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BOOK REVIEW

Review of *The Code of Capital: How the Law Creates Wealth and Inequality* by Katharina Pistor

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Abstract

The Code of Capital significantly advances our understanding of the origins of inequality and provides a framework for evaluating proposed solutions. But reviews have so far missed some of the most important insights of the book, including the author's insistence on the indeterminacy of the law and the corresponding incompleteness of existing solutions to inequality that primarily rely on economic drivers. The review demonstrates the relevance of the book's main contributions for evaluating the shared value thesis for investors and reflects on some of the solutions to the law's indeterminacy proposed in the book, including the author's surprising neglect of the increasing importance of ethics in business when innovation outpaces the law. The review concludes with consideration of the theoretical advancements that *The Code of Capital* makes for our understanding of inequality in the twenty-first century.

Keywords Shared value thesis for investors · Legal foundations of capital and inequality · Ambiguity

Introduction

Recent literature has witnessed a resurgence of concern with economic inequality. While the locus of debate has shifted over the years, from globalization and the moral imperative to remedy inequality (Wolf and Wade 2002; Wade 2004) to redistribution polices (Piketty 2014) and hybrid organizations (Mair et al. 2016), the capitalist system remains an elusive target for reform. Breathing fresh air into these debates and bringing clarity to the definition of capitalism, *The Code of Capital* traces the incremental process by which a privileged subset of assets—land, debt, equity ownership, and knowledge—have been coded in law over centuries. Once coded, these assets are imbued with the qualities of priority, durability, universality, and convertibility that mark their transformation to capital. The defining feature of a capitalist system then, according to the book's author, Katharina Pistor, is the ability to assign enduring legal attributes to assets, and not free markets governed by prices. Inequality is the inevitable result of a system that privileges some asset holders' access to the legal code over others.

While the book makes several important contributions to our understanding of the origins of capital and inequality, its most valuable contribution is to explain how the indeterminacy and malleability of the law systematically sustain inequality. Grafting this insight onto recent proposals for addressing inequality reveals significant vulnerabilities hiding in plain sight. Specifically, solutions that ignore ambiguity in the law will remain partial at best and are no match for asset holders and their lawyers, whose privileged position allows them to game the system.

If the book has a weakness, it can be found in the unsatisfying solutions offered in its conclusion. To be sure, the author makes an admirable attempt to chart a pathway for rolling back the legal code that has given rise to inequality in the first place. Pistor suggests that lawyers, legislatures, courts, and regulators have the agency necessary to claw back legal privileges of the wealthy. But the book neglects the mechanisms that would allow these agents to disavow capital's interests in the first place. Given the emphasis in the book on the role of lawyers in creating and sustaining

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inequality, and the indeterminacy of law, the ethicality of corporate lawyers is a surprising omission from the analysis. Indeed, ethical principles can play a foundational role filling in the gaps when innovation outpaces the law, or when the rules are uncertain or vague in the first place (Bursoni and Vaccaro 2017; Young 2019).

The next section demonstrates the expansive analytical power of the book in shining new light on contemporary debates over the role of the private sector in solving complex social problems, using the example of the shared value thesis for investors. This is followed by a review of the structural characteristics of the legal code that make it so difficult to unravel or re-write on terms that are more favorable to the disenfranchised. The penultimate section reflects on the actors and mechanisms that hold the most promise for addressing inequality. The conclusion identifies avenues for future research that are inspired by both the contents of and omissions from the book.

Indeterminacy and the Materiality Principle

Pistor's account of the indeterminacy and malleability of the law exposes vulnerabilities in proposed solutions that rely primarily on economic drivers to encourage incumbent asset holders to resolve inequalities. Perhaps nowhere is this insight more salient than in evaluating the impact of the shared value thesis for investors on societal outcomes. In gaining mainstream status, the responsible investment movement has shed much of its ethical origins in favor of claims that the integration of environmental, social, and governance (ESG) issues into investment decision-making and ownership strategies can create value for both business and society (Hebb and Louche 2014). This "shared value thesis" for investors relies on a direct link between social impact and corporate competitive advantage (Porter et al. 2019). Inequality has the potential to negatively impact investors' portfolios by eroding long-term investment performance and destabilizing the financial and social systems in which investors operate (Lydenberg et al. 2017). By drawing attention to the legal foundations of capital and the law's inherent indeterminacy, Pistor implicitly raises two important challenges to the shared value thesis as a solution to inequality.

