The Legal Foundations of Global Capitalism[1]

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Draft Paper, September 2014

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Abstract:

This essay roots global capitalism in law and legal institutions. The core thesis is that by transposing features of property law from real assets to financial claims law helped create and multiply capital assets and protect them from downside risk. This legal transformation is key for understanding liquidity – a concept that has eluded analytical traction; it also helps explain why the rate of return on capital tends to be higher than general economic growth, as postulated by Piketty. Property, trust, and contract law are older than capitalism but were adapted to suit its needs; these adaptations predate the age of globalization but they were ready to be used when the opening of capital accounts paved the way to scale them globally. Globalization did not require convergence of domestic law. Legal institutions derived from only few domestic systems together with legal transmission mechanisms that ensure their recognition in foreign jurisdictions sustain global capitalism. It follows that the institutions that sustain global capitalism are increasingly insulated from governance by national polities even as global capitalism cannot operate without them.

[1] Paper to be presented at the first annual meeting of the World Interdisciplinary Network for Institutional Research in Greenwich, London, 13 September 2014. I would like to thank Maciej Borowicz, Jongchul Kim, and Javier Solana for many inspirations for this paper. All errors are mine.

1. Introduction

Hyman Minsky asserted that capitalism is "essentially a financial system". This is the starting point of this essay. It does not seek to derive the essentials of capitalism from surveying its key components (see, however (Hodgson 2014)), but uses the co-evolution of law, finance and capitalism to identify the legal institutions that sustain global capitalism.

Asserting that capitalism is "essentially a financial system" implies that capital formation requires a financial system that allows economic agents to make bets on an unknown future and reap returns commensurate with their bets. It does *not* mean there was no finance before the rise of capitalism; neither does it imply that there is only one capitalist system. People have exchanged goods for money, extended credits, and transferred interests in future harvests for centuries if not millennia (Graeber 2011). Having money, credit, or using futures, however, is not the same as having a full-fledged *system* of financial intermediation geared at making bets today to reap future returns. Such a system requires the pooling of assets at scale and the allocation of gains and losses. The better the pooling 'technologies' the larger the investment volume, but the greater also the possible losses.

The core argument of this paper is that law and legal institutions developed to offer a variety of pooling and sharing technologies that contributed to the formation and growth of capital. In the age of capitalism these technologies were retooled to facilitate the minting of ever-new capital assets. Property rights, trusts and corporations take center stage in this process. All precede modern capitalism, but only in the age of capitalism were private actors empowered to deploy legal structures that had hitherto been reserved for sovereigns (the state or the church) or required their stamp of authority. Traders freely traded goods over long distances alone and in partnership with others; bankers created partnership systems to finance long distance trade (Padgett and McLean 2006), and bills of exchange were brought into circulation. The downside risks, however, were enormous and one could and often did lose one's shirt in these undertakings. Traders from the same place of origin could be deemed jointly liable for breach of contract by one of them and a single partner's creditors could bring down the entire business other partners had invested in and drive them and their families into destitute.

Moving from unmitigated risk to arrangements that facilitated asset delineation, liquidation protection and limited liability was an institutional quantum leap. It required the transformation of legal privileges granted at the behest of rulers into widely available legal forms. Once these legal privileges had made it into the hands of private entrepreneurs and their lawyers, they were combined and recombined to support the expansion and growth of capital. This in turn set the stage for an iterative process of private innovation and legislative, judicial, and regulatory responses that has straddled between private actors asserting autonomy to their legal innovations while simultaneously seeking recognition and vindication of these institutions by state authorities. The capitalist system that emerged from this process is thus best described as a hybrid system: neither purely private nor purely state, but somewhere and to varying degrees in-between. The same holds for global capitalism with the important extension that, because of legal changes adopted a long the way, legal entities can now freely choose the state from which they seek vindication for legal innovation, while employing them across many jurisdictions. As discussed in the final section of this essay, this has important implications for political self-governance.

Institutional differences among capitalist systems have spurred a voluminous literature on the varieties of capitalism (Hall and Soskice 2001). These variations are often traced to law or finance, in particular to civil vs. common law (La Porta, Lopez-de-Silanes, and Shleifer 2008); bank-based versus market-based financial systems (Allen and Gale 2001); or liberal vs. coordinated market economies (Hall, 2001). Indeed, many of these factors are highly correlated (Pistor 2006). There is also a substantial literature on convergence vs. divergence of (capitalist) economic systems (Coffee 1999) (Hansmann and Kraakman 2001; Gordon and Roe 2004). This essay does not deny the persistence of differences among capitalist economies. Economies are complex systems that are shaped by institutions complementarities and path dependencies that give them distinct characteristics (North 1990). Shocks to the system may trigger short-term change, but only rarely alter the path of a system, which tends to converge back on its traditional path (Milhaupt and Pistor 2008). Rather, global capitalism can (and did) develop without convergence of domestic institutions, because diffusion mechanisms were in place that allowed legal institution from one system to be employed elsewhere. These diffusion mechanisms include recognizing foreign law (i.e. conflict of law rules) and maintaining open borders for the flow of legal entities and capital. This is sufficient for putting in motion a transformative process whereby institutions from some legal systems

"infiltrate"[2] those of others typically sidestepping institutions of self-governance. Not all political, economic or legal systems respond to institutional infiltration in the same way. In some, this can trigger far-reaching change; in others islands of global capitalism coexist with the hinterlands of a system that retains many of its traditional characteristics.

Thus, varieties of capitalism can and will continue to exist, but they will co-exist with a global capitalist system that affects their operation. Global capitalism exerts differential effects on countries given their institutional make-up, but more importantly, given their location in a system, which is structured hierarchically. Being at or in proximity of the apex implies control over the making and selection of the rules that sustain global finance, including the power to relax or suspend the full force of the law if and when needed. A position on the periphery, in contrast, implies a role as rule-taker not rule maker even in times of crises when some but not all benefit from the suspension of rules.

2. From Law *in* Finance – to Law *in* Capitalism

The analytical framework deployed in this paper is the Legal Theory of Finance (LTF) (Pistor 2013), which proposes that contemporary financial systems are (1) legal constructed, (2) essentially hybrid, (3) beset by the law-finance-paradox and subject to predictable power dynamics denoted by the (4) elasticity of law. In legally constructed systems power is the differential relation to law. In systems that are legally constructed *and* inherently instable, playing by the rules irrespective of fundamental change can (in the extreme) precipitate the system's collapse.

Here I suggest that the legal construction is key for the rise of capitalism and, indeed, global capitalism; it is a formidable scaling technology in times of expansion, but can wreak havoc in times of crises. Whereas I have argued earlier that this is primarily a function of the tension between legal commitments on one hand and fundamental uncertainty and the volatility of liquidity, on the other, here I will argue that liquidity itself is legally constructed. Further, the legal construction of liquidity helps explain why the system is prone to crises: it does not take much to destabilize a system built on the appearance of enforceable rights when the same or similar rights are granted to too many competing claimants.

[2] I am grateful to Daniela Weber-Rey for suggesting this term.

Contract and property law are the foundations, of this system, as is the principle that individuals and entities operate under a hard budget constraint and those unable to balance their assets and liabilities will be forced to exit and their assets will be redeployed.[3]. This feature distinguishes capitalist from socialist economies (Kornai 1992). Bankruptcy law, which is designed to assure an orderly exit, thus forms part of the foundations of the legally constructed capitalist system. These foundations have been complemented by regulation enacted typically in response to financial crises. Regulation can be described as the "scaffolding"[4] of a system whose foundations are insufficient for sustaining it. It establishes entry barriers, restricts certain activities, and monitors some actors or activities in an attempt to prevent or at least mitigate future crises. Regulation has often slowed the process of financial innovation, at least for a time, but rarely suppressed it. In a system rooted in law, competitive advantage is sought and gained to a large extent by avoiding the full cost of regulation, or regulatory arbitrage. New regulation thus becomes the focal point of innovation [Awrey]. Private actors seek to *avoid* the costly effects of regulation to outcompete others. However, they do not wish to *evade* rules as this might render the new, carefully constructed, products or entities void and as such useless.

The central role law plays in constructing and maintaining capitalism makes it essentially hybrid (Mehrling 2013). Of course, parties may enter into contracts without reference to any formal law and seek arbiters rather than state courts to resolve their conflicts or create any business organization they like even it is not recognized in law.[5] Scaling economic relations to large, anonymous markets, however, requires enforceability irrespective of the identity or origin of the parties or entities. This cannot be achieved by private agreement alone but requires vindication by others – most critically those called upon to enforce them. Law, it turns out, is a formidable scaling technology. This was first demonstrated in the use of law for creating nation states and empires (Napoleons' troops brought the code civil with them); and it is equally evident in the rise of global capitalism.

Law's scaling potential goes further yet. The transformation of real assets into abstract legal claims makes it possible to expand resources infinitely, or at least so it seems for a time. Indeed, the

[3] Minsky calls this the "survival constraint" (Minsky 1986). See also (Mehrling 1999).
[4] I owe this term to Cathy Kaplan.
[5] Although there is a risk that a business arrangement will be deemed a partnership, whether or not all partners were aware of it…

extension of legal protections embodied in property law to contracts is at the very core of the expansion of liquidity (Kim and Pistor 2014) -- a central feature of contemporary large-scale, market-based financial systems. It is the "alchemy" (Schwarcz 1994) that makes privately created means of pay akin to state-issued money. There is an extensive debate as to whether money evolves naturally from exchange relations among private parties or whether it requires a state that designates money as "legal tender" (see (Hodgson 2013) for an excellent summary). The debate stakes out rigid alternatives where there is in fact a continuum. Anybody can issue money (Minsky 1986); the question is whether it will find takers and what will happen when they disappear – which typically happens when doubt arise about whether the money will be sellable tomorrow and thereafter. Both questions are related. Money is more likely to find many takers when backed by a pool of assets or a polity capable of mobilizing resources to acquire the (Kapadia 2013).

