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Lawyers in the Shadows: The Transactional Lawyer in a World of Shadow Banking [1]

Steven L. Schwarcz[2]

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I. SHADOW BANKING AND DISINTERMEDIATION

The financial world has been rapidly changing, with disintermediation being a key feature of the change. "Disintermediation" refers to bypassing the need for bank intermediation between the sources of funds, essentially the capital and other financial markets, and firms that use funds to operate in the real economy.[3] By bypassing banks, firms are able to avoid the profit mark-up that banks charge on their loans.

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[2] Stanley A. Star Professor of Law & Business, Duke University School of Law. E-mail: schwarcz@law.duke.edu. The author thanks Kathryn Bradley, Geoffrey C. Hazard, and symposium participants for helpful comments and Jonathan E. Cote for valuable research assistance.

[3] *See* Steven L. Schwarcz, *Regulating Shadow Banking*, Inaugural Address, Boston University Review of Banking & Financial Law Inaugural Symposium; available at 31 REV. BANKING & FIN. L. 619, 626-27 (2012).

The disintermediated financial system is often referred to, more colloquially, as "shadow banking."[4] Shadow banking already rivals the amount of bank-intermediated credit to households and businesses.[5] The most recent estimate, for 2011, is $67 trillion worldwide.[6]

By reducing the dominance of banks as financial intermediaries, shadow banking has so transformed the financial system that transactional lawyers—especially those accustomed to dealing with banks and bank lending—are facing an array of novel issues.[7] I would like to focus today on one of those issues: To what extent should transactional lawyers address the potential systemic consequences of their client's actions?

II. SYSTEMIC CONSEQUENCES

Although client actions could, theoretically, always have some potential systemic consequences to the financial system, disintermediation has greatly increased that potential. By increasing complexity, disintermediation makes financial transactions and products more difficult to disclose and understand.[8] Disintermediation also increases decentralization, which makes it more difficult for market participants to effectively process information.[9] These information failures make panics more likely: they

[4] *Cf.* FINANCIAL STABILITY BOARD, STRENGTHENING THE OVERSIGHT AND REGULATION OF SHADOW BANKING: PROGRESS REPORT TO G20 MINISTERS AND GOVERNORS (Apr. 16, 2012), at 1 n. 2 (noting that "the use of the term 'shadow banking' is not intended to cast a pejorative tone on this system of credit intermediation").

[5] ZOLTAN POZSAR ET AL., FED. RESERVE BANK OF N.Y., STAFF REPORT NO. 458, *Abstract* to SHADOW BANKING (2010).

[6] Financial Stability Board, Global Shadow Banking Monitoring Report (Nov. 18, 2012).

[7] *Cf. U.S. Regulatory Fog*, FIN. TIMES, June 15, 2012, at 8 (referring to the "persistence of regulatory confusion" in shadow banking); European Private Equity and Venture Capital Association, *EVCA's Response to the Background Note of the Financial Stability Board on "Shadow Banking: Scoping the Issues"* (May 23, 2011) (discussing how confusion about shadow banking could confuse regulatory approaches), available at http://www.financialstabilityboard.org/press/c_110901e.pdf (last visited Jan. 11, 2013).

[8] *See, e.g.*, Steven L. Schwarcz, *Disclosure's Failure in the Subprime Mortgage Crisis*, 2008 UTAH. L. REV. 1109.

[9] *Regulating Shadow Banking*, *supra* note 3, at 13.

allow risks to accumulate unnoticed and unchecked, causing market participants to panic when hidden risks suddenly become apparent.[10] Panics, in turn, often serve as a trigger that can commence a chain of systemic failures.[11]

Disintermediation can also exacerbate information failure by shifting financing in two ways: from firms to markets, and from more formal markets to less formal markets.[12] These shifts not only further increase the likelihood of panics, as explained above[13]; they also increase the potential for systemic risk transmission by increasing the system-wide correlation among financial firms and markets.[14]

Disintermediation additionally increases the potential for agency failure, especially intra-firm conflicts between middle managers and the senior managers to which they report.[15] Middle managers will likely know more than senior managers about the complex and highly technical financial products that disintermediation makes available, making it harder for senior managers to monitor middle managers[16]—especially when senior managers rely on simplifying heuristics, such as value-at-risk (VaR) models, to assess

[10] *Id.* (discussing Dan Awrey's observations in *Complexity, Innovation and the Regulation of Modern Financial Markets*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1916649, that by increasing decentralization, disintermediation creates market fragmentation, interconnectedness, and opacity, making financial markets especially susceptible to endogenous shocks, such as panics).

