Territory v. Money[1]

Law and the Changing Sources of Power in Global Affairs

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The link between property and sovereignty was forged in an age when land was the primary source of wealth and power. Over the course of the last several decades, financial assets have replaced land as the major source of wealth; and financial sovereignty has replaced control over territory and people as the primary source of power, both internally and externally. We continue to organize polities primarily along territorial lines but have advanced the organization of finance along transnational lines. The real sovereigns in this world are no longer the executives who declare war or announce a state of emergency, but the central bankers who in the midst of financial crises suspend the rules of the game to protect the system from collapse. A new transnational order led by central banks is emerging that uses handshake diplomacy rather than treaty law to determine who will have access to the most coveted currencies in times of crisis. They sit on top of a global money system that is coded in law, but the survival of which depends in crises on the suspension of the full force of the law or the declaration of a state of emergency in Schmittian terms.

[1] I would like to thank Roy Kreitner for excellent comments and on earlier version of the paper.

I. Introduction

This paper explores the transformation of sovereignty and property in the age of global finance. The notions of property and sovereignty are both rooted in territory, or land. The most rudimentary definition of states is the organization of power over territory and people within that territory.[2] Sovereignty over territory and people can be exercised by an autocrat (and this is how "the sovereign" is often depicted), but in constitutional democracies also by the people themselves. How sovereignty is configured and exercised is therefore ultimately a question of institutional choice. As we will see, for monetary or financial sovereignty, current institutions favor autocrats or, at best, club like rather than democratic governance.

The relevant property law of that state determines the scope of control rights people can exercise over assets, such as land, personal property, financial assets, and the like. Until well into the twentieth century agricultural or rural land was the most valuable asset in all societies.[3] Indeed, land relations have shaped property law in most legal systems. Land as territory also determines the boundaries of polities both within and among states. Witness federal states subdividing political control along territorial boundaries of their subunits, that, is states or *Länder*.[4] Public international law is built around the notion that sovereign states are bounded by territory and limits the "extraterritorial" reach of state power by principles of comity and the international law of war.

The close connection between land, property and sovereignty has deep historical roots. Yet, land no longer serves as the primary source of wealth or power as it once did. Money has taken its place. This metamorphosis has not occurred over night. Neither has it been the result of market forces or evolutionary trends beyond human control. Rather it required the active support and participation of the sovereign states themselves, some taking a more proactive role, others farming out their legal and financial sovereignty in the hope of a fair share in global finance. Once legal and financial sovereignty has been

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[2] So called "three-element theory". See G JELLINECK, ALLGEMEINE STAATSLEHRE (1905).
[3] THOMAS PIKETTY, CAPITAL IN THE 21ST CENTURY (Harvard University Press 2014).
[4] The term for „state“ in German is derived from the word „Land“.

relinquished, however, it is just as difficult to regain as territorial and political independence after occupation or colonization; perhaps even more so.

The shift from property and territory to money has deeply affected domestic and international relations. Whereas control over territory manifests itself in the last instance in the power over police and armed forces, control over money is vested in state agents that control the issuance of money. They declare war or a state of financial emergency that empowers them to take extra-legal measures at least temporarily.[5] This shift from territory to money has entailed a shift in power both within and across states. It locates most power with countries at the apex of a system of moneys that has been organized hierarchically. It also challenges existing mechanisms of accountability, which were created for polities e organized around people and territory, not the governance of a global system of moneys.

II. Territory and Property

In sedentary agricultural societies power and wealth is rooted in land. Land relations take center stage in the organization of social relations. During the age of feudalism land relations *were* the political order. Lords, vassals, and peasants were all tied to the same land(s) but had different rights to it. From these highly differentiated land relations that determined use rights, control rights, and other obligations, such as military services, sprang the powers those higher up in the hierarchy could exercise. These powers included the power to tax, to adjudicate and to demand said services.

The legacy of feudalism has shaped the property regimes of the European nation states' formal legal orders. Its long shadow is perhaps most visible in England, where despite its formal demise relatively early, the land relations it had fostered lingered on well into the twentieth century, supported by private law institutions: trust law and the practice of strict family settlement. They ensured that control over land remained in the hands of a relatively small elite into the twentieth century.[6] Available data suggest that in the late

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[5] This invokes Carl Schmitt's notion of sovereignty, as the power call a state of emergency. I am not saying that this is the only indicator for sovereignty either normatively or empirically, but it is an important one.

[6] Bernard Rudden, *Things as Things and Things as Wealth*, 14 OXFORD JOURNAL OF LEGAL STUDIES (1994);J. Stuart Anderson, *Property Rigths in Land: Reforming the Heritage*, *in* THE OXFORD HISTORY OF THE LAWS OF ENGLAND (William Cornish, et al. eds., 2010).

nineteenth century fewer than seven thousand families owned eighty percent of all land in England.[7] They typically did not occupy their land but leased and mortgaged it. Leasing had become "a way of life" already in eighteenth century.[8] Law that limited creditor rights with regards to family estates protected them from the wrath of their creditors. Only in the late nineteenth century were life tenants of real property treated like owners of chattel and could creditors enforce against all of their property, including land and even the family mansion.[9] Only then did land become a commodity that could be freely bought and sold, encumbered and seized in full, by secured and unsecured creditors alike. As a result, over 25 percent of all land in England changed hands after these reforms had been put in place.[10] The same happened in colonial America almost two hundred years earlier, when the Debt Recovery Act of 1732 imposed by the English parliament removed the legal privileges that had protected land from (English) creditors and treated realty like chattel. It ended up on the auction block and the former family estates were broken apart.[11]

As these examples suggest, the these he scale and scope of land as a source of wealth is a function of law. Even in France, where the 1789 Revolution swept to power a new economic class and the Declarations of the Rights of Men proclaimed property as universal human right, the practice of modern property law owes much to its feudal origins.[12] The rights of the former landlords were transposed into absolute, private property rights, ready to be acquired by the newly rich bourgeoisie. These rights no longer conferred the power to tax or adjudicate over others, but they created absolute entitlements that could be protected against private parties (with the help of the state) and even against the state. In contrast, the former *dominium utile* of peasants of the feudal order was transformed into lease rights, mere contractual rights with considerably weaker legal protection.