The first challenge is to the idea that investors can unambiguously exercise their rights as shareholders to address inequality. In the absence of legal rules and principles requiring material disclosures on ESG issues, many investors have taken it upon themselves to fill in regulatory gaps (Richardson 2014). These investors engage in dialogue to affect change in corporate behavior and use their legal rights as shareholders to vote proxies and submit proposals (Clark and Hebb 2005; Hebb 2008). Examples of shareholder engagement on issues related to inequality include requesting a vote on executive compensation, seeking fair treatment of workers, and asking for disclosure on taxes and political spending (Lydengberg et al. 2017). Without legal requirements for companies to disclose ESG issues, investors must rely on third-party ESG ratings to assess the social responsibility of a company in their portfolio and determine whether engagement is merited.

The analytical framework laid out in *The Code of Capital* draws our attention to the ambiguity lurking in the rules governing shareholder relations with issuers and in the interpretations that allow these ratings to be gamed by lawyers and their clients. For example, a Guide for In-House Counsel on responding to shareholder proposals for corporate political spending disclosure written by a large corporate law firm in the United States claims, "companies can take simple steps to increase their score on the CPA-Zicklin Index sometimes without altering current practices (Covington and Burling LLC 2015)." The guide goes on to claim that "these steps can help companies be perceived by these groups as good corporate citizens, removing them from activist crosshairs." The guide promotes the law firm's services, including advice on how to earn easy pick-up points on the Index, noting that "CPA's ambiguous factors leave room for judgment and negotiation" and the firm's proprietary database of disclosure practices that are the least invasive yet allow an issuer to earn "full credit" by following a lowest common denominator approach.

The second challenge posed by the book is to the idea that coding ESG issues in law could provide the impetus for meaningful disclosure that is envisioned by its proponents. Materiality is a legal principle used in financial accounting that refers to information that could significantly influence economic decision of its users. While the extension of the materiality principle to ESG issues is not yet coded in law, it is argued that doing so could lead to meaningful disclosure on a broader range of risks facing companies and would force companies to manage these issues in the same way they manage other, more traditional, financial risks (Williams et al. 2018). Inherent in the argument for extending the materiality principle is that indeterminacy in sustainability disclosures is resolved once the principle is formalized in law.

The Code of Capital offers a cautionary tale for pinning our hopes on such a legal principle for resolving indeterminacies in ESG information. For example, corporations are advised to engage with stakeholders to identify and understand material issues to their business. In the absence of detailed rules that anticipate a multitude of contingencies when conducting a materiality assessment, it is not difficult to imagine the ways in which asset holders could exploit ambiguities in the materiality principle. Indeed, scholars have documented the way in which corporate managers exercise discretion in the materiality assessments and limit opportunities for open-ended questions that would allow stakeholders to raise their own concerns (Calabrese et al. 2019; Guix et al. 2019).

The shared value thesis for investors, as a solution to inequality, is incomplete because it neglects the indeterminacy in the law and the incremental fashion with which asset holders and their lawyers have maintained their wealth. As Pistor observes, "law's inherent incompleteness therefore makes for fertile ground for legal creativity and imagination in every possible direction (p. 210)." To be sure, extending the materiality principle for ESG issues in the law could go a long way toward standardization of non-financial disclosures. But on its own, the legal principle does not solve the problem of indeterminacy. Paradoxically, Pistor notes that enshrining such principles in law could make it even easier for companies to evade because now lawyers and their clients can add "but it's legal" to their defense of actions that contravene solutions to inequality.

Structural Determinants of Inequality

To be sure, there are several instances where indeterminacy in the law is not the problem and where more clear and comprehensive laws could close obvious loopholes that give rise to inequality. For their part, institutional investors are engaging with policymakers to advocate for increased corporate disclosures on ESG issues, and many of these investors are supporting regulations that seek to limit corporate tax avoidance and evasion and excessive executive compensation (Lydenberg et al. 2017).

The Code of Capital offers insight into why the shared investment thesis is an incomplete solution to inequality, even in cases where indeterminacy in law is not the problem. In a similar way that Piketty (2014) explains the natural tendency of the global economy toward inequality because the rate of return on capital exceeds the rate of return on growth, Pistor's arguments offer a parallel account of the deterministic direction of the legal code of capital toward greater inequality, citing coordination challenges, concentration of power, and conflicts of interest.

