Recoding
(Metamorphosis of) Capital

Katharina Pistor

[Note: This material is extracted from a book project "The Legal Code of Capital". It is the fourth chapter after the introduction, a chapter on "Coding Capital in Law" and one on "The Code's Base Elements". I extract below a few paragraphs from the earlier chapters that will hopefully enhance the understanding of the materials and their elaboration in this chapter. ***Please do not cite or circulate this draft****, as this is still very much under construction (references have been largely omitted). I am looking forward to your comments!]*

Excerpt 1

Capital is not a thing but a quality. Marx realized as much when he distinguished money as money from money as capital. Something additional is needed, he suggested, to turn a means of exchange into something fit for the formation of wealth. In his earlier writings the "it" was the circulation of money purely for profit. By circulating money for speculative gains, value would be extracted which could then be channeled back into circulation, creating a money multiplier effect. In "Das Kapital" he went a step further. If markets were only about the

exchange of goods and money only a means of exchange, it would be impossible for some to accumulate wealth at significantly higher rates than others. Sellers might increase the price they charge, or cheat on the quality of their products, but they can do this only to a point. These tricks are not a sustainable source for extracting surplus. It must come from a different source and the source he identified was labor.

This book argues that capital is a legal quality and that the right legal protection (or subsidy) can transform any interest from an ordinary into a capital asset. For an interest in a plot of land, a share in a business, an expectation to future profit, or pay for services, etc. to qualify as capital it needs the following three attributes: (1) **P**riority over competing claims; (2) **U**niversal recognition of its priority; and (3) **D**urability or longevity - in short PUD. Priority serves as the trump card over competing claims. Universality ensures that competing interests yield, including who were never at the bargaining table. Lastly, Durability expands the time horizon over which interests thus protected can reproduce. An interest that enjoys these privileges is fit for wealth creation; those that don't or have lost them are not.

It takes only a handful of legal institutions found in 'private law' to turn an interest into capital: the law of property and secured transactions, trust and entity law, and bankruptcy as the ultimate arbiter of competing claims. The endurance of these institutions is striking. They can be traced back to the Middle Ages (even Roman law) and certainly predate the age of capitalism. Even the most complex financial instruments today can be decoded into secured interests, trusts or corporations, and bankruptcy rules. What has changed is the protected interest, the host, not the legal code or its base elements.

Excerpt 2

Priority, Universality and Durability are created in law. We may negotiate preferential rights with our contractual partners or make promises to our children that they will inherit our wealth. However, such promises are good only if they can be enforced against competing claims. A simple contract for the exchange goods or services can do quite well without law. The parties can simply negotiate their own deal. Things become more interesting when considering not a simple contractual relation, but a web of competing claims and counter claims. Individuals buy or lease cars, rent an apartment or mortgage a house, receive salaries, invest some of their income, and put money into a bank account. Entrepreneurs buy input, hire employees, rent premises and enter into contracts for electricity and water, owe taxes, make money from selling goods, pay back loans to creditors. The critical question is what happens if the individual or entrepreneur at the center of this web of relations can no longer meet his or her obligations when they become due. In that case, some mechanisms must be in place to determine, who gets what and in which order of priority.

In short, we need a system of meta rules that determines, which interests trump and on what grounds. Critically, all who might raise competing claims must respect this system. When trade and commerce take place primarily within tightly knit communities even this can be accomplished without law. Everybody in that community will know who has ‘better’ rights and what status confers priority, since this is how things have always been done. When trade and commerce breach the boundaries of communities where the relevant norms are known to all, other solutions become necessary. Transacting beyond stable social

systems requires social scaling technologies, and law is one such technology.

Economies 'of scale' are a widely used concept. It means that economic benefits can be reaped from spreading fixed production costs across more and more units. In a similar vein, law can help scale social and economic relations as long as respect the law even if their personal interests or competing norms are in conflict. Many parties who enter into contracts know and trust each other. In these cases there is less need for formal law. There is ample evidence that long distance commerce can flourish in the absence of formal legal institutions. Trade across the Eastern Mediterranean in the 11th century was supported by a system of middlemen connected by kinship. Italian merchants transacted all over Europe in the 13th century relying primarily on a dense network of kinship ties that was gradually expanded by bringing in new partners.

Law shares these features with informal systems of norms the power to form collective expectations. For any society to function it must have a set of norms that everyone can take for granted. This will help form expectations and minimize deviant behavior as most will internalize the norms or use informal means (shaming, peer pressure) to ensure compliance. What distinguishes law from informal norms is its power to scale relations to actors barely if at all known to one another. The parties to a deal may belong to different communities with different preferences, operate under different time horizons and use different strategies to resolve conflicts. As long as both parties respect the authority of "a common logic" as Hadfield and Weingast call it, they will be able to transact.

What exactly does give law this scaling power? Two explanations are pondered in the literature. The more common one is that fact that law is a product of the state, which commands extensive coercive powers. Having monopolized the means of violence the state can employ them through its courts, bailiffs and police force to enforce not only its own commands, but also contracts, property rights and other interests recognized if and when recognized by law. The mere threat of enforcement may be sufficient to ensure voluntary compliance. The shadow of coercion is needed in this account, because any transaction that does not involve the simultaneous exchange of goods exposes at least one of the parties to the risk that the other will not stick to its side of the bargain. Law, can help resolve this "double-trust problem", because it is backed by the threat of coercion.

The alternative view agrees that enforcement is key, but holds that law does not require the coercive powers of a state. A system of rules can be called "law" according to this view, if it has a central authority capable of pronouncing and/or vindicating rules that bind. Enforcement itself can be left to private parties. They have an interest in upholding the basic 'rules of the game', even to incur costs to enforce commitments on behalf of other market participants in order to benefit from similar actions should their own contractual partners fail to perform in the future. Private parties may not have sheriffs or prisons at their disposable, but they can shame, shun and expel members from the group. Indeed, there is extensive evidence that many rule bound systems rely on this kind of decentralized enforcement – from the collective punishment of outlaws in the Middle Ages to much of international law in our own times.

The two explanations are similar in the sense that both require some kind of central agent with the authority to create or vindicate rules that will be respected by all. The major difference is that in the first case the threat of coercion is a critical for authority whereas its source remains unexplained. It may well be that the link between coercion and the state has been overstated. Clearly, it is impossible to hold an entire people at gunpoint; and the same holds for market participants. Still, we need some explanation as to why anybody is listening to a self-appointed agent who pronounces some rule. This is relevant especially when not all market participants have the same rights, but some claim superior rights to others.