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[7] Ellen Spring, *Landowners, Lawyers, and Land Reform in Nineteen-Century England*, 21 AMERICAN JOURNAL OF LEGAL HISTORY (1977).

[8] See Anderson supra note [] at [].

[9] The Conveyance and Land Settlement Acts of 1893 achieved most of this, but a mandatory registration system had to await the revision of the Land Settlement Act in 1925. See Rudden and Anderson supra note [].

[10] See Spring (1977) supra note [] ate [].

[11] Claire Priest, *Creating an American Property Law: Alienability and its Limits in American History*, 120 HARVARD LAW REVIEW (2006).

[12] Horst Welkoborsky, *Die Herausbildung des bürgerlichen Eigentumsbegriffs*, *in* EIGENTUM UND RECHT: DIE ENTWICKLUNG DES EIGENTUMSBEGRIFFS IM KAPITALISMUS (Wolfgang Däubler ed. 1976).

The national legal orders that codified property rights evolved within territorially bounded nation states. From here they 'traveled' mostly by conquest. Napoleon's troops famously brought the Civil Code with them and so did other powers that conquered the world during the age of colonialism.[13] There was no shortage of attempts to zone, title, register, and transform land relations even against fierce local resistance or conditions that defied the imposition of clear geometry, like the Nile Delta, with its floods and changing river bed.[14]

In sum, land is where private property rights and territorial claims of nation states meet. Under feudalism property and political relations were one and the same. With the transformation of the political orders in modern Europe the two became separated. Nation states claim control over territory and establish legal regimes for property rights within their boundaries. Carrying property rights from place to place has never been easy, because their enforcement depends on state power and state that created certain entitlements are more likely to uphold them than others. In the past, property regimes expanded with conquest and colonization. Nowadays, multilateral organizations, such as the World Bank, lend a helping hand. Zoning, titling, mortgage and collateral laws standardized on Western models have been implemented in countries around the globe often employing companies from countries with a long history in 'triangulating' property rights on foreign soils.[15]

One of the most visible results of these legal transplants is the rise in transnational real estate transactions, also dubbed "land grabs".[16] They confer rights to land to foreign investors, both private and sovereigns. Many countries that find themselves on the sell side of transnational real estates deals are also parties to bilateral investment treaties that protect foreign investors against infringements on their investment rights. The ability of these countries to scale back the transfer of land or constrain its use in the future is thus constrained by the threat of investor arbitration and damages in the hundreds of millions of dollars. The phenomenon of land grabs suggests that land still matters, even in our age of

[13] Dan Berkowitz, et al., *Economic Development, Legality, and the Transplant Effect*, 47 EUROPEAN ECONOMIC REVIEW (2003).
[14] Robert Home, *Scientific Survey and Land Settlement in British Colonialism, with Particular Reference to Land Tenure Reform in the Middle East, 1920-50*, 21 PLANNING PERSPECTIVES (2006).
[15] Klaus Deininger & Gershon Feder, *Land Registration, Governance, and Development: Evidence and Implications for Policy*, 24 WORLD BANK RESEARCH OBSERVER (2009).
[16] Olivier De Schutter, *The Green Rush: The Global Race for Farmland and the Rights of Land Users*, 52 HARVARD INTERNATIONAL LAW JOURNAL (2011).

financial globalization. Still, it no loner has the preeminence in producing wealth or determining sovereignty it once had. Money has taken its place.

III. From Territory to Money

Political economists, including Adam Smith and Karl Marx, have sketched the evolution of economic systems from early nomads to sedentary agriculture, and from here to the age of commerce (Smith)[17] and ultimately to capitalism (Marx).[18] Continuing this line of reasoning, ours is the age of *global* financial capitalism.[19] At every step along this (idealized) evolutionary chain property regimes changed, as both Smith and Marx have suggested. It should come as no surprise that the rise of global financial capitalism is reshaping not only property rights but also the meaning of sovereignty.

The relation of money and finance is much debated in the literature.[20] I subscribe to the view that the two are not distinct, but form a continuum and will therefore use the term "state money" for the legal tender and "private money" for privately issued obligations to pay, or IoUs. In this general definition money is a means of pay that can be issued by private or public agents.[21] As such, it predates the ages of commerce and capitalism. Its role in the economy, however, has changed. It continues to operate as a means of exchange, unit of account, and store of value already accumulated. Its most important contribution to economic growth and development, though, is its ability to generate *future* value. Empirical data indicate that financial assets together with (mostly debt financed) urban housing now make up the bulk of wealth in developed economies; agricultural land has become all but irrelevant.[22]

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[17] ADAM SMITH, et al., LECTURES ON JURISPRUDENCE (Liberty Classics. 1982).
[18] Karl Marx, Die deutsche Ideologie § 3 (Karl Marx & Frierich Engels eds., Dietz Verlag 1969).
[19] Rudolf Hilferding suggested one hundred years ago that we had reached the age of "Finanzkapitalismus". For more recent assertions along these lines see GRETA A. KRIPPNER, CAPITALIZING ON CRISIS (Harvard University Press. 2011).
[20] For an excellent juxtaposition, see Perry Mehrling, *Minsky and Modern Finance: The Case of Long Term Capital Management* Winter 2000 JOURNAL OF PORTFOLIO MANAGEMENT (2000).
[21] There is a huge literature on the nature and origins of money. For recent summaries of the core positions, see GEOFFREY INGHAM, THE NATURE OF MONEY (Polity Press. 2004). and CHRISTINE DESAN, MAKING MONEY: COIN, CURRENCY, AND THE COMING OF CAPITALISM (OUP. 2015).
[22] See Piketty supra note []

As Hyman Minsky observed, anybody can issue an IoU, but not all will find takers.[23] Not every 'money' is a viable store of expected future returns.[24] Some will be in greater demand than others. Furthermore, the relative demand for a specific money species can change over time. In the age of public and private fiat moneys the value of money is not determined by any intrinsic value attributable to its form or contents. Its value is determined by the credibility of the commitment to make good on future pay, and this depends in part on law and in part on politics.

