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Law's Elasticity
An Inquiry into the Relation of Law and Power in Finance

Abstract

Law is a powerful commitment device. By entering into a binding contract, a contracting party can invoke the coercive law enforcement powers of states to compel another party to perform. Many, if not most, contracts are carried out without ever invoking these coercive powers; they operate in the shadow of the law. Less attention has been paid to the flip side of law's shadow: the possibility of relaxing or suspending the full force of the law, or making law elastic. While this may seem anathema to the "rule of law", it is not an infrequent occurrence, especially in times of crisis. The elasticity of law should be distinguished from the incompleteness of law, that is, the inherent limitation lawmakers face in trying to anticipate all future contingencies. In this paper I will offer two tales of the American Insurance Group (AIG) to illustrate the elasticity of contracts as well as of law.

Keywords: Law; Finance; Elasticity law; Incompleteness of law; Financial crisis.

Introduction: Law in Finance

THIS PAPER elaborates on a theme that I touched upon in my earlier work on the "Legal Theory of Finance" (LTF) but did not fully elaborate [Pistor 2013]: the elasticity of law. LTF embraces two seemingly contradictory propositions. First, that contemporary financial systems are constituted in law. This means that law serves more than merely a subordinate role in fixing problems of transaction costs or information asymmetries to ensure that financial markets approximate efficiency [Gilson and Kraakman 1984]; rather financial systems would not exist without law. The ability to enforce a claim against a contracting party, if necessary, by force, is key for large scale, anonymous markets to arise.

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The second proposition is that in crises, the survival of a system that employs binding legal commitments depends on the ad hoc suspension of the full force of the law to avoid its self-destruction when too many seek to enforce their legal rights simultaneously. Jointly, these two propositions render the "Law-and-Finance-Paradox", the notion that law is essential for scaling financial relations to national or even global markets; yet the rigidity of legally binding promises that make commitments credible, threatens the survival of the system whenever ex post outcomes deviate significantly from ex ante expectations. Suspending the full force of the law in times of crisis is often the only strategy for avoiding such an *endogenously* triggered collapse of the financial system.

Asserting that the ex-post suspension of law, or law's elasticity, is critical for the survival of financial systems as currently constituted does not amount to a normative endorsement of either the financial system we have or the suspension of law. Rather, the need to make law elastic follows from the way in which the financial system has actually been configured. Further, the need to call an emergency and suspend the rules of the game as such does not predetermine who should benefit from this action. Experience suggests that the suspension of law is typically a measure of late or last resort. This timing implies that it tends to be reserved for intermediaries and assets that are indispensable for the system's survival. Law itself is, of course, an expression of power as Marxists and legal realists have long argued [Hohfeld 1913; Cohen 1927]; but it is *regularized* power. The ex-post elasticity of law is discretionary, and even if emergency powers are built into statutes that delegate their exercise to specific agents, such as central banks, their timing, scope and their beneficiaries remain (largely) discretionary.

Law's Imperfections

I use the term "elasticity" to refer to the ex-post relaxation or suspension of the full force of the law. This concept needs to be distinguished from two related concepts: incompleteness of law as well as exemptions that are built into the law from the outset.

Law is inherently incomplete as I have argued in joint work with Chenggang Xu [Pistor and Xu 2003]. Law is designed to be general and to last for a long time; it is meant to capture many different yet similar fact patterns but it cannot possibly enumerate them all ex-ante. The incompleteness of law manifests itself in statutory law in one of two ways: the

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law uses broad principles, or standards, that shall be applied to varying fact patterns by a court or regulator; or the law takes the form of specific rules that apply only to the narrow conditions it lists [Kaplow 1992]. In the case of standards, it is difficult to know precisely how a future judge might apply them to new fact patterns; in the case of rules, it will *not* apply unless the specific conditions are met, but this leaves many possible actions that may only be variations on the regulated "theme" beyond the statute.

Law's inherent incompleteness only seemingly flies in the face of Max Weber's famous dictum that capitalism can thrive only when law is rational and predictable [Weber 1981]. This means following procedures and ruling impartially on the basis of legal reasoning. Weber also conceded that there is more than one way to achieve this. The common law, which, for example, derives case law from broad principles that are applied to "like" cases, has been shown to be compatible with capitalism [Eisenberg 1988]. Whether or not a new set of facts will fit an established precedent is often difficult to predict in advance. Attorneys will parse each aspect of the case and point out how it might differ (or not) from fact patterns that are governed by it, and so will the judges who preside over the case. Importantly, though, they are bound by basic rules of legal reasoning, which is the essence of legal predictability [Dagan 2013].

The concept of incompleteness recognizes that the future is unknown and inherently unknowable, a notion that Frank Knight deemed fundamental uncertainty [Knight 1921]. Economists developing economic contract theory modeled incompleteness. Parties to a contract cannot possibly foresee all future contingencies and, even if they tried, the costs of including all of them would be excessive [Hart and Moore 1999]. Most contracting parties therefore choose to enter into binding contracts with the expectation that they will be able to re-negotiate key aspects should changing circumstances require them to do so [Scott 2006]. Only parties that have little reason to trust each other will attempt to specify the unspecifiable and write lengthy, detailed contracts. Even these contracts will, however, remain incomplete. Uncertainty is not a choice but a fact.

The financial instruments that are traded in global markets are contracts: legally enforceable commitments to pay some amount that is specified or depends on future price developments, to the other parties. Some are fairly simple and typically highly standardized. Examples include shares or simple bonds issued by corporations. The quest to list them for trading in deep and liquid markets favors standardization, although information technology has made deviations from the norm more feasible, as it has reduced the information costs associated with them. Shares, for example, come as common stock with a simple template of rights: common shareholders have one right per share to elect the company's board as well as to vote on change in the statute of incorporation and major transactions, such as mergers; they may freely trade their shares and thereby capture any capital gains; and they have a right to receive their share in the company's future profits if and when they are distributed. Unlike creditors, shareholders do not obtain fixed returns; they are compensated for their open-ended commitment with limited liability, which protects them from being held liable for the corporation's debt in case things to wrong.[1] Whereas the shareholders' rights are spelled out as default rules in statutory law, bond holders rely on contracts, or bond indentures, to specify their rights. They too have become highly standardized, as underwriters seek to offload them to a large number of investors who tend to prefer known products.

