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Title

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Publication Date

2008-08-20

The social function of contract law in Brazilian Civil Code: distributive justice versus efficiency – lessons from the United States

“lawyers focus on individual cases, whereas economists focus upon statistics. Statistically, the paternalistic protection of Mrs. Williams by legal restrictions on the credit market imposes high costs on poor consumers as a class.” (COOTER & ULEN)

“jurists see the law suits not the activities. [...] he is not trained to understand what a structure is: therefore, he is more capable to perceive a tree than the forest.” (JOSÉ REINALDO LOPES)

Luciano Benetti Timm¹

ABSTRACT: The purpose of this paper is to describe the current status in Brazilian legal scholarship with regard to the interpretation of Section 421 of the new Civil Code that provides for respect of the social function of contracts. This is normally identified with the paternalist model of contract law and its idea of distributive justice, typical from the Welfare State legislation and policy. Second, the paper suggests a critical reading of this quasi consensus that is coming up among Brazilian jurists through an economic analysis of law and its emphasis on efficiency and the consequences of paternalism. The discussion in Brazil is contextualized with the debate of paternalism *versus* efficiency in contract law in the United States.

KEY WORDS: SOCIAL FUNCTION OF CONTRACTS – PATERNALISM – ECONOMIC ANALYSIS OF LAW – DISTRIBUTIVE JUSTICE – BRAZILIAN CIVIL CODE

INTRODUCTION

The Brazilian new Civil Code (NCC), which was published in 2002 and became effective in 2003, brought about significant changes to Brazilian Private Law.² Not from a

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quantitative standpoint (number of sections), but from a qualitative one (content of the rules).³ By far the most controversial rule is section 421 that provides as follows: “Section 421. The freedom of contract shall be exercised by virtue and within the limitations of the *social function* of the contract.”

Given the methodological presumptions made in the first part of my article, my basic point in this paper is to demonstrate the two conflicting paradigms of the social function of contract law in Brazil that emerged from the dispute over the interpretation of Section 421 quoted below. That dispute is not simply dogmatic, nor does it just deal with “revelation” of Law by legal scholars. As a matter of fact, it can only be meaningfully explained by conflicting views of society and the role of contracts (the social function of contract). The first of the paradigms, I will call the solidarity (or paternalist⁴ as Americans prefer) model of contract law, which is based on a sociological collectivist view of society and by implication of contracts. The second one I will call the law and economics model of contract law – which borrows from Economics the individualist perception of what contract is and its role in society.

I will address the paternalist paradigm in the second part of the article – which usually identifies the social function of the contract law with the purpose of balancing economic and factual power between the parties under the view of the redistributive justice inherent in the Welfare State. In my view, the paradigm is theoretically mistaken since it departs from a misconception of what the contract is, as a fact, in our present society. By

² It is important here to remember that Brazil is the only former colony of Portugal, different from all the rest of Latin America, which makes its legal history very peculiar and somehow different. Probably one of the most striking differences is the influence of German Civil Law.

³ In comparison with the former Civil Code from 1916 – which was based on the German Civil Code and the contribution of Brazilian Romanists such as Teixeira de Freitas – there are at least five new sections: 1) section 157, which allows the nullification of contract in cases of gross disproportion of the result of bargain of the parties as a consequence of inexperience or situation of necessity (which could be translated in United States by the expression “substantial unconscionability” or by the French expression *lesion* or the Latin *lesio*); 2) Section 187 that deals with the forbiddance of the abuse of rights or *abus du droit* for situations in which a party perform its right in order to harm other party (in United States the example is the doctrine of material breach or substantial performance, which protects the party for an abuse of the discretion to terminate a contract in case of minor breaches); 3) good faith or *bona fides* (known by Americans because of the UCC provision); 4) a protection for weaker parties in contracts of adhesion; 5) social function of contracts.

not perceiving correctly what a contract is, the model is wrong about what contract law should be (the social functional of contract law).

In the third part of this paper article, I will discuss the individualist paradigm that has been constructed lately of what a contract and society are: the standpoint of law and economics, which is based on works organized by Sztajn and Zylbersztajn⁵, by Pinheiro and Saddi⁶, but also on preliminary research from the last two years by my Law and Economics group at Pontificia Universidade Catolica do Rio Grande do Sul.⁷ The arguments have support from very recent cases of the Federal Superior Court of Justice (Superior Tribunal de Justiça, STJ)⁸.

I will try to demonstrate by the end of this paper that the quasi common sense of Brazilian scholarship is generally mistaken when it defends the social function of contract law based on an idea of distributive justice and when it seeks, by means of the contract, to create “social justice”.⁹ I will argue that most of the time the model fails when it contradicts with the very basic normative assumptions of the Coase Theorem, arguing in favor of governmental and judicial intervention on agreement between parties, which generates increased transaction costs and a barrier for bargain-making.

⁴ As evidenced by KRONNAM, quoted below, there are at least three kinds of paternalism. The one that I am addressing here is the protection of the weaker party against its own will by means of mandatory legal provisions restricting the unbalance of power among contracting parties such as rent agreements.

⁵ SZTAJN, Rachel e ZYLBERSZTAJN, Décio. *Direito e Economia*. São Paulo, Campus, 2005.

⁶ PINHEIRO, Armando Castelar e SADDI, Jairo. *Direito, Economia e Mercados*. São Paulo, Campus, 2005.

⁷ MACHADO, Rafael Bicca & TIMM, Luciano Benetti. *Direito, Mercado e Função Social*. Revista da Ajuris. , v.103, p.197, 2006; TIMM, Luciano (org.). *Direito e Economia*. São Paulo, THOM SON/IOB, 2005; TIMM, Luciano Benetti. *Direito, economia e a função social do contrato: em busca dos verdadeiros interesses coletivos protegíveis no mercado de crédito*. *Revista de Direito Bancário e do Mercado de Capitais*. , v.33, p.15 - 31, 2006.

⁸ In Brazil, after the Democratic Constitution of 1988, the Federal Supreme Court – which was created in the Federal Constitution of 1891 based on the U.S. Supreme Court – was split and the Federal High Court of Justice was created to adjudicate federal law (such as the Civil Code), except constitutional law, that remained with the Supreme Court. It is the role of the High Court to harmonize the interpretation of the federal statutes among Circuit Federal Courts and among States courts of appeals when interpreting federal law. Unlike in the U.S., federal courts do not have jurisdiction based on diversity issues but only to adjudicate the interests of the Federal Union (such as federal tax laws, federal government civil liability, etc). The jurisdiction of States courts is residual and they normally have to apply federal laws such as the Codes.

⁹ In order to avoid generalizations, I will focus my paper on Civil Code contract law and exclude labor contracts and consumer contracts, regulated by a different body or rules. The Civil Code shall apply by exclusion of those specific laws.

According to the law and economics model of contract law, social welfare does not always mean interference in order to favor the weaker party in cases of unequal bargaining power. On the contrary, recent examples show that state interference within the realm of contract can favor the weaker party in the dispute and harm collective interests, as it disarranges the public space of the market, which is structured upon the expectations of the economic players. Moreover the benefit of the redistribution affects only the party in litigation without any collective beneficial result for those who did not file a law suit. Plus, there is always the chance of passing along the increased costs and private circumvention of the public policy at stake.

By this token, excessive judicial policing of contracts can lead to legal instability, and to insecurity in the economic scenario, which would result in higher transaction costs for the parties to negotiate and to enforce agreements. Furthermore, excessive judicial policing can create bad externalities (*i.e.* effects for third parties), since the risk of loss or the actual loss of litigation of the “stronger” party tend to “spill over” or to be passed along the group (collectivity), which ends up paying for the legally protected weaker party (as it paradigmatically occurs with banking interests, insurance, and as it has occurred in a soy financing agreement in the Brazilian State of Goiás) without receiving the welfare compensatory benefit.

This debate will take advantage of the contract law literature of United States for basically three reasons: a) U.S. literature has undergone this debate for 30 years in a more pragmatic, analytical and to some extent more intellectually rich way than in Europe, so it might have lessons for Brazil (where the debate is very new); b) economic analysis of law was created by American scholarship; c) contracts are legal tools to facilitate market transactions¹⁰, we can suppose that the more developed the market of a society, the more complex and better is its contract law – so the U.S. is not only a paradigm, but moreover a good one¹¹. I acknowledge the differences of American and Brazilian contract law, which

¹⁰ According to Roppo, contracts are the legal costume of a naked economic transaction. Cf. ROPPO. *Il contratto*. Trad. Português. Coimbra, Almedina, 1988, p. 10-11.

¹¹ For the same reason, Roman Law contract law was more complex and developed than the Hamurabi Code, since it was designed to cope with more commercial transactions than the old Middle East and also it was

obviously require caution in borrowing from the academic debate. However the differences of legal systems (at least in contract law) should not be overemphasized especially when we are dealing with general discussions such as the social function of contract law.

This debate in Brazil is interesting for Americans and Europeans and maybe Asian readers because arguments that some scholars made in U.S. and Europe in terms of distributive justice and paternalism in contract law a few years ago were actually applied in Brazil to a great extent. So they might find the Brazilian case as a testing laboratory of models that have been discussed in theory but so far have never been implemented in case law or even in legislation to the same extent.

However before addressing the most relevant arguments, I will set out a few methodological presumptions in the first part. They are not essential, but they make my points clear at least from a perspective of the General Theory of Law (or jurisprudence for common lawyers).¹²

I – METHODOLOGICAL PRESUMPTIONS: THE TRILOGY LAW, LEGAL “SCIENCE” AND FACTS

Science develops by conflicting theories and paradigms. A paradigm is shifted when a dominant way of thinking through problems and a method to solve them supersedes others¹³. This is also true in the “Science” of the Law (or legal scholarship). When there are shared visions of concepts and problems to be addressed by Law and the best way to tackle them, then we can say there is a legal paradigm. Frequently legal paradigms will collide

much more developed than the customs of German tribes such as Franks, Saxons, Lombards, Visigoths, etc. Also we can perceive a development of the Roman contract law following the needs of the market in the Empire, from strictly formal contracts to oral contracts such as service supply, rent, purchase agreements. KASER, Max *.Direito Privado Romano*. Lisboa: Fundação Calouste Gulbenkian, 1999; Wolfgang Kunkel, *An Introduction to Roman Legal and Constitutional History*, second edition (Oxford: Clarendon 1973); SCHULTZ, Fritz. *History of Roman Legal Science* Oxford: Clarendon 1946; SCHULTZ, Fritz *Classical Roman Law* Oxford: Clarendon 1951.

¹² For combination of law and economics, see POSNER, Richard. *The problems of jurisprudence*. Cambridge: Harvard University Press, 1990; and *Law, Pragmatism, and Democracy*. Cambridge: Harvard University Press, 2003.

¹³ KUHN, Thomas. *A estrutura das revoluções científicas*. São Paulo, Perpectiva, 1982.

and one of them will become predominant; small changes and adaptations will improve the paradigm. When this is not possible, alternative paradigms will arise and challenge the predominant paradigms. Some might call it a conflict of “ideologies”¹⁴, others might describe it as a “clash of discourses”¹⁵, or even power disputes among the players of the “field”¹⁶. It does not matter here since this is not the object of the paper.

My paper is about legal scholarship paradigms, that is to say disputes within the “Science” of the Law or conflicts on how scholars describe or interpret the Law. To render my argument more clear, let me simply assume here that there is a difference between the Law (as synonymous of Legal System, i.e., a set of rules and principles developed by legislation and judicial precedents) and the “Science” of the Law (the way the rules and principles are interpreted and described by legal scholarship).¹⁷ This paper concerns Brazilian scholarship and not changes in the Law properly (i.e., “legal changes”). Law might change for a variety of reasons and I will not discuss this topic in my essay. I will just take for granted that laws and principles change from time to time and legal scholarship has to explain the result of those changes within the Legal system.