According to Christine Desan, state money is a constitutional project.[25] Public law identifies the legal tender is (it may well be a note issued by a private entity, as in the case of the Bank of England in the nineteenth century). It allocates resources to its management through a special agent such as a central bank and its powers and constraints in backstopping the currency. Public law establishes prudential requirements for financial intermediaries, imposing more stringent requirements on some, while exempting others. Last but not least, it determines if and for what purposes money can cross borders (inwards and outwards) and for what purposes foreign money can be exchanged into domestic currency. Lastly,

The major difference between state and private money(s) is the fact that the legal tender, whether issued by a public or private agent, enjoys the full faith and credit of the issuing country and that the government can commit the future resources of the country to do so.[26] In contrast, private moneys are issued by entities that face their own binding survival constraint and cannot, on their own, impose a burden on others to help them out. It follows that ultimately private money depends on the willingness of a public entity, i.e. a

[23] HYMAN P. MINSKY, STABILIZING AN UNSTABLE ECONOMY (Yale University Press. 1986).. For an insightful review of Minsky's work and its relevance for contemporary finance, see Perry Mehrling, *The Vision of Hyman Minsky*, 39 JOURNAL OF ECONOMIC BEHAVIOR AND ORGANIZATIONS (1999)..

[24] For an elaboration of the 'money view', which builds and expands on Minsky's work, see PERRY MEHRLING, THE NEW LOMBARD STREET: HOW THE FED BECAME THE DEALER OF LAST RESORT (Princeton University Press. 2011). and Perry Mehrling, et al., *Bagehot was a Shadow Banker: Shadow Banking, Central Banking, and the Future of Global Finance*, SSRN.COM (2013).

[25] See supra …

[26] See Mehlring et al supra note and Zoltan Pozsar, *Shadow Banking: The Money View*, 14 OFFICE OF FINANCIAL RESEARCH, US TREASURY (2014).

state or its central bank – to back it.[27] The more credible and reliable this backstopping, the more valuable the private money in question.

Like a coin, the option to exchange one money for another has two sides: one legal, the other political. Money can carry the right to be accepted at face value, or not. Legal tender does so. Most states also commit to honor their sovereign bonds – and most do so, at least most of the time.[28] Bills of exchange, one of the first widely traded instances of private money, stipulated the amount owed, but were subject to discounts given the risk intermediaries assumed when accepting a piece of paper in lieu of pay in coinage.[29] 'The market' is supposed to determine the value of most financial assets today – but 'it' is also smart enough to look to both public and private law. Risk ratings conducted for the most part by government endorsed rating agencies[30] are critical for determining the price of public and provide moneys as they provide a shorthand of relevant risk factors.[31] Rating agencies will afford the much covered "AAA" rating only if a claim is collateralized or has effective liquidity support by an intermediary, which in turn is backstopped by the central bank.[32] In other words, what counts are *legally* perfected security interests and *legal* access to central bank liquidity.

Politics (or more bluntly, power) comes in when there is no legal commitment, when it is not honored, or when it is unenforceable. Intermediaries without legal access to central bank liquidity may still bet on a central bank rescue. However, they have no enforceable

[27] On central bank collateral guidelines of leading central banks, see Samuel Cheun, et al., *The Collateral Frameworks of the Eurosystem, the Federal Reserve System and the Bank of England and the Financial Market Turmoil*, 2009 OCCASIONAL PAPER SERIES, EUROPEAN CENTRAL BANK (2009).

[28] Sovereign debt defaults do happen, but they are relatively rare. Recent cases include Argentina in 2001 and Russia in1998. In England, a protracted legal battle in the seventeenth century between the Crown and its financiers curtailed the power of the crown to cancel its debt at will. See Douglass C. North & Barry R. Weingast, *Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth-Century England*, XLIX THE JOURNAL OF ECONOMIC HISTORY (1989).

[29] For a comprehensive legal history of the bill of exchange see JAMES STEVEN ROGERS, THE EARLY HISTORY OF THE LAW OF BILLS AND NOTES: A STUDY OF THE ORIGINS OF ANGLO-AMERICAN COMMERCIAL LAW (Cambridge University Press. 1995).. See also Raymond De Roover, *Money, Banking, and Credit in Medieval Bruges*, 2 THE JOURNAL OF ECONOMIC HISTORY (1942).

[30] The so called "Nationally Recognized Statistical Rating Organizations.

[31] See John Jr. Coffee, *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 237 COLUMBIA LAW AND ECONOMICS WORKING PAPER (2003).for a critical account of rating agencies.

[32] As illustration see the rating methodologies for asset backed securities by Moody's available at https://www.moodys.com/Pages/rr003006001.aspx

claims and the final decision lies squarely with the central bank.[33] Holders of private claims, such as asset-backed securities, may find that they can't enforce against the underlying asset for legal reasons,[34] or because the asset itself has declined in value. They will now have to try their luck elsewhere – with private actors willing to buy their assets at a reasonable discount, and if they can't find them, ultimately with a central bank. Central banks exercise substantial discretion in determining which assets they will accept as collateral in return for cash. Originally, the U.S. Federal Reserve Act had limited the Fed's discounting powers to "real bills"; since, central banks have been empowered to determine whether they will also affect sovereign bonds and privately issued debt of different sorts. Holders of assets not currently included in collateral guidelines or facing a steep haircut may hope for an implied "put", that is, they may hope that in times of emergency the central bank will accept any asset as collateral (as it pretty much did after the lass crisis), but this is still a bet.[35]

The desire to convert assets in search for yields or safety suggests that state issued money and privately minted financial assets are linked in a hierarchical relation.[36] The position of every 'money' is determined by its legal qualities (the asset backing and liquidity support structures coded in private law), and when the fail, by the propensity to convert it into better money. The 'best' money is the currency issued by an entity that has the capacity and credibility to support *all* other moneys that no longer find any takers without facing its own survival constraint. It occupies the apex of our global money system.[37] By definition this must be a public entity, i.e. state, for only such entities can credibly commit the future productivity of an entire economy – which it what it takes when an entire financial system must be bailed out .