[11] Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L. J. 193, 214 (2008).

[12] *See, e.g.*, Jerry W. Markham & Daniel J. Harty, *For Whom the Bell Tolls: The Demise of Exchange Trading Floors and the Rise of ECNs*, 33 J. CORP. L. 865, 866 & 882-87 (2008) (describing the displacement of traditional exchange trading and arguing that the benefits of formal markets can include greater transparency).

[13] *See supra* notes 10-11 and accompanying text.

[14] *Regulating Shadow Banking*, *supra* note 3, at 15.

[15] *See* Steven L. Schwarcz, *Conflicts and Financial Collapse: The Problem of Secondary-Management Agency Costs*, 26 YALE J. ON REG. 457 (2009) (describing that agency failure).

[16] *Regulating Shadow Banking*, *supra* note 3, at 20 (explaining why the complexity of shadow banking, combined with the technology that enables it, can exacerbate the intra-firm agency failure).

risk on those products.[17] This increased potential for agency failure can increase systemic risk.[18]

Even beyond those failures, disintermediation poses systemic risk to the financial system because it makes it much more likely that financial firms will engage in profitable but risky transactions, although doing so could externalize harm onto third parties.[19] Conceptually, this is the fundamental source of systemic risk:

> [S]ystemic risk results from a type of tragedy of the commons in which market participants lack sufficient incentive, absent regulation, to limit risk-taking in order to reduce the systemic danger to others. Law, therefore, has a role in reducing systemic risk.[20]

To be sure, bank-intermediated financing had lots of potential to create externalities, causing systemic failure. Bank failure is still the poster child of a systemic collapse, and was largely responsible for the Great Depression. But post-Depression regulation helped to mitigate that potential. For example, banks are now widely subject to prudential regulation—such as limitations on bank capital ratios, and liquidity protection[21] —to help prevent their failures; and government deposit insurance helps, at least in the

[17] *Conflicts and Financial Collapse, supra* note 15, at 463-64.

[18] *Regulating Shadow Banking*, *supra* note 3, at 17–18, 20.

[19] *See Regulating Shadows*, *supra* note 1, at Part II.B.3 (explaining why disintermediation has that effect). *See also infra* notes 30-40 and accompanying text (explaining why disintermediation can increase risk resulting from limited liability and the corporate law duty to maximize shareholder value).

[20] *Systemic Risk*, *supra* note 11, at 193 & 206. The reference above to a "type" of tragedy of the commons reflects that the analogy is imperfect; there is, technically, a tragedy of the commons only insofar as market participants (as opposed to non-market participants) suffer from the actions of other market participants.

[21] *See, e.g.*, Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks,* 2002 U. ILL. L. REV. 215 (2002) (discussing prudential rules to control risks); David Zaring, *A Lack of Resolution*, 60 EMORY L.J. 97 (2010) (discussing leverage caps for banks); Arthur W. Leibold, Jr., *Primary and Secondary Liquidity*, 26 BUS. LAW. 411 (1970) (discussing liquidity).

United States, to prevent bank runs.[22] In the bank-intermediated financial system, in other words, prudential regulation and deposit insurance have mitigated the externalities.

Regulation, however, has not yet adequately addressed—or even come close, in my opinion, to adequately addressing—shadow banking's potential to cause externalities. Although laws such as the Dodd-Frank Act are attempting to apply bank-style rules to shadow banking, that attempt is likely to be inadequate. Prudential regulation, for example, does not apply, and as a practical matter cannot be applied, to all of the firms—including special-purpose entities, finance companies, hedge funds, money-market mutual funds, securities lenders, and investment banks[23]—that operate as shadow banks.[24] And although bank runs cannot occur because these firms are not deposit-taking institutions, disintermediation can potentiate the equivalent of bank runs.[25]