In addition to these plain vanilla "I owe You-s" (IOUs), there is a garden variety of assets, which often start as bespoke financial contracts but are standardized once they receive sufficient take-up. Credit derivatives are a good example here. They were first developed on a case-by-case basis to meet specific customer needs and traded over the counter (OTC). Once demand increased and the issuers of these instruments realized the earning powers associated with large and liquid markets, for which standardization is a prerequisite, they were standardized in private contracts [Morgan 2008; Carruthers and Stinchcombe 1999].

The legal documentation for derivatives, even for the simpler securitized assets from which they are derived, is long and complex. The prospectuses that are circulated by underwriters to attract investors typically span over 300 single-spaced pages and cover not only all regulatory requirements of which there are many, but every possible contingency that lawyers that draft these documents can think of. Length and detail, however, do not make these contracts complete. Like all contracts, they can only anticipate the known unknowns, not the unknown ones. Moreover, the attempt to scale markets by relying on standard contracts has pushed market participants to use the same template for products for which they were not designed. This did not matter much in the boom years but the frictions became apparent in litigation that followed the crisis [Braithwaite 2012].

Law is not only incomplete; it may also be designed to exclude some actors or some activities from its reach. Legal theorists and proponents of

[1] Not every organizational form affords equity holders this luxury. Partners in simple partnership, for example, do not enjoy limited liability and neither do the general partners in a limited partnership. However, they typically participate in the management of the partnership and thereby exert greater control over how it is run.

the rule of law argue that laws ought to be general and apply equally to all. Conversely, statutes that are designed for single or only a small subset of cases are frowned upon [Fuller 1938; Green 1987]. Feudalism was characterized by legal particularism, by a subset of legal rules that applied to different social groups depending on their social status (members of the nobility, city dwellers, peasants, and so forth). Modern legal systems were designed to apply equally to a new legal subject, the citizen of the post-feudal order. Nowhere is this more explicit than in the French civil code, which was first enacted in 1804 with its first book designated to the *citoyen*, his or her status as a legal subject and rights and obligations in civil law. The generality of law also implies the absence of *legal* privileges.

Yet, the generality of law always tends to give way to new differentiation. Max Weber singled out merchants as the constituency: as soon as states had crafted their new national legal codes, they negotiated exemptions and sought endorsement for their own legal particularism [Weber 1968]. They got what they wanted early on: in the leading civil law systems, commercial law was kept separate from civil law. The commercial codes gave parties greater autonomy to design their own contracts and to assume the risks that ordinary civilians were protected from. However, modern legal particularism did not stop there. Exemptions from general principles of the law are ubiquitous and can be found in regulation, which emerged in response to the "risk society" [Beck 1992; Majone 1994], as well as in private law, often in the form of "safe harbors". A good example is the rapid expansion of safe harbors in bankruptcy codes to protect derivatives traders [Morrison and Riegel 2005; Gullifer 2012]. The use of exemptions can be regarded as a legislative tool that ensures broad coverage while carving out some space for activities that are deemed less risky. Such exemptions can pursue a life of their own, however. Skillful lawyers can repurpose them for designing new intermediaries or assets that should arguably fall within the scope of the regulation but are designed to evade them.

Juxtaposing elasticity, incompleteness of law, and exemptions from binding law shows how they are related. The more incomplete a law, the fewer exemptions are necessary to accommodate special interests, and the lower the need for legal elasticity ex post. Conversely, the more complete a law, the greater the pressure to grant exemptions, but also the greater the need for suspending the law ex post. Incomplete law and incomplete contracts are also interdependent. The more incomplete the law, the greater the freedom to contract. The party with the greater bargaining power is likely to use this freedom to write more, not less, complete contracts that bind the other party, thereby shifting the costs of future uncertainty to it.

Even more important than legal certainty, which is enhanced by relatively complete law, trading IOUs in large, anonymous markets requires more, namely the threat of coercive enforcement. Take the example of a speculative contract, or wager: under common law, such contracts were not criminal; they were simply deemed non-enforceable. This put a cap on the scale and scope of financial speculation. In fact, only after this cap was removed by way of legal change—in the US only as recently as 2000 with the passage of the Commodities Futures Modernization Act—did markets in speculative financial instruments, including credit instruments, literally explode [Stout 2011]. Withholding enforceability has become a relatively rare legal tool. One reason may be that it is widely assumed that private parties know best what is good for themselves. Of course, the problem is that they tend to ignore the costs of their doings for others.

States may, however, guard against such negative externalities or other forms of market failure. This is done primarily by way of public-law regulation, which can take different forms: it can be proscriptive, impose entry requirements for financial intermediaries or their manager, rely on disclosure, or establish standards that will be used retroactively to assess the legality of certain actions. The finance industry has a particularly strong dislike of regulatory standards and it is not difficult to understand why. Regulatory standards tend to be vague and over-inclusive, and it is never entirely clear when exactly a transgression has occurred. This incompleteness keeps the industry on its toes, which is precisely why it does not like it. It therefore demands almost reflexively "legal certainty" from lawmakers and regulators alike: clear rules with as little ambiguity as possibility to make the costs of law enforcement calculable.

Legal certainty sounds appealing but it comes at a price [Pistor 2020]. First, legal certainty invites arbitrage. A precise rule can be easily circumvented by designing actions that deviate only slightly from its targeted behavior and thereby mute its effect. Second, highly specific rules and regulations invite equally specific arbitrage maneuvers. Only by countering specificity with specificity can a breach of the rule be avoided. This builds rigidity into contracts and makes them vulnerable to the dynamics of the Law-and-Finance Paradox: on the upside, highly complete contracts support the expansion of markets but, on the downside, their rigidity increases the likelihood of a self-destructive run. In a dynamic setting, this is bound to increase the complexity both of financial regulation and the transactions that it intends to regulate. Some regulators have therefore called for a simplification of regulatory responses, for heuristics, or standards as their equivalents in law [Haldane 2012]. This, however, is precisely what the industry dislikes because it would destabilize future expectations.