In the event that parties dispute not a breach of a rule but the legal quality of an interest, pronouncing a clear rule around which most other market participants are willing to coalesce becomes a tall order.

This is where recourse to coercive powers is most relevant. As Hodgson pointed out, the most powerful expression of the rise of the state and state law is not what it makes people do, but its ability to suppress what they might otherwise want to do. Social practices that had hitherto been used for social ordering, such as feuds and other resort to self-help, now became punishable offenses. This was in the interest of social order and the rulers. Feuds could be highly disruptive for peace, and the ability to maintain peace internally was critical for institutionalizing order for ever more people and larger territories. Peace and stability of norms is also critical for commerce and economic development. The more heterogeneous market participants, the greater the geographical remit of transactions, the greater the need for a system of rules that

can be scaled and upheld, if and when necessary, against competing norms.

In the last instance, therefore, the power to scale norms is tied to the power to coerce -- which is not the same as saying that coercion is always present. For a few hundred years the nation state has (more or less) monopolized the means of coercion. This monopoly may not last. The many instances of internal unrest, civil war and so-called 'failed states' in today's world suggest that it may not be a safe bet to assume that this system will last forever. It may be replaced, but whatever will replace it will establish its own vision of a hierarchy of norms, of higher and lesser interests, and will use coercion to enforce these preferences. We may no longer call them states; and we may not call their norms law; but if they engage in social ordering, they will have to exhibit these state- and law-like features.

[end of excerpts]

Changing the Host

The coding and re-coding of capital is the process by which legal devices that give priority, universality and durability, or PUD, to an asset are stripped from some and grafted onto new assets. In the previous chapter we looked into the early genesis of these legal devices in Western legal traditions. Most emerged prior to the onset of capitalism itself. Marx realized that capitalism could evolve only from factors that were present even before the system had matured but was unable to pin down how a core feature of one system could have been present when that

system was not yet in place. This chapter will show how legal devices, such as property rights, mortgage and collateral law, trust and entity law were transposed from land to stocks, bonds, and other financial assets. This is a complex process that required the demotion of land and the grafting of institutions that had been developed with land in mind to new asset classes. In this process, legal devices were adapted to suit the needs of new asset classes. And to ensure that PUD would work its magic, the results of this legal engineering had to be enforceable. They therefore had to be incorporated into statutes or recognized by a court of law.

Empirical evidence assembled by Piketty and his collaborators for his seminal book "Capital in the 21st Century" shows that well into the 20th century wealth was stored primarily in agricultural land. By the middle of the 20th century, its proportion of total wealth had dwindled to less than 10 percent. Financial assets and urban housing (financed by credit instruments) had taken its place. Surprisingly, no explanation is offered for why or how this happened. How can the major wealth accumulating asset of the nineteenth century effectively disappear from sight and be replaced by new asset classes within only a few decades?

An answer to this puzzle can be found in the following quote by the legal historian, Bernard Rudden:

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

been detached from their original object, only to survive and flourish as a means of handling abstract value. The feudal calculus lives and breeds, but its habitat is wealth not land".

Two processes are in place here: The downgrading of land from a capital asset to an ordinary one, and the upgrading of financial instruments and their vessels to capital assets. This chapter will show how land lost PUD and other assets gained PUD. England will serve as the primary show case, as the more gradual evolution in this country shows how both processes operated in tandem. Land was not dropped like a hot potato and replaced by financial assets. Rather, devices that originally created to use land as a source of wealth were grafted onto different assets even as they remained available for land for some time to come. It took the active removal of PUD from land to dethrone it as the primary source of household wealth. In colonial America English creditors brought similar changes to pass much earlier and much more abruptly, so that the independent USA would start off not with an aristocratic, but a republican land system. Equally radical change occurred in France as the result of revolutionary upheavals. The real laggard was Prussia where the invention of asset backed securities gave the aristocracy another lease on life.

As changes in the legal system of land ownership and its protection by PUD devices got under way, a parallel evolution took form that strengthened PUD for assets placed in trusts and corporations. These are the vehicles for the "funds" in Rudden's quote and they have the requisite PUD. Stocks, bonds, financial instruments more generally, lead a highly volatile life at least as individual species. But they do can be placed in trust or entities and replaced to retain their value as portfolio, not individual pieces. Rules for managing trust assets evolved to

allow trustees to exchange assets to protect the asset base at the same time, as the treatment of land resembled that of chattel. The acid test for determining whether an asset is already or no longer capital is bankruptcy. No asset that can be subjected to relentless enforcement by creditors has the relevant durability to qualify as capital. Not surprisingly, bankruptcy safe harbor rules are a critical feature of the fancies financial instruments in our own time: derivatives, which we will decode in the next chapter.

The Demise Of Land

At the beginning of the nineteenth century -- a time when in England industrialization was already well under way -- English law of property rights in land, or 'realty', offers a peculiar landscape of legal privileges. Writing in 1866, the Economist declared the system "wholly absurd" for a post feudalist world. Fifty years later the system remained still incomprehensible to outsiders. "'Colonials' from the British empire who were trained to take the bar in England 'found that [the law or reality] so difficult, and consequently were failing their English bar exams so frequently, that instead of a paper on real property the Council of Legal Education now allowed them to substitute 'either Hindu and Mahometan law, or Roman Dutch law."[1] Contrary to assertions by economic historians, England's leading role in industrialization was hardly the result of a "clear" property rights regime. Rather, legal devices created in private law helped shield certain assets from the relentless logic of such a regime. Strict family settlement was central for protecting land from the powers of the market place, from being

1. J. Stuart Anderson, *Changing the Nature of Real Property Law*, *in* THE OXFORD

"sold, mortgaged, or dispersed at will."[2] The life tenant -- the family member currently in control of the estate – had rights to the land that were limited by obligations to other current and future family members and these rights could be invoked against his personal creditors. While it was not impossible to use other legal devices, such as the 'trust' (in favor of creditors) to circumvent some of these restrictions land remained immune from large-scale repossession throughout the nineteenth century.