¹⁴ DUMONT, Louis. “Essais sur l’individualisme – une perspective anthropologique sur l’idéologie moderne”. Paris, Éditions du Seuil, 1983, p. 263. “Ideologies” according to Dumont are a body of shared ideas and values in a society according to its representation on the expressed thought of some authors and that could be explained by ideal types”.

¹⁵ LACLAU, Ernesto. *New reflections on the revolution of our time*. Londres: Verso, 1990.

¹⁶ Particularly interesting the work in this point of Dezalay & Garth with respect to globalization and the taking over of American Law firms of the international commercial law and in Brazil of Engelmann. See DEZALAY, Yves & GARTH, Bryant. The confrontation between the big five and big law: turf battles and ethical debates as contests for professional credibility. In *Law and Social Inquiry*, vol. 29. 2004, p. 615; DEZALAY, Yves & GARTH, Bryant. Merchants of law as moral entrepreneurs: constructing international justice from the competition for transnational business disputes. In *Law and Social Inquiry*, vol. 29. 1995, p. 27; DEZALAY, Yves et al. Global restructuring and the law: studies of the internationalization of legal fields and the creation of transnational arenas. In *Case Western Reserve Law Review*, vol. 44, 1994, p. 407. ENGELMANN, Fabiano. *Sociologia do campo jurídico: juristas e usos do direito*. Porto Alegre: Editora Sergio Antonio Fabris, 2005.

¹⁷ This is described accurately by the Luhmann’s Theory of Systems. Law is one subsystem of society and Science is another subsystem and one can not make confusion between those social subsystems. Law is the subsystem of the code licit and illicit or allowed and not allowed and Science is the sphere of true of false. The legal doctrines are not part of the body of law. This is to say the legal scholars do not make law. Parliament, judges and sometimes society itself by uses and customs make law. Niklas Luhmann, *The Unity of the Legal System*. In “Autopoietic Law: A New Approach to Law and Society”. Org. Gunther Teubner. Florença, Berlin, Walter de Gruyter, 1988, p. 242 e ss. I am avoiding here an endless discussion if at the end of the day legal doctrines and scholarship are in fact science or not because of the lack of object and of laws for describing them. Let us just assume that law is a normative science as proposed by Kelsen in KELSEN, Hans. *Pure Theory of Law*. Berkeley: UC Berkeley press, 1967. If some reader has a problem to swallow it, the commas between the word science might make it easier.

Naturally this assumption of separation of Law and “Science” is only methodological, in order to better and more accurately observe the object of study. In the real world of the “Legal field” we are able to observe interconnections between the Science of Law and the Law (Legal System) because prevailing legal theories might have influence on crafting the adjudication system. When distributive and social problems are to be resolved by the rule of Law and not by force, it is expected that political and economic disputes are going to be transplanted into legal ones. Because of that, legal scholarship might be involved in a much more ambitious task than simply “describing” or proscribing the Law neutrally. However, I am not going to discuss neutrality, personal interests, and power disputes in the “legal field”. At this point, I am taking for granted that a change of legal rules and principles by legislators creates room for conflicting paradigms since there will be scholarly disputes on how the norms are to be interpreted and construed by courts in the future (at least in the civil law world as the case of Brazil).

Another assumption in this paper is that Law as a set of rules and principles (law on the books) can also be distinguished from Law as social phenomena or as a social artifact (law in action).¹⁸ In the latter sense, “hard social sciences”¹⁹ are better equipped, methodologically speaking, than the “Science” of the Law to describe what Law as a fact is.²⁰ The “Science” of the Law and jurists are more trained and precise when analyzing legal norms and tend to borrow from “hard social sciences” (the description and observance of facts).²¹ That separation of Law and facts has methodological advantages for understanding the legal paradigms in conflict. However to say that Law is different from simple facts does not mean that they are independent. The same is true of Legal “Science” and “hard social sciences”. All the fields should learn from each other (as much as Biology

¹⁸ TIMM, Luciano Benetti; COOTER, Robert D; SCHAEFER, B. O problema da desconfiança recíproca. *The Latin American and Caribbean Journal of Legal Studies*, v. 1. 2006, Berkeley Electronic Press, <http://services.bepress.com/lacjls/vol1/iss1/>. Access in November, the 15th. of 2007.

¹⁹ This is a neologism I created to separate normative science such as Law from descriptive social sciences such as Economics, Politics and Sociology. Some people do not believe Law is science; others do not believe humanities are not descriptive. But this discussion is not important to my arguments.

²⁰ This is so true that in any great legal tradition it is possible to hold a postgraduate degree in Law without studying methodology of science in some depth.

²¹ See for instance Kelsen, quoted above and HART, H.L.A. *The concept of law*. 2nd ed. Oxford: Oxford University Press, 1997.

is different from Chemistry but they both should interact if medicine wants to overcome illnesses) – that is the room for interdisciplinary research (such as Law and Society, Law and Economics, Legal History, Law and Anthropology, Legal Philosophy).

This is also true for contract law issues. I have suggested elsewhere the methodological distinction between contract (as a fact, as an economic exchange) and contract law (as a body of rules and principles), based on the well known work of Roppo²². Now, I am adding a third distinction (to form a trilogy), that is the “Science” of the contract law (or contract law scholarship), that search to provide models or paradigms of foundations and for the interpretation of contract law, given some assumptions of what contract is in fact – as provided in interdisciplinary studies. Precisely because contract is an exchange, it can be regulated by Law differently from place to place, from one country to another.

Contract law varies according to values and ideology of particular times and societies.²³ Buying a gun in the United States is legal, but in Taiwan it is not. In addition to that, in both countries the exchange might occur, despite the provisions of contract law (law on the books). By the same token, a purchase of marijuana in the *favelas* of Rio de Janeiro and its exportation to Los Angeles are contracts, because the exchange existed, but they are not legal and enforceable agreements.

It is the role of the “Science” of the law of contracts (or contract law scholarship) to systematize, explain and confront the models or paradigms taking into account the law on the books and compare it to the law in action (even if in the latter case, legal scholars must get involved with other social sciences). Scholars may agree or disagree on what a contract is in our society (law in action), and on what contract law rules are or should be, their actual

²² Of course, contract can have a vulgar meaning and also a legal meaning, when the exchange (fact) meet the legal requirements defined by contract law. In ROPPO. *Il contratto*. Trad. Português. Coimbra, Almedina, 1988, p. 10-11. We can find this distinction also in American contract law scholarship, such as KRONMAN, Anthony. *Contract law and distributive justice*, 1980, quoted below. He defines contract law as “the mass of legal rules that regulate the process of private exchange.” (p. 472). In law and economics literature, Professor Shavell seems to admit also this difference in SHAVELL, Steven. *Foundations of Economic Analysis of Law*. Cambridge: Harvard University Press, 2004, p. 322.

meaning and their underlying policy or theoretical foundation (moral issues as private autonomy, economic values as efficiency of ethical questions such as welfare distribution). – law on the books. That is what creates and develops contract paradigms (or models, used interchangeably)

In the civil law world, scholarly disputes of meanings and values of a given legal text related to contract law have been going on for two thousand years (glossators versus post-glossators and versus humanists; *more gallicus versus more geometricus* in the modern world; jurisprudence of concepts *versus* jurisprudence of interests in the Germany of the 19th Century). Historically, the kind of legal rules civil law jurists were used to studying were structural norms, i.e., those established dogmatically under the rights and duties of the parties (such as the *Code Civil Français* or the German *Bürgerliches Gesetzbuch*). In these models, the role of the Science of the Law was to interpret the text, grammatically, systematically and according to its teleology in order to give guidance to courts in their task of resolving disputes according to the system of Law. The great “civilists” were forged under this tradition such as Domat and Pothier in France and Savigny and Windscheid in Germany and developed what we call a classical model of contract law.²⁴ In this kind of scholarship, there is not much room for the discussion of factual issues (what a contract is, i.e., the law in action) and the contract law scholarship departs from the general theory of Law.²⁵

The rise and consolidation of Social Sciences in nineteenth century (such Economics and Sociology) and consolidation of democracy in the western countries in the twentieth century brought about changes in laws and legal scholarship. Probably one of the

²³ Even though in western world and in westernized Asian countries the core ideas remain similar (formed by offer and accepted; rescinded by fraud, error, etc; terminated in case of breach)

²⁴ Classical contract law is that one focus on the freedom of will (meeting of the minds of the parties) and on the *pacta sunt servanda* which was developed in the XIX Century by courts in the common law tradition and by jurists in the civil law tradition. WIEACKER, Franz. *História do Direito Privado moderno*. Tradução de Antônio M. B. Hespanha. Lisboa: Fundação Calouste Gulbenkian, s.d. DAVID, R. *Os grandes sistemas de direito contemporâneo*. São Paulo: Martins Fontes, 1995; LOPES, José Reinaldo de Lima. “O Direito na história”. São Paulo, Max Limonad, 2000; HESPANHA, Antônio Manuel. “Panorama histórico da cultura jurídica europeia”. Portugal, Publicações Europa-América, 1997.

²⁵ SCALISE JR., Ronald. Why no ‘efficient breach’ in the civil law: a comparative assessment of the doctrine of efficient breach of contract. *In American Journal of Comparative Law*. Vol. 55, 2007, p. 756-65.

most interesting changes has been a slowly shift since the twentieth century towards more “functional” or “promotional” rules, especially after welfare state laws (such as tenant-landlord and labor laws, the Portuguese programmatic Constitution of 1976, the Italian Civil Code of 1942; human rights laws), which open the debate among civil law jurists about the very purpose of law itself, that is, its function in society.²⁶ Therefore even for a dogmatic legal “Science” to some extent the interdisciplinary study became a core issue. This is especially true for contracts (and property, which is not addressed in this paper) in Brazil, as I will show in this paper.

Not bound by dogmatic and general theory of Law tradition, nor by the text of the codes or by formalism (due to sociological jurisprudence and legal realism²⁷) and with a different role and tradition, the legal scholarship in the United States has been very prolific on the discussion of contracts and contract law which is rooted in very rich interdisciplinary studies.²⁸ In the U.S., the so-called classical model of contract law has been under attack at least for 30 years. The classical model of contract law defines contract as act of the will of the parties, supposing that each party knows what is best for them and should freely bargain. It also supposes that the courts (meaning the state) shall interfere only if the agreement was not the result of the will of the parties (because of fraud, duress, mistake, etc.) or some breach occurs. Classical contract law also tends to be dogmatic and more concerned with the moment the contract was entered into and not “responsive” to its function²⁹.

²⁶ BOBBIO, Norberto. *Dalla struttura alla funzione. Nuovi studi di teoria generale del Diritto*. Roma: Laterza, 2007. In Brazil, GRAU, Eros. *A Ordem Econômica na Constituição de 1988*. 12^a ed. São Paulo: Malheiros Editores, 2007. In common law world, we case see this discussion formalism versus functionalism in GORDON, Robert. Critical Legal Histories. In *Stanford Law Review*, 1984, vol. 36, p. 57. WEINRIB, Ernest J. *The Idea of Private Law*. Cambridge, Harvard University Press, 1995, p. 01 a 08.

²⁷ Cf. HOLMES, Oliver. *The common law*. New York: Dover Publications, 1991; POUND, Roscoe. Mechanical Jurisprudence. In *Columbia Law Review*, vol. 8, 1908, p. 605.

²⁸ For a detailed and precise comparison between civil law and common law at this point, see SCALISE JR., Ronald. Why no ‘efficient breach’ in the civil law: a comparative assessment of the doctrine of efficient breach of contract. In *American Journal of Comparative Law*. Vol. 55, 2007, p. 721.

²⁹ What Prof. Eisenberg call static model of contract law. Cf. EISENBERG, Melvin. *The emergence of dynamic contract law*. In *Theoretical Inquiries in Law*, vol. 2, p. 01 (2 THEORILAW 1).