[22] In a bank run, some depositors panic, converging on the bank in a "grab race" to withdraw their monies first. Because banks keep only a small fraction of their deposits on hand as cash reserves, other depositors may have to join the run in order to avoid losing the grab race. *See, e.g.*, Jonathan R. Macey & Geoffrey P. Miller, *Bank Failures, Risk Monitoring, and the Market for Bank Control*, 88 COLUM. L. REV. 1153, 1156 (1988) (linking bank runs and depositor collective action problems). If there is insufficient cash to pay all withdrawal-demands, the bank will default. R.W. HAFER, THE FEDERAL RESERVE SYSTEM 145 (2005) (observing that a bank's cash reserves are often less than five percent of its deposits). That, in turn, can create externalities by causing other banks or their creditors to default. Chris Mundy, *The Nature of Systemic Risk: Trying to Achieve a Definition*, BALANCE SHEET, Oct. 24, 2004, at 29. The standard regulatory solution, alleviating depositor panic by providing government deposit insurance, is intended to reduce the risk of those externalities. *See, e.g.*, Douglas W. Diamond & Philip H. Dybvig, *Banking Theory, Deposit Insurance, and Bank Regulation*, 59 J. BUS. 55 (1986) (analyzing optimal contracts that prevent bank runs and observing that government provision of deposit insurance can produce superior contracts).

[23] *Regulating Shadow Banking*, *supra* note 3, at 3, 5, 6 & 14.

[24] There currently is a debate as to whether prudential regulation should at least be applied to financial firms that are regarded as "systemically important financial institutions."

[25] Shadow banking can mimic the effect of a bank run by spurring short-term funding of long-term projects, such as asset-backed commercial paper special-purpose-entity conduits whose failure to roll over their short-term commercial paper in the last five months of 2007 "played a central role in transforming concerns about the credit quality of mortgage-related assets into a global financial crisis." Daniel Covitz, Nellie Liang & Gustavo Suarez, *The Evolution of a Financial Crisis: Panic in the Asset-Backed Commercial Paper Market*, Fed. Reserve Bd. Finance and Discussion Series, #2009-36 (2009), at 16, *available at* http://www.federalreserve.gov/pubs/feds/2009/200936/200936pap.pdf. The European Central Bank also has identified short-term funding of long-term projects as "a major amplification mechanism in situations of stress," which can particularly "foster systemic risks . . . if [it] takes place outside the regulated [financial] system." Klara Bakk-Simon et al., *Shadow Banking in the Euro Area*, European Central Bank Occasional Paper No. 133, at 24 (Apr. 2012).

Furthermore, economists—on whom regulators often rely—are thinking of regulation in possibly misleading ways, further frustrating the regulatory process. For example, economists view externalities as a distinct category of market failure, but externalities are fundamentally consequences, not causes, of failures.[26] Externalities cannot even constitute a unique category of market failure because all market failures can result in externalities.[27] Speaking of externalities as a cause or category of market failure conflates cause and effect.[28]

Most significantly for this symposium, viewing externalities as a category of market failure obscures who should be responsible for causing the externalities. Should it be a "shadow bank" firm whose actions are the immediate cause of externalities, or should it also include a party enabling those actions? In each case, what does that portend for the role of the transactional lawyer?

III. Responsibility Failure

I next argue that the government should be held ultimately responsible for causing at least a significant portion of the externalities in the shadow-banking system. That's because government promulgates laws that enable, or even require, financial firms to engage in risky behavior—and risky behavior is the fundamental source of systemic risk.[29] Viewing government

[26] *Regulating Shadows*, *supra* note 1, at [cite].
[27] *Id.* at [cite].
[28] *Id.* at [cite].
[29] *See supra* notes 19-20 and accompanying text. I am not claiming today, however, that government should ultimately be responsible for the information and agency failures that can also trigger systemic risk. *See supra* notes 8-18 and accompanying text.

as a responsible party challenges the traditional paradigm of market failure, which assumes away government action or inaction as a cause of failure.[30]

For example, corporation laws require maximizing shareholder value, notwithstanding risk to third parties. Because the managers of most firms have obligations under existing law solely to the firms' shareholders,[31] firms that engage in risky projects in order to increase opportunities for shareholder profit may be acting responsibly as defined, indeed mandated, by law—even if the effect is to externalize costs. In those cases, the government could, and I believe should,[32] be viewed as causing the responsibility failure by mandating that risky behavior while failing to protect against the resulting externalities.