In sum, elasticity is an acquired feature of law. While law is inherently incomplete (no lawmaker can possibly anticipate all future contingencies) there exist varying levels of incompleteness. The need to make law elastic ex post depends on the nature of the legal arrangements that are made in the shadow of incomplete law. The more complete these contracts and the greater the *ex ante* assurance that they will be enforceable, the greater the need to relax either the contracts or the law *ex post* to take account of changed circumstances. This inverse relation between contractual design and the need for ex post adjustments holds in legal relations outside finance as well. However, it is particularly pronounced in finance, because of the scale of financial markets and the speed with which they can collapse. Outside finance, there is often more time to adapt legal rules in the regular process of legal or regulatory change.

Two Tales of AIG

In this part of the paper, I will present two tales to illustrate how law's elasticity operates in practice. Both cases involve the American Insurance Group (AIG), one of the near fatalities of the global crisis. The first tale is about contractual elasticity, and specifically about the relation of one of AIG's subsidiaries, AIG Financial Products (AIGFP) with its *private* contracting parties in the period from summer 2007 to September 2008; the second concerns the US government's strategy for stabilizing AIG after September 2008. By telling both stories, I will show that elasticity is not only relevant in relation to regulators or courts as the ultimate guardians of legality; neither are ex post bailouts the only manifestation of elasticity. Rather the need for ex post action is triggered by contractual design: the failure to anticipate events combined with the elimination of ex post renegotiation. It will become apparent that the failure of private parties to resolve the legal disputes over their contractual relationship, and additionally their tendency to insist on their rights as their own survival constraint kicks in, makes government intervention almost inevitable. Lastly, I will show that elasticity is where legal governance ends and power relations begin. As the two AIG tales will show, in the realm of legal elasticity there is neither legal guidance nor effective safeguards against the abuse of power. Ironically, the more contracting parties seek to avoid legal uncertainty by writing complete contracts, the greater the need for discretionary ex post intervention, or elasticity.

For most of its existence, AIG's name represented fully and fairly the contents and scope of its operations. As the company's web page recounts, "[t]he AIG story begins in China in 1919, when American Cornelius Vander Starr started an insurance agency in Shanghai. The enterprise grew first across China, then across the globe, with every new market and culture, we deepened our understanding of risk and helped create innovative ways to deliver value to our clients."[2] The company has provided "a range of insurance products to support our clients in business and in life, including: general property/casualty, life insurance, and retirement", and also more recently "financial services."[3] The company's venturing into financial services was hugely successful for a while but also caused its near undoing in the context of the Global Financial Crisis (GFC). The Congressional Oversight Panel identified two practices that put the company at risk: first, securities lending and, second, credit default swaps [COP 2010]; here, I will focus only on the latter.

In 1987, AIG established AIGFP, a subsidiary that was incorporated in the US state of Delaware but operated out of Connecticut. It started out as a company focusing on interest rate and currency swaps. In the early 2000s, however, it evolved into one the major issuers of "credit default swaps" (CDS), which were designed to provide protection against the risk of substantial declines in the value of financial assets. This may sound like insurance business but CDSs were purposefully designed so that they would not qualify as insurance business for regulatory purposes as this avoided regulatory costs.

AIGFP struck gold when it convinced regulators that protecting parties against losses of assets *they did not hold*, was not deemed an insurance contract, and also benefited from regulatory exemptions in federal regulations. It is a perfect example of how jurisdictional boundaries between regulators can be used for purposes of regulatory arbitrage: to create a product that is not regulated and yet is fully enforceable.

You cannot buy insurance on your neighbor's house and collect the payout when it burns down; you can only insure assets you are economically exposed to. Yet, AIGFP could write a swap contract that allowed it to assume the risk of economic loss associated with assets, even if its counterparty did not hold these assets. Clearly, this design amounts to a

[2] https://www.aig.com/about-us/history.

[3] https://www.aig.com/about-us.

workaround of the principle that *naked* insurance contracts, where the insured is not exposed to the underlying interest, are unenforceable.[4] This worked, because CDS contracts sat at the cross-roads of multiple regulatory regimes; responsibility for overseeing these new financial instruments was shifted from one to the other [Hazen 2009]. State insurance regulators (there is no federal insurance regulator in the US) determined that CDSs were securities that fell under the jurisdiction of federal regulators. The federal Securities and Exchange Commission (SEC) oversees primary and secondary securities markets, except for instruments that fall within the jurisdiction of the Commodities Future Trading Commission (CFTC); and since traditionally swaps, futures and similar derivatives had been associated with commodities, the CFTC, not the SEC, was in charge. The CFTS's powers to oversee derivatives markets, however, were curtailed by the "Treasury Amendment", which had been included in the 1974 statute that renewed the CFTC's powers [Harvey 2013]. Originally intended to exempt primarily derivatives in foreign exchange markets, its wording was sufficiently broad to fend off the CFTC from the emergent credit derivatives markets for decades, not for want of trying especially under Commissioner Brooksley Born (incidentally one of the few female supervisors at top regulatory agencies in the US) [Carruthers 2013]. The Commodities Futures Modernization Act (CFMA) of 2000, finally, explicitly exempted all derivatives from regulatory oversight—a decision that was (partially) reversed in the aftermath of the 2008 crisis.[5]

AIGFP issued credit default swaps that protected assets worth trillions of dollars, charging a modest fee for the risk the company assumed.[6] It looked like a win-win situation: the demand for CDSs grew especially as bank regulators around the world accepted that CDSs operated to offset some of the risk on the balance sheets of banks. AIGFP pocketed the fees and expected never to be charged to make good on its promise. Only when housing markets began to flatten out did the company stop issuing additional CDSs on certain assets, in particular on multi-sector collateralized debt obligations (CDOs). Still, even then, the company did nothing to protect itself against the exposure it had already incurred.

