

The Code of Capital

How the Law Creates Wealth and Inequality

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PRINCETON UNIVERSITY PRESS

PRINCETON AND OXFORD

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Empire of Law

It looks like an elephant's head: the line that represents the growth rate and the amount of wealth captured by different income groups globally between 1980 and 2017; fittingly, it is called the "elephant curve."¹ The broad forehead holds 50 percent of the world's population; over the past 35 years they captured a paltry 12 percent of growth in global wealth. From the forehead a curve leads down toward the trunk and from there, steeply up to the raised tip. The trunk is where "the one percent" sit; they hold 27 percent of the new wealth, more than double the amount held by the people clustered together on the elephant's forehead. The valley between the forehead and the trunk is where lower-income families in the advanced Western market economies are bundled together, the "squeezed bottom 90 percent" of these economies.²

It was not meant to be this way. The 1980s witnessed a surge in economic and legal reforms in developed and emerging markets alike that prioritized markets over government in allocating economic resources, a process that was further galvanized by the disappearance of the iron curtain and the collapse of socialism.³ The idea was to create conditions by which everyone would prosper. Individual initiative protected by clear property rights and credible

contract enforcement would, so the argument went, ensure that scarce resources would be allocated to the most efficient owner, and this in turn would increase the pie to the benefit of all. The playing field may not have been leveled, but the prevailing wisdom was that by freeing individuals from the shackles of state tutelage, all would eventually benefit.

Thirty years later, we are not celebrating prosperity for all, but instead are debating whether we have already, or not quite, reached levels of inequality that were last seen before the French Revolution, and this in countries that call themselves democracies, with their commitment to self-governance based on majoritarian, not elite, rule. It is hard to reconcile these aspirations with levels of inequality that smack of the Ancien Régime.

Of course, there has been no shortage of explanations. Marxists point to the exploitation of labor by capitalists.⁴ Globalization skeptics argue that excessive globalization has deprived states of the power to redistribute some of the gains capitalists make through social programs or progressive taxation.⁵ Finally, a novel interpretation holds that in mature economies capital grows faster than the rest of the economy; whoever has amassed wealth in the past, therefore, will expand it further, relative to others.⁶ These are at least partly plausible explanations, but they fail to address the more fundamental question about the genesis of capital:⁷ How is wealth created in the first place? And, relatedly, why does capital often survive economic cycles and shocks that leave so many others adrift, deprived of the gains they had made earlier?

The answer to these questions, I suggest, lies in capital's legal code. Fundamentally, capital is made from two ingredients: an asset, and the legal code. I use the term "asset" broadly to denote any object, claim, skill, or idea, regardless of its form. In their unadulterated appearance, these simple assets are just that: a piece of dirt, a building, a promise to receive payment at a future date, an idea for a new drug, or a string of digital code. With the right legal coding, any of these assets can be turned into capital and thereby increase its propensity to create wealth for its holder(s).

The roster of assets that are coded in law has changed over time and will likely continue to do so. In the past, land, firms, debt, and know-how have all been coded as capital, and as this list suggests, the nature of these assets has changed along the way. Land produces foodstuff and shelter even in the absence of legal coding, but financial instruments and intellectual property rights exist only in law, and digital assets in binary code, for which the code itself *is* the asset. And yet, the legal devices that have been used for coding every one of these assets have remained remarkably constant over time. The most important ones are contract law, property rights, collateral law, trust, corporate, and bankruptcy law. These are the *modules* from which capital is coded. They bestow important attributes on assets and thereby privilege its holder: *Priority*, which ranks competing claims to the same assets; *durability*, which extends priority claims in time; *universality*, which extends them in space; and *convertibility*, which operates as an insurance device that allows holders to convert their private credit claims into state money on demand and thereby protect their nominal value, for only legal tender can be a true store of value, as will be further explained in chapter 4.⁸

Once an asset has been legally coded, it is fit for generating wealth for its holder. The legal coding of capital is an ingenious process without which the world would have never attained the level of wealth that exists today; yet the process itself has been largely hidden from view. Through this book I hope to shed light on how law helps create both wealth and inequality. Tracing the root causes of inequality has become critically important not only because rising levels of inequality threaten the social fabric of our democratic systems, but also because conventional forms of redistribution through taxes have become largely toothless. Indeed, shielding assets from taxes is one of the most sought-after coding strategies that asset holders covet. And lawyers, the code's masters, are paid extraordinary fees to place them beyond the reach of creditors, including the tax authorities, with the help of these states' own laws.⁹

How assets are selected to be legally coded as capital, by whom, and for whose benefit are questions that cut to the core of capital

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A Code for the Globe

Capital has become mobile and seems to know no borders; goods cross oceans and corporations roam the globe in search of new investment opportunities, or simply a more benign tax or regulatory environment; financial assets worth trillions of dollars are traded daily at the stroke of a key and settled in digital clouds with no land in sight. Yet, there is no single global legal system to support global capitalism; nor is there a global state to back it with its coercive powers. We thus confront a puzzle: If capital is coded in law, how can global capitalism exist in the absence of a global state and a global legal system?

The solution to this puzzle is surprisingly simple: global capitalism can be sustained, at least in theory, by a single domestic legal system, provided that other states recognize and enforce its legal code. Global capitalism as we know it comes remarkably close to this theoretical possibility: it is built around two domestic legal systems, the laws of England and those of New York State, complemented by a few international treaties, and an extensive network of *bilateral* trade and investment regimes, which themselves are centered around a handful of advanced economies.

Extending law in space to people and territories in faraway places is reminiscent of empire. In ancient Rome, Roman law was available

mostly for the elites, but was “out of the reach of most of the population”; to them it was more a “threat to be feared” than a “possible protection.”¹ For most people in most countries, the law that sustains global capitalism is also beyond reach, because these countries only recognize and enforce laws that were made by others. Even the citizens of England and New York State, the jurisdictions where the legal code for global capital is forged, have little say, because most of the activities take place in private law offices, not public legislatures and no longer even in courts, which have been sidelined as potentially too disruptive for private coding strategies.