Farnsworth³⁰ categorized the recent developments of North American contract law scholarship (Science of the Law) in at least five models (or paradigms as I call them):

1) The law and economics paradigm: appliance of core concepts of Economics to contract law, initiated by Coase³¹ and then developed by Posner³², Cooter³³, Polinsky³⁴, Shavell³⁵, and others;

2) The historical or evolutionary paradigm of Horwitz³⁶, Atiyah³⁷ and maybe Gilmore³⁸: which somehow tend to identify contract law as a response to the economic and political changes of society;

3) The paternalistic paradigm: which search to apply ideas of distributive justice and state protection within the realm of contract such as the work of Ackerman³⁹ and Kronman⁴⁰ and the creators of the *critical legal studies*, Kennedy⁴¹ and Unger⁴²;

4) The sociological paradigm of Macneil⁴³ and Macauley⁴⁴: which uses empirical and theoretical sociological tools to investigate how long term business contracts actually work (far from the written agreement and close to relations);

³⁰ FARNSWORTH, Alan. *Contracts*. 4th ed. New York: Aspen, 2004, p. 29.

³¹ COASE, Ronald. *The firm, the market and the law*. Chicago, University of Chicago Press, 1988.

³² POSNER, Richard. *Economic Analysis of Law*. 7th ed. New York: Aspen, 2007.

³³ COOTER, Robert e ULEN, Thomas. *Law & Economics*. Boston, Addison Wesley, 2003.

³⁴ POLINSKY, Mitchell. *Analisis Economica del Derecho*. Madrid: Ariel Ponz, 1994.

³⁵ SHAVELL, Steven. *Foundations of Economic Analysis of Law*.Cambridge: Harvard University Press, 2004.

³⁶ HORWITZ, Morton. *The historical foundations of modern contract law*. In Harvard Law Review, vol. 87, p. 917 (87 Harv. L. Rev. 917); HORWITZ, Morton. *The transformation of American Law*. Cambridge: Harvard University Press, 1977. SIMPSON, *The Horwitz Thesis and the History of Contracts*. In University of Chicago Law Review, vol. 46, p. 533.

³⁷ ATIYAH, P. *The rise and fall of the freedom of the contract*. Oxford, Clarendon Press, 1979.

³⁸ GILMORE, Grant. *The death of contract*. Columbus, Ohio State University Press, 1995.

³⁹ ACKERMAN, Bruce. Regulating slum housing markets on behalf of the poor: of housing codes, housing subsidies and income redistribution policy. In *Yale Law Journal*, vol. 80, 1971, p. 1093.

⁴⁰ KRONMAN, Anthony. Contract law and distributive justice. In *Yale Law Journal*, vol. 89, 1980, p. 472 (89 Yale L. J. 472); also Paternalism and the law of contracts. In *Yale Law Journal*, vol. 92, 1983, p. 1983.

⁴¹ KENNEDY, Duncan. "Form and substance in Private Law adjudication". In Harvard Law Review, vol. 89, p. 1685.

⁴² UNGER, Roberto. "The critical legal studies movement, In Harvard Law Review, vol. 96, p. 563 (1983).

⁴³ MACNEIL, Ian. *Reflections on Relational Contract theory after neo-classical seminar*. In *Implicit dimensions of contract*. Oxford, Hart Publishing, 2003, p. 207-218; followed by SPEIDEL, Richard. *The*

5) The moral paradigms of Fried⁴⁵ and of Eisenberg⁴⁶: which concern the will of the parties and make contract law responsive to their actual and true intent.

According to Professor Farnsworth, one of the drafters of the Restatement Second of Contracts, the most pervasive and influential of those methods in the U.S. with which to approach contract law was the law and economics paradigm.⁴⁷ This is to say that the theoretical problems of contract law raised by those scholars and their way of solving them became predominant in American Law Schools. This was admitted even by the opponent of the method, Professor Unger⁴⁸, in an article written in 1984.

In Brazil, we can find the same debate about the function of law in a much dramatic way as in Europe and closer to the United States for two main reasons. Firstly because the democratic Constitution of 1988 created positive rights and also the Civil Code was recently changed and has created room for intense debates and disputes of paradigms of contract law. Secondly because the Post Graduate Courses in Brazil were well-structured only in the beginning of the 90's of the last century, opening the space for full professors with time and wages to think about legal scholarship as a profession and not a hobby or as a means to access strategic positions of bureaucracy of the state.⁴⁹

characteristics and challenges of relational contracts. In Northwestern Law Review, 2000, p. 823; MACNEIL, Ian. Contracts: adjustment of long-term economic relations under classical, neoclassical, and relational contract law. In Northwestern University Law Review, vol. 72, n° 06, 1978, p. 854

⁴⁴MACAULAY, Stewart. *The use and non-use of contracts in the manufacturing industry. In The Practical Lawyer, vol. 09, n° 07, p. 13; MACAULAY, Stewart. Relational contracts floating on a sea of custom? Thoughts about the ideas of Ian Macneil and Lisa Bernstein. In Northwestern University Law Review, vol. 94, 2000, p. 775; MACAULAY, Stewart. The real and the paper deal: empirical pictures of relationships, complexity and the urge for transparent simple rules. In "Implicit dimensions of contract". Oxford, Hart Publishing, 2003, p. 51-102*

⁴⁵FRIED, Charles. *Contract as promise*. Cambridge, Harvard University Press, 1981.

⁴⁶What Prof. Eisenberg call static model of contract law. Cf. EISENBERG, Melvin. *The emergence of dynamic contract law. In Theoretical Inquiries in Law, vol. 2, p. 01 (2 THEORILAW 1)*.

⁴⁷FARNSWORTH, *op. cit.*, p. 31. Accepting but with bitterness, POSNER, Eric. *Economic Analysis of Contract Law After Three Decades: success or failure. In Yale Law Journal, vol. 112, p. 829 (112 Yale L. J. 829)*.

⁴⁸UNGER, Roberto. *The critical legal studies movement. In Harvard Law Review, vol. 96, p. 563 (1983)*.

⁴⁹ENGELMANN, Fabiano. *Études à l' étranger et médiation des modèles institutionnelles: le cas des juristes brésiliens. Cahiers de la recherche sur l' éducation et les savoirs" n. 7, Paris (no prelo)*

In fact, the Brazilian new Civil Code (NCC), as I said in the Introduction, brought about significant changes to contract law, especially through section 421 that provides for the need to respect the social function of contracts in the realm of private autonomy. With such a broad reading, it is not surprising that there are so many disputes of paradigms about the meaning of the so-called the social function of the contract.

For the sake of clarity, in my view, we have to address differently two social functions at stake. The first is the social function of the contract (*tout court*) in a society, which is factual and apprehended by observance of law in action by means of interdisciplinary studies. In my opinion, the description of this fact is the role of what I call “hard social sciences” (Sociology, Economics). Another thing to address is the social function of contract law. The latter is the role played by legal scholarship in order to try to give guidance to courts, giving some factual assumptions borrowed from other sciences – and its nature is essentially normative. So it is difficult to avoid interdisciplinary study in such a broad general clause such as the social function.

II – PATERNALIST OR DISTRIBUTIVE PARADIGM: THE QUASI COMMON SENSE IN THE SOCIAL FUNCTION OF THE CONTRACT LAW

We are moving towards a quasi consensus in Brazilian legal scholarship concerning the meaning of the social function of contract law provided for in the new Brazilian Civil Code (NCC). This (almost)⁵⁰ common opinion derives from the survey of articles published

⁵⁰ We say “almost” because four articles were found with (more or less) different positions: AZEVEDO, Antônio Junqueira de. “Princípios do novo direito contratual e desregulamentação do mercado (...). *RT*, São Paulo, vol. 750, abr. 1998, pp. 113-120; RODRIGUES JÚNIOR, Otavio Luiz Rodrigues. “A doutrina do terceiro cúmplice: autonomia da vontade, o princípio *res inter alios acta*, função social do contrato e a interferência alheia na execução dos negócios jurídicos”. *In* Revista dos Tribunais, vol. 821, março/2004, p. 81; LEONARDO, Rodrigo Xavier. “A teoria das redes contratuais e a função social dos contratos: reflexões a partir de uma recente decisão do Superior Tribunal de Justiça”. *In* Revista dos Tribunais, vol. 832, fev/ 2005, p. 100; AMARAL, Pedro Eichin. “Função social dos contratos de transferência de tecnologia”, *In* Revista da Associação Brasileira da Propriedade Intelectual, nº 66, set.out/2003, p. 37.

in major national periodicals between the years 2003 and 2005.⁵¹ A significant part of the researched authors understands the social function of contract law as the expression of “social justice”, *i.e.*, as regulations of the contract as a result of the assumption of a Constitutional Welfare State. It is a phenomenon referred to as “publicization”, “socialization” or even as “constitutionalization” of Private Law, which results in institutes traditionally belonging to Civil Law – such as the contract and property – being guided by redistributive criteria inherent to Public Law.⁵²

The principle of the social function of contract law is perceived, within this “near” consensus, as a limitation to the principle of freedom of the contract (private autonomy) – seen as having a libertarian and bourgeois nature, such as consolidated by the civil codes of the nineteenth century such as the *Code Civil* and the *Bürgerliches Gesetzbuch* (BGB) –

⁵¹ Only the major authorities will be mentioned in order to avoid a very extensive list: WALD, Arnaldo. “O Novo Código Civil e o solidarismo contratual”. *Revista de Direito Bancário, do Mercado de Capitais e da Arbitragem*, vol. 21, p. 35; NERY, Rosa Maria Andrade. “Apontamentos sobre o princípio da solidariedade no sistema do direito privado”. *Revista de Direito Privado*, vol. 17, p. 70; DA SILVA, Jorge Cesa Ferreira. “Princípios de direito das obrigações no novo Código Civil”. In “O Novo Código Civil e a Constituição”. SARLET, Ingo (org.). Porto Alegre, Livraria do Advogado, 2003, p. 99; PENTEADO JR, Cássio M.C. “O relativismo da autonomia da vontade e a intervenção estatal nos contratos”. *Revista de Direito Bancário, do Mercado de Capitais e da Arbitragem*, vol. 21, p. 211; GOGLIANO, Daisy. “A função social do contrato (causa ou motivo)”. In *Revista Jurídica*, nº 334, agosto/2005, p. 09; MARTINS-COSTA, Judith. “Reflexões sobre o princípio da função social dos contratos”. In *Revista DireitoGV*, vol. 01, p. 41; PACHECO, José da Silva. “Da função social do contrato”, In *Revista Advocacia Dinâmica*, informativo mensal, nº 34, 2003, p. 496; SANTOS, Eduardo Sens. “A função social do contrato”. In *Revista de Direito Privado*, vol. 13, p. 99; WAMBIER, Teresa Arruda Alvim. “Uma reflexão sobre as ‘cláusulas gerais’ do Código Civil de 2002 – a função social do contrato”. In *Revista dos Tribunais*, vol. 831, janeiro/2005, p. 59; THEODORO DE MELLO, Adriana Mandim. “A função social do contrato e o princípio da boa fé no Novo Código Civil Brasileiro”. In *Revista dos Tribunais*, vol. 801, julho/2002, p. 11. Under a little different viewpoint, but reaching practically the same results, SALOMÃO FILHO, Calixto. “Função social do contrato: primeiras anotações”. In *Revista dos Tribunais*, vol. 823, mai/2004, p. 67. Salomão Filho sees, in the social function of the contract, the integration of diffuse and collective interests in the contract (a theory called “institucionalist”). Older publications predicted this contract's paternalist model. See MACEDO, Ronaldo Porto. “Contratos relacionais”. São Paulo, Max Limonad, 1999; LOBO, Paulo Luiz Neto. *O contrato: exigências e concepções atuais*. São Paulo : Saraiva, 1986; GRAU, Eros. “Um novo paradigma de contratos?”. In *Revista da Faculdade de Direito da Universidade de São Paulo*, v. 96, p. 423 e ss. MARTINS-COSTA, Judith. “Crise e Modificação da Noção de Contrato no Direito Brasileiro”, in “*Revista Direito do Consumidor*”, São Paulo, Editora Revista dos Tribunais, vol. 3, pp. 127 a 154; AMARAL NETO, Francisco dos Santos. “A autonomia privada como princípio fundamental da ordem jurídica”. In *Revista de Direito Civil*, vol. 47, p. 07. For comparative law, GILMORE, Grant. “The death of contract”. Columbus, Ohio State University Press, 1995. ATIYAH, P. “The rise and fall of the freedom of the contract”. Oxford, Clarendon Press, 1979.