[4] The relevant provisions of New York Insurance law stipulate that "insurable interests" include any lawful and substantial economic interest in the safety or preservation of property from loss, destruction or pecuniary damage," N.Y. Ins. L. § 3401.

[5] Section 2(c)(2) CFMA (2000). The Dodd-Frank Act of 2010 forced most derivatives onto exchanges but did not re-establish the approval requirement for commodities-exchange-traded securities that existed prior to 2000.

[6] According to the Bank for International Settlements (BIS), the notional amount of CDSs had reached over $60 trillion in 2007. See Aldasor and Elers 2018.

When asset markets declined and one counterparty after the other made collateral calls, the tide began to turn. AIGFP itself did not keep enough reserves to respond to billions of dollars in collateral calls. It could obtain liquidity only by using its open credit line with its parent company, AIG. This in turn exposed AIG to a cash drain that was further exacerbated by the company's securities lending business. Under this program, AIG (or rather one of its subsidiaries) lent securities to third parties in exchange for cash collateral. The borrowers were allowed to return the securities and demand their cash back at any time. They did this, of course, when asset prices declined. This, in turn, left AIG in the unenviable position of having to scramble for liquidity precisely at a time when asset prices were tumbling. In short, the securities lending program created the same liquidity risk that banks face when depositors demand cash at a time when the bank faces a liquidity shortage, and the value of its own assets are deteriorating. This is the root cause for bank runs [Diamond and Dybvig 1983], or for runs on assets in shadow banking systems [Gorton and Metrick 2012].

In the end, AIG succumbed to a double-death spiral: the cash demands AIGFP made to cover the collateral calls it owed to others; and a rapid devaluation of assets another subsidiary had accepted for cash, which the company now needed more than ever, but was unable to secure without incurring substantial losses. Credit rating agencies downgraded the company, which forced AIG into the arms of the Federal Reserve Bank of New York (New York Fed). However, AIG could have crashed much earlier, arguably in the fall of 2007. The reason that it did not lies in a mixture of incomplete contractual design and in the social relations among key actors at AIGFP and its counterparties. They understood that the relentless enforcement of their respective rights would bring the entire system to its knees, and they were willing to postpone enforcement and negotiate accommodations to gain time. They benefited from contractual arrangements that turned out to be much more incomplete than their drafters had anticipated.

As noted earlier, the notion that contracts are inherently incomplete is well established [Hart and Moore 1999]. This implies that the contractual commitments that constitute financial assets may be less reliable than assumed. Moreover, there is a trade-off between contractual design and the scalability of markets. Scalability requires liquidity, which in turn depends (among other factors) on standardization. After all, as Carruthers and Stinchcombe [1999] have convincingly argued, "buyers, market makers, and sellers all have to share a deep conviction that the 'equivalent' commodities in a large flow of (say) financial instruments are

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really all the same" [354]. Yet, bespoke contracts that are designed for a specific customer or contractual relation can be designed to be more complete; they also typically render higher fees.

In an attempt to square the circle between standardization yet high incompleteness that was necessary to scale markets, while still taking account of specific needs or simply higher fees, the International Swaps and Derivatives Association (ISDA) developed a "Master Agreement". It stipulates the rights and obligations of parties to swaps and derivatives transactions in broad terms [Morgan 2008] [Partnoy 2002]. Specifics are left to detailed schedules that parties can refine as they wish. Prior to the GFC, assets were not traded in anonymous markets but in OTC markets, which were fairly concentrated. Only a handful of the largest financial intermediaries in the US and the UK issued most of the derivatives. Some derivatives were traded simultaneously in fairly liquid markets as well as over the counter, allowing parties to benefit from price discovery in the former and higher incompleteness and fees in the latter [Carruthers 2013]. The GFC brought down this market, not in a single event but in a slow motion process that unfolded over the course of more than a year—from July 2007 to Lehman's downfall in September 2008. This seems to contradict the Law-and-Finance Paradox, one of the core pillars of LTF, namely that binding legal commitments scale markets to size, but can bring them down quickly when markets turn and too many parties seek to enforce their rights simultaneously. As it turns out, however, a network of social relations among individuals that occupied critical positions in major financial intermediaries was the source of elasticity. By agreeing not to enforce their respective legal rights immediately, they delayed this crisis by over a year. In the end, they were unable to divert it, because private agents, even giant insurance companies such as AIG, face a binding "survival constraint" [Minsky 1986].

AIGFP v. Goldman Sachs: A Tale of the Elasticity of Contracts

In what follows, I will recount the unfolding crisis at AIGFP from the perspective of its top management, including its legal counsel, as well as key personnel in the counterparties to the CDS contracts, based on documents the US Financial Crisis Inquiry Commission has made publicly available.[7]

For AIGFP, the financial crisis began in the summer of 2007 with an innocuous email sent on 26 July 2007 to one of its top executives, Alan

[7] http://fcic.law.stanford.edu/resource.

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Frost, by Andrew Davilman at Goldman Sachs (GS): "Sorry to bother you on", said the subject line with the content of the email continuing: "vacation. Margin call coming your way. Want to give you a heads up." Frost replied 18 minutes later: "On what?", to which Davilman replied: "20bb of supersenior."[8] The next day, AIGFP received the details of the claim. GS had bought CDSs, equity derivatives and other structured products from AIGFP to protect from losses on assets worth billions of dollars. It now alleged that the value of these assets had declined beyond the built-in threshold of $75 million to trigger margin calls in the amount of $1.8 billion.[9]

This was the first margin call AIGFP had ever received on CDSs, the non-insurance insurance products it had issued. AIGFP disputed the amount of the claim and after some back-and-forth GS reduced the margin call first to $1.2 billion and then to $600 million, that is only one-third of the original claim.[10] AIGFP paid $450 million on the revised call with the proviso that it had the right to make a counter claim if the assessment turned out to be incorrect. Inside AIGFP, there was also speculation that GS was trying to gain the upper hand in the market by "aggressively marking down assets they don't own so as to cause maximum pain to their competitors."[11]