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[33] As illuminated by the discussions on 'too-big' or 'too-interconnected' to fail and about government sponsored entities. [ADD REFS]
[34] See the Ibanez case decided by the Massachusetts Supreme Court in 2011. See also Dan Whitman, *How Negotiability has Fouled Up the Secondary Mortgage Market, and What to Do about it*, 37 PEPP. L.REV (2009).
[35] On the willingness of different central banks to accept collateral and on what conditions see Cheung et al supra note [].
[36] See Perry Mehrling, *The Inherent Hierarchy of Money*, *in* FESTSCHRIFT FOR DUNCAN FOLEY (2012).. Note, however, that Merhling does not link hierarchy directly to legal quality.
[37] On the hierarchy of money in global relations, see Perry Mehrling, *Essential Hybridity: A Money View of Law and Finance for Foreign Exchange*, 41 JOURNAL OF COMPARATIVE ECONOMICS (2013). and David DeRosa, *Sponsored Transactional Patterns: Comments on Mehrling's "Essential Hybridity: A Money View of FX"*, see id. at..

An effective backstopper of last resort therefore must controls its own monetary policy, issues its debt mostly in that currency, and has the legal power and political support to commit the country's future resources to backstop its financial system.[38] Clearly, not all states can do so and those that can't are not sovereign in the full sense of this concept. Some states may confront a financial system that has outgrown the state's capacity. Consider Iceland, whose banks had accumulated debt that was eight times as big as its annual GDP. Others do not have the legal capacity to offer effective lender of last resort services. They may not issue a currency of their own and/or lack control over their monetary policy (i.e. as result of IMF conditionalities). Or they may be constrained by debt burdens denominated in foreign currencies. Committing the country's own resources is not enough when the debt has to be paid back in a foreign currency over which the indebted country has no control. In fact, once if finds itself in trouble if will also discover that foreign currencies have just become much more expensive. And finally, states or their central banks may lack the undisputed legal power to "do whatever it takes" to support public or private moneys, or face political opposition when exercising it. An example of the former is the legal dispute about the ECB's "open monetary transactions" – a program announced in the summer of 2012 that committed to buy as much sovereign debt on secondary markets as necessary to avoid a flight from the Euro. This was challenged first in the German Constitutional Court and then the European Court of Justice (ECJ), because the Maastricht Treaty denied the ECB the power to engage in fiscal funding. In the end, the ECJ held that the measure was within the powers of the ECB. Legal uncertainty itself can undermine the credibility of a policy, although in this case it did not.[39] In a similar vein, the U.S. Congress's refusal to increase the debt ceiling and the shut down of the government in the fall of 2013 (and threats to do so hence) may at some point erode the standing not only of U.S. sovereign debt but also the dollar in the eyes of investors. Since the U.S. dollar has been the global reserve currency for six decades it would also require an alternative currency as safe haven.

[38] For a full development of this argument see Katharina Pistor, *A Legal Theory of Finance* see id. at..
[39] See the June 2015 ruling by the ECJ. See http://curia.europa.eu/jcms/upload/docs/application/pdf/2015-06/cp150070en.pdf. Note, however, that the German Constitutional Court will still have to review the matter. It has not formal jurisdiction to rule on European law, but it claimed that German constitution law principles, in particular the principle of democracy, were invoked by OMT.

Many other states find themselves way down in the hierarchy of public moneys. They do not control their own currency or can borrow at reasonable cost only in foreign denominations. Ireland is a glaring example of a country, which, in the fall of 2008, committed publicly to write a blank check for its entire banking system only to find itself enthralled in a sovereign debt crisis that required external support from the Troika.[40] Greece is an even starker case. In the summer of 2015 its own central bank, which is part of the system of European system of central banks and no longer autonomous had to stand by when the country's banking system was shut down after the European Central Bank (ECB) refused to continue emergency lending because of Greece's refusal to accept the conditions of the Troika. Argentina is another case in point. The country never gave up its own currency, but it raised most of its debt in foreign currency and under foreign (US) law. It also committed to foreign investors that they would be able to repatriate their profits *and* convert them at a fixed rate into U.S. dollars. That commitment looked credible when Argentina was booming in the 1990s, but became hallow when the country faced a run on its currency and had to close its own banks to prevent a full blown twin crisis: currency and banks. Argentina restructured its debt, but hold-out creditors won a legal battle in U.S. courts that secured their right to full payment notwithstanding the fact that other creditors had accepted a debt restructuring and thereby facilitated the country's recovery. What is more, the court prohibited the U.S. based financial intermediary from making any payments to the restructured creditors if the holdouts were not paid at the same time. It thereby forced Argentina to default again.

Like territorial sovereignty, financial sovereignty is a relative concept. Both are rooted in legal commitments made credible by the threat to use extraordinary means -- military or liquidity -- to back them. Few countries voluntarily cede their territorial sovereignty, although there are cases where states have asked for outside military help or allow foreign military bases. Many more have ceded financial sovereignty. Most have done so 'voluntarily' by joining a monetary union, raising debt in foreign currencies, or constraining their own monetary policy with currency boards and the like. Yet, they may not have grasped the implications of their actions. Once they abandoned capital controls they had

[40] The Troika includes the European Commission, the European Central Bank and the International Monetary Fund)

little preventive arsenal left against capital inflows that might upend their capacity to recue their own financial system.[41]

IV. The Law of Private Money

Private money, that is, IoUs issued by private entities, roams the globe crossing territorial and jurisdictional boundaries at the strike of a key, or at least so it seems. Long distance trade has always relied on long distance financing. Both precede the rise of the nation sate. What has changed is the sheer scale of private in relation to state moneys. Private debt outpaced public debt in developed market economies in the years leading up to the global crisis – a trend that was reversed only when governments were forced to socialize private debt. Like state money, private money is rooted in law. If the rise of territorially defined nation states is rooted in property law, the rise of private money is rooted in collateral, trust, corporate and bankruptcy law.[42] These institutions are defined in domestic law, but they have become mobile. They are the pillars of the so-called shadow banking system.[43]

If simple IoUs are contracts, the law of negotiable instruments is contracts on steroids. Collateral law creates priority rights, privileging some creditors over others. It is the alchemy of structured finance, securitization, and the rise of the shadow banking system. Trust and corporate law offer legal shields to protect asset pools from creditors of their founders, current owners or managers.[44] They have become critical building blocks for securitization and derivatives structures, which rely on the legal segregation of asset pools and prioritization of claims. Last but not least, bankruptcy law ranks creditors by the quality and sequence of their claims. It vindicates the priority rights created long before bankruptcy with important ex ante effects.[45]

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[41] The IMF was an ardent supporter of capital account liberalization in the 1990s but has recently changed course. See IMF, GLOBAL FINANCIAL STABILITY REPORT (International Monetary Fund. 2011). [CHECK].

