**Modern legal practice as the engine of inequality: an essay on Katharina Pistor’s *The Code of Capital***

Carolyn Sissoko[[1]](#footnote-1)

March 8, 2020

Katharina Pistor has written a remarkable and unusual book that exposes a seminal economic and social problem which has been virtually invisible: the coding of capital. As she observes, when non-lawyers discuss contracts, corporations, mortgages and more complex assets, the “law is taken as a given, as exogenous” (222). In fact, these basic building blocks of our society are governed by laws and regulations that are not at all static. This law is the code of capital. Not only is it constantly changing, but there are “masters of the code” who are experts at refashioning it, and they do so on behalf of their clients, the owners of the capital assets.

Pistor’s book is about the essential importance of the activities of the lawyers who are masters of the code. Pistor describes in extensive detail a legal world where aggressively taking advantage of state subsidies is built into the very DNA of how assets are formed. This is a world where the presence of systemic risk protections offered by central banks and governments naturally generates assets that are carefully structured to maximize the value of these protections to creditors, while minimizing their value to employees, suppliers, and tort creditors; and where differential tax and legal regimes generate companies with immensely complex internal structures designed to arbitrage the differences. As a result, “courts and regulators have been put in the service of capital” (152) and “rising inequality is the logical conclusion of [the] legal order” (223). In short, it’s a book that every policymaker, every macroeconomist, and everyone who is seeking a solution to inequality needs to read.

Capital is comprised not just of an asset but also by the law affecting that asset (2).[[2]](#footnote-2) The economics approach of treating the law as defining and enforcing property rights (e.g. North and Weingast 1989) completely fails to capture what this means in modern legal practice. The underlying rights that are enforced are not so much rights over physical things, as rights to create assets – or capital – by following the rules when assembling the various elements of the law (“the modules of the code”) and to have the terms defined by these assets enforced through the legal system. Lawyers who are both creative and strategic succeed in “*mak[ing]* new law from existing legal materials” (160, italics in original).

Lehman Brothers’ internal structure in the years before its failure is a canonical example of this process. The law governing incorporation – or the creation of a new limited liability entity – makes possible immortality (in theory), shielding of assets from shareholders and from the personal creditors of those shareholders, and in the event of the failure of the corporation, loss shifting (55). Due to limited liability when a corporation goes bankrupt, the losses it has incurred through its operation are shifted from the shareholders to the employees, suppliers, creditors, and the state.

Lehman made copious use of the corporate form to partition its assets (52). The subsidiaries of the parent firm would typically send their profits back to the parent keeping only minimal levels of capital in the subsidiary. These subsidiaries were, however, funded by debt. This was possible because guarantees from the parent – based in contract law – were used to protect debtholders only in the event of bankruptcy. Thus, contract law was combined with corporate law to ensure that losses in the event of the failure of a subsidiary would be shifted to employees, suppliers, tort creditors and the state (53). Nowadays creating this kind of structure that uses the law to give special advantages to asset owners is virtually the definition of good legal practice in commercial law. Another way of describing this practice is “privatizing gains and socializing losses.”

This extremely simple example of coding capital represents, of course, only the tiniest fraction of the world that Pistor describes. Other modules of the code include tax law, intellectual property law, real property law, securities law, bank regulation, etc. All of these comprise the material that the masters of the code use to maximize the benefits of the legal system to their clients.

Two recent phenomena have supercharged this process: choice of law and the adoption of aggressive strategies to limit the opportunities of judges to interpret the law before practices preferred by the masters of the code have been normalized and become ubiquitous. In the past, many corporations were deemed by law to be located where their headquarters or their principal business activities were located. Today, however, most jurisdictions give legal recognition to a corporation based on where that corporation has chosen to incorporate (52). Furthermore, the place of incorporation of the issuing entity determines the property law governing financial assets (136). And in many cases the parties to a contract can choose the law that governs the contract (135). Needless to say, granting the masters of the code the power to select the law by which they will be governed no matter where they choose to operate has vast implications.