⁵² This is also the opinion of the main hornbooks and treatises such as besides the work of THEODORO JÚNIOR, Humberto. *O contrato e sua função social*. Rio de Janeiro : Forense, 2003; PEREIRA, Caio Mário

which is considered individualistic and not in line with the Welfare State. By this token, the social function of contract law would be to ensure the prevalence of the communitarian (or social) interests over individual interests in the realm of contracts. Because society has great inequalities, those inequalities would be reflected in private agreements. Thus the distribution of wealth in society through contracts would be unfair if the bargain was to be left unregulated. To reestablish fairness in society, the state must protect the weaker party in private relations through regulation.

Therefore, essentially, the model would imply the protection of the weaker party in the contractual relation – which would often not manifest his/her own free will, but would succumb to the greater bargaining power of the economically stronger party. As a result of this protection there would be a fairer distribution of the economic benefits of the agreement between the parties. The model assumes that freedom of contract could be fictitious, since in fact there would no be free bargain if there is strong disparity of bargain power between the parties. In those cases, it would be more realistic to speak about voluntary submission of the weaker party. Hence, there would be State intervention to re-balance the bargain power of the parties (be it by legislator, be it by judge). This supposes of course a high range of judicial policing of contracts in the name of the social function.

In this regard, the words of Judith Martins Costa are paradigmatic:

“The principle of the social function, now expressly supported by the Civil Code constitutes, in general terms, the social expression within Private Law, projecting, in its regulatory corpora, and in various legal subjects, the guideline of social solidarity (Federal Constitution, section 3º, III, *in fine*). (...) the principle of the social function, (...) indicates a path to follow, as opposed to predatory individualism”⁵³.

This pervasive opinion on the “publicization” of private law in Brazil can be explained by a transplant of European models that are brought by scholars taking their LLD (Doctorate of Law) in Welfarist European Countries, mainly France, Italy, but also

da Silva. Rio de Janeiro: Forense, 2004; DINIZ, Maria Helena. *Curso de Direito Civil Brasileiro*. 23 ed. São Paulo: Saraiva, 2006; GOMES, Orlando. *Introdução ao Direito Civil*. 19 ed. Rio de Janeiro: Forense, 2007.

⁵³ MARTINS-COSTA, Judith. “Reflexões sobre o princípio da função social dos contratos”. In *Revista DireitoGV*, vol. 01, p. 41.

Germany, Spain and Portugal, which by far supersede the number of JSDs in the United States.⁵⁴ Also it can be explained by a left wing political project from a human rights tradition formed during the dictatorship in Brazil that now has been a predominant view in Post Graduate Courses throughout the country.⁵⁵

I have traced elsewhere the intellectual background of this kind of paternalism in contract law, which could be identified with Marxism, social-Christian doctrine and above all Comte, Durkheim and Tonnies's collectivist and solidarity sociology.⁵⁶ As I said before, because "Science" of the Law is focused on norms (contract law norms in our case) and practiced through a dogmatic speech, the underlying assumptions of the model do not appear. However to be fully understood, the presumptions of the paradigm – departed from "hard social sciences" conclusions about facts (what contract is) – must be uncovered. Paternalist model contract law in Brazil, thus, is based on a collectivist view of contracts. As defended by Durkheim, a contract is not the result of the will of the parties, but an organic social fact and the glue of societal tissue in situations of complexity and strong differences among individuals of the same community (a means of "organic solidarity") – like the human body, the individual is a function of the social system and contract is a function of society.⁵⁷

When solidarity is not spontaneous in society, there is anomy, a situation to be corrected by the state. Thus, contract law is the imposition of this solidarity by the state when it is not found spontaneously in societal relations. This is the reason for which there are social rights in Welfare States, since cooperation is a legal duty, not a moral one. The

⁵⁴ ENGELMANN, Fabiano. *Estudos no exterior e mediação de modelos institucionais: O caso dos juristas brasileiros*. [S. n. t.]: 2007. (Inédito). In Europe the debate of paternalism in contract law is still open, as evidence the study of CARUSO, Daniela. Contract law and distribution in the age of welfare reform. *In Arizona Law Review*, vol. 49, 2007, p. 665. For the discussion in German law, see CANARIS, Claus-Wilhelm. *Die Vertrauenshaftung im deutschen Privatrecht*. München: C. H. Beck, 1971. For Italian law, PERLINGIERI, Pietro. *Profili Del Diritto Civile*. Napoli: Edizioni Scientifiche Italiane 1994. For French law, JAMIN, Christophe. "Plaidoyer pour le solidarisme contractuel". *In Le contrat au début du XXIe siècle*. Org. Christophe Jamin *et alli*. Paris, LGDJ, 2001, p. 441 e ss.

⁵⁵ ENGELMANN, Fabiano. "Sociologia do campo jurídico: juristas e usos do direito". Porto Alegre: Editora Sergio Antonio Fabris, 2005.

⁵⁶ TIMM, Luciano. *As origens do contrato no Novo Código Civil: uma introdução à função social, ao welfarismo e ao solidarismo contratual*. *In Revista dos Tribunais*, v.844, p.85 - 95, 2006.

marketplace, according to this view, is anarchy, not coordination of social behaviors.⁵⁸ Having an outdated notion of the interaction of society and the marketplace (corrected lately by the work of Economics and Sociology scholars such as Parsons⁵⁹, Swedberg⁶⁰, Granoveter⁶¹, etc.), this kind of paternalistic paradigm perceives the social function of contract law in a way that makes contract to collide with the markets (as if contract was something different from the market; contract as an act of solidarity and market the survival of the fittest). Therefore, according to this paternalistic model, the social function of contract law would be to promote solidarity, i.e., to correct the power imbalance between parties entering into a contract and to redistribute the economic welfare among them that was not fairly distributed by the bargain process in which the weaker party succumbed to the stronger (“social justice”).

This is the typical role of the Welfare State, i.e., weaken the dimensions of public and private law in order to promote redistributive justice even in the realm of contracts. According to the model – since it has no confidence in the bargaining process – there is a substitution of the party self regulation of contract (autonomy) to a state driven regulation of the contract (heteronomy) that reshapes the division of the economic surplus created by the agreement. That intervention on the will of the parties would occur by means of mandatory legislation and judicial revisions of agreements.⁶²

In this sense, the Welfare State legislation is characterized as being more vague, with broader language to encompass unforeseen situations to be assessed in case by case analyses by courts.⁶³ Because of that, one of the most inaccurate sentences often repeated is that judges in common law have more discretion and liberty to create the Law than civil

⁵⁷ DURKHEIM, E. *Da divisão do trabalho social*. V. 1. 2ª ed. Lisboa, Editorial Presença, 1980, p. 60.

⁵⁸ LUKES, Steven. *Bases para a interpretação de Durkheim*. In *Sociologia: para ler os clássicos*. Organizado por COHN, Gabriel. São Paulo, Editora Livros Técnicos e Científicos S.A., 1977, p. 38.

⁵⁹ PARSONS, Talcott. *O sistema das sociedades modernas*. São Paulo, Editora Pioneira, p. 15 e ss. Cf. ROCHER, Guy. *Talcott Parsons e a Sociologia Americana*. São Paulo, Editora Francisco Alves, s/d, p. 30.

⁶⁰ SWEDBERG, Richard. *Economics and Sociology*. Princeton: Princeton University Press, 1990.

⁶¹ GRANOVETTER, Mark. *Economic action and social structure: the problem of social embeddedness*. In *American Journal of Sociology*. Vol. 91, nº 03, 1985, p. 481.

⁶² CAPELETTI, M. *Giudici legislatori?* Milano: Giuffrè, 1984.

⁶³ FARIA, José Eduardo. O Judiciário e o desenvolvimento sócio-econômico. In *Direitos Humanos, Direitos Sociais e Justiça*, José Eduardo Faria (org.) São Paulo: Malheiros, 1998. In the same book, see also LOPES, José Reinaldo de Lima. Crise da norma jurídica e reforma do judiciário. 1998, p. 68 e ss.

law judges. Brazilian judges are only controlled by recourse to superior courts without any binding precedent rule.

That is probably why the diagnosis (or probably the prognosis) of few American scholars that proclaim the death and the fall of the contract would fit better in Brazil.⁶⁴ But this is not the only resemblance to the academic debate of U.S. The paternalistic model of contract law in Brazil defends some basic claims of Critical Legal Studies in the U.S. First of all, they are similar as to their description of contemporary blurriness of frontiers among Private and Public Law.⁶⁵ Plus they are alike when they defend the prevalence of substance in form. Finally and more importantly, they are similar when attacking individualism.⁶⁶ For an example, see Kennedy:

“These are my most important points: First distributive and paternalist motives play a central role in explaining the rules of the contract and tort systems with respect to agreement. (...) Third the notion that paternalist intervention can be justified only by the ‘incapacity’ of the person the decision maker is trying to protect is wrong – the basis of paternalism is empathy or love(...)”⁶⁷

However, unlike in the U.S., the arguments of paternalists in Brazil are not clearly presented in terms of the underpinning ideology. On the contrary, the arguments are still brought in dogmatic form, as one could describe the social function of contract law only by reference to the interpretation of the Civil Code combined with text of the Constitution⁶⁸. The Critical Legal Studies movement is much clearer in its purpose:

“The ideas and activities of the movement respond to a familiar situation of constraint upon theoretical insight and transformative effort. This situation is exemplary: its dangers and opportunities reappear in many areas of contemporary politics and thought. Our response may, therefore, also have an exemplary character. One of the most important obligations anybody has toward a movement in which he participates is to hold up before it what, to his mind, should represent its highest collective

⁶⁴ GILMORE, quoted above.

⁶⁵ See KENNEDY, Duncan. The stages of the decline of the public-private distinction. *In Pennsylvania Law Review*, vol. 130, 1982, p. 1349.

⁶⁶ KENNEDY, Duncan. “Form and substance in Private Law adjudication”. *In Harvard Law Review*, vol. 89, p. 1685.

⁶⁷ KENNEDY, Duncan. Distributive and Paternalist motives in contract and tort law. *In Maryland Law Review*, vol 41., 1982, p. 563.

⁶⁸ FACHIN, Luiz Edson. “Teoria Crítica do Direito Civil.”. Rio de Janeiro, Renovar, 2000.

self-image. My version of this image of critical legal studies is more proposal than description. It may meet with little agreement among the critical legal scholars. But I have unequivocally preferred the risks of repudiation to those of indefiniteness. In this, if in nothing else, my statement will exemplify the spirit of our movement.

It may help to begin by placing critical legal studies within the tradition of leftist tendencies in modern legal thought and practice. Two overriding concerns have marked this tradition.