[42] I develop this argument in greater detail in a book project entitled "The Legal Code of Capital" (forthcoming).

[43] Mehrling, et al., SSRN.COM, (2013). See also Pozsar, OFFICE OF FINANCIAL RESEARCH, US TREASURY, (2014).

[44] For a comprehensive treatment of the asset shielding function of trust and entity law see Comparative Law and Economics of Trust. (1995). and Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE LAW JOURNAL (2000).

[45] Lucian Arye Bebchuk, *Ex Ante Costs of Violating Absolute Priority in Bankruptcy*, 57 JOURNAL OF FINANCE (2002).

Private law is at its core domestic law. At first sight it may therefore seem that short of full legal convergence globally (a tall order) private money is condemned to stay local. Not so. The legal building blocks for private money are surprisingly mobile. Legal harmonization and transplantation has played some role. The most powerful driver of the mobility of private legal devices are conflict of law rules that empower private parties to choose the legal system that shall govern themselves (as in the case of corporations), their transactions (contract law) and even their property rights (as in the case of financial collateral and intermediated securities).[46] For private money to roam the globe we need only a single domestic legal systems provided that all other legal system endorse and enforce the rights it creates without further review.

This comes very close to the system we have. Today's global money system is dominated by two domestic legal orders: the laws of England and New York. The better part of the vast amounts of private moneys issued and traded are governed by one of these two legal systems.[47] This applies not only to contracts, but also to property, collateral, and corporate law – bankruptcy being the only exception. The creation or vindication of these legal privileges used to be the prerogative of public authorities, ideally of democratically accountable sovereign nation states. Today, these entitlements are created in private law offices in London or New York. They rely on conflict of law rules that give private parties the power to choose their preferred legal system and on international treaty dating back to 1958 that requires member states to enforce foreign and international arbitration awards without reviewing their merits.[48] Without these assurances, the legal entitlements that are at the core of financial instruments would be worth less and would be traded less widely.

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[46] On the advancement of private autonomy in conflict of law rules and doctrine, see Horatia Muir Watt, *"Party Autonomy" in international contracts: from the makings of a myth to teh requirements of global governance*, 6 EUROPEAN REVIEW OF CONTRACT LAW (2010). and Ralf Michaels & Nils Jansen, *Private Law beyond the State? Europeanization, Globalization, Privatiization*, 54 AMERICAN JOURNAL OF COMPARATIVE LAW (2006).

[47] It is difficult to "proof" this point. However, a good approximation is that the ISDA, the international swaps and derivatives association recommends to its members – the who is who in global finance – to use English law as the default for derivatives contracts. See ISDA's Master Agreement. For details see Joanne Braithwaite, *Standard Form Contracts as Transnational Law: Evidence from the Derivatives Markets*, 75 MODERN LAW REVIEW (2012).

[48] This is the New York Convention on the Recognition and Enforcement of Foreign and International Arbitral Awards. See http://www.newyorkconvention.org/.

The recognition and enforcement of foreign laws has always been contentious, even before the emergence of nation states.[49] The long distance merchants of early modern Europe had to submit to the local law of the trading centers where they transacted with locals or strangers from other parts of Europe.[50] In some places they were even compelled to act through local brokers, since they knew the local law. However, merchants organized and frequently negotiated with local rulers the privilege to use the law of their place of origin for transactions among merchants who originated from the same place. The privilege even extended to the movable assets they brought with them.

The co-existence of different sets of rules that were determined in part by place of origin of the transacting party (personal statute) and in part by place of the trade (territoriality principle) fostered legal pluralism. Where several merchants gathered in one place, the transactions between them could be governed by as many legal systems as there were merchants in the room. The rise of nation states reduced this plurality with a strong bias in favor of national law following the territoriality principle.[51] In most countries, contracting parties could still freely choose the law that applied to them, but where property and other legal privileges were involved, the *lex sitae* principle applied. It holds that the place where the asset is located, no the choice of the parties, determines the applicable law. This makes perfect sense in a system where most assets are tangible and never cross borders. When assets readily cross borders, however, the *lex sitae* principle can create as much confusion as the mix of personal and territorial law before. The *lex sitae* rule makes even less sense for incorporeals, legal entitlements that have no physical incarnation other than a piece of paper or computer entry and by implication lack a location. And yet, these assets too rely on legal privileges that afford them priority and enforceability. The trick was to replace the *lex sitae* principle with private autonomy. Private parties could not have achieved this on their own, because for this to work legal change was required in many jurisdictions. It required action not only by the states that happily grant the privileges private parties are craving, but other states where claims to the

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49 See Hessel E. Yntema, *Th Historical Basis for Private International Law*, 2 AMERICAN JOURNAL OF COMPARATIVE LAW (1953).

50 Emily Kadens, *The Myth of the Customary Law Merchant*, 90 TEXAS LAW REVIEW (2011).

51 Yntema (1953) supra note [] and A. MILLS, THE CONFLUENCE OF PRIVATE AND PUBLIC INTERNATIONAL LAW: JUSTICE, PLURALISM AND SUBSIDIARITY IN THE INTERNATIONAL CONSTITUTIONAL ORDERING OF PRIVATE LAW (Cambridge University Press. 2009).

relevant assets would trade and might have to be enforced. Some states had to be forced into compliance by court order or harmonization projects; others complied voluntarily in the hope of attracting capital and paving the way for their own domestic financial sector's participation in global finance.