Creating money(s) is not a question of minting coins or controlling the money printing press, but of employing legal devices that create the appearance of enforceable rights that are akin to property when in fact they are not. Different legal forms can be employed to this end, but the engineering strategy is similar across them. The key is to create multiple seemingly equal claims against the same asset based on the expectation that all will be met. To do so, claims to future cash flows are placed in a pool that is legally separate and protected from creditors of its creators; new claims against the pool, but not against specific assets within it, are created that have the quality of property. Many illiquid assets have been turned into financial assets in this fashion in a process known as securitization (Schwarcz 1994). The problem is that not all of these assets can always be converted into other moneys, such as treasuries, cash, or gold. When demand for a particular money declines anybody with a sufficiently large balance sheet to assume liquidity risk can step in, and often they do. Private entities that face a hard budget can do this, however, only to the point that their own liabilities exceed their assets, which is when their own survival constraint kicks in. Going further is feasible only for entities with a soft budget constraint, that is, public not private entities.[6] In fact, not even all public entities; or states, are equally credible as not all command the resources or political capacity to act as credible backstops for the claims they may wish to assume. Publicness and

[6] This argument rests on the distinction between socialist and capitalist economies introduced by Janos Kornai, namely that entities in socialist systems have a soft budget constraint, while capitalist entities must manage their own resources without outside help. There are, of course, many exceptions within capitalist systems. However, the basic insight still holds true: Any entity that is backed by explicit or implicit insurance is hybrid rather than purely private.

sovereignty are relative terms, and so is private autonomy. The defining features is the extent to which the survival constraint of different entities is truly binding.

This leads to the third element of LTF, the law-finance paradox. It states that when a system that is constructed in law confronts uncertainty and/or liquidity volatility it can self-destruct. Not all commitments made ex ante are equally firm or rigid. Contracts are inherently incomplete (Hart and Moore 1999); in fact, parties often design contracts to leave scope for future adaptation and renegotiation (Gilson, Sabel, and Scott 2009). To achieve scale in anonymous markets, however, commitments tend to be rather firms as this enhances their fungibility. Buyers should be able to rely on a contract without having to inquire into the creditworthiness of the debtor, the intermediary, or worry about the interpretation of certain terms. This requires information (Gilson and Kraakman 2014) and standardization of the product (Carruthers and Stinchcombe 1999); but it also requires credible commitments, i.e. enforceability.

The construction of large-scale anonymous markets based on firm legal commitments law therefore inevitably carries the seeds for their self-destruction. This can happen for one of two reasons: incompleteness of contracts or failure to anticipate the systemic effects of stage contingent, relatively complete contracts. Contracts that fail to anticipate all future contingencies, including natural or man-made disasters, or radical changes in the politics or the economy are incomplete (Hart and Moore 1999; Bolton and Rosenthal 2002). This is nothing new. Legal systems have responded to this by creating safety valves, which give the affected party the right to deviate from the principle *pacta sunt servanda* and rescind the contract on the grounds of "*force majeur*", frustration (Dawson 1984), or ask courts to adopt them to changed circumstances (Dawson 1983). Alternatively, contracts anticipate future contingencies but the solutions they provide exacerbate systemic effects. Contracts can be designed to be stage contingent (Arrow 1974); they may, for example, anticipate changes in the price of reference assets (real estate, treasury bonds) and require one party to offer additional collateral or margins should that prices decline below a certain threshold. In the event that similar triggers are used or they are highly correlated, the "safety valves" can precipitate collapse. The reason is that they were designed to shift the risk to others but did not, and could not purge it from the system. The channels through which this mechanism operates is typically that the counter parties to all contracts with similar triggering events will search for new assets to meet their

obligations at the same time. They thereby increase demand for higher quality assets while simultaneously spreading doubts about the viability the assets they are seeking to patch up.

Relief from this downward spiral can come in two forms: Contractual obligations are suspended, or someone steps in and offers (more) credible money to select debtors so that they can meet their obligations. Both measures entail the suspension of the full force of the law: the principle of *pacta sunt servanda* in the first case, and of the hard budget constraint as defining features of capitalist economies in the second. As discussed, relief can come from private entities, but ultimate relief can come only from an entity capable of mobilizing unlimited resources, i.e. a public one. *Ex post* elasticity of law raises the critical question who gets to decide when, how much, and to whom such allowances – the temporal suspension of the rules of the game or the softening of the budget constraint – shall e made. The short answer is, whoever has the ability and/or will to do so. A longer answer will have to await the discussion of the political economy of (global) capitalism in the last section of this paper. Suffice to note here that the elasticity of the law is the logical consequence of an economic system based on credit finance and constructed in law. Viewed in this light the law-finance-paradox is not an aberration of a system that unexpectedly confronts uncertainty, but a central feature of s system that wants to have the cake and eat it too: long term investments *and* hard budget constraint; risk taking *and* pacta sunt servanda; efficiency *and* prosperity. Moreover, as will be further explained below, liquidity – the companion of uncertainty in destabilizing systems built on firm legal commitments – is itself a creature of the law.

Marx was right that the capitalist system suffers from internal contradictions. However, he was wrong on two fronts: in concluding that this would lead to its inevitable demise and in asserting that law served only as its superstructure (Hodgson 2014). He certainly underestimated the ingenuity of judges, lawyers and legislatures in devising institutions that make the system appear for long stretches of time less contradictory than it actually is, thereby ensuring its continuing appeal. None of the twists and turns of legal innovations has resolved the underlying contradictions of the system; this was neither possible nor intended. For the lawyers who draft trust deeds, corporate charters or a prospectus for a squared collateralized debt obligation, protecting their clients' interests rather than the system at large is what matters.[7] 0

[7] For an intriguing admission that the system had reached a level of complexity that was beyond comprehension for the lawyers drafting these instruments, see a comment by the former general counsel of Citigroup (Darmstadter 2002).

3. Law and the Metamorphosis of Capital

Capital, writes Thomas Piketty in his seminal "Capital for the 21st Century" (Piketty 2014) can be defined as "the sum total of nonhuman assets that can be owned and exchanged on some market" (ibid at p. 46). Capital, or wealth (the terms are used interchangeably) is accumulated over time. Using detailed, long-term data from France, the UK, Germany and the US, Piketty and his collaborators show that the rate of return on capital tends to be higher than the average growth rate of advanced economies. This empirical observation is not further explained or theorized. Neither is another empirical pattern documented in the book, the "metamorphosis of capital", which depicts the decline of (agricultural) land as the primary source of wealth since the late 19th century and the rise of (urban) housing and financial assets in its stead.

The answer to both puzzles – the higher return on capital and its transformation– I suggest, can be found in law and its capacity to expand liquidity by multiplying claims against a single asset and by creating effective downside protections for some of these claims. The accumulation of wealth, thus, is not simply the result of being smart enough to invest in assets that generate the highest returns, but in assets that offer the most solid downside protection. Different assets have been granted liquidation protection over time; and effective liquidation protection in turn generates higher returns compared to assets that do not enjoy the same privilege.[8] Only in the rare incidences when the floor from the downside protection is withdrawn – most dramatically in the crisis of the 1930s – is the growth of capital stopped if not reversed.

To substantiate this claim, a comparative historical account of the transformation of law that paralleled and enabled the transformation of capital basis would be required. This essay has a more modest agenda: to map out critical legal change in English and American law and the dissemination of key legal institution in support of capitalism around the globe. This is not to say that other legal systems did not produce important legal innovations. Double-entry book keeping, the recognition of a corporation as an independent legal person, and the ability of corporations to own shares in other corporations was recognized by continental European legal systems prior to their recognition in

[8] There is a growing empirical body documenting the shift of credit finance into instruments with safe harbor protection. See the discussion infra under [].

English or American law (Pistor et al. 2002). Nonetheless, it seems fair to say that during the 19th and 20th century English and American law played a leading role in spurring innovations that shaped our global capitalist system. Explanations vary from arguments about the inherent nature of the common law vs. the civil law (La Porta, Lopez-de-Silanes, and Shleifer 2008; Mahoney 2001); deeply entrenched norms and social preferences for individual as opposed to collective priors (Pistor 2006), or the political economy (Roe 2006). These arguments shall not be rehearsed again (for a summary of the literature see (Deakin and Pistor 2012)). Suffice to say that once critical institutions are in place they generate their own dynamics. Assets that are protected against loss will accumulate faster than others and their owners will have a vested interest in retaining this privilege; others will seek to extend similar privileges to other assets, and so forth. The final outcome may be difficult to predict and highly contingent on circumstances. One thing, however, is certain: the law will play a central role in determining winners and losers.

Legal change in the law of trusts, business organizations, and collateral law helped square the circle of combining downside protection against liquidation with utmost flexibility in asset allocation. English property law traditionally distinguishes 'realty' and 'personality' and attaches different rules to each (Lawson and Rudden 2002). Until the late 19th century only personal property could be freely alienated and encumbered; reality was held in estate. This implied that land was not a commodity that could be freely exchanged for money; if it was transferred it had to be replaced by land of equal quality. Further, unsecured creditors could not enforce against land held in estate; and even for secured creditors Chancery courts imposed substantial procedural barriers that rendered the estate in effect liquidation-proof (Priest 2006). Last but not least, children would inherit the family estate without the debt accumulated by their forbearers (ibid).

Over the course of the 18th and 19th centuries, the privileges attached to land were gradually eroded. Yet, the privileges themselves did not fade away. Instead, they were transposed to financial assets held in trust and legal entities, or funds. As Bernard Rudden put it(1994, 82/83):

> "The traditional concepts of the common law of property were created for and by the ruling classes at a time when the bulk of their capital was land. Nowadays the great wealth lies in stocks, shares, bonds and the like, and is not just movable but *mobile*, crossing oceans at the touch of a key-pad in the search for a fiscal utopia. (…) In terms of legal theory and technique, however, there has been a profound if little discussed evolution by which the concepts originally devised for real property have been detached from their original object, only to

> survive and flourish as a means of handling abstract value. The feudal calculus lives and breeds, but its habitat is wealth not land."