The first concern has been the critique of formalism and objectivism.⁶⁹

One could argue that the paternalist model of contract law could be associated with Kronman⁷⁰ and Ackerman⁷¹ compromised of ideas of paternalism and distributive justice and efficiency instead of the collectivism of the Critical Legal Studies. However, I do not think this could be done accurately since Ackerman would argue that only in some specific situations, a strict application of housing codes rules protecting the weaker party, could be efficient and distributive at the same time. Kronman, on the other hand, argues that distributive justice is a value of Private Law and should be implemented through contracts, whenever this could be more efficient than taxation. I do not believe the paternalist model in Brazil would accept those consequential analyses in terms of efficiency in society. To accept Kronman and Ackerman arguments, the Brazilian paternalists would have to accept economic analysis and all its presumptions.⁷²

What about judicial precedents? In Brazil, as in countries with the civil law tradition in general, judges are influenced by legal scholars, which play a fundamental role in the judicial *praxis* (especially in lower courts)⁷³. Therefore, judicial decisions will eventually be embedded with these doctrinal opinions. However it is important to remember that there are no binding precedents (*stare decisis* doctrine) in Brazil. Precedents in Brazil do not have even a very strong persuasiveness, differently from some countries in Europe.

⁶⁹ UNGER, op. cit., p. 642.

⁷⁰ KRONMAN, Anthony. Contract law and distributive justice. In *Yale Law Journal*, vol. 89, 1980, p. 472 (89 *Yale L. J.* 472); also Paternalism and the law of contracts. In *Yale Law Journal*, vol. 92, 1983, p. 1983.

⁷¹ ACKERMAN, Bruce. Regulating slum housing markets on behalf of the poor: of housing codes, housing subsidies and income redistribution policy. In *Yale Law Journal*, vol. 80, 1971, p. 1093.

⁷² POSNER, Eric. Contract Law in the Welfare State: a defense of the unconscionability doctrine, usury laws and related limitations on the freedom to contract. In *Journal of Legal Studies*, vol. 24, 1995, p. 283

⁷³ Judges in Brazil are not appointed. They are selected by public exams, taken after graduation, like several countries in Europe.

In a very influential survey, Pinheiro⁷⁴ has shown that one of the major concerns of lower court judges is “social justice”. According to his research, more than 70% of the judges surveyed would rather make decisions in favor of social justice instead of the black letter law or merely from the four corners of the contract. This is illustrated in a judgment of the Court of Appeals of the State of Rio Grande do Sul in which the Court concluded: “The social function of the contract has the objective of preventing the burden of onerous and harming clauses on economically weaker contracting parties”⁷⁵.

In this respect, on the basis of the social function of the contract, some judges have been reviewing contracts under the paternalist reasoning of protecting the weak against the strong, the collectivity (for example, the borrower) against the individuality (for example, the financial institution). One example can be found in the summary of the Court of Appeals of the State of Rio Grande do Sul:

“NATIONAL HOUSING SYSTEM. CONTRACTUAL REVIEW ACTION. INCOME COMMITMENT PLAN. PRICE TABLE. CAPITALIZATION. SOCIAL FUNCTION OF THE CONTRACT. INSURANCE.

Possibility of reviewing and adapting the contract, thus balancing the business relations between the parties within those parameters conferred by the Rule of Law and the inherent function of the Judiciary.

(...) 6. The iniquitous application of the *PRICE TABLE* is withdrawn, and the calculation method for simple interest is adopted, with the purpose of avoiding the anatocism and the geometric and exponential progression of the interests.⁷⁶

In this case, as it usually happens in literally thousands of cases in the State of Rio Grande do Sul Courts, the Court of Appeals has changed the housing financing agreement entered into between the Bank and the borrower, in order to balance the agreement. The

⁷⁴ PINHEIRO, Armando Castelar. Magistrados, judiciário e economia no Brasil. TIMM, Luciano (Org.) *Direito e economia*. São Paulo: Thomson/IOB, 2005, p. 248.

⁷⁵ Civil Appeal 70011602091, Fifteenth Civil Panel of Judges, Court of Appeals of the State of Rio Grande do Sul, decided on June 8, 2005.

⁷⁶ Civil Appeal 70010372027, 9th Civil Panel, decided on August 10th, 2005.

Court understood that the PRICE table (an interest calculation method used in financial mathematics) used to calculate the interest was oppressive because it generated the computation of interests in interests, and that is anatocism, which, according to the understanding of the same Court, is not lawful.

By the same token, the Court of Appeals from the State of Rio Grande do Sul has been prohibiting the interruption of water and electricity supply, as well as of everything related to human dignity, even if the interruption is allowed in the pertinent water or electricity regulations and in the agreements entered into by and between the parties.⁷⁷

In the Federal Superior Court of Justice (STJ), on behalf of the social function of the contract, the mortgage right over the collateral of banks that operated with credit lines for construction companies was weakened. The STJ has preferred, on more than one occasion, to protect the interests of the real estate purchaser.⁷⁸ For these cases, the construction company has taken out a bank loan for the construction of a building (guaranteed by a mortgage on the built property), and undertaken to sell the future apartment to the final purchaser (which, it must be noted, is not forbidden by the law). Thus, the construction company capitalized on the funds received from the bank and from the real estate purchasers. But, in the aforementioned cases, the construction company did not pay the bank, which resulted in the mortgage on the real estate pledged to the purchasers being executed.

III – THE RIVAL PARADIGM: SOCIAL FUNCTION OF CONTRACT LAW FROM A LAW AN ECONOMICS PERSPECTIVE

I believe the conflicting paradigm of solidarism in contract law tends to be the viewpoint of the economic analysis of law like the debate in the U.S. – between critical

⁷⁷ Court of Appeals from RIO GRANDE DO SUL, Civil Appeal 70005790837, published in www.tjrs.gov.br.

⁷⁸ STJ, Special Recourse 187.940, writing the Opinion for the Court Justice Ruy Rosado de Aguiar Jr. and Special Recourse 316.640, writing the Opinion for the Court Justice Nancy Andrichi.

legal studies and law and economics paradigms. This is so because the latter has an antagonist view of what the contract is and of what contract law (and its function) ought to be when compared to the former, since its departing point is individualism. In addition, both are functionalist schools of thought and the problem is to interpret what the social function of the contract law is.⁷⁹

So, from a law and economics perspective, contract, as a matter of fact (or life), is not a “solidarity” link among people living in society but a market transaction in which each party behaves according to its own economic interest as if he or she was in a strategic game (individualism). Therefore, as evidenced by the game theory, a party will only cooperate with the other to the extent he or she benefits from the game (unless contract law or morals step in and state otherwise). This is a tradition that began with the ground breaking study of Adam Smith, on the wealth of the nations.⁸⁰

The existence of collective interests worthy of protection in contractual relationships is not rejected by the law and economics paradigm. However, social welfare in an individual contractual relation can only be identified embedded in the market framework of the agreement at stake, and beyond the judicial proceeding related to the dispute pertaining thereto. That is to say the society or “fairness” is not represented by the weaker side in a specific contractual relation or in one side of the trial but the group or chain of people integrated in one specific market. As Professor Cooter says, commenting the leading case in U.S. about unconscionability,⁸¹: “lawyers focus on individual cases, whereas economists focus upon statistics. Statistically, the paternalistic protection of Mrs. Williams by legal restrictions on the credit market imposes high costs on poor consumers as a class.”⁸²

⁷⁹ About functionalism, see GORDON and WEINRIB, quoted below.

⁸⁰ SMITH, Adam. *Inquérito sobre a natureza e as causas da riqueza das nações*. 2ª ed., Lisboa, Fundação Calouste Gulbenkian, 2 v., 1989.

⁸¹ *Williams v. Walker-Thomas Furniture Co.*, 350 F2d 445 (DC Cir. 1965). In that case, court ruled that it was unconscionable a clause that allowed cross-collateral guarantee in different installment contracts entered to between the consumer and the store, meaning that different goods bought in different times in installments would serve as collateral to any default of any of the installments of any of the contracts entered into with the store. See also Uniform Commercial Code, par. 2-302 and Restatement (Second) of Contracts, par. 208.

Metaphorically, a single contract is a tree and the marketplace (and the set of its social interactions) is the forest⁸³. In this regard, the community in a financial housing agreement is represented by the chain or network of borrowers (and potential borrowers) who depend on the compliance of the agreement of that individual, in order to feed the national housing system, therefore making new loans possible for those who need them.⁸⁴ Thus, if the chain is broken by contractual breaches, the group (collectivity) will lose (as it will be left without funds and pay higher interests). This happens because, conceptually and even in real life, banks do not lend their own money, but rather lend funds acquired from the market.

This understanding also applies to insurance agreements. In this regard, the phrase coined by the jurist Ovídio Baptista da Silva concerning the contractual relations linked to insurance and social security issues is most appropriate, where there exists, as well as in the national housing system, a “*communitary relation of interests*”⁸⁵. In these operations, it is necessary to generate a large number of analogous contracts in order to form the collective fund that will support the interest of everyone, whose satisfaction and safety will depend, on a large scale, on the preservation of and compliance with this chain of contracts.

Therefore, one cannot think about the social interests in a contractual relation and disregard the environment in which it is negotiated and performed – which, undoubtedly, is the marketplace.⁸⁶ This is clearly stated by Shavell:

“It will generally be assumed that the goal of courts is to maximize social welfare. This will usually mean that courts act to further the welfare of the parties to the contract (...). If,

⁸² COOTER & ULEN, “Law and Economics”, p. 282.

⁸³ LOPES, José Reinaldo de Lima. *Crise da norma jurídica e reforma do judiciário*. In. “Direitos Humanos, Direitos Sociais e Justiça”, Eduardo Faria (org.) 1998, p. 82.

⁸⁴ LEONARDO, Rodrigo Xavier in “A teoria das redes contratuais e a função social dos contratos: reflexões a partir de uma recente decisão do Superior Tribunal de Justiça”. In *Revista dos Tribunais*, vol. 832, fev/2005, p. 100 seems to agree with it.

⁸⁵ Cf BAPTISTA DA SILVA, Ovídio Araújo. Speech in: FORUM DE DIREITO DO SEGURO JOSÉ SOLLERO FILHO, 2., Porto Alegre, 2001. São Paulo: IBDS, 2002. p.82

⁸⁶ “(...) the market is widely accepted as a tool, and not as an enemy of the economic and social development”. According to TREBILCOCK, Michael J. “The limits of Freedom of Contract”. Cambridge, Harvard University Press, 1993, p. 268.

however, other parties are affected by a contract, then the well-being of these parties outside the contract will also be assumed to be taken into account by the court”⁸⁷

Thus, it is necessary to recognize that there is a marketplace in which contracts are to occur. This is a public space for collective interaction, which tend to *equilibrium* situations. Indeed, the market exists as a spontaneous social institution, i.e., as fact.⁸⁸ In Coase’s words, the market “is an institution that exists to facilitate the exchange of goods and services, i.e., it exists with the purpose of reducing the costs when exchange operations are conducted.”⁸⁹ Even the Brazilian Federal Law 8884 of 1994 recognizes the market as a public good.⁹⁰

If the market as a fact did not exist, how could one explain that soon after a large soy crop (and therefore of a large supply in the market) the soy price tends to decrease? How can one deny that the rental of beach houses tends to increase in the summer (called high season), when the demand for them increases? And what about the prices of plane tickets, which are different according to the season?

So the market is not separated from society⁹¹; it is an integral part of it. And thus, as any social fact, it can be regulated by institutional rules, especially legal rules (with a higher or lower social and economic effectiveness). Therefore, one cannot say that the market is something artificially created by the legal system as it is stated by some who attack the spontaneous characteristic of the market forces.⁹²

⁸⁷ SHAVELL, op. cit., p. 294.

⁸⁸ HAYEK, Friedrich A, *The Constitution of liberty*. Chicago: The University of Chicago Press, 1997.

⁸⁹ Cf. COASE, Ronald. *The firm, the market and the law*. Chicago, University of Chicago Press, 1988, p. 07.

⁹⁰ “Article 1. This Law sets out antitrust measures in keeping with such constitutional principles as free enterprise and open competition, the social role of property, consumer protection, and restraint of abuses of economic power.

Sole Paragraph. Society at large is entrusted with the legal rights protected herein.”