An important result of this choice of law is that English and New York law are dominant and govern activities worldwide (168). These are common law jurisdictions where judicial interpretation of the law can be as binding as statutory law. This, however, creates a risk for the masters of the code that the interpretation of the law that they prefer may be rejected in court. And so, the masters of the code have developed strategies to prod and constrain the malleability of the common law into the directions that they prefer.[[3]](#footnote-3) They ‘will go to great lengths to avoid giving a court an opportunity to render a negative ruling on the legal coding’ (180). An important tool for staying out of court has been the promotion of arbitration, an out-of-court dispute resolution procedure that produces outcomes that are enforceable in court as long as both parties have agreed beforehand to use arbitration. Arbitration decisions are generally not public and do not have the same precedential effect as court decisions. Furthermore, arbitrators are chosen by the parties to the dispute – and careful choice of an arbitrator can ensure that a legal approach that a judge might reject may be adopted by all parties to the arbitration including the arbitrator. In this environment, ‘the law becomes stale and the judges lose expertise,’ which then enables the masters of the code to ‘position themselves as the only authoritative spokespersons for the law’ (181).

Lehman Brothers provides us with a clear example of how the law is made in the current system. In the years leading up the crisis, Lehman Brothers International (Europe) (LBIE) created a Swiss subsidiary for the purpose of evading EU prudential regulations and used automated back-to-back repo transactions to transfer the risk of its trades to the subsidiary – with no actual transfers of cash for the repos. In administration, the subsidiary’s creditors sued, claiming that the subsidiary owned the underlying assets. A UK court found for LBIE on the basis that both parties intended for LBIE to be ‘clothed’ with formal title, even though the subsidiary bore the risks of the assets, and stated: “It is … counterintuitive to think that one of the largest and most sophisticated investment banking institutions in the world, staffed by some of the foremost experts in the business and advised by the most eminent law firms, should have spent more than a decade solemnly entering into countless thousands of mutual transactions which were either completely unnecessary, completely ineffective or both. …” (75) In short, the court condoned transactions, that were more or less fictitious, and had been engaged in for the sole purpose of regulatory arbitrage – on the basis that the masters of the code must surely know what they are doing.

As a consequence of this legal framework the coding of capital takes place in private law offices and important decisions about what the law means are never considered by either legislatures or judges (133, 214). Kenneth Kettering (2008) describes this process as one of creating “too big to fail” instruments: by the time that a questionable (if not simply wrong) legal interpretation that has been embraced by the masters of the code is finally brought before a judge, the scale of financial transactions that depend on that legal interpretation has often grown so big that a conservative interpretation of the law has implications for financial stability – in which case, an amicus brief from the Federal Reserve in favor of the coding strategy may be forthcoming. Kettering (2008) documents how the foundations of modern financial markets, repurchase agreements, standby letters of credit, and securitization, have all relied on this process of the private sector developing “the law” in advance of legislators, regulators, and judges.

Another consequence of this framework is that governments have lost control of the law. On the one hand, “the expanded choice set for lawyers” means that “no single state controls the limits of what or how lawyers code capital in law” (160). And on the other, “powerful holders of global capital with the help of their lawyers 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” (154). Indeed, after the 2008 financial crisis the governments of the advanced economies effectively had to form a union, the Financial Stability Board, in order to negotiate effectively with the financial industry and the ISDA in particular (150-51).

Underlying this modern legal structure are what economists call property rights; in our modern legal system theses property rights in fact represent the right to state enforcement, not just of contract law and ownership claims, but also of the “private coding” of capital, that is, the creative use of the law to design assets that create vast profits for their owners at the expense of everyone else (4). The result of this legal order is that the masters of the code determine the distribution of wealth in society (162). And their skills are made available only to the best paying clients (20).[[4]](#footnote-4) The logical conclusion of this process is rising inequality (223).

Overall, *The Code of Capital* is an extraordinary exposition of one of the most complex dynamics driving inequality in the modern world. And it is an exposition that only a lawyer could comprehend and write. But it is also important to note that typical lawyer does not have the breadth of vision that Pistor brings to her subject. The masters of the code are often so consumed by the exquisite work required to navigate through the most minute details of the law and regulatory rules that govern their practice, that the forest that they have seeded and watered is often invisible to them.[[5]](#footnote-5) This is what makes Pistor’s work so remarkable: she is an excellent guide through the complex paths that traverse the forest of the code.