This transformation required several steps: First, the extension of liquidation protection originally conceived for real property to trusts, corporations, and, ultimately to 'funds' in what ever legal form they take (Rudden 1985, 214). Second, the balancing of liquidation protection with withdrawal rights (Hansmann and Kraakman 2000a). Third, the enhancement of investor rights to the fund into personal *property* investors could freely alienate and encumber. Fourth and finally, the extension of liquidation protection to claims that don't even pretend to be property.

Liquidation protection through asset delineation

Drawing legal boundaries around some assets and protecting them from the original owners and their creditors accomplished the first step. The trust, a creature of the English law of equity, played a central role in this development. Traditionally used to protect family or charitable property, it evolved into a prime vehicle for "asset shielding" (Hansmann, Kraakman, and Squire 2006). Today, the volume of assets held in commercial trusts far exceeds those held for charitable purposes (Langbein 1997). In a trust arrangement, a settlor places assets in a trust for the anointed beneficiary. The trustee manages the trust in the interest of the beneficiary. He can sell assets and use the proceeds to replace them. However, the trustee cannot appropriate the economic value of the assets; that belongs to ultimately to the trust's beneficiaries. Moreover, the trustee's creditors are shielded from enforcing their claims against the trust, as this would violate the beneficiary's proprietary rights in the trust. Rudden argues that it is therefore misleading to call the trustee "owner"; unlike an owner, he controls the assets in the trust only as "things", not as "wealth" (Rudden 1994).

Asset shielding was also central for the evolution of organizational law (Hansmann, Kraakman, and Squire 2006) (HKS). HKS distinguish "entity shielding" from "owner shielding", where entity shielding stands for the protection of assets from the creditors of the entity's "owners";[9] and owner shielding for protecting the owner from the entity's creditors. Surveying the history of asset

[9] The term "owner" transposes our contemporary understanding of shareholders as owners of corporations to earlier days. However, as will be further discussed below, the nature of shares and shareholding was long disputed and the Functional, the extension of legal privileges that historically had been reserved for land to new forms of financial wealth amounts to "liquidation protection" (Hansmann, Kraakman, and Squire 2006). The notion of share ownership is of relatively recent vintage.

shielding, HKS show that Roman law developed only weak forms of entity shielding. Only in Renaissance Italy and subsequently in England were strong forms of entity shielding incorporated (sic!) into organizational law. At its core asset shielding means preservation of assets against legally valid third party claims, or liquidation protection. Legal devices such as the trust or the corporate form allow asset owners to "partition" (Hansmann and Kraakman 2000b) assets and thereby protect them from their creditors. The law places some restrictions on this practice if done *for the purpose* of hiding assets from creditors in hot pursuit, but not when part of a general business strategy.

Liquidation protection has been granted not only to natural persons (shareholders), but also to entities. This was still disputed in the 19th century; indeed in the US most states restricted shareholding to natural persons and prohibited corporations from holding stock in other entities for much of the century (Blumberg 1987; Pistor et al. 2002). Nowadays, corporations can create multiple subsidiaries (and in different countries for that matter) and divide capital to limit exposure to their most risky operations. They thereby not only externalize the risk, they minimize the downside loss on these operations for the assets of the integrated business. This risk diversification strategy would be unthinkable without the "legal fiction" (Jensen and Meckling 1976) of corporate or trust law. In essence, liquidation protection is a legal subsidy that puts a floor under bets made into an unknown and unknowable future. This privilege is granted selectively, but can be adapted to new forms of assets and wealth.

Shareholder limited liability complements owner shielding with entity shielding. It has become fashionable to call shareholders 'owners' of corporations; yet their ownership is of a special kind. They can freely appropriate the upside of their investments without having to internalize the full downside costs – contrary to assertions that property rights are, at their core, about managing externalities (Demsetz 1966). Protected by limited liability, shareholders can never lose more than what they put in at the outset. In contrast, a partner can lose her personal wealth when the partnership fails to meet its obligations, and most other assets can depreciate in value without the law limiting the owners' downside exposure.[10] Individuals without assets or with assets that do not enjoy similar legal subsidies therefore face the full brunt not only of their own mistakes but also of what to them are exogenous shocks even though they are endogenous to the overall system.

[10] An important exception are non-recourse mortgages that protect home owners against facing the full economic loss of a house bought on an over-priced market.

Hodgson (2015) proposes that one of the reasons why labor cannot compete with capital on equal terms in generating wealth is that human labor cannot serve as collateral. Collateralization, however, is only one form of hedging risk; liquidation protection is another, and arguably a more powerful one. To be sure, individuals can escape losses by filing for personal bankruptcy if such a regime exists, which is less common than corporate bankruptcy, and only within constraints that tend to be more tightly circumscribed.[11]

In short, the transformation of capital from land to financial assets has gone hand in hand with the transposition of legal privileges that had once been reserved for land to new forms of wealth. The causal relation is at times difficult to disentangle. Legal change did not take place in one big swoop; it occurred in an incremental process in which both case law (especially in the chancery courts) and statutory law played a critical role in the face of judges that held on to legal doctrine even when it conflicted with the demands of new wealth. An important milestone was reached in 1925 in the UK when the revision of the Law of Property Act put the final nail into the coffin of feudal *land* rights. To quote Rudden once more: "… the property legislation of 1882 and its successor of 1925 ensure that the one type of property which can no longer be settled is *land*; what is settled – in the sense that the entitlement to income is dispersed among generations – is the fund" (Rudden 1985, 216).[12]

Liquidation Protection vs. Withdrawal Rights

Asset shielding and liquidation protection lock in assets, thereby rendering them illiquid. Feudal land was not a commodity that could be freely sold on markets but had to be exchange for land of equal quality. Trusts are designed to protect a pool of assets against withdrawal by the settlor, the trustee, and give beneficiaries such rights only if and when provided by the trust deed. Other forms of asset shielding also create lock-in effects, and, as HKS have shown, the stronger the asset shielding the greater the restrictions on withdrawal rights tend to be. Partners retain their full withdrawal rights but this comes at a price: exercising this right triggers the dissolution of the partnership and the destruction of wealth. In contrast, shareholders in corporations cannot take out the assets (cash or kind) they contributed. They belong to the corporate entity and are managed by the corporations'

[11] This is illustrated by the difficult of escaping student loans or credit card obligations in personal bankruptcy. These examples call for an inquiry not only when and how the privilege of legal protection is afforded to some assets or claims, but also when it is withdrawn.
12 Italics in the original.

fiduciaries, not the shareholders. Corporations may offer to buy back their shares subject to legal restrictions for protecting creditor interests, or may issue redeemable shares, if corporate law so provides. Yet, these are exceptions that prove the rule: in principle corporate entities are protected from withdrawal.

Remarkably, liquidation protection was fused over time with flexibility in asset allocation. Carruthers and Stinchcombe make the case for 17th century England (Carruthers and Stinchcombe 1999): By "absorbing illiquid government debt into their capital structure, and issuing homogeneous shares on the London stock market, joint stock companies in effect *liqiudified the national debt*" (ibid at 374; emphasis added). They focus on the standardization of claims to facilitate trading. Yet, the intermediation part was arguably of at least equal import. By placing corporations between the Crown and the investors, assets were delineated and protected; by issuing shares to investors they were simultaneously transformed into tradable claims that allowed investors to diversify, but also to use these newly minted assets to back other claims.

The most adventurous form of recombining asset shielding with full withdrawal rights are arguably open-ended mutual funds, and in particular, money-market funds (MMFs) that are equipped with full checking account facilities [Kim]. As trusts or corporations MMFs preserve asset shielding and liquidation protection while managing the pooled assets and substituting them over time. Unlike ordinary corporations they allow their investors (beneficiaries) to withdraw "their" assets at any point in time, a feature that was borrowed from the practice of banking.

The legal foundations for modern day banking also have a long history. The literature has identified several evolutionary paths – some suggest an evolution from bills of exchange to more complex credit relations (Ingham 2004); others emphasize the fusion of long distance trade practices by merchants with local banking practices in the context of a political and economic crisis (Padgett and McLean 2006); and yet others highlight the legal characterization of deposits as safekeeping and eventually as loan contracts with trust law sprinkled in between (Kim 2011, 2013). All explanations have some plausibility; indeed, their different geographic and temporal focus suggests that there was probably more than one path to modern banking practices. For the legal development that ultimately led to the rise of MMFs, the institutional path from safekeeping to deposit relations is, however, most illustrative (see Kim 2011).

In safekeeping contracts ownership and withdrawal rights remain with the depositor. The safe-keeper must guard the assets entrusted with him and return them in the same condition. These full withdrawal rights come at the expense of liquidity: the assets have to stay put. Modern banking would not be possible without relaxing this rule and allowing a bank to use the money deposited with it and invest it in *its own* name – a deed for which a safe-keeper or a trustee would be accused of theft or embezzlement. Indeed, the legal qualification of deposit contracts remained long in doubt (Kim 2011). The issue was finally settled in the mid 19th century, when it was held that banks were not trustees in relation to depositors; rather, deposits were deemed loans with the added feature that the object of lending was fungible money and not a specific good, and ownership could therefore safely be transferred to the bank subject to the contractual obligation to pay the same amount back on demand. As the Lord Chancellor held in Foley v. Hills in 1848:

> "Money, when paid into a bank, ceases altogether to be the money of the principal (…); it is then the money of the banker, who is bound to return an equivalent by paying a similar sum to that deposited with him when he is asked for it."[13]

And yet, the deposit contract gave depositors full withdrawal rights, thereby nurturing their illusion that the money was still theirs. This also facilitated the use of book money, the depositors' contractual claims, against the bank as a means of pay. Only on the occasion of bank runs is the true legal nature of deposit contracts as unsecured contractual claims revealed. To reassure depositors and maintain the illusion of "double ownership" (Kim 2011) of the bank and of the depositor, many countries have created private or public insurance schemes. This, of course, proves the point. Depositors do *not* own "their" money in a legal sense; they only have a partially insured contractual claim. While insurance caps can be modified – another instance of relaxing the rules of the game to make sure it continues – the depositor is at the mercy of the insurer.