⁹¹ WILLIAMSON, Oliver. *The economic institutions of Capitalism*. Nova Iorque, Free Press, 1985, p. 15 e ss. More radical is the position of GRANOVETTER, Mark. *Economic action and social structure: the problem of social embeddedness*. In *American Journal of Sociology*. Vol. 91, n° 03, 1985, p. 481. Equally interesting is the approach of MALLOY, Robin Paul. *Law in a Market Context*. Cambridge, Cambridge University Press, 2004

⁹² Such as defended by IRTI, Natalino. *Teoria generale del Diritto e problema del mercato*. In *Rivista di Diritto Civile*, n. 02, jan/mar, 1999, p. 01. Ver, também, do mesmo autor, *Persona e mercato*. In *Rivista di Diritto Civile*, n. 03, mai/jun, 1995, p. 289. In American scholarship that idea that Law creates the market

In this marketplace reality contracting parties are and ought to be individualist (at least in commercial contracts, maybe not in familial agreements). Parties are obviously trying to get a better deal. The game theory, besides explaining the behavior of contracting parties, also contributes to a normative approach of contract law and to sustain the need for incentives for cooperation, which tends to create a surplus to be divided by parties.

According to bargain theory, in a cooperative game such as in a private contract, parties will tend to cooperate in order to move the good or service to the party that values them the most. This will happen as long as they agree on the amount of surplus to be shared. In short term relationships, parties might not take into consideration further consequences of their attitudes (especially when there is no informal sanction as reputation, bad debtors list). Because the other party can predict this dominant strategy (default) of the other party he or she can refrain from doing business. Contract law can create incentives for cooperation and assure the refraining party that the agreement will be enforced.⁹³

Therefore, pursuant to the paradigm at hand, goods and services shall circulate voluntarily by means of contracts to the party that values them most. Since individuals have different interests and are sufficiently rational (in the realm of commercial contracts at least) to establish order of preferences they will be able to maximize their utility in the exchange process. This will create wealth in society.

Imagine for instance that Caius wants to sell his car; he values his car at 1,000 units. Now imagine that Augustus wants to buy it. Augustus value it at 2,000 units. So if the car is sold by 1,500, splitting the surplus among the parties, a value of 500 units was created by this very single transaction and both parties are better off. In general, individuals know

appears in SUSTEIN, Cass. *Free market and social justice*. Oxford: Oxford University Press, 1997, p. 384: "Free markets are legally constructed instruments..."

created by human beings hoping to produce a successful system of social ordering."

⁹³ LEE REED, O. Law, the Rule of Law and Property: a foundation for the private market and business study. *In American Business Law Journal*, vol. 38, 2001, p. 441.

what is better for them and firms are even more competent in knowing what is better for them.⁹⁴

The underlying supposition of the model is that this kind of social organization is not anarchic. On the contrary, it provides efficient allocation of scarce resources because individual interactions tend to create a spontaneous general *equilibrium* situation.⁹⁵ Market transactions shall occur until no other alternative allocation of resources would be viable from a cost-benefit analysis or until the point that someone benefits without harming the position of other (Pareto Efficiency)⁹⁶ or at least when a party's benefit could compensate the harm generated to the other and also generate a surplus (Kaldor-Hicks)⁹⁷. Given the rationality of the parties there is no reason to assume that parties will not bargain in order to reach *equilibrium* situation (at least in commercial contracts where we can find firms as contracting parties).⁹⁸

The hornbook example is that of the rancher (raises cattle bread) and the farmer (produce soy crops). Assuming that they live near by, if cattle escape from the property of the rancher they can damage the plantation crops. The question is who must build the fence on the property (if it has to be built). Depending on the provision of the law, the parties might bargain in order to reach a more efficient result in terms of cost-benefit analysis (assuming that there is no transaction cost). Supposing that a legal provision obliges the farmer to build the fence but it would be cheaper for the rancher to do so, they would have incentives to bargain in a way that the farmer would pay for the rancher to build the fence if

⁹⁴ SCHWARTZ & SCOTT, 2003, quoted above, p. 568.

⁹⁵ COOTER, op. cit., p. 11 and 40. That is to say when the marginal cost equals the marginal benefit for each service or product.

⁹⁶ "A particular situation is said to be Pareto efficient if it is impossible to change it so as to make at least one person better off (in his own estimation) without making another person worse off (again, in his own estimation)" Cf. COOTER, op. cit., p. 12. According to the model, each party would have a veto power to block situations in which he or she deemed worse off (COOTER, op. cit., p. 44).

⁹⁷ "By contrast, a Pareto improvement, allows changes in which there are both gainer and losers, but requires that the gainers gain more than the losers lose. If this condition is satisfied, the gainers can, in principle, compensate the losers, and still have a surplus for themselves." Cf. COOTER, op. cit., p. 44.

⁹⁸ According to Shavell a "contract is said to be mutually beneficial or, in the language of economics, Pareto efficient, if the contract cannot be modified so as to raise the well-being – the expected utility – of each parties to it. We would suppose that contracts would tend to be mutually beneficial: if a contract can be altered in a way that this would raise expected utility of each party, we would think that this would be done". Cf. SHAVELL, op. cit., p. 293.

they can split the surplus; or else the rancher might prefer to not build the fence and pay damages to the farmer (if it is cheaper to do so).

Now, let me turn to a simple but real example. Suppose that the landlord Octavius rented his house to a certain tenant Gaius. Suppose that Octavius had just rented a house, and in the garage there was a car he bought for his company to substitute an older one still in use. Now suppose that Gaius does not have a car and is also interested in renting the car. As long as both parties benefit, they will enter into a lease agreement. For instance, Gaius will not pay more for the car than he would pay to a rental company. On the other hand Octavius would not rent it for a price that could not compensate at least the depreciation of the vehicle (assuming that the older car would still be working for the company or even that the rent money would compensate selling the old car and give it another destination). At some point in the middle, splitting the surplus, the parties will reach an agreement and that will create wealth. This might sound abstract to a lawyer but the creation of value is easy to prove in legal terms: it is so true that a tax will be due if the rent is to occur and there is no income tax without wealth enhancement.

However if a neighbor Julius values the car more than Gaius he will be keen to give more money to Octavius to rent it. And if in an oversimplification (assuming that no other sanction is at stake such as reputation, etc.) the difference that Octavius would pay could compensate Gaius, he might accept terminate the rent agreement with Octavius and split with him the surplus created. All of those transactions generate wealth and are normally taxed.

Contract law (and also property law) forges transactions that would not occur without it, since it protects the expectations of the parties creating legal obligations to act under certain requirements bargained for. Without contract law (that create legal obligations protected by the state) parties would have difficulties in entering into non-personal relationships (such as familial, friendship), especially those that operate in the future by means of credit and those that need a chain of relations interconnected (such as

house or student loans, insurance, health care, etc).⁹⁹ Market society, unlike tribal and feudal societies, relies very much on non-personal relationships.¹⁰⁰

As stated by Schwartz & Scott¹⁰¹:

“Enforcement, in sum, permits parties to make believable promises to each other when reputational of self-enforcement sanctions will not avail. (...) The lack of enforcement rules and honest courts in many of these countries (‘Third World’¹⁰²), however, prevents the local parties from making promises...”

Thus the main social function of contract law is to allow contracts to happen, the exchange to flow in marketplace, the economic players to allocate risks and commit themselves to futures actions, until they reach the most efficient situation, i.e., when it makes both parties benefit from bargain and distribute the surplus created by the exchange.¹⁰³

Because of that, I believe that the “efficient breach” doctrine¹⁰⁴ should be cautiously applied to Brazil.¹⁰⁵ It can be right when describing the rational behavior of the

⁹⁹ SHAVELL, *op. cit.*, 291.

¹⁰⁰ Trebilcock clearly shows how the western contemporary society has chosen the market system and defines the choices for the economic and social efficiency. In this, “(...) the decisions on the production and the consumption are de-centralized and depend on a myriad of individual decision by producers and consumers, acting as a consequence of individual preferences and incentives, thus minimizing the role played by social conventions and *status*”. Cf. TREBILCOCK, “The limits...”, p. 268.

¹⁰¹ SCHWARTZ & SCOTT, *op. cit.*, p. 12.

¹⁰² Words of the authors, not mine.

¹⁰³ SCHWARTZ, Alan & SCOTT, Robert. Contract Theory and the limits of contract law. *In Yale Law Journal*, vol. 113, 2003, p. 541.

¹⁰⁴ “Efficient breach” meaning that a party to a contract might breach if a second best option appears in a way that the breach party compensate the injured party and still keep a surplus (Pareto efficient). See ULEN, Thomas. The efficiency of specific performance: toward a unified theory of contract law. *In Michigan Law Review*, vol. 83, p. 341: “The key advance was the economists' recognition that there are circumstances in which at least one party can be made better off, without making anyone worse off, by one party's breaching rather than performing a contractual promise. The law, it has been urged, should not hinder the breaching of contracts where the breach offers a Pareto superior outcome” CRASWELL, Richard. *Contract remedies, renegotiation and the theory of efficient breach*. *In Southern California Law Review*, vol. 61, 1988, p. 629; POSNER, Eric. *What the efficient performance hypothesis means for contract scholarship*. *In Yale Law Journal Pocket Part*, vol. 116, 2007, p. 439.

¹⁰⁵ SCALISE JR., Why no..., p. 721. Legally speaking, in Brazil it would be impracticable the use of efficient breach doctrine since the standard remedy for breach is specific performance unlike the American contract law (in which the standard remedy are damages). The efficient breach doctrine explains the damages remedy as a result of the breach and not specific performance because the result of a breach in the latter would be forcing the party to comply with its duties and not to pay damages.

party that breaches the contract having an alternative allocation of his or her resource, compensating the harm caused to the other party. However it can be wrong when describing how contract law actually is (the theory does not add anything from the point of view of relief to the breaching party) and how it ought to be, since contract law must be able to keep people out of the courts, especially considering the case of Brazilian courts – which is very subsidized by the government creating incentives to litigation, in addition to the rule that the loser in court pays the winner’s fees; and there are problems with the case docks being overloaded.¹⁰⁶ By itself, the lack of speediness increases the transaction costs and might create incentives for breach. Moreover the doctrine emphasizes an *ex post facto* (a better opportunity) to permit the breach of an *ex ante* bargained agreement. In that case, there would be fewer incentives to get a better deal in the first place (and to behave diligently).

As a matter of fact, the lack of legal implications of the doctrine makes difficult to assess its contributions to contract law (from a comparative law analysis at least). If the goal of the theory is to describe only U.S. contract law and the efficiency of its rules regarding breach of contract, then it is fine if its presumptions are met. If the aim of the theory is to “demoralize” breach, likewise, there is no major problem. Law and economics paradigm should not have a moral underpinning of breach anyway.

However if the doctrine is to have a normative implication, what would it be? That the breaching party should not pay damages to the injured party? I doubt it. What probably makes sense would be that the theory justifies damages as the rule for breach instead of specific performance. In that case, the doctrine would recommend a change of the laws in countries like Brazil where specific performance is the typical remedy. The problem with that is that specific performance is a right of the injured party, but he or she might always in Brazil prefer to sue for damages instead. Moreover we would need very accurate empirical

¹⁰⁶ For a general overview of Latin America, see BUSCAGLIA, Edgardo. A quantitative assessment of the efficiency of the judicial sector in Latin America. *In International Review of Law and Economics*, vol. 17, 1997, p. 275. For a more accurate and precise assessment of Brazilian Judicial Power see *Court Performance around the world: a comparative perspective*, World Bank Technical Paper # 430, WTC430, 1999. For present figures, see the Report of the Brazilian National Council of Justice, *Justice in numbers*, http://www.cnj.gov.br/images/stories/docs_cnj/relatorios/justica_numero_2005.pdf

research to test if specific performance is not more efficient than damages (again, taking into account the case of Brazil).