The private rights, obligations and entitlements that governed real estate were opaque. They existed in documents filed in drawers of local solicitors and produced only in the event of litigation. There was no publicity in the form of registries for land titles, liens or mortgages on the land. English colonizers were busy advocating zoning and titling land in territories far away, but it took until 1925 to introduce mandatory title registration in the homeland. By that time the system of landed wealth was literally falling apart as a result of the combined effects of a series of piecemeal legal change and changing economic conditions. Land titles were registered; life tenants were treated for all purposes, as full owners of the land who could alienate it at will; with these changes in place creditors, including unsecured creditors, could finally seize and sell their debtors' land to satisfy their claims. The results of these changes were palatable: Just as in the US two hundred years earlier, estates were put on the auction block to pay for accumulated debt or to use the proceeds to invest in shares and bonds, that is, the wealth producing assets of the 20th century. After hundreds of years of stasis, in the first two decades of the 20th century alone, 20 percent of all land changed hands, and the process accelerated after the adoption of the Land Settlement Act of 1925. Land was no longer the durable

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2. Ellen Spring, *Landowners, Lawyers, and Land Reform in Nineteen-Century England*, 21 AMERICAN JOURNAL OF LEGAL HISTORY (1977). at 41

asset it had been; it became just another asset that could not only be leased and pledged, but also seized and sold.

Weakening the Family Estate

In the middle of the nineteenth century between one half and two thirds of land in England was subject to strict settlement and thus not freely alienable. The rule against perpetuity remained in place, but it could be relaxed or circumvented with the help of sophisticated lawyers. Life tenants could lease, mortgage, even sell parts of the land, if they were allowed to do so under the terms of the settlement, and so they did. Estimates suggest that by the early nineteenth century hardly more than 10 percent of land was owner occupied, the rest was leased. As Andersen put it "leasing was a way of life".[3] It had to be, since settlement ensured that land ownership was highly concentrated and only by leasing land could owners reap its economic value and non-owners obtain access to land. A survey of landholdings in the 1870s revealed that there were one million landowners out of a total population of thirty million. Strikingly, "80 percent of the law of Great Britain was owed by fewer than seven thousand persons."[4] Land had long seized to be a source of sustenance and become a source of income and an insurance scheme for members of landed families. Many tried their fortune in industry and commerce, but made sure that a substantial part of their earnings was plowed back into landed wealth.

Mortgages were also wide spread. Many families found it impossible to maintain their lifestyle on income generated from rents and leases alone. They could not monetize the value of the

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3. J. Stuart Anderson, *Leases, Mortgages, and Servitudes*, *in* THE OXFORD HISTORY OF THE LAWS OF ENGLAND: VOLUME XII: 1820-1914 PRIVATE LAW (William Cornish, et al. eds., 2010). at 110.
4. Spring supra at 51.

land by selling it, because they were bound by strict settlement. So they mortgaged it on terms commensurate with the settlement, benefiting from usury laws that kept interest at 5 percent maximum until it usury was abolished in 1854. This worked for both sides as long as debtors did not default, an event that would leave creditors in the lurch. For mortgages did not empower creditors to sell the land unless the mortgage deed explicitly empowered them to do so. The most a mortgagee could obtain was a "writ of elicit", which entitled him to up to half of the debtors land for satisfying his claims from the rents and leases the land produced. Insolvent debtors could be put in jail, but for the upper classes imprisonment was relatively luxurious and could be used to emerge debt free from bankruptcy settlement.

That this obscure system nonetheless produced "workable" results[5] for creditors and debtors alike has been attributed to the ingenuity of lawyers who found ways around the strictures of the law. They created new contractual devices to protect mortgagees, employed trusts to allow life tenants to put aside assets to meet their creditors' needs, and so forth. It is not without irony that lawyers who had created the obscure system of land rights in the first place, indeed remained the strongest force of resistance against reforms, were employing their well-rehearsed skills now to protect creditors against the interests of the estate.

Two parallel developments ultimately lead to the demise of agricultural land as capital: The strengthening of life tenant's discretion over land at the expense of other family members and the estate; and the expansion of creditors rights at the expense of its owners and 'remaindermen'. This required that the private rights were successfully challenged in court and/or over-written

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5. 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). at 47.

by statute. Change was piecemeal and occurred over more than a century. Legislative reforms were not infrequently undermined by courts or overturned in further statutory change. Legislative caution is not surprising, given that as late as 1840 seventy-five percent of the members of the House were landowners. Only in 1880 did they find themselves for the first time in history in the minority. Over the course of the next two critical reform acts that had first been anticipated in the 1830s were finally passed: the Conveyance Act, which created a statutory right for all mortgagors to sell assets in the event of the debtor's default; and the Settled Land Act, which gave life tenants the unfettered power to sell all land and created a land registry – although registration remained voluntary until 1925.

At least as important as legislative change was the fact that life tenants sought ever-greater autonomy from the strictures of the strict settlement. Many found themselves in a double bind: Under the terms of the settlement they had to pay income from the land to family members being prevented from investing in the land as this would have altered the estate they had to preserve for future generations. At a time when new technologies spread into agriculture and mining fueled the process of industrialization, these legal constraints prevented them from extracting value that might benefit the family estate in the long term. The pull and push for land reform resulted in a series of small changes that gradually transformed the legal land regime. In 1840 life tenants were empowered to mortgage land belonging to the estate for the purpose of agricultural drainage. The Chancery supervised the new regime and required a private statute to affirm the powers of life tenants or trustees. Nine years later supervisory powers were transferred to the Board of Enclosure Commissioners and with that the pace of change accelerate. The Board enacted a series of general acts

that allowed life tenants to mortgage not only for drainage but also for all kinds of agricultural improvements. By 1864, the power to invest in local railways was added. Moreover, the Chancery court could authorize the sale of estate land without private statute on a case-by-case basis. The gradual liberation of life tenants from stripped land of the most important legal protection that given it durability: protection against seizure from unsecured creditors. Without the legal privilege of durability, it came to lead the life of any other asset.

The decisive final changes came in response to the deep depression in agriculture in 1879. After the repeal of the Corn Laws in 1849 liberalized trade competition from North America increased. Legal protections of the family estate had prevented life tenants to respond swiftly enough to these new challenges. The economic crisis was the final trigger to bring down a regime that had long outlived its purpose. Once the Conveyance Act and the Settled Land Act of 1881/2 had taken away the last remnants of a feudal land regime, land was no longer fit as a capital asset.

Remarkably, even the judiciary, a staunch defender of family settlement, now helped accelerate change. In a widely cited case decided in 1892, the Marquis of Aylesbury wanted to sell his estate, including the mansion house to Edward Guinness, the head of the Guinness empire who was on his way to become the first Lord Iveagh.[6] By that time life tenants had been empowered to sell their land, but not, at least not without approval, the family mansion. As a nouveau rich, the head of the Guinness brewing empire, of course, was keenly interested in occupying the mansion. The family objected and the lower court sided with the family. The appeal court used a provision in the 1881 Settled Land Act to side with the life tenant. The purpose of

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6. Spring, AMERICAN JOURNAL OF LEGAL HISTORY, (1977). at 55.

the Act, it argued, was to prevent the ruin of agriculture. Placing social objectives over and above the legal privileges family members had enjoyed for centuries was a radical move. It helped pave the way to a more rational but also less protective property regime for land.