An investor in MMFs does not even have as much. The promise that investors can always redeem their funds at full value is just that, a promise. It may trigger liability if breached, but against a defaulting, illiquid MMF that is not a powerful weapon. And yet, institutional investors and corporations have parked billions of dollars in MMFs for the higher interests they receive as compared with bank accounts the insurance limit of which they routinely exceed anyhow. When the Reserve Primary Fund "broke the buck" in September 2008, the Federal Reserve stepped in and

[13] Foley v. Hills and Others, II HLC 27 at 37.

provided liquidity by buying assets that MMFs would have otherwise had to sell at fire sale prices to meet the investors' redemption requests. It squared the circle of combining liquidation protection with full withdrawal rights by guaranteeing ex post the value of the assets[14] - no insurance premium charged. In other words, the Fed softened the budget constraints for MMFs without a consideration thereby signifying the hybrid nature of these entities. In the last instance their survival depends on the mercy of a public entity.

Tradable Property in Lieu of Withdrawal

The above analysis suggests that liquidity is not an economic epiphenomenon but a legal construct. Assets are transformed into abstract legal claims, multiplied, protected against downside loss, and transformed into tradable assets.

For shares to be freely tradable they had to be treated as personal property – another important legal innovation. HKS suggest that allowing shareholders to freely trade their shares was a way to compensate shareholders for restricting their withdrawal rights. This is a typical functionalist explanation, but getting there required quite some conceptual and doctrinal leaps. As Baron Parke remarked as late as 1837, "(t)he difficulty arises from confounding the corporation with the persons who take the profits: those persons have no right to anything but the profits … the company is as much distinct from the proprietors as one man with another."[15] It took courts some time to realize the implications of asset partitioning and restricted withdrawal rights for the legal status of shareholders. This was not made easier by the fact that in the 19th century the core asset of most corporations was real estate. English courts wrestled with the question whether the shareholders' stake should be "considered a legal or equitable *estate in real property*" (Rudden, 1985 at 237, emphasis added). This was not only an economic but also a deeply political issue at a time when the right to vote was reserved to land owners. Some courts even granted shareholders in companies whose assets consisted primarily of real estate the county vote (ibid).

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[14] In response the SEC has been pushing for MMFs to publish floating values of their assets to remind investors that their money may not be as safe as they think; under pressure from the industry this requirement has been curtailed to cover only funds with institutions as investors and assets comprising of corporate debt or municipal securities. In contrast, individual investors shall be protected in their (dis)illusion that a MMF is just like a bank account. See William Alden, "After Split Vote, SEC approves Rules on Money Market Funds,' The New York Times, 24 July 2014, available at www.nytimes.com (last visited 24 July 2014).

[15] Bligh v. Brent (1837) 2 Y&C Ex 268 quoted in Rudden (1985) at 228.

A more recent variant of reallocation assets without withdrawal is "rehypotheciziation". This practice refers to the serial use of the same security by the pledgor to secure the pledgee and then again by the pledgee to secure her own loan. The practice of re-pledging is not entirely new; brokers have long use it to secure financing from banks to fund loans to their customers under margin-call arrangements (Kettering 1998-2000). To secure the loan from the bank they used the assets pledged to them by their customers and re-pledged them. The pledgee did not have to wait until the debtor defaulted on the loan to seize the asset and enforce against it; she could simply double up and convert it into another pledge. The Uniform Commercial Code (UCC) in the US codified this practice, subject to approval of the original pledgee. In 1999 the UCC was further amended to allow for re-pledging without consent of the original pledger thereby paving the way for extensive re-hypothecisation in the context of OTC derivatives (Kettering at 1123): The asset that sold subject to the obligation to return it upon repayment of the loan is sold in another repo-transaction by the original creditor. Here again, multiple proprietary interests are created in the same asset and each can be used in further transactions multiplying its effect as 'security' for all these claims.

Liquidation Protection for Financial Assets

As we have seen, MMFs epitomize the combination of liquidation protection and full withdrawal rights. A further step in the same direction was granting liquidation protection (safe harbors in bankruptcy) to holders of financial collateral – money and securities that were used to back other financial transactions.[16]

The production and use of financial collateral is inextricably linked to the rise of securitization and the development of the markets for derivatives. Securitization has been used on a large scale only since the 1970s, first for residential mortgages and increasingly to transform commercial real estates, receivables, and other pools of assets including derivatives into more liquid ones. The legal technique is essentially the same as the one used by joint stock companies in early England (Carruthers and Stinchcombe 1999). First, the illiquid asset is placed in a pool that is segregated and protected against the original owners and their creditors; second, standardized claims against the pool are issued and traded. Originally, the pooling agent for mortgages in the US was a government-

[16] The term financial collateral itself is a creature of recent legal developments. See (Gullifer 2012)

sponsored entity, Fannie Mae, which also guaranteed the performance of the pool. It did not absorb the assets into its own capital structure as the joint stock companies had done in the case of England's national debt (Carruthers ibid). Instead it created pools of securitized assets that served as collateral for the claims issued to private investors.

Private agents subsequently copied the model.[17] Firms wishing to raise debt finance at costs lower than the market establish a special purpose vehicle (SPV) in the form of a trust or limited liability company and transfer to this entity certain claims, such as receivables. Depending on the standing of the debtor, an additional guarantee from a reputable financial institution, such as bank, may be added. For accounting purposes, this transaction can be deemed a sale of receivables to the SPV rather than liability even as for tax purposes to loan will be deductible [Claire Hill]. To be bankruptcy remote should the originating firm becomes insolvent, the transfer must be a "true sale", that is, the SPV has to be sufficiently independent from the sponsor. This can be achieved by placing an independent director on the board; or better yet, by appointing a trustee. Banks that developed the practice of serving as each other's trustee for the many SPVs they created.[18] The SPV then issues notes to investors who base their risk assessment on the default risk of the pool of assets in the SPV, not its sponsor. Ultimately, though their fate was determined by the latter and its ability or willingness to step in and back the SPVs when the value of the asset pool went into free fall. In a further twist, the receivables pooled in the SPV are, of course, contractual claims, but they serve as collateral for the notes the SPV issues to its investors, who benefit from their classification of collateralized assets as low risk in managing their own capital structure.

Last but not least, legal change was introduced that exempted certain contractual claims from the general operation of bankruptcy law. Most legal systems impose an "automatic stay" on all creditors, secured and unsecured, once an entity files for bankruptcy. This is meant to ensure a proper compilation of claims, an assessment of the prospects for reorganizing the insolvent entity or otherwise implement an orderly liquidation procedure that respects the priorities of pre-bankruptcy claims. Counter parties to derivatives – i.e. claims derived trough the delineating, pooling and repackaging them in law – are allowed to net out their claims. In effect, they have been given the status of property that can be freely removed from the pool.

[17] The first collateralized mortgage obligation (CMO) was issued in 1983 by Salomon Brothers and First Bank of Boston – but still jointly with FHLMC.
[18] See cases pending in NY 2nd Circuit [ADD]

A common justification for this special treatment of derivatives is that financial collateral differs from other forms of collateral, because it is liquid. Indeed, some authors have argued that safe harbors in bankruptcy are the shadow banking system's equivalent of deposit insurance in regular banking (Goralnik 2012). The liquidity *generated* by shadow banking, so the argument goes, warrants this kind of legal protection. This not only assumes that liquidity is unambiguously a good thing; it also turns causality on its head. Financial instruments *became* liquid because they were property-ised (Kim and Pistor 2014); that is, privileges otherwise associated with enumerated property rights were bestowed on contractual claims. It is unlikely that these markets would have expanded to multi-trillion dollar markets without the safe harbor protections (Roe 2011) that were first granted in the US in the Bankruptcy Code of 1978 to commodity and forward contracts; extended in 1982 to securities brokers and clearing agencies, and in 2005 to other derivatives, ensuring that "no derivative [was] left behind" (Sissoko 2009). The attractiveness of derivatives for structuring lending arrangements should not be surprising: who would not prefer a bankruptcy-proof claim?

By privileging counter parties to derivative contracts bankruptcy codes effectively "redistribute wealth from ordinary creditors to derivatives counter parties" (Edwards and Morrison 2005, 118). The legal implications of this are anything but clear from a doctrinal point of view. Some have argued that because securitization is designed to waive bankruptcy rules that are not at the disposition of private parties they could have been deemed illegal (Kettering 2008). Yet, few securitizations have ever been tested in courts and legal certainty was ultimately achieved by legislative intervention.

As we have seen, selective protection of some interests or assets against downside risk is a pattern that can be traced back in time. It seems an odd fit for capitalism, a system hailed for the discipline imposed by competition and hard budget constraints. In fact, this legal subsidy turns out to be critical for its operation.

4. Law and Global Capitalism

If capitalism is rooted in law and law is national, then global capitalism poses a puzzle. How can a system that is dependent on national law prosper outside nation states and the legal systems they

created? Possible answers lie in the convergence of laws across countries; conflict of law rules; and the creation of an autonomous body of transnational law.

Following Fukuyama's utopian assertion that with the collapse of the socialist world the end of history was in sight (1993), Hansmann and Kraakman predicted "the end of history for corporate law" (Hansmann and Kraakman 2001). Market forces, they suggested, would push national legal systems towards convergence on the most efficient institutions – i.e. those in support of markets and market-based allocation of assets.[19] Others have emphasized the resilience of domestic institutions that would continue to diverge (Bebchuk and Roe 1999); and some have taken an interim position suggesting that functional convergence is the most likely outcome (Coffee 1999; Gilson 2000). Notwithstanding differences of opinion, all assume that for convergence to occur legal change needs to take place at the level of the nation state; they differ on how likely this outcome is or how similar institutions must look for (functional) convergence to result.

