

FROM THE FINANCIAL TO THE SOVEREIGN DEBT CRISIS: CHANGING PATTERNS OF PRIVATE LAW (*)

1. — How did private law change because of both the financial crisis and the sovereign debt crisis? Furthermore, why did these changes occur?

When we wonder what private law is, here at Oxford and in Italy the answer — and the perception of this topic, what the Germans would call *Vorverständnis* — may be quite different. Twenty years ago, when I spent a few months at Cambridge to study contractual remedies, I discovered to my great surprise that the Professor of « civil law » was teaching, in reality, ancient Roman Law.

In Italy and more generally in civil law countries — the countries that regulate private law through a civil code — the distinction between public and private law is very well-defined and private law is something more than the sum of contracts, torts and, *inter alia*, unjust enrichment, but rather identifies a dimension that is « autonomous » and unique in the legal realm, *ordo juris*.

Consequently the question is: for a civil law scholar, such as myself, did private law change because of the financial crisis and the sovereign debt crisis?

We might answer that the rules of private law did not change because of these events: first the private debtors' insolvency and then the public debtors' insolvency.

All things considered, this is the answer that we frequently read in law books or that we heard in several occasions and that are usually repeated in law schools: private law rules are always the same, in some cases for hundreds or thousands of years.

I believe, instead, that this is not true, because the crises of 2008 and of 2010, even if they didn't modify the statutory law, have still severely challenged some of the most basic paradigms of private law, which have traditionally determined its development ⁽¹⁾.

This radical shift of fundamental private law paradigms is not surprising, given that economic crises not only provide an opportunity to introduce new rules because of the contingencies but normally produce great cultural melt-

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⁽¹⁾ S. GRUNDMANN & Y.M. ATAMER (ed.), *Financial Services, Financial Crisis and General European Contract Law*, The Netherlands 2011; cfr. A. SOMMA, *Legal change and debt crisis*, in *Astrid — Rassegna*, n. 5/2012.

ing pots. As a consequence, financial crises stimulate new ideas and open new legal options radically shaping legal systems into new forms for decades to come ⁽²⁾.

2. — I will try to explain why the recent financial crises challenged some of the cornerstones on which the law that governs the relationships between private parties has traditionally been based ⁽³⁾.

Private law is built on the idea, or better on the assumption of a radical separation from public law. In other words, private law implies that the state and the market are two completely separate and autonomous phenomena ⁽⁴⁾.

The state and the market present opposite structural characteristics as shown by the following key statements.

a) The public sector is held together by authority and by its imposition; on the contrary, the market is a free space of self-determination, submitted to the evaluation of interests' holders.

Adam Smith taught us that we cannot entrust ourselves to the butcher's generosity to do our shopping and nonetheless an « invisible hand » ensures the functionality of transactions.

According to the traditional approach, regulation and contract law are natural enemies.

b) Private law is characterized by the fact that those entering into legal relationships in the market place are considered equal. Furthermore, they are masters of their own interests.

Contractual justice and social justice coincide in the well-known French aphorism, which replicates the Kantian expression: *Qui dit contractule dit juste* ⁽⁵⁾.

c) According to the *laissez-faire* model, the sphere of competence reserved to private agreements must be submitted to the determination and autonomous evaluation of interests' holders.

From this point of view, the search for contractual equilibrium simultaneously satisfies both the individual and the collective welfare.

3. — So how did the two recent financial crises challenge these well established principles?

⁽²⁾ A.A. BERLE & G.C. MEANS, *The Modern Corporation and Private Property*, New York 1932; A.A. SOMMER jr., *Whom Should the Corporate Serve? The Bearle-Dodd Debate Revisited Sixty Years Later*, in *Delaware Journal of Corporate Law*, 16 (1991), p. 33 ss.

⁽³⁾ R.A. POSNER, *A Failure of Capitalism*, Cambridge 2009.

⁽⁴⁾ M. FREELAND & J.-B. AUBY (ed.), *The Public Law/Private Law Divide. Une entente assez cordiale?*, Portland 2006; M. RUFFERT (ed.), *The Public-Private Law Divide: Potential for Transformation?*, London 2009.

⁽⁵⁾ C. JAMIN & D. MAZEAUD, *La nouvelle crise du contrat*, Paris 2003.

In order to answer this question it is worth recalling the causes of the financial crisis ⁽⁶⁾.