Exporting law has a long history. English settlers and colonizers applied the common law throughout the growing empire and sent judges to far-off places to implement it. Napoleon Bonaparte’s troops brought the French legal codes with them wherever they went, extending the reach of French law to Poland in the East, and to Spain, Portugal, and Egypt in the South. Imperialism was not only about military conquest, but also about spreading the legal system of the European states to the colonies they created in Africa, Asia, and the Americas. This is why the legal systems of most countries around the globe belong to one of the three leading “legal families”: the English common law, the French civil law, and the German civil law.² Even countries that escaped colonialization were pressured to adopt Western law, Japan being the most prominent example. The Meiji Restoration triggered an extensive legal modernization project that first focused on French law, but the country ended up transplanting mostly German law.³

The diffusion of European legal systems throughout the world has greatly reduced legal variance, but it has not produced uniformity. To begin with, not only do the dominant legal families vary from one another, but even legal systems that belong to the same family are quite different. Law is not static but evolves over time as new cases are litigated and statutory law is amended in response to changing norms or political preferences. The same legal family lineage therefore does not produce identical or even similar laws on the books, much less the convergence of these laws in practice. Societies have copied laws from one another for millennia, but to be effective they have to be adapted to local conditions.⁴ Static laws

that fail to reflect preferences of social norms, or do not respond to a changing environment, remain black letters on the books with little impact on social ordering.⁵

But what is good for effective law and democratic self-governance is not necessarily good for capital. The same qualities that make law vibrant and relevant for a polity make it volatile and uncertain in the eyes of foreign traders and investors. They are unfamiliar with local practices and political processes, which render local institutions unpredictable in their eyes. Recall that in Adam Smith's account, the lack of institutional certainty in foreign places *was* the invisible hand that drove merchants back home, where they would invariably share some of their spoils with their community. For the merchants, this presented itself as a massive institutional failure, which greatly increased their costs of doing business and reduced their private gains. If institutions could be streamlined around the globe, business would become more predictable and the merchants could simply dispense with the invisible hand and keep their spoils for themselves.

Building the legal infrastructure for global commerce has taken, for the most part, one of two forms: the harmonization of laws in different states, and the recognition and enforcement of foreign law. The latter has been much more successful in protecting capital globally, but it did require that countries adapted their own conflict-of-law rules to ensure that private choice and autonomy would prevail over public concerns.

Expanding Private Choice

The trend to outsource law to private agents by offering the option to choose domestic or foreign law as they please has been a response to the difficulty of harmonizing the law by political means. Extensive legal harmonization was tried at first—especially in the period following the Second World War, with the goal of reinvigorating global trade and investment. The European Union (EU) is the poster child for countries coming together to forge common rules for a common market. Negotiating a common set of rules that are agreeable to all, however, proved to be slow and cumbersome—even for countries

with a long history of mutual borrowing and common roots going all the way back to Roman law.

The alternative to the deliberate harmonization of laws through the political process is legal and regulatory competition among states combined with private autonomy for the law's end-users, who get to pick and choose what is best for them. For this to work, countries do not need to engage in laborious legal harmonization projects regarding the contents of, say, contract or corporate law; they only need to put in place conflict-of-law rules that endorse the choices that private parties make. These rules have the additional advantage that they are so arcane, their passage ruffles few feathers in the day-to-day political process.

There are specific conflict-of-law rules for every area of the law, such as contracts, torts, property rights, corporate law, and so forth. For contract and corporate law, conflict-of-law rules have converged to a remarkable extent on the principle that the parties to a contract or the founding shareholders are free to choose the law by which they wish to be governed. Without this legal support structure, Lehman could not have built an empire of hundreds of subsidiaries that were incorporated in different jurisdictions and often ones where none of them ever did any business, nor intended to do so; neither would the certificates that NC2 or the Kleros clones issued to investors have found many buyers, had they not been assured that the legal rights they embodied would be recognized beyond the Cayman Islands or the tiny US state of Delaware. The willingness of states to allow private parties (and their lawyers) to pick and choose the law that best suits their interests explains the remarkable dominance of English and New York laws for the coding of global capital.

When it comes to property rights, however, most states still insist on their legal sovereignty and impose domestic law on assets that are located within their territory. But territorial control is of little use for assets that lack physical form or location; for tradeable financial assets, other criteria had to be found to determine whose law should govern them—and ideally criteria that would point to one and the same legal system when invoked in different countries. To this end, legal practitioners and some academics gathered under

the auspices of a prominent forum, the Hague Conference on Private International Law, and hammered out an international treaty that standardized conflict-of-law rules for financial assets.⁶ The result was a rule with the catchy acronym PRIMA, which stands for the “place of the relevant intermediary approach.”⁷ Under this rule, the legal system in which the entity that is issuing the assets is incorporated also determines the property law for the assets it issues. Since under the now dominant incorporation theory, the place of incorporation is for private parties (the founders) to decide, so is the property law for the financial assets this new entity will issue. Some jurisdictions offer even greater flexibility to private parties by allowing them to choose, in the contract between account holder and account manager, the law that shall govern them.⁸

In contrast, most intellectual property rights have remained a sticking point, because they can’t be minted in private contract; patents don’t exist but for an *official* act, as discussed in chapter 5. While patent lawyers may convince a patent office of a novel interpretation of what counts as an invention, the final decision lies in the hands of the courts. States have harmonized some aspects of intellectual property rights in international treaty law, TRIPS for example, but many details still remain in the hands of individual sovereign states.

Despite their resistance to divest control over property rights, states ended up giving away more than they may have intended. They have done so not through legal harmonization of substantive law or even of conflict-of-law rules, but by signing on to regional or bilateral investment treaties. These treaties rarely talk about property rights and instead focus on the *investments* made by foreign investors and their protection in the host state. Investments can take any form, from entering into contracts, licenses, concessions, all the way to ownership of shares or real property. The Trojan horse in these treaties is a dispute settlement mechanism that goes by the acronym ISDS (investor-state dispute settlement). It allows a foreign investor to bring a case for damages against the host state in an arbitral tribunal outside its territory. The language of the treaties is sufficiently open-ended to give arbitrators the power to grant damages for “unfair and inequitable treatment” that are on par with damages for

expropriation.⁹ In doing so, they effectively confer property rights status on contractual commitments and curtail the powers of states to determine the claims they wish to recognize as property rights.