A different path to global capitalism is conflict of law rules (referred to as private international law, or PIL, in the continental European tradition). They determine, which legal system shall govern a given case. PIL is domestic law applied by domestic courts once they established their jurisdiction. There has been a strong trend towards endorsing private autonomy in PIL, that is, to leave the choice of the applicable law to private parties (Watt 2010). The virtues of private choice of the applicable law were extolled in the debate about regulatory competition in corporate law (Winter 1977; Kahan and Kamar 2002) (Roe 2002) with parallels in other areas of the law, such as contracts (Gillette and Scott 2005) and financial regulation (Choi and Guzman 1997; Romano 2001). Much of this literature has a strong normative bent: market actors are said to know best the rules that suit their needs and should therefore be allowed to choose them. Top down harmonizers are said to be more likely to select the wrong rules, favor political rather than efficiency outcomes (Carney 1997), or create new divergences (Teubner 2001). An alternative view is that social preferences should trump private interests and that PIL should be employed to counter regulatory arbitrage, protect social preferences and preserve the distinctiveness of national law and legal institutions by extending the scope of national law beyond the territorial boundaries of the nation state (Fox 1997; Pistor 2010; Riles 2014). Yet, the global trend has been in the opposite direction.

[19] This is most explicit in quantitative studies where the size of financial markets is used as outcome variable; law that furthers expansion is deemed efficient. See the hugely influential studies by La Porta et al.

A third channel for globalizing capital is creation of a new body of transnational law. This can take the form of soft or hard rules that are private or public, or hybrid. Creating formally binding international law requires treaty negotiation, ratification, and subsequent transposition and implementation at the domestic level. However, in the age of globalization a new crop of "global rulers" (Büthe and Mattli 2011) has emerged: regulatory clubs such as the International Organization of Securities Commissions (IOSCO), the Basel Committee of Banking Supervisory (BCBS) or the International Accounting Standard Board (IASB) with members drawn from domestic regulators and/or the private sector. The recommendations of these bodies are not binding in a formal legal sense, but they influence regulatory practices in countries whose regulators are members of these organizations and they are often incorporated into binding legislation. Countries that refuse to abide by soft law are threatened with exclusion from markets (jurisdictions) that champion these rules.

Legal globalization has been supported by all three dissemination techniques. Conflict of law norms were invoked to protect legal innovation where possible by including choice of law and forum clauses; where this conflicted with legal norms found in key markets, thus creating the specter of intervention, the call for autonomy was replaced with the claim that only a 'level playing field', i.e. legal standardization, would ensure that markets would prosper. Slowly but surely, domestic law was side stepped or pushed aside. The crowning achievement in the quest to dislodge global finance from domestic law for now is the creation of a private transnational dispute resolution mechanism for financial claims (see infra).

Financial Contracts without Borders

The globalization of law by way of PIL, standardization and transnational law has also paved the way for globalizing shadow banking. Finance is one of the most tightly regulated industries. Every country with a sizeable financial sector has experienced financial crises in its past and typically responded to them by tightening regulations. In this catch-up game between financial innovation and regulation the governance of banks has taken the forefront. This reflects the historical experience of these entities as the primary locus of financial trouble. In response, financial innovation has increasingly moved to the fringes of regulated entities: to un- or less regulated

entities, such as MMFs, and to financial products that could be created without regulatory oversight, held off balance sheets, or employed to arbitrage around existing regulations. These strategies were carefully designed to formally comply with existing laws while exploiting openings in the regulatory scaffolding within and across countries. Indeed, the frictions between legal systems have been described as one of the most fertile grounds for regulatory arbitrage (Thiemann 2012).

To this end the financial industry has received from time to time a helping hand from regulators and legislatures – not surprisingly especially in countries with a powerful financial sector. In the US, the so-called Treasury Amendment (TA) to the Commodities Future Trading Commission Act of 1974 (CFTC) Act exempted derivatives from regulatory oversight. Treasury successfully argued that foreign currency futures trading was best left to the informal network of banks and dealers already active in these markets (Harvey 2013; Awrey 2013). The final language of the statute was sufficiently broad to exempt *all* derivatives (not only foreign exchange derivatives) from the CFTC's oversight for the next 40 years. Attempts to change this resulted in litigation and personnel changes at the top of the CFTC. Only in the aftermath of the global crisis have attempts succeeded to regulate OTC derivative – mostly by forcing them onto regulated exchanges.

The timing of the TA turned out to be prescient. In 1970, the first securitized mortgages were issued by the government sponsored entity, Fannie Mae (Hyman 2011, 228). This sparked the rise of the securitization market and the expansion of derivatives (Carruthers 2013). As we have seen, securitization is the first step in liquidifying assets by segregating and creating tradable stakes in a pool of illiquid assets (see supra); and derivatives are the next iteration. Structuring derivatives employs similar asset techniques for separating out default, interest rate, and liquidity risk and allocating them to different agents, or tailoring them for purposes of regulatory arbitrage.

As processes of financial intermediation shifted from entities to products and markets, transnational expansion was made easier too, especially as countries opened their borders to free capital flows (Eichengreen 2008). Banks might still choose to set up a subsidiary or branch office in a foreign jurisdiction,[20] but they were now able to attract investments in their products, hold or trade them on

[20] Establishing a subsidiary requires compliance with regulatory requirements in the new home country of the subsidiary as well as notification of the parent company's regulator. Establishing a branch is administratively easier, as it only requires notification of the host country, but exposes the parent to greater risks. These principles were established by the Basel Concordat of 1982 and subsequently refined. For details, see (Pistor 2010).

their own or their clients' account even without doing so. Moreover, they could shift the default risk associated with certain products to entities in different parts of the world that were fully insured by their home governments. The German state-owned Landesbanken were systematically employed as arbitrageurs in the shadow banking system to this end (Pozsar et al. 2010, 32).[21]

Being freed from the shackles of regulatory oversight did not mean that global finance operated outside the law. That would have defeated the purpose of globally scaled finance, which depends on the ability to enforce instruments created in one place elsewhere in the world. Scaling the new financing techniques globally required standardization of the products. Yet, in light differences between legal systems, standardization inevitably conflicted with the laws and regulations of some jurisdictions. The solution was the development of standardized contracts dressed with conflict of law clauses to insulated them as a far as possible from 'hostile' rules found in other jurisdictions and choice of forum provisions to minimize interference by domestic courts.

Financial intermediaries and their lawyers recognized the need for streamlining rules for global finance as early as the 1980s. While tailoring derivatives products to clients produced substantial fee income, it impeded scalability. That required some standardization. To this end the International Swaps and Derivatives Association (ISDA) was founded by the major financial intermediaries in these markets and their law firms[22] (Morgan 2008). The Association developed Master Agreements for different derivatives and has actively lobbied for legislative change and international standardization of rules related to ISDA products. ISDA's members have to commit to adopting the master agreements (MAs) in their transactions even as they tailor them to the specific needs of their clients. This was facilitated by separate 'schedule's deemed part of the agreement, an arrangement that killed two birds with one stone: enough standardization to ensure that instruments would be marketable *at scale* and sufficient differentiation to justify higher fees. Further, ISDA urged its members to use choice of law clauses to adopt English law or New York law as the default legal system to fill any gaps in these contracts (Braithwaite 2012). As a default, MAs also provide for the jurisdiction of the courts of England and Wales or New York.

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[21] The post crisis debate faulted primarily the banks and the fact that state ownership had rendered them unfit for competitive markets. This argument misses the strategic role these and similar entities (such as the GSEs) played for these markets. It is at least plausible that the markets would not have taken off to the extent they did absent the public backstopping built into the system through these intermediaries.

[22] A list of members can be found on the association's web site; see http://www2.isda.org/membership/members-list/ (last visited 30 July 2014).

In short, ISDA created a fairly autonomous regulatory regime for globally traded financial instruments employing contract law. And yet, this regime does not and cannot reside in a legal vacuum. It employs domestic contract law of select jurisdictions for structuring agreements and for filling gaps in master agreements that are inevitably incomplete. Several disputes were litigated in recent years over the core netting provision of the MA (see supra), which left sufficient ambiguities for reasonable people to disagree (Braithwaite 2012). The English courts called upon to resolve this issue interpreted ISDA Master Agreements in ways that differed with positions ISDA took in amici briefs. They also indicated the precedential value of their rulings by stating the need to clarify once and for all the meaning of these widely used contracts. The latter in particular put ISDA on notice; for all its sophistication in drafting standardized contracts the organization does not control their interpretation and can't even ensure that courts in the default legal system (England!) follow its lead. ISDA may, of course, amend the MA in response to rulings that obvert the association's goals. Yet, this does not eliminate the wild card in the system, domestic courts parties may invoke by filing claims and who may, against all odds, assert their jurisdiction and issue rulings with prospective effects. The answer to this challenge is a new disputes resolution tribunal established in the Hague, the capital of international law.

The "Panel of Recognized Market Experts in Finance", or PRIME,[23] is not an international court, but a private arbitration panel. Yet its location invokes the authority of international tribunals located in the same city (Golden 2008). Situating PRIME in London or New York would have given a rather different impression. PRIME's explicit goal is to take transnational financial disputes out of the hands of domestic courts that lack the expertise and understanding of the needs of the global financial market place.

The beauty of this arrangement is that global financial contracts will be taken out of the hands of domestic courts, while they can still be employed to enforce PRIME's rulings. This is possible, because most countries around the world have ratified the 1958 New York Convention on the Recognition and Enforcement of Foreign and International Arbitral Awards. It requires member states to employ their coercive powers to enforce awards rendered by foreign or international tribunals without reviewing their merits. A similar arrangement does not exist for enforcing court

[23] The tribunal opened its doors in 2013. See http://primefinancedisputes.org/ for details (last visited 29 July 2014).

rulings. Only if public policy (*ordre public*) is implicated can domestic courts review the merits of the case, an exception that has been interpreted restrictively by most courts (van den Berg 1981). Shifting dispute resolution to arbitration has another major advantage: It makes it much harder to police the boundaries between areas of law where private autonomy shall rule and others deemed not at the disposition of private parties.[24] The reason is that arbiters appointed by the parties will make this decision and their decisions can be reviewed only in annulment procedures or in the unlikely event that domestic courts invoke the *ordre public*.