In the context of globalization, states remain locked in a trajectory of deregulation of capital markets because of roving capital. Any move to repair the loopholes in the law that gives rise to inequality would require coordinated global action. Otherwise, those entities that can exit will do so, leaving those entities that do not have the resources to exit to suffer the consequences of a less competitive legal environment. Paradoxically, then, Pistor notes that such solutions aimed at addressing inequality lead to greater inequality. While these observations are not new—indeed, globalization of financial markets has long been identified as a driving force behind deteriorating social conditions and inequality (Weiss 2003; Rodrik 2011)—what Pistor offers is a new take on why these coordination problems exist by drawing attention to the legal foundations of the global financial system. She doubts that a new social contract between capital and society is possible, even if such a contract is in capital's interests to secure its own survival, given the diffuse nature of capital and the polity.

Pistor also identifies more sinister reasons for sustained inequality. She describes how asset holders that have managed to code their assets in the law are once again turning to the law to exploit their first-mover advantage. It is not just priority rights but the ways in which asset holders and their lawyers have leveraged sophisticated and nuanced legal mechanisms to assign durability to those assets that ensure that accumulation of wealth continues. For example, patents are often targeted as a significant source of inequality but Pistor explains how trade secret laws have sustained the ability of innovators to hold knowledge captive to private interests long after the patent expires. Similarly, property rights serve as an important mechanism for assigning private ownership of land but it was the invention of the trust that provided durability of those rights and protected land owners from creditors and tax authorities.

Indeed, across all the assets that have successfully been coded in the law, Pistor recounts a familiar pattern as the "former disrupters of existing law or technology learn quickly that only by invoking legal protection of their own (...) can they protect their gains (p. 131)." While institutional investors are making important gains engaging companies on executive compensation and political spending, there is little evidence to suggest that investors are targeting these more nuanced legal protections that Pistor shows are central to the reason that inequality persists.

Pistor's analysis also suggests that institutional investors are themselves subject to conflicts of interest and contradictions. Fiduciary duty requires most institutional investors to prioritize financial returns over social objectives. The long-term investment horizon of institutional investors is supposed to reconcile this tension (Porter et al. 2019). *The Code of Capital* highlights several examples, however, where the tension between financial returns and societal objectives is not easily reconciled by referencing the long-term. Pistor explains how shareholders use the mechanisms of debt financing, asset shielding, and loss protection to extract profits from corporate entities while shifting risks to the public, effectively told through a postmortem of Lehman Brothers. Institutional investors can only be a partial solution to inequality, as they are unlikely candidates to lead the unraveling of the legal structures upon which their own financial viability depends.

If Not Investors, Then Who?

If not investors, then who will champion the incremental rolling back of the complex legal protections that asset holders and their lawyers have carved out over centuries? Pistor argues that because states play a central role in governing private contracts and other legal mechanisms on which the coding of capital depends, they have the agency to reclaim these powers. The concluding chapter reviews several measures that these actors could take to roll back the privileges afforded to some asset holders, such as implementing rules that prevent further extension of privileges to these asset holders and reducing opportunities for legal arbitrage.

Pistor recognizes, however, that pursuing these actions would require state actors to free themselves from the "cognitive and financial grips of capital." The concluding chapter revisits an example given earlier in the book to explain the ways in which different state actors are tied to capital's interests and the problem of relying on the state not only to distribute wealth but to uphold legitimate claims in the first place. In an Indigenous land claim case, the Belize state disregarded the decision made by its own Supreme Court ruling in favor of the Mayan people's claim to property rights. The Supreme Court engaged in legal reasoning and concluded that the Mayan claim was consistent with the Belize Constitution. In this case, ambiguity worked in favor of the disenfranchised but the state had strong financial incentive, in the form of future tax revenues, to encourage mining on the land. The ambiguity in the Constitution was again used to neglect the court ruling. While certainly not the first to point out the intricate linkages between state and capital's interests, Pistor offers new insights by explaining how ambiguity in law reinforces these linkages.

Other examples of the intricate relationship between state and capital offered in the book point to more benign drivers linking state actors' interests to capital. For example, Pistor notes the intimate relationship between judges and lawyers in the American legal system. She also points to the evolution in the legal industry as a source of creative exploitation of ambiguities in the law and the exorbitant tuition payments for law school that make corporate law a necessary choice for many graduates. Pistor briefly considers the role of reduced tuition and other forms of incentives for practicing alternative forms of law that are more beneficial to society but quickly dismisses these solutions based on their high cost.