This responsibility failure is much more problematic for shadow banking than for traditional banking. Banks are highly regulated entities for which the obligation to maximize shareholder value may be more limited than for corporations.[33] In contrast, firms that operate as shadow banks are more likely to be corporations or similar entities, such as limited liability companies that adopt corporate governance standards, that are subject to a

[30] *Regulating Shadows*, *supra* note 1, at [cite].

[31] *See, e.g.,* John R. Boatright, *Fiduciary Duties and the Shareholder-Management Relation: Or, What's so Special About Shareholders?*, 4 BUS. ETHICS Q. 393 (1994) (discussing the duty of managers to shareholders).

[32] *Cf.* ANDREAS PAPANDREOU, EXTERNALITY AND INSTITUTIONS 156–58 (1994) (arguing that the cause of inefficiency is the failure of institutions to "reshap[e] the boundaries of agents' actions").

[33] Banks, like corporations, have a duty to maximize shareholder value. *See, e.g.,* Susan Saab Fortney, *OTS vs. The Bar: Must Attorneys Advise Directors that the Directors Owe a Duty to the Depository Fund*, 12 ANN. REV. BANKING L. 373, 382 (1993) (examining when financial institutions' fiduciary duties may shift from the shareholders to creditors). However, banks appear to also have a duty to depositors, which could limit their ability to take risk. *See* Lane v. Chowning, 610 F.2d 1385, 1388-89 (1979) ("[F]or it is well settled that the fiduciary duty of a bank officer or director is owed to the depositors and shareholders of the bank."). *See also* Julie D. Manasfi, *Systemic Risk and Dodd-Frank's Volcker Rule*, 4 WM. & MARY BUS. L. REV. 181, 204 (2013). *But cf.* Fortney, *supra* at 387 ("While some courts have referred to a fiduciary duty to depositors, the vast majority of judicial opinions refuse to recognize such a duty.")

comparatively unrestricted obligation to maximize shareholder value.[34] Moreover, banks are subject to prudential regulation intended to protect them from failures due to risky actions.[35] In contrast, it would be impractical to impose prudential regulation on all of the firms that operate as shadow banks.[36]

Another reason that responsibility failure is more problematic for shadow banking than for traditional banking is the limited liability of investors who manage firms in the disintermediated financial system.[37] Because those investors are not financially responsible for liabilities of their firms, their interests may conflict with the interests of their firms and, more importantly for externalities, with the interests of third parties harmed by their firms: even if a firm eventually becomes liable for the externalized harm, the limited-liability investors will not become liable.[38]

Limited liability is, of course, commonplace, even in traditional finance. We therefore tend not to focus on liability limitation at the firm level, simply accepting it as a fact of life. By facilitating decentralization, however, shadow banking makes limited liability much more likely to cause externalities.

[34] *Cf.* Peter Conti-Brown, *Elective Shareholder Liability*, 64 STAN. L. REV. 409, 459–60 (2012) (observing that most investment banks are now run as limited liability companies, rather than partnerships).
[35] *See supra* notes 21-22 and accompanying text.
[36] *See supra* notes 23-24 and accompanying text.
[37] *Cf.* Edouard Challe, Benoit Mojon, & Xavier Ragot, *Equilibrium Risk Shifting and Interest Rate in an Opaque Financial System*, Ecole Polytechnique, Centre National De La Recherche Scientific (September 2012), at 6, *available at* http://hal.archives-ouvertes.fr/docs/00/72/89/28/PDF/2012-19.pdf (noting that systemic risk arises partially because limited liability increases intermediaries' risk tolerance).
[38] *Regulating Shadows*, *supra* note 1, at [cite].

For example, the relatively small firms, including hedge funds, that operate as shadow banks are often managed directly by their primary investors, who typically divide up a significant share of the firm's profits; they therefore have strong incentives to take risks with the firm that could generate large profits.[39] This is radically unlike the management incentives in large firms, such as traditional banks, in which senior managers tend to share only indirectly in profits and are more invested in maintaining their jobs (and thus less motivated to take actions that risk the firm).[40]

Because these (and similar) laws[41] enable or require firms operating as shadow banks to engage in risky behavior without protecting against the resulting externalities, I believe that the government should be held ultimately responsible for causing a significant portion of the externalities in the shadow-banking system. I next examine what duty transactional lawyers should have to try to improve those laws.[42] Thereafter, I examine what duty transactional lawyers should have to try to prevent client-caused externalities, assuming those laws are not improved.[43]

IV. LAWYER RESPONSIBILITY

For purposes of this analysis, I will make two assumptions: that the client-firm's actions do not actually violate law,[44] and that those actions

[39] *Id.* at [cite].