As is often the case, however, the strengths of this work are closely related to its weaknesses. The approach Pistor takes is that of the grand narrative discussing the coding of capital from the middle ages to the present. And the arc of her narrative is organized around the role played by the coding of capital in the history of capitalism. This leads her to make some very broad generalizations about the nature of capitalism itself. While some of these claims are a refreshing antidote to, for example, the approach of mainstream economics, others merit some critical analysis.

Pistor’s approach to money is what economists would call heterodox, though with her focus on the relationship between money, debt and capitalism itself, she appears to owe more to the sociology of money (Ingham 2004) and the new history of capitalism (Desan 2015).[[6]](#footnote-6) For example, she writes: “the ability to spend money one does not have is – for better or worse – the very essence of capitalism.” (199) and “Debt, the private money that has fueled capitalism since its inception, is coded in law and ultimately relies on the state to back it up” (107).

This ties in closely with the theme of master coders designing assets to generate wealth for their clients, because one of the master coders’ goals is convertibility or the ability to convert the assets they create into state-issued cash (78). To this end they “rely on state power in times of crisis” when “ad hoc rescue actions … prevent the collapse of the value of their assets for fear that failing to do so might bring down the entire system” (223). In short, Pistor argues that the masters of the code design assets with the understanding that in a crisis the state will be obliged to bail them out. In her grand narrative, Pistor does not restrict her claims to the current financial system, but claims that this state support, socializing losses is “the curse of private debt finance” (203), effectively claiming that capitalism has always been founded on this socialization of losses.

While the 2008 crisis provides strong evidence for this approach as a modern phenomenon, the idea that state bailoutsof private sector entities have been fundamental to capitalism historically is open to question. England provides a counter-example. The first extraordinary lending policy adopted by the Bank of England in 1811 was carefully structured to ensure that the private sector would bear any losses on the loan, and as a result in the worst crisis of the early 19th century the Bank had a loss ratio that rounds to zero (Sissoko 2019). Eighty years later a similar structure would be used in the 1890 Baring crisis, when the Bank supported the convertibility of bills of exchange by allowing Baring to separate into a “good bank” that held the bills and a “bad bank” that held the risky debt. Support for the “bad bank” was structured so that 94% of the risk of the loan was borne by other private sector financial intermediaries – and ultimately it was the partners in Barings who sustained all of the actual losses (Sissoko 2016). This is evidence for a view of capitalism that is very different from Pistor’s: it works best when the costs of crisis are spread across the private financial system and there is no expectation of bailouts from the state.

Indeed, the care that the Bank of England took, when providing support to the 19th century English money market, to ensure that the risk fell on the other private banks is undoubtedly related to the fact that it was a privately-owned institution. Thus, it is important to recognize that the relationship between state power and private power in the cradle of capitalism was very complex and deeply interwoven – and is not amenable to simple claims about state bailouts.

Pistor makes similar broad claims about the nature of capitalism when she seeks to answer the question of “how did this specific relation between private and public power, private code and public law, come about?” She sees not just the foundations of the modern system in the past, but a continuity of the system over the centuries (218). She argues that the historical vibrancy of capitalism derives from the ability of private actors to code capital in law (209). Indeed for Pistor the difference between capitalism a century ago and capitalism today is that the older institutions were weak and thus the invisible hand could do its’ job, whereas today the invisible hand has become superfluous as “institutions are in place that allow economic agents to enforce their rights and interests anywhere” (7).

While Pistor’s discussion of the present state of affairs is accurate, her presentation of both the legal history and the history of capitalism often involves generalizing from specific examples that are not representative of the complexity of the history. In support of her view that the innovative vibrancy of capitalism through the centuries has depended on legal coding, she cites the remarkable work done by English country solicitors to protect the interests of the landed elite (159). Through the 18th and the 19th centuries, however, capitalist development was much more closely related to the commercial class and developments in commercial law. And in this era both jurists and legislators sought very deliberately to design an effective system of commercial law, in consultation with the merchants directly.