Next to property rights, bankruptcy law as well has remained stubbornly local. The reason is that bankruptcy law is the place where losses are realized and allocated, which is inherently a political task. Moreover, bankruptcy is the acid test for the rights and privileges the parties negotiated or that state law granted them long before default loomed on the horizon. If these rights cannot be enforced in bankruptcy, they are not worth much, which is why bankruptcy law is said to exert substantial *ex ante* effects.¹⁰

One would think, therefore, that standardizing bankruptcy rules should not be a problem for global trade and finance, but this could not be further from the truth. Politicians are reluctant to assume losses or devise rules that would force them to commit to a loss allocation mechanism. Ever since the fall of the German Herstatt Bank in 1974, the need for a common resolution mechanism for banks that live globally has been apparent. The bank was relatively small but internationally active, with extensive foreign exchange operations in New York that had racked up substantial losses. German regulators closed down the bank in the middle of the trading session at the New York Stock Exchange, leaving everyone there to run for cover.¹¹ Yet, to this day there are still no rules to govern the resolution of globally active banks; only the Eurozone has put in place a common resolution regime for banks that are regulated at the EU level.¹² For the remaining banks there is still no transnational resolution regime in place.¹³

Given how politically sensitive property and bankruptcy laws are, it should not come as a surprise that this is where the battles over the global code of capital are being waged. The following sections will discuss separately the battles for property and bankruptcy law.

Private Property versus Sovereignty

Property and sovereignty are distinct but related concepts. Morris Cohen drew attention to the mirror image of “Property *and* Sovereignty” in a paper published in 1927, just a few years before a massive financial crisis revealed the fragility of the system he analyzed.

Property, he suggested, is private and signifies *dominium*; sovereignty is public and stands for *imperium*.¹⁴ Yet, as he explained, “[t]here can be no doubt that our property laws do confer sovereign power on our captains of industry and even more so on our captains of finance.”¹⁵ Property rights are derivative of sovereignty, but they also confer on private parties certain sovereign powers. Indeed, the battle over the global code of capital is all about who should determine the contents and meaning of property rights: states or private parties; the democratic public or the captains of industry and finance.

The disputes that mark these battles often look like classic expropriation cases, in which a powerful state confiscates an asset in violation of private property rights. In most cases that concern the protection of property rights in global relations, however, the dispute is not at all over the object itself or the violation of specific rights but rather is over who gets to determine what *is a property right*: the Sovereign or private parties. When private parties claim this prerogative for themselves, Sovereignty is “under siege.”¹⁶

Intellectual property rights have been harmonized by international treaty law, but even the much-maligned TRIPS Agreement of 1994, established only minimum standards, which leave plenty of room for divergent national rules. Recently, however, a case brought under the ISDS regime of the (former) North American Free Trade Agreement (NAFTA) has sought to dislodge a sovereign state’s power to set the terms for recognizing intellectual property rights. This quest was ultimately unsuccessful, but it took the tribunal two years to reach this conclusion, while taking the opportunity to review the case law of a sovereign state for compliance with the interests of a foreign investor. The US pharmaceutical company, Eli Lilly, brought the case and has led the way for turning ISDS into an appellate body for domestic courts, and surely others will follow.

Eli Lilly was founded in 1876 by a veteran of the US Civil War, Mr. Eli Lilly. The company is headquartered in Indiana but operates on a global scale. The company secured patents in Canada for its drugs Strattera and Zyprexa used for patients who suffer from schizophrenia, depression, and other psychiatric disorders, in 1979

and 1980, respectively. Years later, the company filed for separate patents for a new set of components that were used in these drugs, thereby seeking to prolong the duration of the original patent (a practice that is not uncommon). These patents were granted as well, but later became embroiled in a legal dispute in which Eli Lilly sued another company in Canada for infringing its patents, and it was in this context that a Canadian judge revoked Eli Lilly's second patents for Strattera and Zyprexa.

Under Canadian law, a patent must be “new, useful and non-obvious” at the time the patent is filed.¹⁷ After reviewing the patent, a lower court held that replacing a few components did not make the drug any more useful than it had been before. The second patent for Strattera and Zyprexa therefore did not meet Canada's legal requirements for granting a patent and the patents were therefore revoked. The case went on appeal and was remanded to the lower court, but on a second appeal Canada's Federal Court upheld the lower court's ruling. Eli Lilly was still not ready to give up and appealed to Canada's constitutional court, which did not take the case.¹⁸ Having run out of legal options under Canadian law, the company notified the Canadian government in 2015 that it would file an investor-state dispute under NAFTA, demanding \$500 million in compensation.¹⁹ The company argued that the revocation of the patent amounted to an infringement of the company's “investments” in Canada.

NAFTA was an international treaty between Canada, Mexico, and the United States with the goal of fostering trade and investment among these three countries, which has since been replaced by USMCA, the “United States-Mexico-Canada Agreement.”²⁰ As one would expect in a treaty among sovereign states, most of the rights and obligations it spells out, such as opening their borders to goods and services from the contracting parties, bind these three countries as the treaty's signatories. However, NAFTA also created rights for private parties, specifically for foreign investors, and these rights are armed with a powerful enforcement mechanism. If a foreign investor believes that his “investments” have been infringed by a host state, it can lodge a complaint with an arbitral tribunal and seek compensation for damages. Unlike victims of human rights violations,

investors do not have to seek remedies in a domestic court first; they can go straight to a tribunal outside the territory of the host state they are suing.²¹

Similar enforcement mechanisms by private parties against host states have been built into more than three thousand bilateral investment treaties (BITs). More than eight hundred cases alleging infringements of investments have been filed over the past three decades, with a total of \$522 million in damages paid out, or about 40 percent of the sums demanded.²² Investors don't always win; states do so in at least one-third of the cases, with the remaining cases being either settled (typically without disclosure about the terms of the settlements) or decided in favor of the investor.