Even if we assume that those legal problems are not at stake and the doctrine should be assessed by its own theoretical terms, i.e., if a better alternative of allocation of resources was available, then a party should be free to breach and compensate the injured party. Still, there are a few pragmatic problems. Firstly, in a cost-benefit analysis one might take into account not only the legal sanctions, but non-legal sanctions such as goodwill and reputation (what are really difficult to measure and even model in economic terms).¹⁰⁷ And secondly, that legal assessment of damages can only be done in court, so only by fiction can one separate the substantive and procedural issues (therefore one must bear in mind proceedings aspects when assessing an “efficient breach”). Litigation will increase transaction costs. Moreover courts lack information to assess perfectly the damages because breaching a contract means to pay for the actual harm and loss of profit (or put the party in the position he or she would be in if the agreement has been performed). Finally, if the breach creates a surplus to be divided by the breaching and the injured party, wouldn't the injured party, supposedly rational, accept the deal?

These arguments create a strong presumption against the applicability of “efficient breach” doctrine. Plus, they create a favorable presumption of efficiency of liquidated damages clauses and to some extent even reasonable penalty clauses, as a means to avoid creating litigation. They also generate incentives for the performance of the agreement or to bargain in case of breach (at least in Brazil).¹⁰⁸ It would avoid increasing transaction costs to define damages. The pragmatic problems of the efficient breach theory become more evident when applied to International Public Law. Would anyone that argues in favor of the “efficient breach” doctrine say that in Bilateral International Treaties (BIT) signed by two countries in order to protect the investments of companies from the other State (which is

¹⁰⁷ Accepting that other than legal sanctions interfere in contract breach, see SCHWARTZ & SCOTT, *Contract Theory*..., p. 542.

¹⁰⁸ Supporting my view, is the opinion of DOGDE, William S. *The case for punitive damages in contracts*. In *Duke Law Journal*, vol. 48, 1999, p. 629. Against it but with strong sophisticated arguments TALLEY, Eric.

very analogous to a contract mechanism), the State could breach contracts with companies entered into under the rules of the Treaty if a second better option appears?

To apply this to the real world, let us look at an example. Suppose that Bolivia had a BIT with Brazil and that Petrobras, the Brazilian oil company, had investments in Bolivia protected by an agreement signed within the scope of the Treaty. If the Venezuelan Oil Company run by Hugo Chavez offers a better deal so that Bolivia could compensate Petrobras for the taking of its assets in Bolivia and also create a surplus to be split by Bolivia and Petrobras, why wouldn't Petrobras accept it? And why would the international commerce world perceive Bolivia's breach in a negative light?

In long term relationships where parties would have ongoing duties to each other, they will be more willing to cooperate spontaneously.¹⁰⁹ In such a case, the role of contract law would be not blocking the flow of the relation. This would happen recognizing the practices of the parties, the uses of trade and the good faith as a reasonable pattern of behavior (some sort of *lex mercatoria*) that would avoid expenditures with *ex ante* detailed agreements.¹¹⁰ In those clearly incomplete agreements the role of the court would be to complete the terms of the contract according to its framework, its uses and practices, and not according to the judge's discretionary idea of justice. Thus, the increase of arbitration in Brazil, today number four in number of arbitrations in the International Chamber of Commerce court of arbitration, is not surprising.¹¹¹ Arbitrators seem better fit for this role of completing complex contracts because of their sophisticated backgrounds, their expertise in the field at stake, very different from a judge of a court of justice overwhelmed with all kinds of claims.¹¹²

Thus, under an economic analysis, the paternalist model of contract law is not able to achieve its purpose of increasing welfare in society, since it might randomly benefit

Contract renegotiation, mechanism design, and the liquidated damages rule. In Stanford Law Review, vol. 46, 1994, p. 1195.

¹⁰⁹ COOTER, *op. cit.*, p. 75.

¹¹⁰ Cf. Macneil and Macauley, quoted above.

¹¹¹ According to the Annual Report of the Arbitration Court of the International Chamber of Commerce, 2006.

some individuals but proportionally harm more people. Enhancing legal protection of one of the parties (tenants for instance) normally brings with it an increase of overall costs to the marketplace (renting in this case). Those costs tend to be passed on by suppliers to the demand side (as examples below are going to illustrate), which ends up paying a higher price. Even if we assume that not all the increases in costs might be transferred (passed on) this will not mean more efficiency (social welfare improvement). And that is why, generally speaking, redistributive justice goals collide with efficiency goals in contract law.¹¹³

For instance, assume that the law provides that cars can only be rented with i-pods attached and with leather seats for the protection and happiness of buyers. Naturally those costs will be passed along to buyers to a greater or lesser extent. This will tend to increase the prices of the car which might “drive” some buyers off the market. By this token some customers would not buy the car at the increased price. So the result might be a significant amount of people without cars and few people paying a lot to have them. Society is clearly losing out in this hypo.

Further, even the redistribution effect is problematic because it can be randomized and maybe redistribute wealth from other buyers or tenants and not from the richer segment (seller, landlord).

As a result, judicial intervention in favor of the weaker party can generate externalities in the situation of a party that is not fully paying (internalizing) the benefit received from a bargain, but instead has been favored from some *ex post* intervention of the state in the contract (such as what happens in banking contracts in the Court of Appeals of

¹¹² DEZALAY, Yves et al. Global restructuring and the law: studies of the internationalization of legal fields and the creation of transnational arenas. In *Case Western Reserve Law Review*, vol. 44, 1994, p. 407.

¹¹³ Under very theoretical specific situations (in which courts would not be prepared to assess), economic modeling can evidence converge between efficiency and redistribution in contract law. The main paper to discuss that was ACKERMAN, Bruce. Regulating slum housing markets on behalf of the poor: of housing codes, housing subsidies and income redistribution policy. In *Yale Law Journal*, vol. 80, 1971, p. 1093. His argument was then developed to other context by CRASWELL, Richard. Passing on the costs of legal rules: efficiency and distribution in buyer-seller relationships. In *Stanford Law Review*, vol. 43, 1991, p. 361.

Rio Grande do Sul, that limit the interest rate to 12% due to an old usury statute¹¹⁴). So this party is externalizing its cost to the other debtors to his own benefit, resulting in a socially inefficient situation.¹¹⁵ This can happen in insurance contracts, when the court might force an insurance company to cover an excluded event in the policy of the insured, as in the Louisiana Circuit Court Hurricane Katrina litigation¹¹⁶, or in energy and water supply agreements.

Plus, its result in practice is to augment transaction costs without tackling the problems that would lubricate the market in situations of imperfection – thus deviating parties from efficiency even more. By increasing transaction costs, paternalist contract law can simply run some business practices out of the market (or in some cases increase the price of goods or services without a proportional benefit in terms of social utility – creating some externality in chain contracts such as insurance) and contribute to the actual decrease of welfare in society.

Moreover, it opens the door for opportunism, allowing the weaker party to have all the economic pie and all the benefit of the agreement. For instance if a court establishes an interest rate in private loans inferior to the one paid by the government's bonds (which is considered risk zero)¹¹⁷, or when the court awards an injunction requiring the insurance company to cover a surgery or treatment not provided according to the policy or even to avoid cutting the supply of electricity, it is not creating value, it is not splitting the surplus

¹¹⁴ POSNER has an interesting economic analysis of usury laws. He argues that they are efficient, keeping banks off the market of lending money to the poor (since they predict that courts would not enforce an interest rate that would cover their default risk). In POSNER, Eric. *Contract law in the welfare state...*, quoted above. However his argument would not apply to case since people protected by judiciary in those cases were not people living (at least directly) from the welfare system.

¹¹⁵ TALLEY, Eric. *Contract renegotiation, mechanism design, and the liquidated damages rule*. In *Stanford Law Review*, vol. 46, 1994, p. 1214-5.

¹¹⁶ In re Katrina Canal Breaches consolidated Litigation in 466 F.Supp.2d 729. In this case, the Circuit Court consolidated litigation of Katrina insurance cases in which the insured try to recover loss due to the flood resulted for the breach of New Orleans Canals even if policy exclusions for flooding. For a detailed discussion, see ANDREWS, W. et all. *Flood of uncertainty: contractual erosion in the wake of hurricane Katrina and the Eastern District of Louisiana's ruling in re Katrina Canal Breaches consolidated Litigation*. In *Tulane Law Review*, vol. 81, p. 1277 (81 Tul. L. Rev 1277). Curiously the 5th Circuit for Mississippi has reached an opposite conclusion in Paul Leonard and Julie Leonard v. Nationwide Mutual Insurance Co (499 F 3d 419).

¹¹⁷ In Brazil, the reference rate for government bonds used to be 17% per year and the Court of Appeals of Rio Grande do Sul used to limit the private interest rate on 12% (avoiding what they call usury by banks).

among the parties. It is allowing one of the parties to have everything and also creating incentives to pass along the cost to the others.¹¹⁸

Even more interesting are some past decisions of the Superior Court of Justice that split among the parties the unforeseen increase of dollar rate in car leasing agreements in Brazil in 1999 that were entered into in dollars. Due to a government policy, the Brazilian currency (*Real*) was devaluated and the leasing installments of consumers increased more than 150% as result (because the agreements with banks were entered into in dollars). The Court then split the increase of the rate of the dollars among the litigants. This kind of leasing in dollars eventually disappeared from the market.

Obviously, I am not arguing here that all contracts are complete and as a matter of efficiency courts should enforce them literally.¹¹⁹ But I am arguing that courts should avoid exercising discretion against the specific terms of a contract freely entered into in the name of very broad terms as “social justice” and “social function” with a view to redistribute justice. They could not do it without bearing in mind the final consequence of the chain of events. They are not able to use statistics to measure who is actually benefiting and who is actually losing. As mentioned above, though not impossible in theory the convergence of redistributive justice in contracts with efficiency, the low probability that courts could find that point in real trial cases, creates a great presumption in favor of *pacta sunt servanda*. The tax system would presumptively more efficiently redistribute the wealth produced in society when contracts and property rights are enforced.¹²⁰

¹¹⁸ The Report of the Brazilian National Council of Justice, *Justice in numbers*, http://www.cnj.gov.br/images/stories/docs_cnj/relatorios/justica_numero_2005.pdf, is very illustrative in this point. The State of Rio Grande do Sul is well known for its position in protecting the weaker party. The result is that the court is overloaded with cases and with a much higher rate of new filled cases than other parts of Brazil where litigation was not feed in the same level of intervention in contracts. Also because litigation is subsidized by the State (only a small fraction of the costs of the trial are actually paid by the parties), the increase in new filled cases creates other burdens to tax payers.

¹¹⁹ For a discussion on the most efficient method of interpretation of a contract, see SHAVELL, *op. cit.*, 301 e ss. particularly interesting is the opinion, of SCHWARTZ & SCOTT, 2003, quoted above, p. 568. According to their opinion in commercial agreements, courts should interpret a contract narrowly and close to its textual meaning, without deviance from the four corners of the document.

¹²⁰ SHAVELL, Steven & KAPLOW, Louis. Why the legal system in less efficient than the income tax in redistributing income. *In Journal of Legal Studies*, vol. 23, 1994, p. 667.

The next thing to discuss is whether the market is perfect, that is to say whether it always works properly and efficiently. And the answer to this question is no. Truly, sometimes companies can do bad things and create externalities (e.g. environmental or anticompetitive practices). Hence, there is a possibility of intervention or regulation by legal institutions when there are market failures (basically the existence of transaction costs, of economic power, of asymmetry of information and of externalities) which could not led to the most beneficial situation for society.