By November 2007, margin calls not only from GS reached AIGFP almost on a daily basis, despite the fact that AIGFP disputed them and that both parties were in continuous negotiations about how much, if anything, AIGFP truly owed to GS. Internal email correspondence at AIGFP suggests that GS had been requested to stop sending these calls but that its system generated them automatically. Based on personal exchanges with GS personnel, however, top management at AIGFP concluded that they were in a "bona fide" relationship with their counterpart. At this point in time, they had received only one other margin call, from Société General, which retreated after AIGFP disputed the claim.[12]

If the AIGFP executives had hoped that all they needed to do was to buy some time, they were mistaken. Soon margin calls picked up again and eventually every major banking institution in the world that had bought protection from the company against a decline in asset value (and most large banks had) were making calls. AIGFP challenged them

[8] Email GS to AIGFP 26 July 2007.
[9] Margin Call Goldman Sachs v. AIGFP.
[10] Details are available from a conference call with PWC, AIGFP's auditor. See PWC memo 8 August 2007.
[11] Internal email exchange at AIGFP 15-16 August 2007.
[12] Casano Email 1 November 2007.

routinely and negotiated with each bank the amounts they were willing to pay. The list of banks that had made collateral calls in reference to super-senior CDSs by 23 September 2008 included Bank of America, Bank of Montreal, Barclays, Deutsche Bank, Goldman Sachs Capital Markets, Goldman Sachs International, HSBC plc, HSBC USA, Merrill Lynch International, Rabobank, Royal Bank of Scotland, Société General, UBS, and Wachovia.[13]

Of interest is why none of these counterparties simply invoked its contractual rights against AIGFP by calling a default when the company did not meet its margin calls. The answer lies in the incompleteness of their contract, which relied on a mechanism to resolve the dispute that was no longer available, namely the existence of a market in the relevant instruments. This triggered prolonged negotiations that deferred the demise of AIG, the parent corporation on whose cash lifeline AIGFP depended. The margin calls were made for the most part under a Credit Support Annex to the ISDA Master Agreement. ISDA's Master Agreement stipulates the basic rights and obligations between two financial intermediaries who expect to execute multiple transactions with one another in the future. It is just over 20 pages long and confines itself to the barebones of a derivatives contract. Over the years, ISDA has complemented this document with multiple Annexes and Schedules that allow the two parties to a master agreement to add more specific legal language to their legal relation depending on the nature of the transaction entered into. Specifically, the Credit Support Schedule was designed for parties that wish to make use of collateral or similar forms of credit protection. Under this schedule, the secured party has the right to demand payment from the other party if the value of the secured or protected assets decreases below a threshold defined in the contract. Importantly, the secured party that makes the call also has the power to determine the value of the claim.[14]

This explains why Goldman Sachs sent a note seemingly out of the blue claiming a $1.8 billion margin call. Under ISDA's Credit Annex, the *Pledgor*, in this case AIGFP, may dispute the amount and even make a return request. If the parties are unable to resolve their dispute, they can invoke the Annex's dispute resolution mechanism, which stipulates several valuation mechanisms: the parties may base their calculations on positions that are not in dispute; they may seek "four actual quotations

[13] AIGFCIC00384231, available at http://fcic-static.law.stanford.edu/.

[14] An example of a Credit Annex (which is not freely available) can be found at Lehman HSBC USA Credit Support Annex. See specifically Paragraph 3 "Credit Support Obligations", subsection a.

from Reference Market-makers", or fewer if four are not available. Finally, if no quotation is available for a particular transaction, then the "*original calculations* will be used for that transaction."[15]

This arrangement effectively creates elasticity ex post by freeing each from contractual constraints in times of market failure. The dispute resolution provisions empower the party that makes the collateral call to control the process. It calculates the loss and in the absence of verifiable alternative prices, its calculation will prevail. Knowing this, the protection seller (AIGFP, for example) has no choice but to raise a counter claim, arguing that it has overpaid on a wrongfully calculated claim and now offers its own calculation to retrieve the difference. By doing so, *it* becomes the "valuation agent" and can therefore impose its own solution on the other side. This scenario of claims and counter claims sets the stage for a potentially endless back and forth, a game in which whoever blinks first will lose. Either party can put an end to this tournament by paying up the claimed amount or by defaulting or by claiming that the other party had defaulted.

AIGFP had to avoid default with every one of its counterparties as this would have laid bare the fact that it did not have the reserves needed to back its promises to protect its clients' assets, and this in turn would likely have triggered a run on the company. For the same reason, none of AIGFP's counterparties dared claim that AIGFP had defaulted either. Bringing down AIGFP would eliminate the appearance of credit protection that these entities had represented to their regulators and would have forced them to raise fresh capital immediately to comply with capital adequacy rules. Further, AIGFP's counterparties must have known that bringing down the central node in the network of CDSs that were worth trillions of dollars might well trigger a meltdown of the global financial system. Using CDSs to short the market, as many acquirers of these instruments had done, still required the CDSs themselves to deliver, and this meant keeping AIGFP up and running.

This case study demonstrates the interplay of *ex ante* incompleteness and *ex post* elasticity of contracts. Incompleteness is typically interpreted as unlimited foresight: under conditions of fundamental uncertainty, no contract can possibly anticipate all future contingencies. Yet, it is typically assumed that contingencies that are anticipated (such as the default by one party) are actually resolved. This is where the Credit Annex fell short. It anticipated the possibility that the parties would dispute the valuation of assets, and even the possibility that no reference prices would

15 *Ibid*., Paragraph 5.

be available for them (although the drafters of the Annex hardly anticipated that markets would cease to exist). The procedure that was meant to solve the dispute, however, simply shifted the right to make claims and determine their value back and forth between the two parties. It thus failed to provide a solution within the contractual framework, leaving it to either party to call a default and bring the contractual relation to an end. The reason the default provisions were not invoked to the fullest extent was that even the most powerful players realized that by doing so they would likely bring down the entire financial system on which they too depended.