As noted, Eli Lilly did not seek dispute settlement under NAFTA right away. It first battled in the Canadian courts for recognition of its (second) patents. This makes sense, because the company needed an act of state: the recognition of a property right in the form of a patent.²³ After having lost its case, Eli Lilly now argued that the patent's revocation by the Canadian courts amounted to "unfair and inequitable treatment" and "indirect expropriation" under the NAFTA treaty. The reason given was that the Canadian court's interpretation of the Canadian Patent Act deviated from its earlier case law in a "dramatic" fashion.

In effect, the claim challenged the prerogative of Canada to create its own intellectual property rights; it also sought to subject the country's judiciary to review by an ad hoc arbitral tribunal. Both claims stretched the limits of investor protection under NAFTA. The treaty had not harmonized patent law among the three countries; their power to stipulate their own property regimes was therefore not affected. And while courts are not beyond the reach of review of ISDS tribunals, the threshold for holding states liable for a wrongful court decision is pretty high: under existing legal standards, only the *denial of justice* would be reviewed, not just any court ruling that seemed legally doubtful or even faulty—and Eli Lilly had already spent ample time in the halls of Canada's courts. At bottom, the company challenged the interpretation of Canadian law by Canadian courts, but it managed to spin it into a violation of investor

protection rules under NAFTA and found a tribunal that was ready to hear the case.

Anyone can make audacious claims, but to win a case one needs a legal authority—a statute, a case, or a treaty on which a claim can be grounded. NAFTA’s open-ended language gave investors ample ammunition. Article 1105 of the agreement stated that foreign investors have a right to “fair and equitable treatment” in the host state where they invest, and Article 1110 further stipulated that “[n]o Party may directly or indirectly nationalize or expropriate an investment of an investor of another Party in its territory or take a measure tantamount to nationalization or expropriation of such an investment.”

A state is, of course, not a unitary actor; state power is usually divided among three branches of government—the executive, the legislature, and the judiciary; and in the federal system, municipalities and states exercise authority quite independent from the central government. However, for the rights and obligations states have under international law, the internal division of power is secondary; the sovereign state is the subject of international law and actions other official actors take, such as regulators, administrators, even judges, that are deemed to violate international law will be attributed to that state. In fact, it is not uncommon for states to be held liable under international law for actions taken by sub-units of a federation, whether or not the federal state had jurisdiction over the issue in dispute. A good example is the *Metalclad* case, which imposed \$16 million in damages on the federal state of Mexico for the refusal of a municipality to grant an American investor a license for a waste management facility in its community, notwithstanding the fact that under Mexican law the town had the exclusive power over granting or denying the license in question.²⁴

Extending a state’s liability for acts of its judiciary, however, is more contentious, and for good reasons. In countries that are committed to the rule of law, the judiciary is designed to be independent of both the executive and the legislature; judges are accountable only to the constitution and the laws of a given country. If a foreign investor was able to easily challenge a ruling by an independent court and obtain a huge damage award from the country in which the

court is located, this could easily sway courts in future cases and undermine their impartiality. In fact, the Canadian government insisted that only the complete denial of justice might possibly give rise to liability. After some more probing by the tribunal, however, the government's lawyers conceded that failure to grant due process might count as well. The tribunal quickly turned this into a new standard for its review powers over domestic courts: an allegation of "manifest arbitrariness or blatant unfairness" of a country's case law opens the door to investor-state disputes.²⁵

The tribunal then proceeded to examine the history of Canadian patent case law to see whether the legal treatment of Eli Lilly received by the Canadian courts met this standard. But the tribunal did more than this; it heard an expert witness who presented statistics comparing the Canadian court's patent rulings with similar rulings in the United States and in Mexico, pointing out that patent holders have a much lower probability of seeing their patents revoked in the United States than in either Canada or Mexico.²⁶ This argument was obviously off target, because NAFTA did not harmonize patent law, or any other area of the law for that matter; nor does the treaty require court practices in the three countries to converge. The only relevant question was whether, in the Eli Lilly case, *Canadian* courts had strayed from their own established record in a manifestly arbitrary fashion. The tribunal's willingness to entertain the comparison between Canadian, Mexican, and US courts suggests a bias in favor of investor interests over state sovereignty.

In the end, the tribunal concluded that the courts' rulings in the Eli Lilly case fell well within the scope of existing case law; it took two years to reach this decision, during which the arbitrators who presided over the case earned hundreds of thousands and the fees for the lawyers who represented the two parties reached millions of US dollars.²⁷ Eli Lilly had clearly tried to pull off an aggressive litigation strategy, which may have persuaded governments with fewer resources to settle the case early in order to avoid additional costs. Dealing with aggressive litigants is, of course, nothing unusual. Domestic courts do so on a daily basis and they have few qualms over dismissing a case when all the plaintiff has to offer are wordy

allegations that are not well supported by the facts. Their incentive structure is, of course, a different one. Judges on state courts are not paid by the cases they resolve but work on a fixed (and much lower) salary than do most professional private arbitrators. In contrast, private arbitrators earn their fees one case at the time.

Attorneys who aggressively seek cases for litigation have appropriately been termed “bounty hunters”; but this term also fits private arbitrators who pursue dispute resolution as a for-profit business. Worse, by accepting the case and then expanding the tribunals’ scope of review into judicial conduct beyond the threshold of denial of justice, the tribunal in the Eli Lilly case turned itself into another appeals court, its own assertions to the contrary. In the end, Canada won the battle; but it is not yet clear who will win the war and have the final say in *making* property rights: sovereign states or private agents.

Paving the Way for Global Derivatives

Patents and financial assets are both commonly described as *intangibles*; these are not objects that can be touched, but are creatures of the law. If anything, financial assets may be even more footloose than intellectual property rights, because they do not need an official act of state to come into existence. They are coded in the modules of the code of capital, over which lawyers have much sway subject only to the odd challenge in a court of law. Granted, they still need some domestic legal system to sanction the coding strategy, but lawyers can pick and choose from among a menu of legal systems on offer.