To enhance the credibility of a claim to future pay parties will often secure it by another asset: a piece of land, a barren of gold, stocks, bonds, or simply cash. Security interests create priority rights. They give an enforceable claim not only against a contracting party, but against competing creditors with lower ranked rights. Holding a priority right is critical whenever rights compete, especially in bankruptcy. It is also a valuable tool for purposes of regulatory arbitrage: Secured claims face lower capital charges than unsecured claims, and the difference can be turned into additional revenue creating lending operations. For this to work, globally traded assets this implies that they must be enforceable in domestic courts around the world.

Consider a standard securitization scenario case: A bank extends a loan to finance a home located in country A that is secured by a mortgage registered in that country. Under the conventional *lex sitae* rule that law of state A governs the mortgage. What happens when the mortgage is pooled with other mortgages, sold, then placed in a trust (a special purpose vehicle) created under the laws of country B and securitized by issuing certificates to investors in countries around the globe? The investor at the other end of the chain of these transactions expect to receive their shares from payments on the loan, and, should the debtor default, from the proceeds of the house after it has been foreclosed and sold. But who has the right to foreclose and under what law? If standard mortgage rules had been followed, each entity that bought a mortgage (pooled with thousands of other mortgages) would have had to be registered in the local register where the house is located. That is the implication of the lex sitae rule. It clearly does not fit a global mass market for securitized mortgages. One strategy to deal with this problem was to treat the loan as a negotiable instrument and rely on the doctrine "the mortgage follows the note".

Another strategy was to register the mortgage in the name of an intermediary who held it pro forma on behalf of all investors subsequently acquired securities backed by this asset.[52] Devising a legal mechanism to ensure that the mortgage is tied to the cash flows that are packaged and repackaged does not resolve the issue, which law governs the asset backed securities that specify these cash flows. The dominant solution is to look not for the location of the securities but for the location of the intermediary that manages the account in which they are held. And the location of the intermediary can be freely determined in accordance with the incorporation theory. In corporate law, two principles have long competed for dominance in determining which law should govern the affairs of a corporation: the "*seat* theory" and the "incorporation theory".[53] Corporations are legal creatures. Sovereign states as their creators that bestowed them with a set of rights and responsibilities did not necessarily recognize similar creatures set up under different rules or required them to re-incorporate under their rules should they wish to do business Any organization wishing to do business on the territory of that state would therefore have to incorporate (possibly even re-incorporate) under local law. This is the essence of the "seat theory". In contrast, the incorporation theory, which allows organizations to choose the law that shall govern them by incorporating in one jurisdiction even if they do all their business in a different one. It embodies the age-old principle of "personal law": Like the merchants of early modern Europe who brought their law with them, corporations can carry their law of incorporation around the globe. The major difference is that merchants had a birth place, whereas today's corporations can choose that too.

Over time, most legal systems have abandoned the seat theory – more or less voluntarily. Higher legal principles – such as the Commerce Clause of the U.S. Constitution or the principle of the free movement of persons (including legal persons) and capital under European Union Treaty Law – were interpreted to deny nation states the right to impose their local law on legal entities operating on their soil.[54] Other jurisdictions

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[52] The system was set up in the U.S. and called MERS (Mortgage Electronic Registration System). For details, see Adam J. Levitin, *The Paper Chase: Securitization, Foreclosure, and the Uncertainty of Mortgage Title*, 63 DUKE LAW JOURNAL (2013).

[53] For an overview of these two theories, see Peter Behrens, *International Company Law in View of the Centros Decision of the ECJ*, 1 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW (2000).

[54] On the early cases in European Law, see Wymeersch, *Centros: A Landmark Decision in European Company Law*, *in* CORPORATIONS, CAPITAL MARKETS AND BUSINESS IN THE LAW (Theodor Baums, et al. eds., 2000). and Vanessa

succumbed to the incorporation theory in order to attract foreign business organizations that wished to invest or simply benefit from tax haven status in turn for franchise fees. As a result, business organizations have become true globetrotters. They can freely choose where to incorporate and carry this law with them to other places. Unlike natural persons, legal persons don't need a visa; they can naturalize themselves in a jurisdiction of their choosing by incorporating there, resting assured that other jurisdictions will recognize them.

Putting the two together – the place of issuer or intermediary for determining the law that creates priority rights in incorporeals and the incorporation theory – we obtain the mechanism by which institutions of private law, and by implication, private money, can roam the globe. This makes for the somewhat counterintuitive result that the law governing global finance is remarkably local. It is the law of the country where intermediaries choose to incorporate or maintain accounts for the investors whose financial assets they hold: London and New York. ***

V. Money and Sovereignty

The world of moneys is not flat but hierarchical. Within a single system state money tops the hierarchy. The legal qualities enshrined in private moneys and the capacity of their issuers to access central bank liquidity determines their position in the hierarchy. In the global realm with free capital flow things become more complicated. Different state moneys form a hierarchy as we have seen before. The apex is currently occupied by the U.S. dollar and the U.S. Federal Reserve functions as our de facto global central bank with the Bank of England a close second. The Fed's position in the hierarchy is not carved in stone or written in law, but follows from its willingness and capacity to rescue the global system, as exemplified in the most recent global crises. The English pound and its guardian, the Bank of England, are close followers. These two countries also host the major financial centers with the most favored legal systems for private moneys. This has important political

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Edwards, *Case-law of the European Court of Justice on Freedom of Establishment after Centros*, 1 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW (2000).

implications for their own internal governance, but also for other countries that control neither the global reserve currency nor the private law used to mint private moneys.