Minting Collateral for Global Use

As discussed, one of the major accomplishments of law in support of capitalism is to transform contractual into property-like claims, a process Kim and I have elsewhere described as "propertyization". Property-ization has also become a hallmark of global capitalism especially with respect to collateral. This is remarkable, because property rights are deeply embedded in local political, social and legal structures (Licht, Goldschmidt, and Schwartz 2007). This is most apparent for land, not the least because statehood is defined by control over territory. Locality matters, however, also for movable or personal assets. Most conflict of law rules use the location of an asset as the connecting factor in property disputes. In principle this should also apply to collateral, which is a right *in rem*.

Securitization and collateral are the central pieces in the shadow banking system that emerged in the US since the 1970s and has spread around the globe. Dislodging collateral from local law was therefore critical for the rise of global shadow banking. The parallel financial system that has emerged since the 1970s performs similar functions as the regular banking system. However, it does so in different ways and uses different legal institution to accomplish its goals. In the words of Pozsar et al. (2010, 13), " (i)n essence, the shadow banking system decomposes the simple process of deposit-funded, hold-to-maturity lending conducted by banks, into a more complex, wholesale-funded, securitization-based lending process that involves a range of shadow banks." Collateralization is key for shadow banking as it provides backup for contractual claims that lack other guarantees, such as deposit insurance. Collateral is also important for regulatory arbitrage, as

[24] See the discussion of autonomy in PIL supra.

secured loans are deemed to be less risky and therefore subject to lower capital adequacy requirements or discounts (haircut) (Segoviano et al. 2013).

For global capitalism to expand it needed collateral that was elastic rather than fixed and would be enforceable in the courts of key markets. At a time when only tangible assets were recognized as legally valid and perfecting a collateral required that the asset used as security was handed over to the creditor (as in most civil law jurisdictions until quite recently), the law was simple and enforcement predictable. By the same token, asset backed financing remained highly constrained. Legal change over the last two decades ensured that financial intermediaries were allowed to mint their own collateral and that these privately created property rights would be recognized in the courts of key markets.

Change was first introduced in the US, where a revision of the New York state version of the UCC relaxed perfection requirements for financial collateral. It also extended the contractual choice of law clause already built into the code to financial collateral thus created (Kettering 1998-2000). As a result of these changes, financial intermediaries could create collateral without as much as registering it. This shifted the right to enumerate property rights from states to private parties. Financial intermediaries were also put in a position of choosing the law that would apply to the rights *in rem* as they could determine where the asset would be issued, i.e. by creating a new entity in the preferred jurisdiction. This in turn was made possible by the spread of the incorporation theory for determining the law applicable to corporation. Whereas in the past quite a few countries insisted that a corporation had to be registered where its head quarter or main place of business was, the predominant PIL today is that a legal entity that complied with the law of the place of incorporation of its choice would be recognized by other legal systems as well irrespective of where it does its business.[25]

Still, this did not rule out the possibility that a domestic court in some jurisdiction would use domestic PLI and apply local law.[26] This example shows that contract law and PIL are insufficient

[25] The battle between incorporation and seat theory waged until the first decade of the 21st century. The European Court of Justice ultimately forced the remaining jurisdictions in Europe to abandon the seat theory that had governed since the late 19th century in the name of free mobility of capital and legal persons. See(Wymeersch 2000)on the first major decision that paved the way (Centros); [ADD REFs]

[26] Indeed, an legal opinion ISDA commissioned on German law suggests that the *in situ* rule would be applied. [ADD]

for creating a robust global legal framework for financial collateral. More was needed and the solution was legal harmonization in key jurisdiction. Legal harmonization was facilitated by supranational bodies, in particular the EU, which can issue secondary law that is binding on member states and may be invoked by private parties under the ECJ's direct effect jurisprudence. ISDA prides itself with spearheading the discussion that led to the adoption of the EU's Financial Collateral Directive (FCD). The association created the "Collateral Law Reform Group" in 1999 and issued a report in the same year that singled out

> "the many obstacles then existing to efficient creation, perfection and enforcement of financial collateral arrangements in Europe, including cumbersome and archaic formalities, restrictive insolvency law rules and other difficulties in the then 15 Member States."[27]

While the FDC did not follow all of ISDA's recommendations, the directive as enacted in 2002[28] prohibits member states from imposing any formal requirements on the "creation, validity, enforceability or admissibility in evidence of any financial collateral arrangement" (Art. 3); ensures that the financial collateral holder can exercise a right of use (i.e. re-hypothesize the collateral) (Art. 5)[29]; recognizes close-out netting provisions (i.e. safe harbor clauses in bankruptcy) (Art. 7) and streamlines conflict of law rules, by insisting on book entry as the relevant "location" of the collateral (Art. 9). Thus, the directive incorporated the most relevant legal elements for legalizing the private minting of collateral in EU member states.

The directive brought about substantial change even in England, which on this occasion was not at the forefront of innovation. England excelled, however, in not making use of any of the carve outs the directive provided and instead used it to "disapply" key aspects of its own collateral and insolvency law. As critiques have remarked (Gullifer 2012), this was done mostly for purposes of financial expedience without much thought given to the purpose of the rules that were overruled, much less a debate as to why financial collateral was privileged over other collateral. Perfection

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[27] ISDA Letter to the European Commission, Internal Market and Services DG of 3 April 2006 in response to an inquiry by the Commission on the implementation of the 2003 FDC. Document available at http://ec.europa.eu/internal_market/financial-markets/collateral/consultation_results/docs/isda_en.pdf (last visited 30 July 2014). See also ISDA's comments on the proposal for the said directive available at https://www.isdadocs.org/speeches/pdf/pos.collateral.pdf (last visited 30 July 2014).

[28] Directive 2002/47 of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements, L168/43 (2002), available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32002L0047&from=EN (last visited 30 July 2014).

[29] An exception is made only for member states that in the past had not allowed appropriation and wish to maintain that rules (Art. 2(3)).

requirements had been created for a reason, as Gullifer (2012) suggests, namely to ensure that others had notice of pre-existing claims to an asset and prevent the false appearance of wealth in cases were most assets were encumbered. By freeing financial collateral from these constraints the re-use of collateral or repos was formally legalized. The EU directive thus achieved in one big swoop what otherwise might have taken many more years to accomplish: overcoming concerns of legal policy and consistency of domestic legal regimes.

Within the EU, the standardization of collateral had yet another important effect. The introduction of the common currency, the Euro, created the need for a policy instrument that would convey the European Central Bank's inflation target to market participants within the monetary union. In the absence of a common sovereign debt instrument comparable to the US treasury bill, the ECB increasingly relied on collateralized over night lending operation for monetary policy. This has placed collateral at the heart of the Euro-system at least prior to the crisis.[30] This made the ECB a critical liquidity provider for the global shadow banking system. Not surprisingly, the ECB has used its secondary rule making powers extensively to set collateral guidelines (Cheun, Köppen-Mertes, and Weller 2009). The FCD set common standards for collateral throughout the EU; and the ECB complemented this achievement by establishing criteria for ECB eligible collateral for the Eurozone (Papadia and Välimäki 2011). In fact, the ECB fully endorsed the adoption of the financial collateral directive (FCD),[31] emphasizing its contribution to legal certainty, the management of credit risk, *and* European monetary policy. In its comments on the original draft directive it only bemoaned the fact that some provisions did not go far enough, expressing its concern that "other types of financial risk management *commonly used in financial markets* would be regarded as being unenforceable" (ibid recital 3). In other words, rules, regulations and ECB guidelines should follow the markets by conferring on privately minted assets the privilege of property.

The use of collateral as building block for shadow banking and for monetary policy thus illustrates the interdependence of the financial and monetary system – notwithstanding conventional

[30] With the collapse of securitized asset markets in the crisis there has been a decline in assets not only in the Euro area. This decline implies that the recently announced ECB policy to purchase such assets to provide greater liquidity will not have quite the effect that is intended.

[31] The ECB has the power to issue opinions on legislative acts by the Council or Eurozone member states that affect its policies. On the FCD see Opinion of the ECB of 13 June 2001 at the request of the Council of the European Union concerning a proposal for a Directive of the European Parliament and of the Council on financial collateral arrangements, C196/10, 12 July 2001, available at http://www.ecb.europa.eu/ecb/legal/pdf/c_19620010712en00100013.pdf (last visited 30 July 2014).

approaches in economics to treat them separately (Mehrling 2007). It also supports the notion that finance – the core feature of capitalism – is essentially hybrid.

"Stateless Trusts"[32] *and Other Creatures of International Law*

Harmonization thus can be a powerful tool. Still, uncertainties remain, since legal standards are transposed or interact differently with pre-existing legal institutions, thereby creating "irritations" not only in domestic law (Teubner 2001), but also new frictions in the body of law that was to be harmonized. Legal institutions that reside outside domestic jurisdictions can mitigate this problem. The "stateless trust" (Smith 2013) is an example of such an innovative legal solution.

Trusts are important legal constructs to facilitate asset shielding and liquidation protection (see supra) and are therefore widely employed in securitization.[33] Other organizational devices, such as the corporate form or limited partnerships can also be used to similar ends, but they are less flexible and typically come with higher entry requirements. The problem with trusts in the global context is that they do not exist in the civil law. Domestic courts in these jurisdictions may therefore refuse to recognize it or the asset partitioning it was meant to achieve. Some civil law countries have developed functionally equivalents to trusts, such as "separate patrimony" or "real subrogation" (Raczynska 2013). However, this does not guarantee that courts will trust structures as equivalent or afford the same protection to them.