This may sound as though financial assets might be coded in a garden variety of legal systems, but this would defy the purpose of creating assets that have global reach. In practice, most financial assets that are traded globally are coded in only two legal systems—the laws of England or New York State. Finance may be global, but the legal code that carries the core features of financial assets is remarkably parochial. Other states may impose regulations on financial intermediaries or assets within their borders, but even mandatory rules are rarely airtight, and the art of coding capital is all about identifying

gaps and fitting coding strategies, including those permitted under foreign law, within them.

The big stumbling block for seamless global markets based on domestic law, however, is bankruptcy law. As suggested earlier, bankruptcy is where life and death decisions are made and where losses must be accounted for. Not surprisingly, sovereign states have been reluctant to relinquish control over this sensitive legal domain.

England was one of the first states to adopt a modern bankruptcy statute in 1705, which enabled traders to escape their old debt and start a new life in commerce after bankruptcy. To take advantage of the new law, one had to prove one's status as a trader.²⁸ Over time, bankruptcy law became a battle field for big vs. small creditors. Big creditors lobbied hard in England to retain their stronghold over the bankruptcy process; eventually, they had to cede control to judges.²⁹ However, the big banks among them have managed to reassert their own control over debtors by using a special kind of collateral, a floating lien, which gives the bank a powerful position vis-à-vis other creditors and ensures that insolvency cases involving their debtors are settled for the most part outside the bankruptcy court.³⁰

The contemporary equivalents to big banks that seek to control the bankruptcy process are counterparties in derivatives transactions. As discussed in chapter 4, derivatives markets were built on the assumption that all assets will trade continuously and that therefore positions can be bought, sold, or re-hedged at any moment to find the optimal hedge for a new exposure. But if and when only one of the counterparties files for bankruptcy, the music stops. Bankruptcy law is geared toward protecting the debtor's remaining assets in order to make whole as many creditors as possible; and sometimes to give the debtor a new chance in life.

To achieve this end, creditors of the insolvent debtor are typically barred temporarily from enforcing their individual claims. They have to wait long enough to ensure that all claims are gathered and ranked according to their priority status pre-bankruptcy. Yet, representatives of derivatives traders, the modern captains of finance, successfully lobbied the legislatures in more than fifty countries to

amend their bankruptcy codes and create a “safe harbor” for derivatives and repos, thereby exempting these financial assets from rules that are binding for everybody else. The main selling point was that making domestic laws compatible with private contracts was key for countries to participate in global derivatives markets.

The tribute for accomplishing this feat belongs largely to the International Swaps and Derivatives Association (ISDA).³¹ Organized as a nonprofit corporation in the state of New York, its operation now spans the globe, with offices in New York, London, Tokyo, and several other global financial centers. It is not the only private organization in the business of coding law for global finance but is arguably the most influential.³²

ISDA was formed in 1985 at a critical moment in the development of the market for credit derivatives. At the time, the issuers of these innovative instruments each fashioned their own derivatives contracts with the help of lawyers, who mapped out the legal terrain, ensured that innovative products would fit within the constraints created by existing laws and regulations, or devised ways to mitigate their impact. These contracts were tailored to the specific needs of their clients, but this limited their potential to be scaled and eventually be traded in global financial markets.³³ Standardization greatly enhances the scalability of assets, and ISDA was formed to create the foundation for scalable markets in products that were standardized, yet offered enough room for tailoring them to meet the needs of specific clients and for lawyers to charge the fee premiums that come with bespoke products.

The success of ISDA has been beyond anyone’s imagination. Today, the association has more than 850 primary members in sixty-seven countries—the who’s who in global finance and, as associate members, the who’s who in global law.³⁴ ISDA’s contracts are used primarily for derivatives that are traded over the counter (OTC) to the tune of hundreds of trillions of dollars.³⁵ These markets were hit by the financial crisis, but statistics for 2016 suggest that, in aggregate, they have rebounded almost to their pre-crisis level.³⁶

ISDA’s key contribution to the emergence of a global derivatives market was a contractual platform for swaps and other

derivatives—the “Master Agreement,” or MA for short.³⁷ It is a framework contract, fondly referred to by ISDA insiders as a piece of private legislation, which specifies the rights and obligations of counterparties wishing to engage in derivatives transactions with one another. Once the basic MA has been signed, a special schedule is drawn up that contains the details for each specific transaction between the two parties to the MA. Still, the MA is not intended as a substitute for domestic law but uses it as a gap filler. It prompts the parties of the MA to choose a default law and to elect the courts from that legal system for resolving any disputes. Notably, the MA advises the parties to limit their choice to one of two legal systems, English law or the law of New York State. The parties may choose otherwise, but they are advised that they risk increasing legal uncertainty if they do so.

Until the global crisis of 2008, ISDA favored dispute resolution in courts over private arbitration. During the benign market environment that preceded the crisis, only few disputes ever made it to court.³⁸ In the crisis, however, litigation spiked and ISDA had its hands full trying to explain to judges who had never before encountered the MA or the transactions it governed, how it should be interpreted, and to do its best to ensure that individual judges would not stray too far from interpretations that most market participants had taken for granted. In order to contain the risk of legal uncertainty, a new arbitral tribunal has now been established: the “Panel of Recognized International Market Experts in Finance,” or its somewhat contorted shorthand PRIME, which sounds more like a steak house than a private court for high finance.³⁹ The location is as noteworthy as the name: The panel does not reside in just any town, not even in one of the global financial centers, but in The Hague, where the International Court of Justice, the Permanent Court of Arbitration (which houses PRIME), and the International Criminal Court, among others, reside. The priests of high finance, who issue their own “private legislation,” still like to bask in the aura of legal authority, or so it seems.

Well-crafted contracts offer guidance not only for good but also for bad times and ISDA’s MA is highly attentive to questions of

default and termination, which loom large in finance. The counterparties to derivatives are in the business of minting private money, assets that are cloaked in law to give them the appearance of state money, only at higher rates of return; and invariably they will find themselves from time to time unable to convert their private money into state money at the speed and for the price they desire. Typically, this occurs at the most inopportune time, that is, when their own creditors are knocking on the door and insolvency looms.