Given the book's emphasis on the role of lawyers—indeed, a chapter dedicated to these Masters of the Code—it is surprising that the analysis includes almost no mention of the micro- or meso-level solutions that might transcend the cognitive or financial pressures on these agents. Except for a few casual mentions of ethical training for corporate lawyers, dismissed by Pistor in the absence of broader reforms to the legal education system, nowhere in the book does the author considers individual ethical systems or corporate governance systems in which corporate lawyers operate or commensurate corporate governance, ethical, and professional standards as remedies to the cognitive and financial captivity of these actors.

The author uses the remainder of the concluding chapter to review some of the more radical proposals for overhauling the capitalist system, driven by a recognition that incremental solutions to rolling back the legal code offer no guarantee that indeterminacies in law will not be used by new interests and create new inequalities. But in her review of these radical solutions, Pistor is herself skeptical of their practicality. Indeed, she notes the prohibitively high costs of peacefully transitioning away from the current capitalist system envisioned by Posner and Weyl (2019) and Menke (2019), due to the requisite coercion to implement these radically different visions than what currently exists and the expropriations to compensate existing asset holders. This realization leads her to the unsettling conclusion that "there may not be a viable alternative to the pragmatic, gradual approach ..., to rolling back the legal privileges that give capital its edge over competing claims (p. 233)."

To be fair, while the moral philosophy of ethics in legal scholarship is vast, empirical studies are limited, leaving Pistor with little evidence on which to draw for evaluating an ethical solution to law's indeterminacy. But given the status and role of corporate lawyers assigned by the book in minting capital in a way that breeds inequality, and Pistor's insistence on the indeterminacy of the law, the author's arguments demand more thorough examination of corporate governance dilemmas and the potential ethical principles and remedies that could address these problems.

Conclusion

The Code of Capital opens several new and important avenues for research at the intersection of law, corporate social responsibility, and ethics. Indeed, the indeterminacy and malleability of the law necessitate a wider breadth of solutions that take seriously the political and structural dimensions of the rules that give rise to and sustain inequality. A legal scholar herself, Pistor admits that a legal solution to inequality is insufficient, as "elevating new claims by bestowing on them legal protection of the kind that capital has enjoyed for centuries does not change the system; it reproduces it (p. 230)."

I have argued that ethical principles could serve as an important safeguard against the problems that Pistor identifies in relation to the indeterminacy of law and the corresponding exploitation by powerful interests that determine how the law is interpreted. As such, ethics deserves more serious attention in scholarship on inequality than it currently receives. For example, future research on sustainable investment might explore the role of corporate lawyers in the value chain. What influence do these actors have on their clients' interpretations of duties to shareholders and other stakeholders? What influence do they have on corporate decision-making with respect to ESG issues, and particularly, those ESG issues that lack clear standards or measurement? What ethical duties, if any, do corporate lawyers owe to society, and what are the corporate governance mechanisms that could lead to more socially desirable interpretations of the law?

The Code of Capital also provides us with a new analytical framework for evaluating contemporary solutions to inequality. By exposing the inherent indeterminacy, malleability, and structural deficiencies that characterize the law governing the assignment of rights and other legal attributes over assets, Pistor's analysis can be extended to show that institutional investors can only ever offer a partial solution to inequality. While this interpretation of Pistor's analysis and its extension is not intended to diminish the role of responsible investment—indeed, institutional investors have shown great promise in fulfilling their role as capital stewards—*The Code of Capital* draws attention to the incompleteness of economic solutions, and the imperative of exercising self-reflexivity when advocating for new laws to repair existing loopholes. Indeed, "but it's legal" is a powerful defense. By acknowledging the indeterminate nature of the law, we can begin to design solutions that aim at not only repairing the law but also building a complementary moral framework to guide interpretation of the law.

I fear that I have barely scratched the surface of the book's sophisticated and expansive account of the legal foundations of capital. The volume eloquently traces the legal foundations of capital across an expansive range of historical, political, and geographic contexts. At the same time, the fact that someone with no formal legal education can navigate the book with relative ease is a testament to the brilliance of the author's organization, clarity, and ability to distill complex and interdisciplinary arguments to a single volume. *The Code of Capital* takes us beyond the stale observations about the economic origins of and solutions to inequality and offers a much-needed framework that weaves together the political, legal, and economic explanations of inequality in the twenty-first century. What Piketty's *Capital in the 21st Century* did empirically for our understanding of inequality, Pistor's book does theoretically for our understanding of inequality.

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