Strengthening Creditors' Rights

The expansion of creditor rights evolved in lockstep with the strengthening of life tenants, and the two developments re-enforced one another. On the one hand, life tenants were treated in law as full owners with the right to both mortgage and alienate their property at will; on the other, creditors obtained the right to enforce against all of the debtors' assets, seize them and put them on the auction block. It took until the 1880s for the Conveyance Act to give full legal credence to these rights, but steps in this direction can be found throughout the century.

By the 1820s, legal practice recognized the right of creditors to seize and sell debtors' personal assets if such rights were explicitly stated in the mortgage deed. For to land the rules of strict settlement had to be observed, which meant that at most half the land could be transferred to a creditor to satisfy his claims. In 1852, procedural rules were introduced to allow the Chancery court to order the sale of land in foreclosure proceedings. In the 1860s a law established that a creditor had the right to sell unless this was explicitly denied in the deed, thus shifting the burden of proof from the creditor to the debtor. Moreover, unsecured creditors obtained the right to enforce not only into the debtor's personal property, but upon obtaining a judgment, also into land. Further, the debtor could obtain power of attorney from the debtor to confess judgment under the 1838 law and use this to enter judgment in a

court of law and enforce against land. The Judgments Act, however, was reversed in 1864 indicating how threatening these reforms were to landowners and their representatives in Parliament.

The expanding powers of creditors is also reflected in the rise of the "bankers' mortgage", which dates back to the eighteenth century. The simple transfer of the title deed to a bank could encumber the land, unbeknownst to other creditors. Attempts to introduce greater transparency were met with the standard defense that this would increase the cost of credit especially for smaller borrowers. Not until the creation of mandatory title registration in 1925 was this bank privilege reformed.

As the ability of creditors to enforce against land as the most valuable asset of most debtors improved, the question whether purchasers could obtain full title if the rights of other creditors or estate holders and been trampled obtained greater urgency. In general, the trend was to protect the purchaser. This was particularly important for transactions that occurred in private rather than court foreclosures.

England's Periphery

In England's North American colonies change came some 150 years earlier. The same groups that sought to protect their own family wealth back home called for reforms. As creditors in the colonies many a landowner found these rules too constraining. As a general rule, English law prevailed in colonial North America. Local governments had the right to enact their own laws lest they were deemed "repugnant" to the laws of England. Some colonies in North America enacted laws that improved the rights of creditors (including unsecured creditors) to enforce against land, while others sought to protect landed interests even more

than English law did at the time. The 1732 “Act for the More Easy Recovery of Debts in his Majesty’s Plantations and Colonies in America”, or the Debt Recovery Act overruled these local variations. It was a backlash against attempts by legislatures in the colonies to protect debtors in the midst of an economic recession. The Debt Recovery Act eliminated the special protections for land against creditors. From now on land was to be treated just like personal property could be seized and sold by creditors, including unsecured creditors, to satisfy their claims.

The effects of the reforms were pronounced. Much of the wealth in the colonies was tied to land, and in the South also to slaves. In New England, land accounted for 81% of all wealth. In the South, it was only 46.6 percent, as 36.6 percent was invested in slaves. In fact, slaves were widely used as collateral to secure loans as they were treated like chattel property and as such could be more easily seized and sold. In fact, some legislatures had sought to reclassify slaves as real property in order to protect debtors - much to the concern of creditors. The Debt Recovery Act implied that debtors in the colonies could no longer rely on English property law to protect their land against foreclosure. Land could be seized in the same procedures that in England were available only for personal property. If creditors defaulted on their loan these assets could be auctioned to realize their cash value. The only protection that remained was that creditors had to seek satisfaction from personal property before turning to land.

The American colonists fiercely resented this Act. Hamilton even called it a case of the legislature grossly overstepping its powers. The inequity the Act created was tangible: English creditors could foreclose against the land of colonist debtors whether or not they had bothered to obtain a mortgage to secure

their claims. However, if ever a creditor colonist would try to do the same in the English homeland, the old law of realty would stand in the way.

Despite early resentments most state legislatures adopted core feature of the Act after independence. Only some states deviated from this pattern and chose to retain the safeguards of the English property regime, the state of Virginia being a prime example. Other states took recourse to debt moratoria in times of economic hardship, but they were temporary and had no long lasting effect on the structure of land ownership.

The history of the Debt Recovery Act in colonial American offers interesting insights into the political economy of legal privileges. In England reform efforts dating back to the 1820s had only gradually relaxed the most protective legal privileges. The same privileges were swept away in the North American colonies by a single act – and almost one hundred years before any reform movement was set in motion in the homeland. These reforms busted landed wealth and created conditions for a republican, not feudal land regime. Under pressure from the electorate, however, legislatures post independence sought to buffer the effects of a regime that gave creditors relentless enforcement powers.

No such relief was available in colonial India. English colonists implemented land reforms aimed at broadening access to credits at lower rates. The outcome of these reforms was an army of landless peasants, who evicted from the land and turned against their colonial rulers. In response to this ‘mutiny’ a Royal commission was charged with identifying its causes and traced them to well intentioned reforms aimed at rationalizing credit in the agricultural sector. Peasants would borrow from moneylenders who charged usury interest rates. If debtors failed to repay, creditors harassed them, demanded to be fed, sat

outside their homes and showcased their shame to the rest of the village. English colonial rule introduced land titles and established courts to enforce creditor rights against recalcitrant debtors. The reforms were remarkably successful in transforming the credit market. New creditors flooded the market and interest rates plummeted giving many more creditors access to finance at remarkably low rates. What followed was the logical conclusion of the reforms: Mass evictions when weather related downturns in the agricultural sector left many peasants unable to make good on their promises. The old, high interest charging creditors would have given many another chance. After all, their own business depended on captured debtors. The new more diffuse market of creditors did not offer this kind of reprieve. Nor had the new creditors built in any buffer for bad times by charging higher interest rates during good times. Competition had driven down interest rates that made some precautions economically non-viable. The debtors themselves had no legal defenses. The entire reform scheme was based on the premise that a rational property regime set in motion a positive growth cycle whereby productive peasants would be rewarded, but unproductive ones punished by losing the land. There was no safety valves, much less legal asset shielding devices, in this scheme for debtor default without fault, much less for its occurrence on a large scale.