Emergency Power and the AIG Bailout

The storm the engulfed AIG was a long time coming. It was delayed only because the counterparties to CDSs did everything within their power to delay the day of reckoning. But there was only so much they could do. The more assets deteriorated in value, the more the financial intermediaries that had hesitated to call a default on AIGFP came under stress and left them little choice but to find cash wherever they could, irrespective of the systemic risks this might entail. After all, private entities face a binding survival constraint, which limits their ability to accommodate others. When Lehman Brothers filed for bankruptcy and credit agencies downgraded AIG, the company made a final attempt to raise capital on private markets. When this fell through, it was left with two options: bankruptcy or a government bailout.

The fact that these were the only options remaining supports the argument that credit-based financial systems are "inherently hierarchical" [Mehrling 2012]. Every individual, every firm, every bank, and every central bank can be depicted as a balance sheet, each with its own assets and liabilities, with the liabilities of one being the assets of another, and vice versa. Not all assets and not all liabilities are equal, however. All truly private entities are subject to a binding survival constraint. Only states that are monetary sovereigns, that is states that issue their own currencies and most of their sovereign debt in that currency, can manipulate their own survival constraint—and this includes their agents, such as central banks. It follows that while private entities can help each other out in times of distress, they can and will do so only when their own survival constraint kicks in. A private entity that cannot obtain cash in private markets to pay down its own obligation therefore has only two ways to go: it can descend to bankruptcy or it can try to reach the top of the hierarchy where the central bank resides.

Under the US Federal Reserve Act, emergency loans are available not solely to financial intermediaries. The version of the Act that was in force at the time of the AIG bailout reads as follows:

> In unusual and exigent circumstances, the Board of the Governors of the Federal Reserve System […] may authorize any Federal reserve bank […] to discount for any *individual, partnership or corporation,* notes, drafts, and bills of exchange when such notes, drafts and bills of exchanged are indorsed or otherwise secured to the satisfaction of the Federal reserve bank; *Provided*, that […] such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions…[16]

AIG had to struggle to obtain a lifeline from the Federal Reserve (the Fed). In a meeting with Treasury Secretary Geithner on 29 June 2008, AIG's chief executive, Bob Willumstad, inquired whether AIG might borrow from the New York Fed, should such a need arise in the future.[17] The then president of the New York Fed, Timothy Geithner, refused to provide such an assurance and pointed to the moral hazard problems such a commitment might trigger. On 9 September 2008, Willumstad met again with Geithner, this time expressing "AIG's interest in becoming a primary dealer to gain access to the New York Fed's Primary Credit Facility ("PRCF"), which had been created shortly after the near collapse of Bear Stearns.[18] This request was also denied. By 15 September 2008, the day that Lehman Brothers filed for bankruptcy, it had become clear that AIG would not be able to raise enough capital on private markets to survive. Geithner therefore asked JP Morgan and Goldman Sachs to orchestrate a private bailout for AIG. Their investigation led them to the conclusion that "AIG's borrowing needs exceeded AIG's value by tens of billions of dollars" and both investment banks politely declined.[19]

Given the fallout from the failure of Lehman Brothers and the fear that a failure of AIG and, by implication, of AIGFP, might force major banks from around the globe to scramble for additional capital at a time when capital markets had stopped functioning, the Fed decided to act. It picked up where the private parties had left off, used the template they had developed, and offered AIG a take-it-or leave-it option: the New York Fed would lend AIG $85 billion at an interest rate of 12%; in return, it would acquire the right (a warrant) to acquire 79.9% of AIG's common stock.[20] AIG's board of directors was given two hours

[16] Section 13(3) 12 U.S.C. §343 (2006).

[17] See the summary of facts in Starr International Company, Inc. v. United States. In Fed Claims Court: US Court of Federal Claims, Docket No. 11-778C, 121 Fed CI. 428 at 444 (hereinafter Starr v. US).

[18] *Ibid*.

[19] *Ibid*. at 447.

[20] This right was later changed to the acquisition of preferred stock.

to accept the deal and to enter into a credit arrangement with the New York Fed as the lender. The credit arrangement was executed on 21 September 2008 without a vote of the existing shareholders. Under the terms of the agreement, the company's CEO, Bob Willumstad, had to step down and was replaced by Ed Liddy, who was appointed chairman of the board and CEO of the company. Further, a government-appointed monitoring team was installed to protect the Fed's credit exposure to AIG.

Subsequent litigation brought by AIG's major shareholder, Starr Company (hereinafter Starr), a company registered in Panama and owned by AIG's former chief executive Maurice Greenberg (who had been forced to step down after a government inquiry in 2005) challenged the legality of the terms of the government bailout. The plaintiff claimed that the government "illegally exacted" (or expropriated) the shareholders of AIG by obtaining a controlling ownership stake and that it had no power to do so. This claim ultimately failed for reasons set out below. The trial did, however, reveal detailed information about the structure of the bailout and how it compares to the bailout (or re-capitalization) of other private entities. Between 15 and 30 September 2008, the Fed lent $155.8 billion, or twice the amount AIG had received, to other financial intermediaries without taking any equity stake in them. Moreover, the "shareholders of Citibank, Goldman Sachs, Bear Stearns, and all the firms that had access to the PDCF [the Primacy Dealer Credit Facility] got 'a windfall as a result of government assistance'" according to Treasury Secretary Geithner's testimony at the trial.[21] Also striking is the direct comparison with the conditions for Morgan Stanley's bailout package as summarized by a table in the court's opinion, which has been replicated below (Table I).[22] The two packages differed drastically from one another with regards to interest rates and the imposition of the government as a shareholder as signified by equity.

These banks collectively "received tens of billions of dollars in Government assistance" on par with, if not in excess of, what AIG had received.[23] Moreover, not only did AIG face harsher terms than any of the other entities that received government largess but its balance sheet was also used to make other financial intermediaries whole again. This took the form of an additional $62.1 billion lending facility to AIG, which, on the direction of the New York Fed, was used to acquire

[21] Starr v. US (2015) supra note 16 at 485.

[22] *Ibid*.

[23] *Ibid*. at 481.