Central banks in the apex countries have the power over 'life and death' in the midst of a financial crisis for entities within their jurisdiction and beyond. They can use their emergency lending powers, or not (witness the Lehman Brothers case), and change their collateral requirements for lending to include assets they never bought before or adjust haircuts to soften the blow for private actors who have nowhere else to go. Central banks also control who has access to their currency within their countries and beyond their shores. Access to foreign currencies is of critical importance for all exporters and importers as well as for financial intermediaries who must settle their accounts in one of these currencies. Those lucky enough to be located within the jurisdiction of the central banks that issue the most valuable currencies have, in principle, always access to that currency. The only question is at what price, and that too is in the hands of central bank in the form of collateral guidelines or conditions for accessing liquidity facilities. Those outside can try to hedge their exposure to detrimental market development with currency swaps and the like. In times of crises, however, these markets no longer function. Private agents therefore depend ultimately on their own central bank to ensure access to the foreign currency they need to settle their accounts. Because central banks can produce their own currency, but not that of other countries, they must have stored them in the form of foreign exchange reserves or enter into a deal with the central bank that issues the currency in greatest demand.

This is precisely what central banks have done. In the midst of the crisis they entered into ad hoc swap agreements with each other to ensure that no central bank in the club would run out of the other bank's currency.[55] Not every central bank was invited to participate in these deals, however. Only central banks of countries whose currencies were in greatest demand deemed to be critical for the stability of *their* financial system were invited to join. Reciprocal swap lines were drawn up among the "C5" – the U.S. Federal Reserve, the Bank of England, the Bank of Japan, the European Central Bank, and the Swiss National Bank. Several other countries also benefited from ad hoc swap lines extended to

[55] Maurice Obstfeld, et al., *Financial Instability, Reserves, and Central Bank Swap Lines in the Panic of 2008*, 99 AMERICAN ECONOMIC REVIEW (2009).

them, such as Singapore or South Korea. The rallying cry of all other central banks became "Where is my swap line?"[56] These countries benefited from financial integration in good times, but the crisis revealed that ultimately they were at the mercy of those at the apex of global finance. When everyone is fleeing to safety, not having access to this currency of last resort exacerbates uncertainty and deepens the crisis. Countries that joined the global financial system by removing capital controls and recognizing financial assets and entities created under foreign laws have compromised their sovereignty even if they retained their own currency.

The C5 at the center of the global financial system have taken note, and, after inviting Canada (whose former central bank chief, Mark Carney, had taken the helm at the Bank of England) to join the club, have made their reciprocal swap lines permanent. Remarkably, a short public announcement by the C6 in November of 2013 was all it took to institutionalize a global backstopping regime that privileged those at the top.[57] The central banks of all other countries are left with the hope that they will receive an ad hoc swap line in times of need. The ramifications of this divergence for future crises should be clear. Those with assured access to the most coveted global currencies will have a greater probability to survive the crisis unscathed. A run will ensue first on the periphery of the system where access is uncertain. There is relatively little that the countries on the periphery can do about this. They may hedge against currency risk and require private entities to do the same or impose capital controls. Given the sophistication of derivatives markets they will have to constantly adjust their regulatory regimes to regulatory arbitrage strategies. If and when all this fails, they have to get external help from the country that controls the currency they need or the IMF, and they will have to accept the strings attached to the rescue operation.

The countries at the apex face their own vexing problems of democratic accountability. Central banks are designed as independent institutions, and as such, are not subject to direct oversight or orders by the executive. Some face scrutiny in the form of hearings or investigations (as in the U.S.) or by courts if they overstep their legislative mandates (as in

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[56] Brad Sester, *Where is my swap line? And will the diffusion of finanical power Balkanize the global response to a broadening crisis?*, 2008 COUNCIL ON FOREIGN RELATIONS FOLLOW THE MONEY BLOG (2008).
[57] For a critical assessment, see my comment in Project Syndicate [ADD LINK]

the case of the Eurozone).[58] Still, their powers have been defined in sufficiently broad terms to lend credibility to statements by central bankers like Ben Bernanke and Mario Draghi that they would do "whatever it takes" to rescue the financial system from the brink. Post crisis, attempts have been made to reign in the free wheeling powers of central banks, but the fundamental problem remains. Central banks that are largely insulated from political oversight are engaging in decisions and actions that are much more redistributive in nature than inflation rate targeting, which of course also has distributional implications.

There are good reasons to protect central bank independence in this way – especially when the main concern is inflation, which can be induced by those in power hoping that the printing press will rescue them from economic malice and electoral backlash. Our current global money system, however, poses different challenges. Inflation has been largely contained – not the least because of central bank independence. The current threat is uncontrolled credit expansion, and the threat of deflation once a credit boom bursts. Credit expansion emanates for the most part (China being an exception) from the private sector and in forms that are difficult to monitor. Capital adequacy rules are meant to limit credit expansion, but they apply only to the entities they explicitly target, for the most part only banks. Even for them they have proved toothless when transactions were moved off their balance sheets with the help of private law devices, such as trusts and corporate law, and complementary accounting rules.[59] Post crisis regulators have caught up, but financial intermediaries and their lawyers have not abandoned their search for new regulatory arbitrage opportunities. In a system that is as heavily regulated as finance, avoiding regulatory costs is key for attaining competitive advantage. Their actions are protected by deeply rooted principles of private autonomy in contracts and the ability to shop for jurisdictions that afford them priority rights and other legal privileges. Most of these activities happen outside the view of central banks (or other financial regulators) and forces them to focus more on ex post damage control than ex ante prevention. Depending

[58] The Treaty on the Functioning of the European Union provides explicitly for the justiciability of the ECB. See also the reference to the most recent case on the legality of the ECB's OMT announcement.

[59] On the governance of accounting in different EU member states and its impact on off-balance sheet practices, see Matthias Thiemann, *Out of the Shadow? Accounting for Special Purpose Entities in European banking systems*, 16 COMPETITION AND CHANGE (2012)..

on the size of the crisis damage control may require extraordinary measures (or at least seem to).

Central banks are loath to openly declare a state of the emergency for fear of accelerating the crisis. Instead they will take measures that suspend the rules of the game and offer liquidity where no liquidity is owed to stabilize the system. Of course, they will argue that this is within their powers. The Federal Reserve has kept the global system on liquidity boosts for a full seven years. Only in December of 2015 were interest rates raised and even this timid measure is constantly under threat of being reversed because of market volatility. The last thing the guardians of the money system wish to do is precipitate another crisis by trying to end the previous one -- and take the blame for it. Still, the contrast with their battle against inflation is striking. Chairman Volcker had little qualms about ratcheting up interest rates to eighteen percent in the early 1980s to combat inflation. The IMF regularly imposes similar draconian measures on emerging markets that face financial collapse.[60] Central banks at the apex may be powerful enough to declare a state of emergency, but confronted with repeat tantrums of private money don't seem sovereign enough to end it.