Coding New Wealth in Law

The nineteenth century witnessed the proliferation of the trust and the rise of the incorporated entity. The genesis of both legal institutions is, of course, much older (see chapter 2 above) and the possibility of using this legal device to shield assets against creditors was well understood. The rise of the middle class meant that many more were seeking legal protection

for their newly gained wealth. Demand for trusts increased as a result.

In addition, the 1844 company act made the corporate form widely available. In essence, the corporate form did for business wealth what the trust did for personal wealth: It shielded assets from creditors. Both institutions shield assets from the original owners and their creditors; and both make it possible to freely substitute assets in the name of preserving the value of the asset portfolio, not specific items. As Kohler put it, law gave priority to the assets' economic value, not their physical manifestation.

This change required alterations to trust law especially regarding the role of trustees who evolved from safe-keepers into portfolio managers.

Trusts and Funds

Trusts mushroomed as a new middle class rose with riches amassed in trade, commerce, investment and production. They sought to protect their wealth and the preferred legal mechanism was the trust. Trust law became increasingly systematized and institutionalized as a legal vehicle for managing and protecting wealth. Assets transferred into trust became much more varied. In the 18th century land remained the dominant trust asset. Throughout the nineteenth century government bonds were on the rise and at the end of the nineteenth century the road was paved for including shares and other financial assets. The legal interests, rights and obligations of beneficiaries and trustees were adapted to accommodate these changes.

Settlors began to authorize trustees to invest trust assets more flexibly, giving them at times substantial discretion to sell original assets and invest the proceeds into different ones. They also increased the scope of their powers. Still, most

trust deeds were silent on the rules that should govern the management of the trust portfolio. Invariably conflicts arose when the value of trust assets declined and beneficiaries' expectations disappointed. Once again, Chancery had to develop the principles. It took a rather conservative, asset-preserving, approach. This can at least in part be attributed to the fact that the Chancery court often served as a trustee and sought to avoid liability. The rules it chose to govern its own affairs were generalized to other trustees. They stated that government bonds were safe and could therefore serve as trust assets, but most other financial assets were not. Equity (corporate shares) were deemed as having only market, and no intrinsic, value and were therefore banned for much of the century. Special requests to allow a reallocation of investments into the shares even of a state chartered venture, such as the East Indian Company were denied.

Legislative intervention sought to push the court into a more flexible direction, but with little effect. Only when some George Hadfield MP ambushed a bill in the early 1860 was a provision introduced that specifically permitted investments in shares of the Bank of England and the East India Company. Only with the passage of the Settled Land Act of 1882 (see supra), were trustees allowed to invest 'capital money' into railway company debentures.

More flexibility in managing the trust portfolio meant more powers to trustees and with it the possibility of abuse. The obligations of a safe keeper are easily circumscribed; those of a portfolio manager less so. The rules of the Chancery erred on the side of specific rules rather than broad standards of liability. Further, a series of fraud scandals implicating solicitor-trustees in the 1850s triggered a legislative backlash that called for criminal punishment of trustees. This in turn

prompted a broad debate about the appropriate liability standards. Concerns were raised that that few 'honorable persons' would be willing to perform the role of trustees if they faced the risk of criminal liability. "Honest but mistaken" trustees should be protected from liability. This argument for reducing liability for those managing other peoples' money is still with us today and has gained new prominence given that many banks who performed trustee functions for asset back securities and their likes have been sued for breach of their duties. For much of the nineteenth century, courts would not buy this argument. They preferred specific guidance on what assets were deemed safe. Trustees would therefore frequently consult with the court before making investment decisions to escape liability later on. At the end of the century, legislative intervention paved the way for a more accommodating trust law. The Trustee Act of 1888 established that a trustee should not be held liable just because he breached some rules established by the Chancery. Instead, his actions should be considered under prudential standards as fiduciaries. These standards were subsequently transposed to corporate law and continue to frame the question of director and officer liability today. As a result, Chancery also turned its attention to develop governance standards for the management of trust portfolio. Specifically, it required trustees to separate funds held in trust from their own assets or those of other clients.

Trusts are important asset shielding devices, but their duration was limited by the rule against perpetuity. The settlor's 'dead hand' should not govern assets for generations to come. Yet, the rule was not as rigidly enforced as it may sound and lawyers proved adept at exploiting even small loopholes in existing law to undermine its reach. Consider the following case. The property of a married woman could be placed

in trust and thus shielded from her husband's creditors. As the beneficiary of the trust, however, she could transfer her assets, if she so wished. In the last 18th century, however, Chancery held that a married woman's trust was inalienable. Legal practice swiftly sought to mimic the effect of this ruling inserting provisions, such as "without power of anticipation", or "not to be available to creditors by way of execution" into trust deeds. In the end, this did not withstand legal scrutiny, but the attempt illustrates the ingenuity of lawyers in taking every opening in case or statutory law to enhance the trust as an asset preserving device.

By mid century, the core features of trust law as a property regime for all kinds of assets were firmly established. As Anderson put it: "The building blocks of property law were there to be used, manipulated, and worked around by lawyers whose technical knowledge could be acquired from comprehensive professional texts readily, if expensively, available to all. Everyone could work form the same templates. All they needed was to express their variations in the correct idiom."[7] Those who knew the idiom or had access to lawyers who did were able to shield assets from others, including tax authorities and thereby augment their wealth.

The Business of Incorporation

If the trust was the major legal device for shielding personal wealth, the corporation became the major device for pooling and protecting commercial and industrial wealth. We earlier traced the origins of asset shielding devices earlier all the way to late thirteenth century Florence and recounted the rise of the chartered corporations in the17th century. By the 18th century the incorporated business entity was thoroughly

7. Anderson ibid at 267.

familiar throughout Europe, even as its usage remained curtailed. The law at the time required special approval for incorporating an entity and obtaining the full set of legal privileges: legal personality, capital lock-in, asset shielding, tradability of shares, as well as limited liability.

While the full package of the corporate form was not readily available without government sanction, many an entrepreneur sought to replicate at least some of its features. Firms would organize a reverse merger into still existing yet moribund chartered companies, or write up agreements that claimed the attributes they wished to obtain, including free tradability of shares, even shareholder limited liability, even as they remained unincorporated. In England, the 1720 Bubble Act declared it a fraudulent act to issue shares to the public lest the company had received the seal of state approval for corporations. This, however, did not put an end to such practice. In fact, courts vindicated many partnership contracts that emulated critical features of the corporation. The Bubble Act also exempted certain industries, such as shipbuilding and mining from its reach. In these sectors, varieties of the corporate entity evolved. Last but not least, numerous companies sought and received requisite permissions. As a result, in the early nineteenth century a significant number of joint stock undertakings were operating throughout the UK. According to Harris, by 1810 the cumulative capital of these firms had reached over 90 million English pounds and by 840, four years before companies were allowed to freely incorporate, capital had more than doubled to 210 mln.[8] That accounted for about 35.8 percent of the country's relevant stock.[9] In short, even before the corporate form became widely available it had significant

8. Harris, Tables 72 and 73 at pp. 194/5
9. Ibid

weight in the economy, especially in capital-intensive industries.