It has been argued that the crisis is much more a crisis of contract law than of corporate governance. Actually, the crisis of 2008 was caused by several factors. In particular it is worth mentioning three of them:

i) The under-estimation of the risk generated by derivatives and financial operations in general;

ii) The under-estimation of the risk generated by cognitive failures, such as the idea that rating agencies didn't need specific regulations because the contract would have been sufficient to regulate something that was conceived as limited to private parties;

iii) The existence of normative asymmetries that determined arbitrage in favor of certain legal systems; consider for example the non-uniform application of the rules of Basel 2 or Great Britain's resistance to the standardization of the European finance regulations.

4. — Among these three examples, I think it is useful to focus in particular on the first one.

An emblematic example of a regulatory failure is the way credit default swaps have been treated. In particular, three key rules have created a regime of 'immunity' and of exemption in favor of these operations resulting in a commodification of the economic risk.

I refer, in particular:

i) To the choice made by both the US legal system and the European systems not to create, for the issuing of credit default swaps, a sort of « legal reserve » in favor of those legal entities that are subject to a public authorization and precautionary supervision (i.e. banks or insurance companies);

ii) To the main accounting regulations: both the US and the international accounting standards adopted in Europe allow a company that issues a security to state on its balance sheet the fair value according to the mark-to-model technique, thus drawing it from a mathematical model;

iii) Finally, to the power of banks to mitigate the credit risk through the acquisition of credit default swaps (CDS) which are issued by institutions that have a favorable rating thanks to an agency (i.e. Standard & Poor's, Fitch & Moody's) recognized by the supervisory banking authorities.

5. — The case of the securities issuance exemplifies the problem concerning the regulation of the market.

⁽⁶⁾ G. NAPOLITANO & A. ZOPPINI, *Le Autorità al tempo della crisi. Per una riforma della regolazione e della vigilanza sui mercati*, Bologna 2009; C. ALLMENDIGER *et al.* (ed.), *Corporate Governance nach der Finanz — und Wirtschaftskrise*, Tübingen 2011.

What is sold and bought are « legal products »: their very nature and character identify them with the contractual management of a financial risk.

The contract *is* the product.

Such « legal products », allowing the transfer of risk from one subject to another, end up modifying significantly the expected behavior of private parties and the economic incentives.

For example, an article recently published by two well-known economists explains that the presence of a CDS modifies the creditor-debtor relationship and makes creditors less willing to accept an agreement, rendering bankruptcy therefore more likely ⁽⁷⁾.

6. — I will now try to point out four possible moments that show how both the public and private debtor crises have challenged the foundations (not of private law) but of the idea of private law.

The first concerns the paradigm that identifies the contract as an instrument of individual and collective wealth maximization ⁽⁸⁾.

Today, it is apparent that we must ask ourselves whether the contract promotes welfare at an individual level, which could be defined as microeconomic efficiency, or at a macroeconomic level, i.e., for the society as a whole (macroefficiency).

The financial meltdown caused by sub-prime mortgages proves that this second target has not been achieved.

The evident disassociation between the individual welfare and the social welfare is due to a market failure. Given this market failure it is fair to wonder whether the remedy should be found, ex post, within contract law, or, on the contrary, through an ex ante public regulation.

In common law countries some scholars suggest exploiting the good faith clause: parties not only are bound by what they wrote, but also by what they should have written according to a social paradigm as understood by judges.

In case of a systemic failure it will be the judge the one deciding what should have been provided in the contract, based on correctness and good faith.

For civil law countries, such as Italy, a regulatory approach through regulatory agencies is definitely more common and efficient ⁽⁹⁾.

⁽⁷⁾ P. BOLTON & M. OEHMKE, *Credit Default Swaps and the Empty Creditor Problem*, Working Paper 15999 <http://www.nber.org/papers/w15999>; May 2010.

⁽⁸⁾ M. MAUGERI & A. ZOPPINI (ed.), *Funzioni del diritto privato e tecniche di regolazione del mercato*, Milano 2009.

⁽⁹⁾ M. D'ALBERTI & A. PAJNO (ed.), *Gli arbitri dei mercati. Le Autorità indipendenti e l'economia*, Bologna 2009.

7. — The second paradigm of private law that is challenged is that of parity, of cooperation on an equal footing, the « arm's-length bargaining power » as a constitutive element of private law relationships ⁽¹⁰⁾.

As the crisis has shown, there is an apparent informational and relational disparity between parties of a contractual relationship, given that one of the parties is not able to understand and evaluate the importance of the contractual relationship it participated in and the risk it assumed.

This point leads to the idea that it is necessary to find the proper remedy for these asymmetries that allow one party to always prevail over the other.