According to ISDA's MA, bankruptcy is a triggering event that allows the non-defaulting party to clear out all outstanding claims against the party that finds itself in bankruptcy proceedings, and to pay what it owes, or take out what the debtor owes to it.⁴⁰ There is no waiting, no concern for the other creditors, and no consideration for reorganizing the defaulting debtor. With these contractual provisions, the MA sought to create a special default regime for derivatives traders that allows them to reposition their bets even as one of their counterparties finds itself in bankruptcy. In fact, the close-out netting provisions of the MA were in direct tension to most countries' bankruptcy laws. These laws typically prohibit the use of bankruptcy as an event that triggers contractual default; they also impose a wait period, or automatic stay, on any enforcement actions by any creditor;⁴¹ and they give the receiver in bankruptcy the right to cherry pick contracts that the other party must fulfill, even though it may not recover its own obligation in full from the insolvent debtor.⁴²

Bankruptcy is mandatory law, therefore private actors cannot just contract around it; they can't even strategize about where to file for bankruptcy, because it is almost impossible to know in advance which of the parties might default at some future date, and because of bankruptcy's mandatory nature, it will typically be the debtor's home laws that will govern bankruptcy. The only remaining option was to get legislatures to change their bankruptcy laws so that they would accommodate the provisions of ISDA's MA, that is, to make state law consistent with private contracts. ISDA did just that; in total, the association successfully lobbied more than fifty legislatures to change their bankruptcy laws.⁴³

The United States is where it all began. The federal bankruptcy code of 1978 included safe harbors for derivatives of *government* securities, presumably to protect the market for sovereign debt from the default of a financial intermediary; this small opening was used to lobby for similar carve-outs for derivatives on private assets.⁴⁴ The argument in favor of bankruptcy safe harbors was that the default of a single counterparty could rapidly spread throughout the entire market and threaten to bring it down. These markets therefore had to be insulated from the ordinary working of bankruptcy statutes. After the battle was won for swaps and other derivatives, repurchase agreements, or repos, followed, although the case for them was much weaker than for derivatives.⁴⁵ Step by step, the list of assets that were exempted from core features of bankruptcy proceedings was expanded; in 2005, even the veneer of judicial scrutiny of assets that the private sector slated for special treatment under bankruptcy safe harbors came off, when the US Congress required judges to refrain from using their own legal judgment to classify them. According to the law as amended, it was enough that an agreement “is of a type that has been, is presently, or in the future becomes, the subject of recurrent dealings in the swap or other derivatives markets.”⁴⁶ The market, not the judge, defines the meaning of derivatives—a remarkable outsourcing of judicial competence.

With the groundwork laid in the United States, ISDA knocked on the door of regulators in Brussels with an in-house report in hand that highlighted “inefficiencies” in the laws of many EU member states for derivatives, in particular in their bankruptcy and collateral laws.⁴⁷ Unless it mended its ways, the report suggested, Europe would miss out on the wonders of the global derivatives markets. With hindsight, Europe may have been better off had it taken a pass on this opportunity. The European Commission and its staffers, however, were receptive students of ISDA; a new directive was passed that required all EU members to create safe harbors for derivatives in their domestic laws.⁴⁸

These legal changes hardly ever raised objections or caught the attention of the broader public. Exemptions from the ordinary operation of bankruptcy law were sold to legislatures as technical fixes

that were necessary to ensure that their country would be able to integrate with the global marketplace. The fact that bankruptcy safe harbors altered the priority rights of creditors and subordinated trade creditors, as well as claims of employees and other ordinary creditors to the counterparties of derivatives transactions, was swept under the carpet. So was the fact that the privileging of these assets prompted others to organize their loan contracts as derivatives as well. Who would not want a priority right that is enforceable against the rest of the world, if all it takes is tweaking a contract? Lawmakers tilted the playing field in favor of the top tier of financial intermediaries, who were deeply vested in derivatives markets without giving it much thought. They realized only after the crisis that in doing so, they had also put their own governments on the hook.

When financial markets collapsed, the close-out netting rules allowed derivatives traders to get out faster than everybody else, and their exit poured oil on the fire.⁴⁹ When Lehman's UK subsidiary LBIE filed for insolvency, 1,693 of its over 2,000 outstanding derivatives transactions were closed out immediately.⁵⁰ Far from insulating counterparties from the downfall of one of their fellow market participants, close-out netting helped deepen the crisis, because derivatives traders ran for the exit as soon as they saw the writing on the wall, closed out their outstanding claims, and took the cash the debtor owed them, thereby reducing the assets available for others or for a possible reorganization. The possible contagious effects of close-out netting rules had been identified already in the late 1990s by a prominent policy forum, the Bank for International Settlements (BIS).⁵¹ However, nobody dared to openly oppose these rules; they only politely drew attention to their potentially adverse effects. This was not enough to prevent far-reaching legal changes from taking hold that an organization as powerful as ISDA was lobbying for at the time.

When these warnings finally materialized, states had the option of allowing the debtors to fall or injecting fresh capital into the failing debtor, only to watch counterparties of derivatives transactions walk away with the cash. Of course, if close-out netting showed that they owed something to the debtor, the counterparties had to pay up themselves; but this still put them into a better position than

most other creditors: They could draw a line and move on with their business and reposition their bets, while other creditors had to wait until all claims had been filed and a full assessment of the debtor's leftovers had been made.

The great financial crisis served as a wake-up call that the concessions lawmakers had made to finance not only did not produce the desired effects but were even counterproductive. Contrary to the advocates of these new financial instruments, they were not safe, and neither did bankruptcy safe harbors protect the market for derivatives, much less anybody else. Many legislatures now had second thoughts about bankruptcy safe harbors and decided to roll them back.

One would think that what a legislature has given it can also take back. But this proved more difficult, not the least because of the size of global derivatives markets. Millions of MAs governed by English or New York law were in use that contained close-out netting rules. Even if one state decided to change its domestic bankruptcy law and to roll the clock back to the state of the world prior to ISDA's global lobbying campaign, that state would not necessarily be able to prevent a foreign private party from making use of its contractual close-out netting rights in time to preserve the debtor's assets. Because ISDA's MA is governed by English or New York State law, the court that presided over a bankruptcy case in a different country would have to ask a court in one of these two jurisdictions for assistance. Even if they accommodated the request, this takes time, and time is in short supply whenever a major financial intermediary has to be put on life support.