That is the secondary social function of contract law – to correct market failures in order to allow parties to achieve maximum utility (increase wealth in society) – i.e. to make contracts work as they should. The Law would take care of the structure of the market and of the environment in which the contracts are made, but distribution of welfare among parties would remain private. The State would not need to interfere to redistribute the surplus created. It would create regulation to avoid abuse of economic power or to require disclosure of information (of products, of stocks, of companies, etc).¹²¹

When markets are imperfect, there are transaction costs (costs incurred by the parties for searching for potential partners, for negotiating with them and enforcing an agreement, and protecting each party's assets).¹²² The role of private law (especially contract law), in this case, is to reduce these transaction costs, i.e. to “lubricate transactions”. It can also be stated that, at least, from an economic viewpoint, the better the institutions, the more developed the market will be, due to the decrease in transaction costs.¹²³

¹²¹ According to SCHWARTZ & SCOTT, 2003, quoted above, this is not proper the role of contract law, but securities and antitrust regulation and environmental law. In my opinion contract law should be ready to accept those inputs of antitrust or securities law since bad things in the market tend to occur by mean of contracts. Thus, there is an intersection point between the “pure” contract law and those regulations. It is contract law that will deem null and void an anticompetitive agreement (against public policy). Antitrust law can allow it, but is more often used for fines or civil liability.

¹²² COASE, Ronald H. *The firm, the market and the law*. The University of Chicago Press, Chicago, 1988, p. 07.

¹²³ See NORTH, Douglas. *Institutions, Institutional Change and Economic Performance*. Cambridge, Cambridge University Press, 1990. See also WILLIAMSON, Oliver. *Por que Direito, Economia e Organizações?*. In “Direito e Economia”. ZYLBERSTAJN e SZTAJN (org.). São Paulo, Campus, 2005, p. 16 e ss.

As Coase points out, because there are transaction costs, legal rules affect efficient allocation of resources in society. Contract law should not create a burden in the way of impeding a situation of bargain (*i.e.*, cooperation) that would bring efficient distribution of welfare by consent. In the words of Professor Cooter¹²⁴:

“Some transaction costs are endogenous to the legal system in the sense that legal rules can lower obstacles to private bargaining. The Coase Theorem suggests that the law can encourage bargaining by lowering transaction costs. Lowering transaction costs ‘lubricates’ bargaining. (...) We can formalize this principle as the normative Coase theorem: *Structure the law so as to remove the impediments to private agreements.* (...) It assumes that private exchange can allocate rights efficiently. (...) Besides encouraging bargaining, a legal system tries to minimize disagreements and failures to cooperate, which are costly to society. (...) *Structure the law so as to minimize the harm caused by failures in private agreements.*”

Economic analysis provides measuring tools for this social functionality of contract law.

For an example of this reasoning, see the research conducted by the Institute PENSA/University of Sao Paulo for the “green soy” case.¹²⁵ It has empirically proven that the appellate review of agrarian contracts in the state of Goiás caused difficulties for farmers there to finance crops the following year, thus showing that the benefits for those who filed lawsuits were negatively counterbalanced by the losses of the remaining collectivity that worked in the soy planting market.¹²⁶

The situation in that case was that some crops, like soy, were financed, in many cases, by private capital, in other words, *traders* purchased the crop in advance, paying the agriculturist immediately, and the latter was able to capitalize planting. And in the following year, this agriculturist, who had already estimated his profit in the advanced sale price, delivered the product.

¹²⁴ COOTER, *op. cit.*, p. 93 e ss.

¹²⁵ For a diagnosis of the problem, see Newsletter Valor Econômico – Ano 5 – número 990 – Quarta-feira, 15/02/2006. Caderno ‘Agronegócios’.

¹²⁶ According to the announcement in the Seminar at Instituto PENSA, at USP, on December 5, 2005.

But there was an unexpected valuation of the soy, and some agriculturists filed a review suit for these agreements, alleging there was unpredictability, unjustified enrichment, social function of the contract, in order to not comply with the agreement, i.e., in order to avoid delivering the product of their crops. The trial judge rejected the claims.

The Court of Appeals of the State of Goiás, based on the social function of the contract, reviewed the agreements and released the farmers who filed the lawsuits, who were deemed weaker parties, from full compliance with the agreement.¹²⁷

The consequence (collective or social) of this was that all the others farmers who did not file lawsuits were harmed, since the traders of the region did not want to continue with this advanced purchasing of the crop, due to an obvious risk of loss in the operation, since if, in the year following the agreement, the soy price would be lower than the agreed one, they would have to bear the loss, and if it were higher, the farmers would file lawsuits for the non-compliance with the agreement.

The Federal Superior Court of Justice (with jurisdiction similar to the Supreme Court of U.S. with respect to non constitutional issues) reversed the decisions of the court of Appeals of the State of Goiás with surprising economic reasoning:

“The social function of contract cannot disregard its primary and natural role, which is economic. By selling his future crop, one expect that the seller includes in his price the calculus of all costs that might affect his production, including those derived from the contract itself as well as those derived from the conditions of the plantation.”¹²⁸

The same Federal Superior Court of Justice reversed all decisions of the Court of Appeals of Rio Grande do Sul that had limited the interest rates in banking finance agreements (loans, housing, etc) using an economic rationale:

¹²⁷ Civil Appeal 79.859-2/188, First Civil Panel; Civil Appeal 82.254-6/188, First Civil Panel.

¹²⁸ Special Recourse 803481 from Goiás, Justice Nancy Andrichi, Third Panel, 28/06/2007, Official Gazette, 01.08.2007 p. 462; Special Recourse 783404 from Goiás, Justice Nancy Andrichi, Third Panel, 28/06/2007, Official Gazette 13.08.2007 p. 364.

“What substantiates the economical reasoning that, in a conjuncture of a monthly inflation rate next to zero, interests exceeding 1% per month are abusive? With the due respect, there is no rationality therein, much less of economic nature. In any commercial or industrial activity, the price of the product sale cannot be lower than the respective cost. (...) The interest rate is fully disconnected from the inflation rate. The inflation is low, but the cost of the money is high (...) and cannot be reduced by legal writing. This is economic policy dictated by a government deed, which goes against the judiciary control”¹²⁹.

Recently the Federal Superior Court of Justice also reversed preliminary injunctions given by State Courts that had forbidden private companies that explore the concession of energy and water supply to cut off electricity and water supplies. In the last case, the President of the Court used a consequential argument to allow the supply cut of consumers that did not pay the bill:

“It is not reasonable to forbid the cut in the supply of water for those consumers that, when duly notified, keep in default of payment of the bill (...) The reading of the records show that the continuing default of water bills affect the company that is exploring the concession and creates a bad consequence to sound finance of the same company, what could bring as a result in collapse of water supply in the county”¹³⁰

There are interesting court decisions that, even without resorting to economic analysis tools, intuitively realize this social function of contract law in a market environment like the case discussing the possibility for a Federal Court to limit interest rates in house financing mortgages:

“To admit the legality of the procedure intended by the claimants (contractual review of a real estate financing) would imply in the appearance of a dangerous precedent, with serious consequences for the complex and strict national housing system, whose structure and operating mechanism has been well explained by Caio Tácito [...]: ‘furthermore, the real estate agreements are, in this case, an integral part of an interconnected

¹²⁹ Special Recourse 271,214 of the High Court of Appeals, Relater Associate Justice Ari Pargendler, dated of March 12, 2003.

¹³⁰ Superior Court of Justice, Preliminary injunction of Justice Barros Monteiro, Suspensão de liminar e de sentença 804/SP.

whole, of a global financing system that has the additional role of maintaining the stability of its financial feeding sources [...].”¹³¹

Besides transaction costs, there are other imperfections in the market: a) there can be problems in the competition framework, which makes free competition and free initiative difficult due to a great concentration of economic power (such as monopolies and oligopolies); b) there can be problems related to information asymmetry; c) or with externalities, among others.¹³²

For the first aforementioned problem, in Brazil there is the so-called anti-trust law – Law 8884/94 (similar to the *Sherman Act* in the United States) – that deals with market structures, and tries to inhibit the abuse of economic power, resulting in the creation of the Brazilian regulatory agency for competition: the Administrative Council for Economic Defense (CADE). By controlling economic power that could reasonably affect the market – *i.e.*, by prohibiting the abuse of dominant positions and by means of agreements among competitors such as cartels, one would be indirectly controlling the power imbalance between the contracting parties to a reasonable extent.¹³³

To correct the information asymmetry problem there is the Consumer Defense Code (Law 8038/90), which guarantees, in its section 6th, wide access to information on products and services traded in the market, under penalty of strict civil liability of the supplier. For this reason, the Consumer Law is the spouse of the Competition Law, and both complete each other for to regulate the market.¹³⁴ Securities regulation from Comissão de Valores Mobiliários (CVM, the Brazilian SEC) will cover problems with asymmetry of information in stock exchange. The Civil Code and the duty of good faith (Section 422) can be used as a means for a court to require disclosure of information in commercial agreements too.

¹³¹ – 4th Circuit Federal Court. Civil Appeal 17,224, Wrote the opinion for the Court: Federal Judge Luiz Carlos Lugon.

¹³² On this subject, see in further detail, COOTER, Robert e ULEN, Thomas. *Law & Economics*. Boston, Addison Wesley, 2003, p. 10 e ss.

¹³³ FORGIONI, Paula Ana. *Os Fundamentos do Antitruste*. São Paulo: Revista dos Tribunais, 1998.

¹³⁴ MARQUES, Cláudia Lima. “Contratos no Código de Defesa do Consumidor”. 2^a ed., São Paulo, Editora Revista dos Tribunais, 1995, p. 27.

The problem of externalities (external cost) can be addressed also by antitrust law or even environmental law and contract law should be prepared for connections with the body of laws as mentioned above.

Considering all these aspects, if we follow this line of thought, what can contract law offer to the market and what is its social function?¹³⁵

- a) It can offer a regulatory milestone liable of legal protection;
- b) It can minimize communication problems;
- c) It can safeguard the assets of each agent;
- d) It can create protection against opportunism;
- e) It can generate reimbursement and risk allocation mechanisms;
- f) It can leave the door open for antitrust, securities regulation, environmental and consumer protection in very specific cases.

In short, contract law provides security and predictability to economic and social operations, protecting the expectations of economic players – which corresponds to an important institutional and social role. The tax system will provide redistribution of wealth.

CONCLUSION

We have tried to demonstrate the position of Brazilian jurists and the national Judiciary on the controversial section 421 of the New Civil Code, which apparently limits the freedom of the contracting parties to its social function.

It has been shown that most legal scholars in Brazil tend to see that Section 421 as a manifestation of Private Law “publicized” by Constitution, which would be guided by distributive justice criteria in order to benefit the less favored. This understanding has been justifying the position of some country courts that support the contract review, entitling the

¹³⁵ One could make the analysis of the contract more complex as a regulatory system involving institutional, interactive and social aspects, but this subject has already been approached in an article named “A hipercomplexidade do contrato em um sistema econômico de mercado”, published in the book *Law and Economics*. Luciano Timm (org.). São Paulo, THOMSON/IOB, 2005.

judge (State) to interfere in the agreement entered into between the parties, to annul clauses, and to establish rights and obligations not bargained for by the parties, since the contract would not be a space for freedom, but for oppression, the judge being responsible for the re-balancing of the contracting parties' powers.

In this paper we defended the position that an economic analysis of Law can be used to explain the social function of contract law in a market environment. This position allows the identification of social welfare not necessarily only for the protection of the weaker party in the contract, but also in the set of individuals who, effectively or potentially, might be party to a certain market of goods and services. Furthermore, we argued in favor of using an economic analysis of Law in contracts realm in order to reach more accurate perceptions of contract's externalities and social efficiency.

Our final conclusion is that there is a difference between contract (fact) and contract law (rules and principles). Contracts are devices for the circulation of goods and services within the society. This is the social function of contracts. Contract law operates to solve the problems created by market imperfections by means of:

- a) Offering a regulatory milestone liable of legal protection;
- b) Minimizing communication problems;
- c) Safeguarding the assets of each agent;
- d) Creating protection instruments against opportunism;
- e) Generating reimbursement and risk allocation mechanisms;
- f) Leaving the door open for antitrust, securities regulation, environmental and consumer protection in very specific cases.

Last but not least, the tax system and social security will provide redistribution of wealth to correct inequalities.