This in fact hinders the free and orderly functioning of the market, given that the constitutive value that nourishes the market is trust among private parties.

It is worth stressing one fundamental characteristic of European private law: most of EU private law addresses legal relationships arising from a structural disparity. The idea of the legal intervention is to correct this disparity through judicial intervention.

8. — A third paradigm that is challenged is that of self-sufficiency in the contractual relationship.

The Italian Civil Code, like other civil codes of the civil law tradition, tells us that the contract has the force of law between the parties. This formula contains a double idea.

In an etymological sense, the contract is the law of that particular case. The agreement is self-sufficient because it does not require anything else to take effect.

To challenge the idea that the contract must be seen only as the law of a single fact we can introduce the notion of *contract governance*. An evaluation of the contract as an agreement between the parties is possible only on the condition that they evaluate, the same as corporate governance does, also the context in which the rules operate and their real efficiency ⁽¹¹⁾.

A good example is executive compensation, which of course is a contract

⁽¹⁰⁾ V. ROPPO, *Contratto di diritto comune, contratto del consumatore e contratto con asimmetria di potere contrattuale: genesi e sviluppo di un nuovo paradigma*, in *Id.*, *Il contratto del duemila*², Torino 2005, p. 23 ss.; da ultimo, *Id.*, *Prospettive del diritto contrattuale europeo. Dal contratto del consumatore al contratto asimmetrico*, in *Corr. giur.*, 2009, p. 267 ss.; *Id.*, *Regolazione del mercato e interessi di riferimento: dalla protezione del consumatore alla protezione del cliente?*, in *R. d. priv.*, 2010, p. 19 ss.; a different view in A. ZOPPINI, *Autonomia contrattuale, regolazione del mercato, diritto della concorrenza*, in C. RABITTI BEDOGNI e P. BARUCCI (a cura di), *20 Anni di Antitrust. L'evoluzione dell'Autorità Garante della Concorrenza e del Mercato*, t. II, Torino 2010, p. 1095 ss.

⁽¹¹⁾ K. RIESENHUBER, *Contract Governance — A Draft Research Agenda*, in *ERCL*, 2009, p. 248 ss.; cfr. N. LIPARI, *Crisi del contratto e crisi del diritto*, in F. DI MARZIO (ed.), *Il nuovo diritto dei contratti*, Milano 2004, p. 513 ss.

between the corporation and its officers: the question is whether the payment is connected to performance ⁽¹²⁾.

9. — All this, and this is the fourth and conclusive point, brings us to reconsider the fundamental distinction that has characterized and still characterizes the separation between private and public law (at least) in the civil law systems ⁽¹³⁾.

The above, in fact, implies a relevant change: from the idea that public and private belong to totally different levels, to the idea that public and private law share the same mission in regulatory terms ⁽¹⁴⁾.

The G-20 2008 summit provided that all financial markets, products and participants are regulated or subject to oversight.

In this perspective, a new body of *regulatory contract law* is growing. We witness that some duties are relevant both in contract law and in public regulation and that they are enforced through both contractual liability and regulatory sanctions ⁽¹⁵⁾.

A synthesis of the above considerations can be found in Sabino Cassese's formula, « public arena », expressing the idea that it is not correct to think of the legal experience within the contraposition between public and private law. According to Sabino Cassese it is necessary, instead, to substitute it with a new paradigm, characterized by the « interchangeability of roles, modification of relationships, and commerce in rules and in regulatory principles » ⁽¹⁶⁾.

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⁽¹²⁾ G.B. PORTALE, *Un nuovo capitolo del governo societario tedesco: l'adeguatezza del compenso dei Vorstandsmitglieder*, in *R. soc.*, 2010, p. 1 ss.

⁽¹³⁾ L. NIVARRA, *Diritto privato e capitalismo. Regole giuridiche e paradigmi di mercato*, Napoli 2010.

⁽¹⁴⁾ W. HOFFMANN-RIEM & E. SCHMIDT-ASSMANN (ed.), *Öffentliches Recht und Privatrecht als wechselseitige Auffangordnungen*, Baden-Baden 1996.

⁽¹⁵⁾ G. GITTI (ed.), *L'autonomia privata e le autorità indipendenti*, Bologna 2006; G. GITTI e G. VILLA (ed.), *Il terzo contratto*, Bologna 2008.

⁽¹⁶⁾ S. CASSESE, *L'arena pubblica. Nuovi paradigmi per lo Stato*, in *R. trim. d. pubbl.*, 2001, p. 607.