The "Convention on the Law Applicable to Trusts and on their Recognition" has addressed this problem. The Convention was adopted by 32 countries in 1985 and has entered into force in 12 countries (including in tax havens, such as Luxembourg and Switzerland), only one of which is a common law country (the UK). For purposes of conflict of law rules, the Convention treats trusts as contracts: The settlor shall determine the law; if a determination is lacking the law "with which it is most closely connected" (Art. 7) shall govern. Importantly, a trust that is validly established in accordance with the applicable law shall be recognized as a trust (Art. 11) – even if it is not known in the recognizing system. In this way, the common law trust was smuggled through the backdoor into civil law systems where it can exert legally binding effects– a unique achievement in the world of

[32] (Smith 2013)
[33] The term financialization is of recent vintage and has acquired various meanings. It is used here to depict the transformation of illiquid assets into financial assets. See also (Krippner 2011).

conflict of law, where recognition typically implies that a comparable institution exists in the recognizing country.

There are other examples where international legal instruments are used not to harmonize domestic law but to outsource legal institutions from domestic legal oversight. The prime example is bilateral investment treaties (BITs). These treaties incorporate their own, comparatively broad, definition of investor rights that should be protected by expropriation remedies typically reserved for property. BITs often list a whole panoply of such rights that include licenses, concessions and contract claims. The interpretation of these treaties is delegated to arbitration tribunals who, quite purposefully, tend to have little if any knowledge of the host country's law in question (Roberts 2013). BITs have given rise to hundreds of disputes in the course of which a new body of transnational property law may be evolving notwithstanding property's traditional attachment to local law (Lehavi and Licht 2011). Originally designed primarily for protecting foreign direct investment against nationalization or expropriation, they are increasingly mobilized to challenge host government actions on regulatory matters, including the restructuring of sovereign debt or bank restructuring that may conflict with the interests of foreign creditors.[34] The conventional distinction between debt and equity, contract and ownership, is blurring also in this domain.

Global Capitalism – Legally Constructed

Capital assets don't exist in nature but are creatures of the law. Global capitalism does not need a global state or global law, because national law is scalable. As long as legal institutions are allowed to move across borders – itself a legal act – it can sustain institutions and practices in the transnational realm. Not all legal institutions travel equally well; nor are all countries equally equipped to deal with the volatility that some institutional arrangements might entail. As we have seen, the extension of the privilege of property to new assets selectively has been a core feature of capitalism, both domestic and global. This is bound to create and *unlevelled* playing field. Extending it to all would obviously inflate the value of property rights; selectivity is key for creating value and by the same token the root cause of inequality (Piketty 2014).

[34] See *Abaclat v. Argentina*, No. ARB/07/5, Decision on Jurisdiction (ICSID 2011) holding that BITs can be invoked by bondholders of sovereign debt; see also *Ambiente Ufficio S.p.A. Argentina*, No. ARB/08/9, Decision on Jurisdiction and Admissibility (ICSID 2013); see also the pending claim (No. ARB/12/29 ICSID) *Ping An Life Insurance Co. of China v. Belgium*, for a challenge by Chinese bond holders in Fortis against the restructuring of the bank.

5. The Political Economy of Global Capitalism

The analysis presented in this essay has shown that the core elements of LTF can be employed to explain the legal foundations of global capitalism. One element that has been hinted at but requires fuller treatment is the political economy of (global) capitalism, in particular how law relates to power.

This question is typically posed as one of crisis management, although it also plays into how rules are made, who has framing powers over such rules, etc.. Still, the state of emergency clarifies the issues at hand: If upholding the legal order might trigger its very demise, can or should it be suspended, and if so by whom?.[35] This debate concerns primarily the constitutional order, but as Agamben has argued, can also be applied to the economic order. War times are periods when not only human, civil and political rights are vulnerable, but contracts and property rights too are being relaxed in the face of overarching military concerns. Depending on their severity – actual or perceived -- financial crises have similar characteristics. If the full faith and credit of the financial system and/or the sovereign that is backing it is at stake it only makes sense to ask whether *pacta sunt servanda* should trump over ex post interventions that effectively suspend their full force. Here too the question is, who gets to decide. Within a single polity such as a nation state the power to suspend the full force of the law has ben associated with the sovereign (Carl Schmitt) – or one of its agent. In global capitalism sovereignty and agency are more difficult to pin down. There is no central lawmaker, executive, judiciary or designated global central bank.

State sovereignty is expressed by the power to control people within the territorial boundaries of the state in question; indeed state sovereignty is largely, though not completely, bounded by territory. With legal transmission belts in place that allow legal institutions to travel these boundaries have become ever more porous. Consider the ability of corporations to act as sponsors of subsidiaries that operate in foreign jurisdictions yet governed by the laws of the home or even a third country. The rise of corporate power has prompted a discussion about "corporate sovereignty". It resides, as Barkan (2013) has shown, in the "negative spaces of the international state system". Corporations

[35] See (Agamben 2005) for an excellent review, in which he traces the debate back to the Roman concept of *Iustitium* and situates Carl Schmitt's contribution in this debate.

(and their agents) operate and expand their mandate in areas where state power does not reach intentionally or where loopholes remain.

In a similar vein, financial sovereignty can be depicted as the space where state and financial intermediaries (corporations) meet and their respective survival is determined. Sovereign is whoever has the power to determine the survival of the other side, which is a function of the relative size of their balance sheets and their willingness to employ it to launch a rescue operation. There are many examples of private entities often reprieve to sovereigns either voluntarily or through pressured if not coerced "private sector involvement" (PSI) as the International Monetary Fund likes to call this arrangement. In the last instance it requires access to unlimited source of high-powered money; this, as we have seen, is a characteristic of public, not private entities. Financial sovereignty thus implies controlling the asset of last resort for global capitalist system.

In the period of the gold standard, this place was occupied by whoever had accumulated most gold, England until World War II, and the US thereafter. Ever since the US has abandoned the gold standard, fiat money has taken its place, or more precisely, the US dollar as the global reserve currency. Its place at the apex of the global financial system is determined by the credibility in the eyes of investors of the American polity to step in and back the currency now and in the future.

During the global financial crisis the US Federal Reserve has effectively performed the role of lender and dealer of last resort. It has backstopped the US financial system and extended a helping hand to sovereigns and financial intermediaries elsewhere through lending facilities created on the basis of its emergency (sic!) lending powers. The Fed did not act entirely on its own, however, but cooperated with other central banks. The post-crisis arrangement is increasingly looking like an oligopoly, a consortium of six central banks (C6): The US Federal Reserve, the Bank of England, the European Central Bank, the Swiss National Bank, the Bank of Canada, and the Central Bank of Japan. In the midst of the global financial crisis they created swap lines amongst each other to protect the international payment system and ensure that contracts denominated in their respective currencies could be performed even if one of the central banks experienced short fallings in its foreign exchange reserves (Obstfeld, Shambaugh, and Taylor 2009).

These arrangements have meanwhile been made permanent by a little noticed announcement of the named central banks.[36] It is a remarkable example of ad hoc institutionalization of transnational legal arrangements without public oversight. At the time this announcement was made the global crisis had subsided. Emergency powers could therefore no longer be evoked. Nothing in the statutes of the C6 empowers these agencies explicitly to engage in global financial governance. They can only invoke the general mandate to stabilize their respective *domestic* currencies – a nice example of law being designed ex ante as highly incomplete, precisely to give the central banks the powers to do "whatever it takes" in Ben Bernanke's famous terms in the midst of a crisis. But it also illustrates the accountability problems inherent in ambiguous legal standards.

The central banks have been legally constructed as independent agencies in their respective jurisdictions that are purposefully protected against direct political oversight. Insulating central banks from politicians was deemed crucial for ensuring that they would fight inflation – the old nemesis of financial stability – against spendthrift governments. The power inherent in this arrangement has not been employed to ensure that they could support countries and economic systems of *their* choosing in times of crisis. Only the home countries of the six central banks are insured against running out of foreign reserves in the world's major currencies; non-members are not, but will have to bargain for similar arrangements on an individual basis[37] or hope for hoc arrangements in the midst of a crisis.[38] Either outcome is most likely for countries that might pose a threat to the country granting the benefit – i.e. have deep financial and economic relations with it that might expose both sides to the risk of economic collapse should one of them run out of the other's currency. Countries that have insufficient economic weight in the global economy will have to fend for themselves or seek help from the IMF.

To insure themselves against this risk, many emerging markets have accumulated huge foreign exchange reserves – parked typically with leading banks in major financial centers. The reserves generate moderate returns even as foreign capital from better-insured markets pours into them in

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[36] See, however, Pistor, "Central Banking's New Club Class" in Project Syndicate, 2 December 2013, available at http://www.project-syndicate.org/commentary/katharina-pistor-crticizes-the-new-great-divide-in-international-monetary-management (last visited 30 July 2014).
[37] The People's Banks of China, for example, has entered into a separate swap line with the Bank of England.
[38] This happened during the global crisis, when the Fed included Singapore and other select emerging markets within the perview of ad hoc swap lines. However, these countries have not been included in the permanent swap lines created in late 2013.

pursuit of higher yields, thus exposing them to the very risk against which they are seeking insurance. The cost of this arrangement is that, according to IMF estimates, somewhere between twelve and twenty percent of world GDP (Segoviano et al. 2013) is neither invested nor used for other social objectives as determined by the polity of that country. Where a country finds itself in the global system of capital is hugely dependent on its access to the world's major currencies in times of crises. The particular arrangement cobbled together by the C6 creates preferential treatment for some and thereby discriminates against others. They have created a club good not a public good, which will affect the operation of financial markets already at the ex ante stage.

For all their independence, the power of central banks is not unlimited. Legislatures may curtail their powers – as the Dodd-Frank Act has done in the US[39] and reform legislation has done in other countries as well (Gadinis 2012). This addresses one issue – the question of central bank accountability – but it does not resolve the more fundamental question as to who should legitimately have the final say over suspending the rules of the game domestically or globally. If politics is about power and power about choosing winners and losers then this is ultimately a political question.