Because the MA was used in millions of *transnational* derivatives transactions, no single state had the power to effectively roll back the bankruptcy safe harbors; states had no option but to coordinate, and they needed to impose on ISDA and its primary members that they had to play along. States used the "Financial Stability Board" (FSB), a relatively new policy body, which is housed at the Bank for International Settlements (BIS) in Basel, Switzerland, to coordinate and act as a spokesperson for their demands.⁵² They agreed not to dismantle close-out netting entirely, but to impose a 48-hour waiting period before any netting rights could be exercised. Nevertheless,

they struggled to find a viable strategy for enforcing this mandate, as modest as it was, because states cannot simply rewrite the contracts that private parties use for their own transactions.

In the end, the FSB negotiated a deal with ISDA to create a new protocol to the MA that would include the new waiting periods. Of course, there was no guarantee that the financial intermediaries that use the MA would sign up for that. After all, contracts are voluntary in nature. So, the states that the major players in global derivatives markets call their home, namely the United States, United Kingdom, France, and Germany, pressured “their” banks to sign, or else face major regulatory repercussions.

Under the protocol, the parties to a derivatives contract agree that they will respect the bankruptcy law of the defaulting party and abstain from close-out netting for up to 48 hours or two business days (whichever was longer).⁵³ In November 2014, ISDA announced that the new “resolution stay protocol” had been signed by eighteen banks, bringing 90 percent of the outstanding derivatives (in notional amounts) into the fold.⁵⁴ The big banks had been caught in the regulatory net, which was tightened in the aftermath of the financial crisis. In contrast, the players on the other side of the derivative deals, mostly hedge funds, are only lightly regulated and therefore did not face similar pressure. They balked and refused to sign the protocol, thereby largely muting its effect. The conundrum was solved only when the US Federal Reserve stepped in and issued a rule that prohibited banks that fall under its regulatory supervision, including subsidiaries of foreign banks—a substantial share of globally active banks—from entering into derivatives trades with any counterparty that refuses to sign up for ISDA’s protocol.⁵⁵

The hedge funds had, of course, the option to look for counterparties other than the big, regulated banks; but in truth, this is easier said than done. They knew very well that the big banks had something no other financial intermediaries do: a lifeline to their central bank in the form of liquidity backstopping (through reserves and access to the discount window), and, in the worst-case scenario, perhaps even bailouts. Like other financial markets, derivatives markets too operate in the shadow of the state and its financial prowess.

After a long battle, governments scored a goal, even though a 48-hour waiting period may not seem all that remarkable. Of interest, however, is not only what they did, but *how* they accomplished it. Governments took a page from the script of ISDA's own screenplay. ISDA had used contracts to forge a piece of private legislation; the government now used a protocol to the same contract as a regulatory tool. The fact that sovereign states had to co-opt a private business association, namely ISDA, to achieve their regulatory goals, indicates the extent to which states have lost control over the governance of global finance. The silver lining is that ISDA participated in the deal and positioned itself not just as industry advocate, but as co-regulator. The key actors representing the association may have realized that only by playing along would it be able to fend off more aggressive regulatory strategies and thus retain much of its stronghold over global finance.

In the Service of Capital

The Eli Lilly case and the story about bankruptcy safe harbors for derivatives illustrate how traditional law enforcement agencies, such as courts and regulators, have been put in the service of capital. The holders of capital do not always win their first battle; rather, they chip away at existing legal barriers slowly but stubbornly until little stands in the way for principles that, not too long ago, appeared—to use Justice Cardozo's words—as “unbending and inveterate,” to erode into sand.⁵⁶

Eli Lilly mobilized private arbitration tribunals to scrutinize state courts in their role as lawmakers and law enforcers. The company sought to portray its treatment by the courts as akin to denial of justice. It argued that it had a right to a patent, however flimsy the evidence that the new compounds it added for the second patent over the same drugs actually made a difference, and that the Canadian courts denied Eli Lilly justice by revoking it. Denial of justice is by no means beyond what some courts in some countries might do; but even according to the complaint the company had filed, there was not much “there” to build such a case. Instead, Eli Lilly

must have hoped that the prospect of a \$500 million liability verdict would force the Canadian government to cave in and settle, if only for some smaller amount. Eli Lilly fought a lonely battle, but the strategy of shedding doubts on the impartiality of courts and intimidating governments has been effectively tried and tested to discredit the legal system of foreign countries; this time it was used even against a country that scores high on indicators that measure the rule of law and non-corruptibility; and consistent with these data, the Canadian government was unwilling to budge.⁵⁷

The story about ISDA and its lobbying of legislatures and regulators in dozens of countries takes the relation between private actors and law enforcers to another level entirely. ISDA created facts on the ground by developing the MA, a contractual device that was soon used for millions of transactions involving derivatives, many of which were used in cross-border deals. After having demonstrated that a private contract can sustain a global market in financial instruments, ISDA began to lobby legislatures to adapt their laws to make them consistent with ISDA's contractual instrument—turning the principle that contracts have to be consistent with the law on its head. Within a couple of years, it had persuaded all the leading economies, as legislatures feared to harm their domestic financial industry if they did not play along.

In the end, though, ISDA had to concede that it could not rule global derivatives markets alone. The network of contracts, which resembles a bowl of spaghetti that is almost impossible to disentangle, needs not only default rules, which some countries will always happily provide, but it also must reckon with default and bankruptcy of key participants—this is where private contracting finds its limits. When states pushed back in a concerted action, ISDA had little choice for fear that they might regulate it out of existence. However, in assuming regulatory functions over industry members, ISDA crossed the line between private and state regulator.⁵⁸ It may not have coercive powers on par with states (yet), but its MA is the foundation for global derivatives trades, and players in these markets have little choice but to adhere to ISDA's rule book. And now, the association has demonstrated that it is willing not only to

cross swords with states, but to cooperate with them in order to bring about regulatory change, however modest it might seem to advocates of even stricter rules.