Recoding Capital on the Continent

In England, the legal code of capital evolved gradually. Well-known Legal devices were transposed onto new asset classes: from land to financial assets and their uses was expanded from protecting personal to protecting corporate wealth. On the Continent, changes in legal institutions occurred more in leaps and bounds, propelled wars and revolutions. Feudalism as a political order survived longer, not the least because legal innovation, such as asset backed securities, helped indebted aristocrats to refinance their debt. Another important difference between England and the Continent is that a legal institution that took center stage in England, the trust, was not available on the Continent. This hybrid between contract and property with its third party effects yet lacking publicity simply did not fit into the more rigid categories of property and contract law of the Roman law tradition.

The Birth of Asset Backed Securities

The French Revolution swept away feudalism and set in motion its demise throughout the Continent. The Declaration of the Rights of Men and of the Citizen of 1789 proclaimed a radical new conception of property, not as *the* foundation of social order in all its aspects – political, economic, and social – but as a right of autonomous individuals. In the words of the Declaration: "Property is an inviolable and sacred right, no one can be deprived of it, unless demanded by public necessity, legally constituted, explicitly demands it, and under the condition of a just and prior indemnity."

This upended the complex set of hierarchical social relations tied to land the old regime had sustained and nurtured. Status and hierarchy no longer defined individuals; they were now all citizens with equal rights and responsibilities vis-à-vis one another and the state. Owning land no longer implied the right to tax or adjudicate. Freed from these public functions and privileges land was destined to become an ordinary asset that could be used, leased, encumbered or sold at the owner's (or creditor's!) discretion.

The new idea of property may have done away with feudal privileges, but it did not eliminate hierarchy and priority, or the uneven distribution of rights to land. The laws passed to implement the Declaration of the Rights of Men re-established hierarchy now founded on wealth, not status. They divided entitlements to land into those that were simply abolished (because they were too reminiscent of the older order) and those that could be bought out. The buy-out option closely tracked the economic value of the land for the bourgeoisie, which had been propelled to power. It applied even to land that had been transferred to the church, cities and other legal entities in perpetuity (*mortmain*, or dead hand). The result was a massive redistribution of land from old to new elites. Peasants faired less well. Their use rights (the *dominium utile*) were re-characterized in legal terms as a lease. The new owners, however, frequently ignored these contractual rights. They or the developers to whom they sold the land evicted peasants by invoking their superior property rights. The breakup of the feudal order not only freed peasants from the land; it also freed the land from peasants. Nonetheless, the re-classification of land as an asset that could be freely sold, leased, and mortgaged, also implied that it could be seized. Landed wealth thus followed the ups and downs of credit and economic cycles

without the legal protections that had previously given it durability.

In the German lands change came more gradually. The Prussian top down reforms in the early nineteenth century spearheaded by Stein and Hardenberg sought to avoid a revolutionary uprising of the kind France had experienced. Serfdom was abolished in 1807, but remnants remained in place until the 1850s. The famous Martin's Edict of 1811 re-defined property not in terms of social and political hierarchy, but as a unified property right. Yet, the edict was subsequently amended and partially repealed and thus had little long lasting effect. At the time Germany was unified in 1871, the country was still predominantly agricultural and a monarchy with the landed elites retaining considerable sway over political power.

This is rather surprising, for the landed nobility was at the brink of bankruptcy in the 1760s. Prussia’s extensive warfare with its Eastern and Southern neighbors eroded the economic foundations of feudalism as troops trampled fields destroying crops and livestock and leaving the landed elite deep in debt. The only asset of value they had was land and its value had been destroyed. If land changed hands at all notwithstanding legal restrictions, it did so at fire sale prices. In the 'natural' course of things this should have resulted in the quick demise of land as the foundation of feudalism, and with it the regime itself. A legal innovation gave feudalism another lease on life and power. The basic idea came from a merchant, Mr. Büring, who proposed the following plan to Prussian Emperor, Frederick the Great:[10]

The landed nobility should get together and create a mutual credit association. The association would issue bonds payable to

10. The details of the plan are presented in English translation in D.M. Frederiksen, *Mortgage Banking in Germany*, 9 THE QUARTERLY JOURNAL OF ECONOMICS (1894). at pp. 47-51

its bearer at 4 percent guaranteed by the association for principal and interests. According to the original plan, certain number of bonds should be handed over to the landowner who could pay down their debt by handing them to old creditors, or sell them to new creditors to raise funds. In practice, the association issued the bonds directly and gave landowners the cash equivalent. Every landowner could apply for an amount of bonds (or cash) equal to between one-third and one-half of the value of the estate. In return the land was mortgaged to the association. Land owners had to pay 4.5 and 5 percent interests, that is, between 50 and 100 basis points over and above the coupon rate of the bond issued to the new creditors. The difference was used to pay for expenses of the association and to cover any losses the pool might entail. Landowners were responsible for paying interests; the principal obligation was owed by the association and was backed by the land the owners had pledged to it. The King capitalized the association with an up front loan of 200,000 thalers at two percent interest. Membership in the association, the *Schlesische Landschaft* (Silesian estate association) was made compulsory when it was established after some delay, whereas Büring's original plan had envisioned voluntary opt-in.

In short, the basic concept for asset-backed-securities (ABS), that is, papers backed by a pool of assets and issued to investors, was born. We will further explore contemporary ABS schemes in the next chapter, but it is worth pointing out the distinctive characteristics of the original Prussian ABS-scheme: The Prussian association was a mutual debtor association and debtors backed the debt collectively. In contrast, modern day securitization schemes are creditor driven and employ trusts or limited liability vehicles.