TABLE 1
Two Bailouts: AIG vs. Morgan Stanley

	AIG		Morgan Stanley	
16 Sept. 2008	$14B loan	12% Interest Rate	$16.5B loan	2.25-3% Interest Rate
22 Sept. 2008	$37B loan	12% Interest Rate	$60.6B loan	2.25-3% Interest Rate
		2% Commitment Fee		No Commitment Fee
		8.5% Undrawn Amounts Fee		No Undrawn Amounts Fee
29 Sept. 2008	$55B loan	79.9% Equity	$97.3B loan	No Equity
		$85 Billion Commitment Ceiling		No Commitment Ceiling
		25% Collateral Haircut		6-10% Collateral Haircut

outstanding CDSs from AIG's counterparties at *nominal* value. In short, AIG was forced to buy out the CDS contracts from the counterparties of its subsidiaries even though neither it nor AIGFP had been accused, much less convicted, of fraud.

The facts of this case fit neatly into the LTF analytical framework but they also raise questions about the border between incompleteness and the elasticity of law. The case certainly confirms that, in the midst of a crisis, entities that are, or at least are perceived to be, critical for the survival of the system will benefit from a relaxation or even suspension of the rules of the game. The AIG bailout may have been tainted by the misjudgment of the Treasury Secretary, Hank Paulson, and the Fed's Chairman, Ben Bernanke, regarding the likely repercussions of allowing Lehman to fail. However, it is also clear that the government was already concerned about AIG prior to Lehman's demise. AIG had been denied access to the Fed's lending facilities just two months earlier but was now deemed eligible for a fullly-fledged bailout. In fact, the Fed approved the bailout even though Goldman Sachs and JP Morgan concluded that AIG was technically insolvent. After all, this is the meaning behind their statement that the company's liabilities exceeded its assets by tens of billions of dollars. The decision to bail out AIG arguably violated the

Fed's emergency lending authority because Section 13(3) of the Federal Reserve Act (FRA) authorizes the Fed to discount (that is, to lend against collateral) only if the debt instrument is "indorsed or otherwise secured". As a rule, central banks lend only against collateral. In fact, Chairman Bernanke and Treasury Secretary Paulson insisted that they had been legally prevented from bailing out Lehman, because the company was technically insolvent. If AIG was equally insolvent, it should have entered liquidation, just as Lehman had done; it should not have been bailed out.

One might argue that the words "otherwise secured" give the Fed wide discretion to determine what assets can serve as collateral. This would suggest that the real issue was ex ante incompleteness of the statute (the FRA) rather than ex post elasticity. Indeed, a member of the New York Fed's office of legal counsel recounted to my class that, to assure itself that AIG had sufficient assets that could serve as collateral, he and others went to AIG's offices in downtown New York and collected the share certificates of all of its subsidiaries.[24] Share certificates, however, can hardly count as conclusive evidence of value especially after financial markets have frozen, making evaluation impossible. Under these conditions, the determination of insolvency fell into the hands of the Fed, just as the determination of asset value had been left to the parties of the CDS contract under ISDA's Credit Annex.

Once the Fed had decided to employ its emergency lending powers, it exercised its discretion in determining the conditions for the loan. As the comparison with other bailout programs suggests, these conditions were quite harsh especially to the company's shareholders who were not given a say and were effectively pushed out.

Starr, the vehicle through which Maurice Greenberg owned the largest block of shares in AIG prior to the government bailout, sued for damages. The court of first instance agreed with the plaintiff that the government's acquisition of shares in AIG amounted to an "illegal exigency". Specifically, while Section 13(3) of the FRA authorizes the Fed to require collateral to lend against, it does not give the Fed the authority to acquire shares on behalf of the US government. The wording of the provision does not include ownership; according to the opinion, neither were such measures implied. The court scrutinized existing case law on implied government powers, arguing that "a federal entity's incidental powers cannot be greater than the powers otherwise delegated

[24] For reasons of confidentiality, I will not disclose the name.

to it by Congress".[25] Moreover, it pointed out that Congress passed the Government Corporation Control Act in 1945, which prevents government entities from acquiring a controlling stake in a private corporation without "express congressional authorization".[26] Last but not least, never before had the Fed required a controlling stake when exercising its emergency lending authority.

The argumentative strategy of Starr and its lawyers suggests that, even in times of emergency, the Fed is still subject to legal constraints, and the court agreed. In the end, this did not amount to much because the court concluded that Starr was not entitled to any damages. Without the government bailout, the court argued, AIG would have had to file for bankruptcy on 16 September 2008 or shortly thereafter, and in such a scenario, the shareholders would in all likelihood have received nothing at all—where there is no damage, there can hardly be any compensation. The court concluded that "a troubling feature of this outcome is that the Government is able to avoid any damages notwithstanding its plain violations of the Federal Reserve Act. […] Any time the Government saves a private enterprise from bankruptcy through an emergency loan, as here, it can essentially impose whatever terms it wishes without fear of reprisal. […]."[27]

Put differently, where law is elastic, power is not only not institutionalized but it is also unchecked. This was an astonishing conclusion for a court of law to arrive at but it was unable to solve this conundrum. "With some reluctance, the Court must leave that question for another day", it concluded.[28]

Starr appealed the decision only to find its claim entirely dismissed by the US Court of Appeals for the Federal Circuit.[29] This court held that, as a shareholder, Starr did not have standing to bring the case. The only party that was injured, if at all, by the terms of the bailout would have been AIG, the corporation, not its shareholders, but the company had not filed a claim. And while under the corporate law of the state of Delaware (where AIG is incorporated), shareholders have the power to bring a case on behalf of the corporation, namely a derivative action, only current shareholders have this right. Moreover, such action is not available in federal law, including constitutional claims.

This opinion throws the conclusion of the court of first instance into even starker relief, because the only actors with incentives to sue are the

[25] Starr v. US (2015), supra note 16: 503.
[26] *Ibid*. at 504.
[27] *Ibid*. at 454.
[28] *Ibid*.
[29] Starr International Company, Inc. v. United States, US Court of Appeals for the Federal Circuit, 9 May 2017, 856 F.3d, 953.

shareholders. If they do not have standing, then the government does not face the threat of litigation even if it engages in illegal conduct. It is not even bound by reputation bonds.