The two stories highlight the transformation of law enforcement that has taken place over the past several decades. Powerful holders of global capital with the help of their lawyers have not only found ways to utilize the law for their own interests; they have turned the legislatures, regulators, even courts in most countries, into agents that serve their interests, rather than those of the citizens to whom they are formally accountable. Contrary to standard Marxist accounts, they have done this without occupying directly positions of state power; instead, they have perfected the art of utilizing the powers of the state indirectly. They have concocted their own world of law, stitched together from different domestic legal systems with international or bilateral treaty law thrown into the mix.

Looking back, there was no grand strategy that set out how private parties would conquer the state's coercive powers without submitting to its rules. Instead, private lawyers have pieced together different portions of legal rules that were adopted in different eras, and their combined effect became apparent only after all the pieces had been put into place.

The first piece of the puzzle was the 1958 New York Arbitration Convention.⁵⁹ It offers coercive law enforcement to parties who prefer to resolve their disputes in private arbitration by assuring them that they can use the courts of any state that has ratified this convention to execute these awards against assets found on their territory. State courts may not review the case on its merits before executing the award; they may only check that basic principles of due process have been observed. Alternatively, they may raise the specter of a violation of "public interests," but although this principle sounds like a catchall phrase, it is narrowly construed and only rarely used to justify setting aside an arbitral award.⁶⁰

The second piece of the puzzle is a convention adopted in 1966, which established the International Centre for Settlement of Investment Disputes (ICSID).⁶¹ It is housed at the World Bank and facilitates investor-state disputes by maintaining a roster of arbitrators

for parties to choose from, for filing cases, and, laudably, nowadays making most of them available online. Countries that sign up to the ICSID Convention accept that state-investor disputes will be heard by a private tribunal under the auspices of ICSID and that they must accept the verdict. There is no appeal, only a request for interpretation and revision, and as a last resort, an annulment process, which requires a pretty high threshold of proof.⁶² In recent years, several countries have cancelled their membership in ICSID in protest of rulings that they found unjust. However, the convention still counts 154 states as its members.⁶³

The third piece of the puzzle is the 1969 Vienna Convention on the Law of Treaties.⁶⁴ It incorporates the ground rules of international law, building on centuries of international practice, and stipulates what an international convention or treaty is, how it is adopted, when it enters into force, and what rights and obligations states assume once they have ratified such an instrument.⁶⁵ The provision of greatest interest for investors that find themselves engulfed in disputes with sovereign states is Article 27; it holds that a state cannot invoke its own “internal law as justification for its failure to perform a treaty.” In plain English, the rights that arbitral tribunals fashion from the thin language of bilateral investment treaties supersede domestic law, including a country’s constitution. Again, it seems puzzling that sovereign states would sign up for this, but until the introduction of ISDS in bilateral investment treaties, international law was enforced by international courts or by arbitration between two sovereign states; disputes at this level are rare, as most conflicts are resolved through diplomacy, but private parties have proven much less constrained.

Fast forward 40 years, with more than three thousand bilateral investment treaties in place and more than eight hundred state-investor disputes brought, and we can see how the puzzle comes together into a powerful picture. The treaty language of most BITs requires that investors are given “fair and equitable treatment” (this is similar to the language of NAFTA discussed in the Eli Lilly case above) and should be protected from direct or indirect expropriation, but what this means is nowhere defined. It is left for arbitrators,

who are drawn primarily from private practice. They are less interested in public policy and have insisted that state law, including constitutional law, is irrelevant for interpreting treaty law.⁶⁶ Article 27 of the Vienna Convention gives them effective cover to raise their own interpretation over and above domestic law of the host state in a dispute.

The interpretation of law is always an act of lawmaking; this lies in the nature of trying to make sense of words in light of the complex reality of facts to which the law is applied. Still, the open-ended language of the treaties and the absence of a higher court that would unify its interpretation gives arbitrators enormous interpretative powers. Moreover, arbitration is a one-off affair; there is no appeal, there are only annulment proceedings, which, as mentioned, are difficult to win.

Determining what kinds of tribunals should have the power to determine when foreign investors may claim priority rights over public interests in their host states has come to a head in the public debate over TTIP—the Transatlantic Trade and Investment Partnership between the United States and the European Union. This bilateral agreement was meant to further break down barriers to trade and investment between these two economic powerhouses, giving companies unfettered access to markets on either side of the Atlantic. A cornerstone for deepening international economic relations for the Obama administration, it suffered a serious backlash when civil society organizations mobilized against it across Europe. The inclusion of ISDS was a major bone of contention, because it sidelined domestic courts in the member states of the EU as well as the European Court of Justice for matters that often cut to the core of domestic constitutional and EU treaty law.⁶⁷

In the end, the adoption of TTIP (and its trans-Pacific counterpart) was thwarted for domestic reasons in the United States, where the election of Donald Trump as the forty-fifth president has ushered in a period of greater unilateralism and the primacy of national interests.⁶⁸ However, there has been progress on a different front. Canada and the EU have entered into a “modern” treaty (CETA), as the two parties call it, which acknowledges the right of states to change their laws “regardless of whether this may negatively affect an investment

or investor's expectations of profits."⁶⁹ This might sound harsh to investors who have come to rely on using investment treaties as an insurance device against future legal change; but it only confirms the basic principles of democratic self-governance. Legal change is part and parcel of political and social change, and foreign investors should not be given a veto right over such change by threatening with a multi-million dollar liability claim.

Moreover, in a clear break from the practice of using ad hoc tribunals staffed with private arbitrators, CETA will establish a new standing tribunal for resolving disputes between foreign investors and their host states—Canada or one of the EU member states. The tribunal shall have a panel of fifteen members who will be appointed for a renewable 5-year term by a joint committee of the two parties to the treaty (i.e., the EU and Canada) rather than be selected by the parties to the dispute; and the tribunal's president in turn chooses three members of the panel for resolving a specific dispute.⁷⁰ What difference this new tribunal might make in practice remains to be seen; however, its design suggests that there is more than one way to constitute tribunals that resolve disputes between foreign investors and traders and their host states. In the best of all worlds, the new tribunal will show how to solve disputes between sovereign states and foreign investors in a balanced fashion, giving due course to the private as well as the public interests that are at stake.