The scheme was soon emulated not only for the benefit of the old landed elite but also to finance the buy-out option their former serfs received when they were “freed” from the land. They were typically established and backed by local governments. From here it was only a small step to private mortgage banks, which soon prospered in cities and the commercial centers when trade barriers were reduced by the customs union of 1834. In contrast to the credit associations these banks were organized and run by creditors. Some combined traditional deposit taking with mortgage banking funded by issuing debt instruments. In France, the Crédit Foncier, founded in 1852, set the example for using short-term redeemable bonds to finance long-term mortgages. The basic model was for banks "to buy from borrowers real estate annuities for a specific number of years, and sell to capitalists bonds redeemable by drawings."[11] Only few mortgage banks allowed borrowers to extinguish the bond by early repayment or allowed all bondholders to redeem on demand. Borrowers would repay over a period of up to 75 years. Moreover, the bank retained discretion over how many bonds could be redeemed in a given year. This, of course, is a far cry from the open-ended money market funds that are funding asset-backed securities today, which allow investors to redeem their 'deposits' on demand. Just as credit associations before them, mortgage banks also charged borrowers between 1/3 and 1 percentage more than what they paid to lenders and used the spread to fund expenses and for loss reserves.

The use of these financing techniques shows how legal devices – property, collateral, and entity law – can be used to protect, if not create, capital. Without the ability to refinance their debt, the Prussian aristocracy would hardly have survived into the nineteenth century -- for better or worse.

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11. Frederiksen at 63

Once the genie was out of the bottle, it was used for a variety of other purposes, which ultimately helped strengthen the rising middle class in Germany, just as trust had done in England. In essence, credit associations and mortgage banks create a new asset class: a debt security that was more than a simple IoU, because it was backed by real assets. Backing obligations with assets is no guarantee against future loss. While late nineteenth century observers observed that "owing to the mutual liability of so many estates, no loss to the bondholders can ever be imagined"[12] reality turned out differently. World War I and the period of hyperinflation that followed it made that statement history. Of course, this did not prevent other economists from making similar remarks about the likelihood that housing markets would crash in the early twentyfirst century. We will return to that episode later on.

Corporate Entities

Just like England Continental Europe also experienced the rise of the corporate form in the nineteenth century. In fact, the corporate entity is very much a Continental “invention” with roots both in Roman and Canon law. The big state chartered corporations of the seventeenth century, the English and Dutch East Indian companies were chartered almost back to back in 1600 and 1602 respectively. The French Code de Commerce of 1807 created the basic legal framework for joint stock companies with the core attributes of independent legal personality, asset shielding and lock in, tradability of shares, and limited liability. Incorporating such an entity, however, required state approval. Free incorporation remained beyond reach on the Continent until 1867 in France and 1870 in Germany and when it finally came, it arrived with significant strings attached. The

12. Frederison at 57.

German corporate law installed a mandatory "supervisory board" in the governance of the corporation to compensate for the retreat of direct state monitoring. It also raised entry requirements both in the form of minimum capital requirements and by stipulating that shares had to be issued with a par value of at least 1,000 Reichsmark. This was well beyond the means of ordinary investors and encouraged banks and other corporate entities to acquire each other's shares. Governments remained weary of company promoters that would set up an entity, raise debt finance and abscond with the money. That scenario had been repeated many times in the series of founder booms and busts of the nineteenth century. Yet, turning back the clock became increasingly impossible. While the full fledged corporate form was not easily available, company promoters could graft some of its features on other forms of business organizations that were. The société en commandite, which can be traced as far back as the middle ages, was much en vogue. Its entity status was recognized by law, it could issue 'units' in lieu of shares, which were freely transferable, and it could even protect unit holders with limited liability as long as at least one member retained full personal liability. Further down the line it became possible for that partner to be a limited liability entity.

The corporate form became increasingly fashionable for small and medium size firms and new laws were enacted towards the end of the nineteenth century that facilitated incorporation without making shares freely tradable. That gave shareholders of family owned businesses, for example, the benefit of asset shielding without exposing themselves to the vagaries of changing ownership shareholders with different agendas. These important changes notwithstanding, the Continental legal systems remained skeptical of the corporate form and the possibilities

it opened for shielding assets and potentially harming creditors. Mandatory law continued to regulate the capital structure of corporations, and not only in the form of minimum capital requirements for establishing a corporate entity, but also with regards to dividend rules, the authorization and issuance of new capital, and other capital maintenance requirements. Further, the possibility for a single individual to create a legal entity became available in Germany, for example, only in 1980. It was the final concession by the legislature that it could not really control the free use of this asset-shielding device, as entrepreneurs found numerous ways to circumvent restrictions.

Bankruptcy: The Acid Test

The code of capital is a set of legal rules that bestow priority, universality, and durability (or PUD) on assets. The base elements of the code (property and collateral, trust and entity law, and various combinations thereof) remained constant, even as the assets they were grafted onto changed over time.

The validity of code's base elements is tested ultimately in bankruptcy. This is the acid test for the various legal jokers creditors created in the hope that when the time came, their rights would trump. Bankruptcy shifts control rights from owners to creditors. This is not a violation of property rights. After all, owners were free to use assets in whatever way they wanted. They were free to take bets with their assets, but if they lose them the tables turn and the final say over the remaining assets is handed over to creditors. Property may be an 'absolute' right (see Chapter 1), but it is not immune to the enforcement of legal liabilities. The moment of table turning from debtor to creditor reveals the hierarchy of rights established in law. To ensure an orderly settling of claims

modern bankruptcy law creates a procedure for handling the competing claims to the debtor's remaining assets. Its goal is to prevent a run on the debtor's assets and to reallocate them in ways that respects legal right created outside bankruptcy. As a general rule, property rights trump contractual rights; secured creditors unsecured; and senior rights holders those of junior rights holders.

These principles, however, emerged only over time. Indeed, bankruptcy law evolved in lockstep with changes in land, collateral, and entity law over the same time frame. At the beginning of the nineteenth century bankruptcy (or insolvency) remained a punitive regime in all of the major European legal systems. Debtors' prisons were the norm. There were, however, considerable differences in levels of (dis-) comfort the imprisoned debtors had to endure. Debtor prisoners were gradually replaced by bankruptcy procedures that sought to preserve and reallocate assets rather than punish debtors. In England, special arrangements were made already in the eighteenth century for traders so that they could be cleared of fraud and launch a come back in commerce. This could be done by committing, even staging an act of bankruptcy with the help of one of the creditors (i.e. by denying once presence when a creditor called) or by entering a debtor's prison. This allowed them to gain time (it effectively put a stay on the enforcement of debt) time and renegotiate with their creditors. Junior creditors did not always fair well in the backroom deals that cleared their former debtors. Legislatures were therefore reluctant to leave bankruptcy issues squarely in the hands of creditors and instead sought to intersperse (local) government bankruptcy commissioners. Private arrangements remained popular, however, not the least because creditor commissioners were rare in the countryside and did not offer much legal certainty in the

major cities either as there was no common oversight. Still, the 1849 Bankruptcy Act stipulated that to be valid, private arrangements required court approval. Approval was given only if creditor representing at least 6/7 of the outstanding debt had given their consent. In extreme cases, creditors could still seek imprisonment for debtors, but it was for courts to determine whether their deeds amounted to immorality or whether they had simply been out of luck.