Finance Beyond Law

In this paper I have tried to elaborate further on a concept that I first introduced in my paper on the legal theory of finance, namely the elasticity of law. I have shown that elasticity exists where power is institutionalized, as law ends and unregulated power begins. Law is power, of course; it institutionalizes the coercive powers of states. Access to this power is key not only for state agents but also for private actors in organizing their horizontal relations with others: their family affairs, inheritance matters, business dealings, and, of course, their financial relations. Public and private agents alike can employ law to disguise and legitimate the control they exercise over others. As long as power is exercised within legal constraints, there is still room for legal contestation and for the resolution of disputes within regularized procedures. The results they produce may not always be just, but they will for the most part be consistent with procedural predictability or the absence of rule by fiat. Beyond the confines of the law, discretion rules.

No system of law can possibly be complete and thereby avoid the need to rely on ex post elasticity and discretion. However, systems that survive only by *regularly* crossing the line between rule-bound behavior and ad hoc rule by fiat become ungovernable. Their dependence on law for achieving scale and complexity only disguises the fact that when the stakes are high, unconstrained power rules. The more often this pattern repeats, the more predictable this outcome becomes and this, in turn, will invite discretionary actions by private and public actors alike. Actors within such a system know that their survival will ultimately depend on their proximity to the apex of a deeply hierarchical system.

It is not an accident that the central banks that rescued the financial system from the abyss last time around have all been unable to extricate themselves from their deep entanglement with finance. Central banks have, of course, never only set monetary policy; their actions have always implicated the behavior of regulated banks and other financial intermediaries with and without access to such banks. They no longer govern the financial system indirectly and at arm's length; they are part and parcel of a system that they will protect at all costs. This is true for the US Federal Reserve as it

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is for other central banks, including the European Central Bank (ECB), which interacts even in normal times with a much larger number of financial intermediaries and a broader range of assets [Papadia and Välimäki 2011].

This has become only too apparent with the outbreak of yet another financial crisis in 2020. Unlike the 2008 crisis, which was endogenous, this crisis was triggered by a health pandemic (a coronavirus labeled COVID-19). At the first sign of trouble in financial markets, however, central banks took out the playbook from the last crisis and expanded liquidity faster and in unprecedented volumes [Menand 2020]. The new regulatory framework that was put in place after the last crisis—the Dodd Frank Act in the US and the banking union in the EU—had placed banks on a more resilient footing but did not, and arguably could not, have anticipated this exogenous shock to the market. The US Fed has bought commercial paper and corporate bonds from non-financial firms and has extended liquidity facilities to states and municipalities. There is no longer any doubt that the true guardians of finance are the central banks, that is, the lenders and dealers of last resort [Mehrling 2011]. True to the elasticity of their new-found governance, they invent their tools as they go along [Bernanke 2015]. The legal stop gaps that were put in place after the last crisis to curtail the Fed's emergency lending capacity have been cast aside by crafty legal engineering. By applauding the means because the ends are desirable, we effectively endorse not only the central banks' usurpation of power but their rule beyond the law, at least in terms of money and finance. Given how central finance has become to the operation of major economies, we risk sacrificing the rule of law. One response to this dilemma has been to call for the regularization of central bank powers by explicitly conferring certain emergency powers on them [Menand 2020; Conti-Braun and Skeel 2020]. Unless the system itself is reformed, however, these can only be short-time fixes, because the next crisis will undoubtedly test the elasticity of these rules.

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Résumé

La loi est un puissant dispositif d'engagement. En concluant un contrat contraignant, une partie contractante peut invoquer les pouvoirs coercitifs d'application de la loi des États pour contraindre une autre partie à s'exécuter. Beaucoup de contrats, sinon la plupart, sont exécutés sans jamais invoquer ces pouvoirs coercitifs ; ils opèrent dans l'ombre de la loi. Moins d'attention a été accordée à l'autre côté de l'ombre de la loi: la possibilité d'assouplir ou de suspendre toute la force de la loi, ou de la rendre élastique. Si cela peut sembler anathème pour « l'état de droit », ce n'est pas rare, surtout en temps de crise. L'élasticité du droit doit être distinguée du caractère incomplet du droit, c'est-à-dire la limitation inhérente aux législateurs lorsqu'ils essaient d'anticiper toutes les éventualités futures. Dans cet article, je proposerai deux histoires autour de l'assureur AIG pour illustrer l'élasticité des contrats ainsi que celle du droit.

Mots-clés: Droit; Finance; Banques centrales; Théorie des contrats; Incertitude.

Zusammenfassung

Das Gesetz stellt ein starkes, bindendes Mittel dar. Beim Abschluss eines verbindlichen Vertrags kann sich eine Vertragspartei auf staatliche Zwangsvollstreckungsbefugnisse berufen, um eine andere Partei zur Vertragserfüllung zu zwingen. Viele, wenn nicht sogar die meisten Verträge werden durchgesetzt, ohne dass diese Zwangsbefugnisse jemals in Anspruch genommen werden; sie handeln im Schatten des Gesetzes. Weniger Aufmerksamkeit wurde der anderen Seite des Schattens des Gesetzes gewidmet: der Fähigkeit, die volle Kraft des Gesetzes zu lockern oder auszusetzen, oder das Gesetz elastisch zu machen. Dies mag dem „Rechtsstaat" ein Gräuel sein, ist aber nicht ungewöhnlich, besonders in Krisenzeiten. Die Elastizität des Gesetzes muss von der Unvollständigkeit des Gesetzes unterschieden werden, d.h. von der inhärenten Beschränkung des Gesetzgebers bei dem Versuch, alle zukünftigen Eventualitäten zu antizipieren. In diesem Artikel biete ich zwei Geschichten rund um den Versicherer AIG an, um die Elastizität von Verträgen wie auch von Gesetzen zu veranschaulichen.

Schlüsselwörter: Recht; Finanzen; Zentralbanken; Vertragstheorie; Ungewissheit.