[40] *Id.* at [cite].

[41] Such as the laws discussed that require maximizing shareholder value and limit liability.

[42] *See infra* Part IV.A.

[43] *See infra* Part IV.B.

[44] In the U.S., and I imagine in most other legal systems, lawyers have a duty to not engage or assist a client in performing an unlawful act. *See, e.g.,* RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 16 cmt. c (2000) ("A lawyer may not do or assist an unlawful act on behalf of a client . . . ."); ABA Model Rule of Professional Conduct 1.2(d); William Ewald, *Comparative Jurisprudence (I): What Was it Like to Try a Rat?*, 143 U. PA. L. REV. 1889, 2123 (1995) (discussing why lawyers typically rely upon black-letter rules of law). The lawyer should try to persuade the client to comply with the law and, if unsuccessful, ultimately may have to resign.

cause harm only to third parties.[45] I therefore focus on the responsibility of transactional lawyers to the public without needing to examine their responsibility to clients, qua clients.[46]

A. *A Lawyer's Public Duty to Ensure Good Legal Rules*

Lawyers should have at least some aspirational duty to the public to ensure good legal rules and governance.[47] Tocqueville argued that a public duty derives from the special status of lawyers in society, tantamount to nobility, whereas Brandeis argued that such a duty derives from the unique ability of lawyers to engage in public life.[48] In recent years, though, the concept of a lawyer's public duty may be losing vitality. Professor Gordon has observed, for example, that since the 1970s, the idea that lawyers have a public duty "has been in decay," and now "has almost no institutional support in the rules and disciplinary bodies that regulate the [legal] profession."[49] Moreover, whatever this public duty may now be, it appears at most to be morally desirable, not ethically required.[50]

[45] Even if a client-firm's actions do not actually violate law, a lawyer still may have a duty to inform the client of possible harm *to the client* that the lawyer is aware of. Once so informed, the client-firm can decide whether to accept this harm as a cost of doing business. *Cf.* Rodney J. Uphoff, *Who Should Control the Decision to Call a Witness Respecting a Criminal Defendant's Tactical Choices*, 68 U. CIN. L. REV. 763, 768 (2000)(describing the client-centered approach to lawyering as identifying legal problems and presenting options to the client so that the client can ultimately select its course of action).

[46] In that examination, I am not advocating for or against any particular substantive laws. Nor am I arguing that laws should necessarily require parties to internalize all the costs of their behavior.

[47] *Cf.* MODEL RULES OF PROF'L CONDUCT Pmbl. para. 1 (2013) (stating that a lawyer is "a public citizen having special responsibility for the quality of justice."); *see also id.* para 6 ("As a public citizen, a lawyer should seek improvement of the law.").

[48] *See* David Luban, *The Noblesse Oblige Tradition in the Practice of Law*, 41 VAND. L. REV. 717, 718, 721 (1988) (noting Alexis de Tocqueville's description of lawyers as an American aristocracy and Louis Brandeis' exhortation that lawyers engage in law-reform activities).

[49] Robert W. Gordon, *A New Role for Lawyers?: The Corporate Counselor After Enron*, 35 CONN. L. REV. 1185, 1209 (2003). *But cf.* William H. Simon, *Earnings Management as a Professional Responsibility Problem: A Response to Steven Schwarcz's "The Limits of Lawyering,"* 84 TEXAS L. REV. 83, 88 (2005) (arguing that lawyers should not participate in conduct that is "socially harmful").