Debtors' prisons for the poor were formally abolished in only in 1861. The first unified body of bankruptcy law was promulgated in 1869. Debates about the pros and cons of a unified procedure had started in the 1830s. The major issue of contention was land. As long as access to debtors' assets remained restricted by strict settlement, a shift from criminal to civil bankruptcy could hardly bring much relief to creditors. Not surprisingly, the landed elite fought a long and hard battle to protect land from bankruptcy. And land became fully executable in bankruptcy only with the passage of the Settled Land Act in 1882.

Extending bankruptcy to new forms of wealth was not easy either. The main reason was that the legal classification of stocks, bonds and other financial assets was uncertain. Had they been classified as personal property, creditors would have been able to enforce against them. Instead, securities were deemed "intangible property" and as such not subject to the writ of execution (*fieri facias*).

On the other hand, securities offered new opportunities for debtors to hide their wealth from creditors. Bills of sale came to particular prominence in this regard. An entrepreneur would, for example, issue a bill of sale that was secured by stock or other assets – basically an asset backed commercial paper in contemporary terminology. Enforcing against this security,

proved difficult, however, for a number of reasons. First, the bill itself did not count as personal property. Second, the transaction could be voided in court, because the very act of issuing the bill might be deemed as a preferential treatment of one creditor or as an act of bankruptcy. Moreover, if the stock or other asset that backed the security remained in the possession of the debtor, it was likely to end up in the pool from which all creditors were satisfied. The legal treatment of securities in bankruptcy continues to be an issue to this day, as evidenced in many cases litigated in the aftermath of Lehman's bankruptcy. We will return to this in Chapter 6).

With the proliferation of corporate entities there was the additional need to sort out what would happen if they defaulted on their debt. Partnerships were dissolved when one partner withdrew – as he would in the event of his personal insolvency. Corporations could be liquidated voluntarily if the shareholders so decided, but there were no clear rules about involuntary corporate insolvency. The English Parliament first introduced a procedure for courts to order the winding up of a company that was unable to pay its debt in the middle of the 19th century. In addition, a private resolution regime evolved outside statutory law and legal mandates by turning a collateral into a floating charge. The floating charge gives creditors security "against all present and future property". It is a super-pledge with super-priority rights against anyone else. Courts upheld the floating charge and thereby vindicated the private resolution regime for which it provided the legal anchor. Moreover, floating charge holders soon obtained the right to replace management of an indebted entity with their own. When courts vindicated this practice, they effectively endorse the private resolution regime.

On the Continent the devastation of the thirty-years war made insolvency a wide spread occurrence and triggered early changes to insolvency practices. Earlier, the simple rule of first-come-first-serve prevailed, which gave the creditor who first managed to seize any assets the right to seek full satisfaction. Only in the major trading centers (the Hanseatic cities in particular) had created procedures that enabled all creditors to raise their claims in an orderly proceeding – albeit not without voices raised that outsiders were often short-changed.

The first comprehensive insolvency law in Continental Europe was enacted in France in 1838. The Prussian law of 1855 followed largely the French model. In France, insolvency law was incorporated in the commercial code, affirming that its purpose was to address debt resolution for commerce, not personal affairs. The Prussian insolvency law created separate procedures, one for ordinary debtors, and another for traders, firms and corporate entities. Interestingly, the code made clear provisions for the possibility of extending insolvency from partners to the firm, not however, from shareholders to the corporation. Even prior to the enactment of a full blown corporate law, the entity shield was fully recognized. The orderly liquidation of the remaining assets took center stage. Owners and secured creditors could pull out their assets. The remaining creditors would receive cash, and if the cash raised from selling the remaining assets fell short, then cash in proportion to their claims. Insolvency had a cleansing effect and the distributed assets were deemed unencumbered. To avoid the only procedure available once bankruptcy was declared, namely liquidation, the debtor could try to reach a settlement with creditors. Once sanctioned by a court it exerted the same cleansing effect as did full insolvency procedure. Critically,

settlement had to occur prior to the opening of bankruptcy procedures. Since creditors had the right to call, debtors had to seek this form of protection rather earlier in what otherwise would become and end game. Thus, there was room for reorganization and private settlement in Continental Europe as well. However, German creditors had no devices like the floating charge at their disposal to trump other creditors and thereby limit the number of creditors at the table. Indeed, attempts by German banks to mirror this regime were voided in court for unduly disadvantaging trade and other smaller creditors.

Metamorphosis unpacked

There is solid empirical evidence for the fact that wealth does not always take the same form. Thomas Piketty devotes an entire chapter on the "metamorphosis" of capital in which he documents these changes: from the dominance of agricultural land, to the dominance of (urban) housing and "other domestic capital" as well net foreign capital in the twentieth century.

This poses an interesting puzzle for anyone interested in institutions and institutional change. Picketty himself devotes most of his attention to economic shocks, especially the decline of all forms of wealth in the 1930s and its resurgence after World War II. Yet, the data reveal that the major shift from agriculture to other sources of wealth occurred in the nineteenth century -- prior to the major wars and great depressions that upended national economies in the first part of the twentieth century. In this chapter, I have shown that we can solve the puzzle by taking a closer look at the legal institutions used to protect wealth and follower their path from asset class to asset class. As we have seen, the legal protections that lend assets their PUD were weakened for land

and grafted onto other assets. Land declined as a source of wealth not simply because demand declined, or some exogenous shock occurred. It declined because the key protection of land -- its insulation from bankruptcy and reallocation -- was stripped away. Housing and financial assets rose to prominence not simply because of their inherent qualities, but because they benefited from the same legal protections that had earlier served almost exclusively to protect land. Bernard Rudden alluded to this process in the quote given earlier. The analysis presented here supports his claim. The secret to capital is PUD and PUD is provided by time honored legal rules. The specifics of these rules vary from country to country, but the basis principles are the same. Legal hierarchy can be created in different ways. Assets that benefit from rights at the top of this hierarchy and will therefore trump competing claims have the quality of capital; those that are pushed from the pedestal have it no longer; and who never enjoyed these legal privileges are unfit for wealth creation.