At the global level we are thus facing a paradox in the governance of finance and capitalism that is not dissimilar to the one we encountered at the domestic level, but arguably more severe: Global capitalism is a creature of law and of legal devices that facilitate the creation of capital assets by employing legal devices that create multiple claims that are mutually compatible only as long as no serious attempt is made to enforce them simultaneously. Whenever too many try and doubts appear about the ability of all to get their money's worth, the system must collapse – absent fraud or snake oil traders, although they admittedly exacerbate the problem. The system is therefore inherently prone to crises and ultimately dependent on backstopping by entities with potentially unlimited resources. These are by definition public, not private. There is obviously more than one way to allocate these resources even in the midst of a crisis. That effect who the ultimate risk bearers of the system are. The greater the focus on protecting existing capital assets against devaluation, the greater the share or non-asset holders, and the greater ultimately the divergence between capital and growth.

[39] Sec. 1100 of DFA seeks to curtail the lending powers of the Fed by emphasizing "unusual" circumstances and stressing that any relief is for liquidity purposes, not for rescuing an insolvent institution. However, at the same time the scope of eligible entities is expanded so that the net effect of the reform is somewhat ambiguous.

Equally important are remedies against the practices that led to the crisis in the first place. Hyman Minsky famously argued that in the midst of a crisis the rescue of the system should take center stage; but he also called for a critical review of the practices that led to the crisis and their invalidation. As he himself acknowledged, this has rarely happened even within a single polity, such as the US (Minsky 1986). One the crisis has been overcome – by suspending the full force of the legal commitments that led to it – there is little appetite left for reform, and if those who benefited most from the system survived the crisis largely unscathed, even less. At the global level there is no polity that could possible address this issue and the fora that do exist – such as the Financial Stability Board (FSB) – are representatives of national regulators who device the rules for global finance and capitalism behind closed doors. Tellingly, the FSB started off as another arm of the G8 created as the "Financial Stability Forum" in the aftermath of the East Asian financial crisis. Only in the 2008 global crisis was membership extended by US President George W. Bush to other countries that had manifestly become part of the global financial/capitalist system. For FSB recommendations become legally binding, they must be presented to domestic legislatures at some stage; but they can be highly effective even without *all* legislature's stamp of approval as long as they are implemented in the largest markets.

Hierarchy, as Mehrling (2012) argues, may be *inherent* to money or finance, and by implication to capitalism. But its nowhere more pronounced than at the global level where cost sharing arrangements are almost completely absent. There is no resolution regime in place for transnational financial intermediaries, even though the multinational effects of a failure of such an entity have been known since the infamous Herstatt case of 1974 when German regulators closed down a bank with many open trading positions in New York in the middle of the trading day. There is no international resolution regime for insolvent sovereigns. The most we have been able to stitch together are ad hoc arrangements for specific countries or crises, such as the London and Paris Clubs to address the fallout from the Latin American debt crisis. Attempts to create a global bankruptcy regimes advocated by the IMF's vice president, Anne Krueger, in the early 2000s were blocked by the US Treasury before they were discussed more broadly. There is no collective insurance regime countries that are most affected by a crisis could tap into without being penalized. They may turn to the IMF or the Troika for help but at the cost of relinquishing part of their sovereignty for the duration of the loans. And they are being told time and again that it is there job to follow the rules. Suspension of the law is quite explicitly available only for those closely to the

apex of the hierarchy of global capitalism. There is no global tax regime that could ensure some redistribution within the global capitalist system in accordance with normative goals the majority of the populace affected by it might prefer. And there is, of course, no free movement of people to places where they might escape the full brunt of a system that invariably is prone to crises.

6. Concluding Comments

Max Weber is frequently quoted for his assertion that a rational legal system is a precondition for capitalism to emerge. Weber certainly recognized the importance of predictability in the sense of one's ability to rely on general, standardized rules that will be enforced according to established procedures. However, he also recognized that capitalism can be sustained by legal systems as different as the common law and the civil law, the former based on greater reliance on ad hoc, fact specific rule generation, the latter on formalistic reasoning. Commercial law, i.e. the law governing stock markets, commodity exchanges and trade, he suggested, are examples of "modern particularism" in the age of legal rationalization. He attributed this to two factors: First, "occupational differentiation and the increasing attention which commercial and industrial pressure groups have obtained for themselves"; and second, "the desire to eliminate the formalities of normal legal procedure for the sake of a settlement that would be both expeditious and better adapted to the concrete case" (Weber 1978). He described this as a widespread phenomenon already in his own time. And yet, he himself would have probably been surprised by how far legal particularism and the style of capitalism it supports were carried over the following century. The best illustration for legal particularism in the age of globalization is probably ISDA with its own court, the panel of recognized international experts in finance (PRIME). Other examples abound, including private arbitration for adjudicating laws promulgated by sovereigns, including democratic legislatures, or the delegation of governance over entire market segments to key market participants as in the case of OTC derivatives.

This did not happen in one straight evolutionary development. The disaster of the Great Depression and World War II gave rise to renewed attempts to coordinate monetary policies within the Bretton Woods system (Eichengreen 2008). That experiment largely failed – as did attempts in Europe to coordinate exchange rate policies before finally trying to resolve the issue once and for all by

introducing of the Euro. That experiment too has badly backfired, as the unending Euro crisis evidences.

It is tempting to attribute this to the fallacy of any attempt to govern markets and instead suggest that they should best be left to regulate themselves -- with a helping hand extended from time to time to ensure that transaction costs are kept in check. And yet, as others have argued (Hodgson 2014) and as this essay has tried to emphasize: neither finance nor capitalist system it sustains exist outside, but are structured in, law. The failure of domestic of international public governance can therefore not be assessed without considering the other side of the hybrid coin: private law institutions. Efficiency and private autonomy have been used for widening the scope of legal particularism in business and finance supported by conflict of law rules that allowed legal institutions to travel across jurisdictional boundaries. Governance by general norms that apply equally to all sits uneasily with the legal privileges that comes with particularist regimes. Moreover, such a system tends to be hostile to cost sharing arrangements. This redistributes the system's costs to the least mobile, who also tend to be at the lower end of the income and influence scales.

An observer of the global financial system commented at a close-door event that absent a workable transnational resolution regime for financial intermediaries – which would require cost recognition and cost sharing – open borders for capital may not be sustainable. The argument can be broadened to apply to global capitalism without cost sharing especially in, but not limited to finance.

Before concluding I should delineate this argument from the well-known policy trilemma of globalization, democracy, and national sovereignty. Dani Rodrik has argued powerfully that it is possible to attain two of these goals, but not three. Globalization might work, if all played by the same rules established by a global rule maker, yet few if any country is willing to relinquish sovereignty to the extent such a regime would require. Conversely, national sovereignty might be compatible with globalization, but only by sacrificing democracy. Finally, democratic self-governance at the national level is workable, but would restrict the scope of globalization.

The argument developed in this essay shares similar concerns, but its emphasis is different. First, the tri-lemma applies only to some, not all countries. Countries at the top of the global system can have it all – at least as long as they can marshal the resources to rescue the system from its own follies.

This makes these countries particularly unlikely proponents of cost sharing agreements, which would compromise their ability to rescue their own system. On the system's periphery national sovereignty is already curtailed even in the absence of a global government that would standardize rules. In other words, these countries face a "policy dilemma" rather than a policy trilemma (Rey 2013):[40] they already relinquished sovereignty and have to cope with the tension between globalization and democratic self-governance.

Second, the idea that standardizing rules at the global level would alleviate the problems of global capitalism appears deeply flawed from the perspective of the LTF framework. In a system that is inherently instable playing by *always* by the rules will precipitate disaster. The critical governance challenge thus is not legal harmonization but where the power resides to suspend the rules in a crisis on which this system founded, and for whose benefit. Relatedly, a rule bound system will always have regulatory arbitrage as a defining feature -- just as there will always be tax avoidance in a system that imposes a direct charge. Obtaining exceptions or working around costly rules become the strategy for creating comparative advantages over competitors. The answer to this is not abolishing all laws or standardizing them once and for all. Instead, it has to be an evolving process of monitoring and adapting rules in light of changing circumstances and in view of shared norms of all stakeholders in the system, not only those of the likely winners.

Third, global capitalism was not created by the Washington Consensus; its genesis is much older and rooted in the law of property and trusts that predates the age of capitalism. This makes the system much more deeply entrenched than this policy critique would suggest. Without the policies pursued under the Washington Consensus – in particular liberalization (i.e. deregulation) and privatization -- have facilitated its expansion. Of equal importance was legal change that ensured the mobility of legal institutions across jurisdictional boundaries. Once in place, this system rooted in decentralized hard-wired institutions is difficult to dislodge. That poses a challenge not only to national sovereignty and democratic governance, but also to globalization. It takes a polity that is willing and able to backstop a capitalist system from self-inflicted collapse.

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[40] Note that Rey discusses a different trilemma, that of monetary policy with floating or fixed exchange ranges in a world of free capital flows. The trilemma states that in a financially interdependent world, fixed exchange rates transmit monetary policies from the center to the periphery of the system. The corollary is floating exchanges rates which are said to lead to monetary policy independence. Instead, she argues that in a globalized world monetary independence can be attained only by macroprudential management of capital accounts (ibid.

Capitalism has, of course, survived much longer than Marx ever predicted – albeit not without severe crises. This has been attributed to its self-healing, rejuvenating capabilities (Kaletsky 2010). Viewed through the lens of the framework employed in this essay, capitalism is sustained by law: binding commitments on the upside, and their suspension, where necessary on the downside. It looks more like a non-mutual symbiotic, or parasitic, relation between two species in which one lives off the other. The point is that capitalism is more dependent on its host – a polity willing and able to backstop it – than is often realized. As long as the polity is playing along this works; but the lifeline may not be infinite.

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