[50] Luban, *supra* note 48, at 737. *Cf.* Simon, *supra* note 49, at 92 (observing that not participating in socially harmful conduct is "most compatible with the idea of lawyering as a dignified calling"); Steven L. Schwarcz, *The Limits of Lawyering: Legal Opinions in Structured Finance,* 84 TEX. L. REV. 1, 43-44 (2005) (observing that "as vigorously as scholars have criticized lawyer conduct, the scholarship often does not propose actual legal constraints on, but merely

The debate over a lawyer's public duty has taken on its most concrete form in the area of tax law: whether there is a "duty to the system"?[51] Some argue that tax lawyers have a public duty to see that the "tax system is meeting the needs of government."[52] Others assert, however, that whatever is within the letter of the tax law should be permissible.[53]

The argument that tax lawyers have a public duty is based on their "peculiar knowledge of what is wrong with tax law," which "makes especially valuable [their] objective opinion about what should be done—and sometimes what should not be done—to remedy defects. Special qualifications bring special responsibilities which may not be passively discharged."[54] The few examples of how tax lawyers should discharge those responsibilities appear to be limited, however, to specific transactional contexts.

Thus, one commentator argues that tax lawyers would breach their duty to the revenue system by helping to structure corporate inversions.[55] The rationale is that these "transactions are shams because those employing the technique are able to claim substantial reductions in their U.S. tax

aspirational goals for, such conduct [insofar as it impacts the public]. And where the scholarship does propose legal constraints, they are often impractical . . . .") (citations omitted).

[51] David J. Moraine, *Loyalty Divided: Duties to Clients and Duties to Others—The Civil Liability of Tax Attorneys Made Possible by the Acceptance of a Duty to the System*, 63 TAX LAW. 169, 170 (2009).

[52] *Id*. at 191. *See also* BERNARD WOLFMAN & JAMES P. HOLDEN, ETHICAL PROBLEMS IN FEDERAL TAX PRACTICE 1 (2d ed. 1985) ("There are times, however, when the lawyer, while pursuing his client's interests competently, loyally, and discreetly, must hold himself and his client's interests in check in order to perform the less defined, seemingly contradictory duty which he owes to the system as a whole.").

[53] Moraine, *supra* note 51, at 191.

[54] *Id*. at 189.

[55] These are transactions "through which the corporate structure of a U.S.-based multinational group is altered so that a new foreign corporation, typically located in a low- or no-tax country, replaces the existing U.S. parent corporation as the parent of the corporate group." Anthony C. Infanti, *Eyes Wide Shut: Surveying Erosion in the Professionalism of the Tax Bar*, 22 VA. TAX REV. 589, 592 (2003).

liability without in substance affecting [their] ownership, headquarters, operations or business practices."[56] It is unclear, though, whether any such special responsibilities should extend to changing tax law to eliminate these types of transactions or to otherwise reforming fundamental tax-law policy:

> One of the chief problems here is that most tax lawyers have hardly any conception of what is involved in approaching a tax issue from the over-all legislative standpoint. They can readily perceive the adverse effect of the tax laws upon a particular client or transaction. They can then phrase the legislative solution they think necessary to remove the claimed tax obstacle or burden. But they are usually quite incapable of standing off from the problem and their proposed solution and viewing both from the perspective of the general public interest. The difficulty is largely one of lack of experience, not lack of judgment or moral values.[57]

Assuming arguendo that the special qualifications and expertise of tax lawyers should invest them with a special public duty, that same rationale would not appear to be applicable to transactional lawyers in the shadow-banking system. Those lawyers do not have specialized qualifications or expertise comparable to those of tax lawyers, nor are the problems of government responsibility failure particularly technical.[58] Also, it is unclear how a lawyer might attempt to correct government responsibility failure in a specific transactional context. Correcting government responsibility failure would need to engage fundamental legal policies, like whether managers should have a duty only to shareholders and whether limited liability should

[56] *Id*. at 608-09.
[57] WOLFMAN & HOLDEN, *supra* note 52, at 216-17.
[58] Professor Ribstein has argued that a possible basis for imposing a duty on lawyers to improve the law may come from their monopoly position on legal services. Larry E. Ribstein, *Lawyers as Lawmakers: A Theory of Lawyer Licensing*, 69 MO. L. REV. 299, 301 (2004). It is unclear, though, if he merely proposes an aspirational duty. He later suggests that licensing merely provides lawyers with an incentive to engage in law-reform activities. *Id*. at 327.

be absolute. As discussed, reforming fundamental legal policy may be better suited to public debate.[59]

Moreover, whatever public duty transactional lawyers in the shadow-banking system should otherwise have, they should temper that duty by considerations for their client-firms. A lawyer may not, for example, take a position directly adverse to a current client during law-reform efforts.[60] That conflicting duty could well impede the law-reform agenda of many a transactional lawyer.