Consider for example, the English common law governing commercial contracts – or negotiable paper, which was very deliberately turned into a coherent system by Lord Mansfield, Chief Justice of the King’s Bench from 1756 to 1788. He set the standard that “judges used the principle that the custom of merchants was part of the common law as the basis for maintaining control over the development of the law … into a sensible body of law” (Rogers 1995: 221). Later jurists built on the principles that he established: decisions were based on information about commercial practice provided by merchants either through testimony or via special juries and should balance two goals, certainty and the promotion of trade and commerce (Rogers 1995: 211-22). In short, neither merchants nor their proxies were making law. This attitude that traders propose and the judge disposes was also the norm in the US until at least the 1930s.[[7]](#footnote-7)

As for the English legislature, consider how one of the “age-old limitations on coding capital” that Pistor seeks to re-establish was first enacted into law. The rule that financial contracts that can be characterized as wagers are void – and therefore not enforceable in a court of law – was part of the 1845 Gaming Act. Parliament recognized that the laws governing speculation both on the Stock Exchange and off of it were incoherent. For example, derivatives on some classes of stock were enforceable in court while derivatives on other classes of stock were not. So Parliament formed a Committee to interview stock market participants alongside other book-takers (H.C. 1844). The 1845 Gaming Act was then adopted at the recommendation of the Committee.[[8]](#footnote-8) Six years later the implications of the 1845 Gaming Act for the stock market were established when a court interpreted the law, finding that whether or not it applied to a specific transaction was a factual question: Did either party intend to purchase or sell the underlying shares? If not, the transaction was a wager and void.[[9]](#footnote-9) This principle was promptly adopted by US jurists[[10]](#footnote-10) and in 1884 was adopted by the Supreme Court of the US.[[11]](#footnote-11) In short, 19th century English and American legislators were far less ready to grant special exemptions to commercial interests than Pistor implies (205-07).

For a more recent example, consider the comprehensive package of statutes that were adopted by the US legislature in the 1930s after the partial collapse of the financial system and the Great Depression. The Glass-Steagall Act addressed the problem of asset price bubbles by separating commercial from investment banks (Senate Report 1933; Sissoko 2017). The Federal Home Loan Bank Act provided support for and regulation of the mortgage industry. Legislators were aware that financial activity was likely to flow from regulated entities to unregulated entities (SEC 1945: 44), so a package of laws was designed to ensure that only tiny unregulated financial intermediaries could exist. The Securities Act and the Securities Exchange Act covered investment banks, securities exchanges and over-the-counter markets for securities. The Commodity Exchange Act effectively required derivatives contracts on commodities to be exchange traded. And the Investment Company Act required registration of investment companies and put strict restraints on their borrowing activities. The result was almost half a century of financial stability, followed by complacency and the destabilizing reforms that Pistor documents.

Overall, the case can be made for a thesis directly opposed to Pistor’s claims regarding the relationship between the law and capitalism. There is significant evidence for the view that the vibrancy of Anglo-American capitalism depended not only on the malleability of the common law legal code, but also on jurists and legislators who took responsibility for both investigating current commercial practice and carefully shaping the common law into a coherent system.

This reframing of the history indicates that something has been going very wrong with our “capitalist” system in order for the masters of the code to play the role in making law that Pistor explains so well. According to Pistor legislators have been expanding the capacity for the coders to make law “in the hope of keeping the motor of the economy humming” (215). If she is correct about their goals, then by reframing the history, we also show that jurists and legislators have been doing the opposite of what is needed in order to sustain a capitalist system. They should be actively engaged in the design of a sensible legal structure to support commerce, and the situation that Pistor describes is an aberration that reflects a failure to adopt the kind of law that supports a vibrant capitalist economy.

