, without changing the basic parameters that define the activity itself. The constitutive rules, in this case, remain intact: here we have the so-called "inviolability dogma" of constitutive rules (similarly, Feis & Sconfienza, 2012). In turn, the paradigm of elasticity emphasizes that the sporadic change of the rules that constitute the system – rules which, in the aforementioned quote of John Searle "create or define new forms of behavior" – can avoid, as we have been learning since the Great Depression, a complete financial meltdown (Pistor, 2013: 321).

To sum up, under the elasticity paradigm the law-finance paradox is finally recast as a paradox that is inherent to the very notion of a constitutive rule: the preservation of certain games may depend (temporarily, at least) upon its occasional subversion. If on one hand this latter paradox can be used to formulate a critique against the notion of constitutive rules, on the other hand it can also insinuate new ways to implement the regulation of markets (including financial markets) beyond the static models premised on the notion of incompleteness.

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3 Comments

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Horacio Madkur

Excelente artículo, de una claridad inusitada, y plantea todo un desafío para la investigación el concepto de elasticidad de la ley



August 6, 2013 at 7:54 am



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