B. *A Lawyer's Public Duty to Prevent Client-caused Externalities*.

The foregoing analysis focused on a lawyer's public duty to try to ensure good legal rules and governance. That analysis should be distinguished from the question of a lawyer's public duty to try to prevent client-caused externalities enabled or required by bad legal rules and governance.[61] Even if the government is ultimately responsible for those externalities, the client-firm itself is the party immediately causing the externalities.

In a prior article,[62] I observed that because all transactions create externalities,[63] a lawyer is participating in creating externalities any time the

[59] *See supra* note 57 and accompanying text (observing that reforming fundamental tax-law policy is better suited to public debate).

[60] Model Rules of Prof'l Conduct R. 6.4 cmt. (2012) (noting that Rule 1.7 which deals with representation adverse to a current client applies to law-reform efforts). *See also* John S. Dzienkowski, *Positional Conflicts of Interest*, 71 Tex. L. Rev. 457, 535 (1993); Geoffrey C. Hazard, Jr. & W. William Hodes, 2 The Law of Lawyering: A Handbook on the Model Rules of Professional Conduct §§6.4:101–103 (2d. ed 1990, 1993 supplement) (discussing positional conflicts of interests and law-reform activities affecting client interests, including the disclosure requirement when a lawyer knows a client may be materially benefitted by a decision in which the lawyer participates).

[61] The analysis in this Part IV.B thus implicitly assumes that the client-firm's actions that cause those externalities do not violate law. *See supra* note 44 and accompanying text (making it an assumption of this analysis that the client-firm is not actually violating law).

[62] *The Role of Lawyers in the Global Financial Crisis*, *supra* note 1, at 222.

lawyer helps a client facilitate a transaction. However, a paradigm of social ordering is that, left to independent bargaining, parties work out arrangements that—except to the extent the arrangements create unlawful externalities—benefit the overall public good:

> [The] fact that parties in pursuit of self-interest agree to an exchange indicates that the exchange in question is likely to enhance allocative efficiency. Furthermore, the fine tuning arising out of the bargaining process serves the common good by assuring that increased value is purchased at the lowest possible expense. Reciprocity, then, not only permits the alignment of individual self-interest and the common good, but it does so in a manner that . . . is very reminiscent of Adam Smith's "invisible hand."[64]

To the extent lawyers advise on whether arrangements are lawful and help to facilitate lawful arrangements, they therefore can be seen as social engineers contributing to this social-ordering paradigm.[65] If lawyers were constrained from helping to facilitate bargained-for lawful business transactions that nonetheless may cause externalities, they would be forced to substitute their judgment about externalities for that of their clients. To the extent clients have more or better information about the consequences of a

[63] *Cf.* ALAN STONE, REGULATION AND ITS ALTERNATIVES 91, 97 (1982) (observing that "[s]trictly speaking, virtually every activity involves an externality").

[64] Michel Rosenfeld, *Contract and Justice: The Relationship Between Classical Contract Law and Social Contract Theory*, 70 IOWA L. REV. 769, 847 (1985). *See also* Richard A. Posner, *Wealth Maximization and Judicial Decision-Making*, 4 INT'L REV. L. & ECON. 131, 132 (1984) (asserting that courts should use "wealth maximization" as a guide to judicial action where "the goal of such action is to bring about the allocation of resources that makes the economic pie as large as possible, irrespective of the relative slices"); ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 291–92, 547–48 n.292 (Kathryn Sutherland ed., Oxford University Press 1993) (1776):

> As every individual, therefore, endeavours as much as he can both to employ his capital in the support of domestic industry, and so to direct that industry that its produce may be of the greatest value; every individual necessarily labours to render the annual revenue of the society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. By preferring the support of domestic to that of foreign industry, he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention.