Indeed, Pistor recognizes in several passages that the modern legal system has changed significantly from what it was in the past. Formerly, governments were more careful to protect their legal sovereignty by limiting the right to choose to be governed by foreign law (160). In addition, the growth in the coding of intangible assets, such as patents, has significantly increased the value of legal coding (165). Equally important, legal practice has changed significantly. In the years after World War II legal education expanded dramatically in the United States and was accompanied by the use of much more aggressive legal strategies than had been the norm in the past. And because of the structure of US law, where each state has its own law, but also has the obligation to recognize entities created under the law of other states, the US was a natural “incubator for developing highly competitive legal coding strategies” that were designed to exploit differences in the law across states (177). This new aggressive approach to law has been exported globally which helps explain how the practice of law has been transformed.

Despite the broad generalizations that Pistor makes about capitalism, ultimately she concludes that wholesale reform of capitalism is not a pragmatic solution and she opts for “persistent incrementalism” to address the problems that she describes. Her proposals include: an end to special exemptions from the law, the rolling back of exemptions that have already been granted such as the enforceability of derivatives contracts, the rolling back of choice of law rules, restrictions on private arbitration, strengthening of the mechanisms by which damages can be claimed by those harmed by legal coding, proactive measures to prevent crises, coordination to avoid regulatory competition, and finding a means of paying for legal education that doesn’t force new lawyers to work for master coders. These are excellent recommendations. But to successfully restore vibrancy to economies that have been capable in recent decades only of anemic growth, these recommendations need to be accompanied by something else: a change in the attitude of our legislators and our judges so that they take responsibility for designing a coherent legal infrastructure to support economic activity and to balance the interests of all participants.

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1. Senior Lecturer, University of the West of England. Email: Carolyn.sissoko@uwe.ac.uk [↑](#footnote-ref-1)
2. Indeed, this is implicitly recognized by economists in the very structure of national accounts data: they track the legal ownership of assets and by doing so measure capital as a factor of distribution, not of production (Knibbe 2019). [↑](#footnote-ref-2)
3. Of course, bodies like the International Swaps and Derivatives Association (ISDA) also lobby – often successfully – for statutes that promote the interests of the masters of the code and their clients. [↑](#footnote-ref-3)
4. Evidence of the attitude towards regulators fostered by this modern legal structure based on “master coders” is given in a recent report on an IRS investigation of Microsoft, where the IRS, recognizing the complexity of the issue, hired elite private sector lawyers. According to the news report an attorney for Microsoft argued that “It was fundamentally wrong for the IRS to use high-powered litigators … because ‘they know how to win, and that’s very different’ than the IRS’ mission. The IRS was supposed to work with taxpayers to ‘find the right number,’ she said, not focus on winning.” (Kiel 2020). [↑](#footnote-ref-4)
5. Pistor writes: “Lawyers tend to ignore the[] external effects of their coding efforts. They put their clients’ interests first and are paid well for doing so. Few therefore consider the broader effects of their doing, and the ones who do hope for the invisible hand to correct the structural biases they create for their clients. They don’t realize that the success of their coding strategies has turned the invisible hand into a fairy tale.” 166 [↑](#footnote-ref-5)
6. Pistor cites both of these sources in footnote 41 to Chapter 8. [↑](#footnote-ref-6)
7. Regarding the T.J. Hooper case in which Judge Learned Hand held that while “in most cases reasonable prudence is in fact common prudence … courts must in the end say what is required” (60 F.2d 737 (2d Cir. 1932)), Epstein (1992: 3) observes “ Hand’s opinion fell securely within the legal mainstream of his own time and was greeted with relatively little commentary.” [↑](#footnote-ref-7)
8. Gaming Act, 8 & 9 Vict., c. 109 (1845). [↑](#footnote-ref-8)
9. Grizewood v. Blane, 138 Eng Rep 578 (C.B. 1851) [↑](#footnote-ref-9)
10. American judges in the 19th century typically found English precedents in matters of commercial law extremely persuasive. In the fifty years after Grizewood, this British case was cited 25 times in jurisdictions throughout the United States, and during the same period many of the states that did not have wagering statutes enacted them, including Illinois, with its growing commodities trade. [↑](#footnote-ref-10)
11. *Irwin v. Williar*, 110 US 499 (1884) [↑](#footnote-ref-11)