VI. The Legal Link between Money and Territory

Territorial sovereignty is derived from control over land and people, directly through physical force or indirectly through law. Financial sovereignty is derived from legal authority to issue legal tender, to recognize private moneys and enforce the rights they entail. Money is much more dependent on law than land has ever been. Land relations can be governed by brute force, but not money. It requires more sophisticated forms of governance. The difference has increased over time. Bullion can be weighted and stored,[61] but even in the case of bullion, its value ultimately hinged on the ability to exchange it for goods and services not only today but also tomorrow. To travel freely and follow the ever greater expanse of trade and investment, money had to be dematerialized and eventually

[60] See Krippner supra note [] on the political economy of this story.
[61] Although most countries keep their gold in the vaults of the Bank of England or later the New York Fed. Note, however, that the German parliament recently insisted on shipping the country's gold back home….

demobilized. For it to continue to serve as a meaningful store of value it had to be privileged in law. The success of the bill of exchange as credible private money hinged on legal privileges only law could confer on it: To be treated not just as a piece of paper but as shorthand for a whole set of legal rights: An enforceable right to be paid in legal currency on presenting the paper without facing counter claims. This required legal authority so that the rights embedded in the piece of paper carried weight beyond the contracting parties. And if another legal authority recognized these privileges, they could travel beyond the territorial boundaries of the state that where they had been created. Eventually, even the paper on which claims were written became to cumbersome and costly. After New York faced a "paper crunch" in the late 1960s, shares, bonds and other securities stayed put in the accounts managed by financial intermediaries. Only rights to these assets were traded.

Herein lies law's scaling power of law. All social orders are rule bound systems. They organize rights and entitlements by quality, timing, status or some other criteria. Members of the group are bound by social norms and will be sanctioned if they breach them. Law is more readily scalable, because it does not depend on membership. To the extent law's more abstract authority is established (a big if in many countries to be sure), its reach can be extended beyond its own citizens and territorial boundaries. All that is needed is that other legal systems recognize the rights, entitlements and other privileges it created. Law's scalability, however, creates its own problems. The law-finance-paradox is a good example.[62] It stands for the inherent tension credible legal commitments and the simple fact that in a world beset by fundamental uncertainty the relentless enforcement of these commitments can blow up the system. There is therefore a need for relaxing or suspending the full force of the law in exceptional circumstances even as this undermines the credibility of law. The problem can be mitigated by making finance less reliant on constant refinancing at ever shorter intervals – a practice that Minsky called "Ponzi finance". Ponzi finance, however, is at the heart of our contemporary financial systems and regulators are shying away from any serious attempts to reorganize it. The dominant strategy therefore has been to offer the suspension of the full force of the law only selectively: To those at the apex of the system. The full credible commitment of the law is typically retained on the

[62] See Pistor (2013) supra note [].

periphery, that is in parts whose collapse does not pose a threat to the whole system. This happens both within and across countries. Quantitative easing was first granted to dealers that interact directly with central banks and their counter parties; home owners came last. A similar time line is apparent in international comparisons. When England moved ahead with a bank rescue package, the U.S. and other West European countries had little choice but to follow suit as money was quickly moved to the new havens. This set in motion rescue strategies by countries further down in the hierarchy, not all of which were sustainable. Ireland and Portugal could not afford rescue schemes on the scale of their neighbors and had to deal with the consequences by submitting to their dictate (mediated by the Troika).

Law's scaling power is directly linked to the problem of political accountability. When laws are made in one jurisdiction but exert effects in another, it becomes more difficult to hold lawmakers to account or to adapt laws to local needs. Countries may discontinue the recognition of foreign law – but this is a blunt weapon that will be costly to use. And countries that have ceded part of their legal sovereignty as members of the European Union have done, they are legally constrained to do so.

VII. Concluding Comments

Territorial sovereignty depends on the ability of rulers to control territory and people ultimately by the use of force. Charles Tilly has famously likened war making and state making to organized crime.[63] To succeed, rulers had to control their external enemies, suppress their internal enemies, protect their friends and their clients so as to extract resources from them that were needed to sustain their rule. This required ever greater investments not only in military, but also in tax systems and political governance to sustain it.[64] Financial sovereignty depends on the ability to backstop one's own financial system. Financial sovereignty too has an internal and an external dimension. Financial sovereignty requires maintaining a delicate balance between fostering financial expansion on one hand, and building capacity to backstop the system, on the other. Financial sector development

[63] Charles Tilly, *War Making and State Making as Organized Crime*, *in* BRINGING THE STATE BACK IN (Peter Evans, et al. eds., 1985).
[64] Douglass C. North & Barry R. Weingast, *Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth-Century England*, XLIX THE JOURNAL OF ECONOMIC HISTORY (1989).

can be fostered by encouraging private actors to take risk and by backing their actions with legal devices that grant them priority and enforceability – or recognizing the legal devices other countries have. A country's backstopping capacity depends foremost on the currency regime. Countries that control their own currency and can borrow on international markets in that currency can always rescue their own financial system. Others will have to guard domestic financial expansion more carefully lest they find themselves at the whim of others. For in finance protecting friends and their clients can be the undoing of sovereignty for all countries but those on the apex of the system. The latter are not immune but can insure themselves by protecting not only internal but also external friends and their clients. This they do at the expense of accountability to other domestic constituencies.

Perry Mehrling, *Minsky and Modern Finance: The Case of Long Term Capital Management* Winter 2000 JOURNAL OF PORTFOLIO MANAGEMENT (2000).
Charles Tilly, *War Making and State Making as Organized Crime*, *in* BRINGING THE STATE BACK IN (Peter Evans, et al. eds., 1985).
Douglass C. North & Barry R. Weingast, *Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth-Century England*, XLIX THE JOURNAL OF ECONOMIC HISTORY (1989).