[65] *The Limits of Lawyering*, *supra* note 50, at 29.

business transaction (other than the transaction's legality[66]), they would be better positioned to make business decisions. Lawyers who are specialists only in law are ill-trained to assess and weigh the costs (including externalities) and benefits of business transactions they help to facilitate.[67]

Therefore, where the consequences of a client's action would be third-party harm that falls short of actually violating law, a lawyer should have no obligation to identify those consequences to the client or to resign from the engagement. Individual lawyers should not have to decide at the risk of liability whether client actions are socially harmful if society itself has not made that decision by making the actions unlawful.[68]

Some lawyers may nonetheless wish, for aspirational or even practical reasons,[69] to inform the client of any such harmful consequences and to withdraw from the engagement if the client persists in its action. A lawyer

[66] *Id.*

[67] *Id.* In another context, for example, I have asked how a lawyer asked to opine on a proposed break-up leveraged buyout could even attempt to balance costs and benefits where the resulting transaction creates a more efficient business but, in the process, costs a thousand jobs, impoverishes a community, and destroys families. Imposing a duty on lawyers to second-guess or impede their clients' lawful business decisions would generally be inefficient. *See, e.g.*, James A. Cohen, *Lawyer Role, Agency Law, and the Characterization "Officer of the Court"*, 48 BUFF. L. REV. 349, 387–88 (2000) (cautioning against "[c]laims that lawyers should be free to disobey the client's lawful instructions"); Sean J. Griffith, *Afterward and Comment: Towards an Ethical Duty to Market Investors*, 35 CONN. L. REV. 1223, 1234 n.43 (2003) (cautioning that "[v]aguely defined duties to 'the public' threaten to increase the agency costs of the legal representation as lawyers may seek to pursue their own ideological goals in favor of client interests"). A lawyer nonetheless has the right to raise with the client the possibility of the client's actions causing externalities. *See infra* note 70 and accompanying text. A prudent lawyer might wish to do this, perhaps in the form of questions, to help ensure that the client has considered the consequences. E-mail from Kathryn Bradley, Professor of the Practice of Law, Duke University School of Law, to the author (Mar. 26, 2013).

[68] *See* Steven L. Schwarcz, *Reply—We Are All Saying Much the Same Thing: A Rejoinder to the Comments of Professors Coffee, Macey, and Simon*, 84 TEX. L. REV. 93, 101-02 (2005) (discussing the observation of legal ethicist Richard Painter that although it is "sound in principal" for a lawyer to embrace aspirational goals, vague aspirational goals might serve as a "definition of professionalism" but should not be used to "impose liability on lawyers").

[69] It can be risky to help facilitate transactions that violate norms even though the transactions would not actually violate law. If a transaction is later criticized, the lawyer can suffer reputational loss. *See Limits of Lawyering, supra* note 50, at 36-42 (examining what lawfulness should mean in a world of changing norms). *See also id.* at 37 (citing JONATHAN R. MACEY & GEOFFREY P. MILLER, BANKING LAW AND REGULATION 346 (2d ed. 1997) (suggesting that "large [law] firms [are] the most appealing targets because they have the deepest pockets") and Nathan Koppel, *Partial Protection—Plaintiffs Face a Supreme Court Barrier When Suing Law Firms for Fraud*, AM. LAW., July 2004, at 77 ("Law firms are an alluring deep pocket for defrauded investors.")).

should always have the right to inform the client of that third-party harm and to withdraw from the engagement if the client persists in its action[70]—provided that any such withdrawal is not "noisy."[71] This right to speak out protects the integrity of our profession, and the moral authority of a lawyer who decides to speak out can be profound.[72]

A recent ethical query in The New York Times grapples with this very issue.[73] A tax lawyer asked whether it is "ethically permissible" to advise "wealthy companies of ways to reduce their tax bills through sophisticated legal structures" that "take advantage of legal loopholes in the tax legislation."[74] Ethicist Klosterman answered as follows: "[Y]our principal responsibilities lie with the company hiring you. . . . You should, however, voice your moral apprehension about the use of such loopholes to the company you represent."[75]

V. CONCLUSIONS

I have examined the role of transactional lawyers in a world of shadow banking. By reducing the dominance of banks as financial intermediaries, shadow banking has transformed the financial system,

[70] *Cf.* ABA Model Rule of Professional Conduct 2.1 (providing that "[i]n rendering advice, a lawyer may refer not only to law but to other considerations such as moral, economic, social and political factors that may be relevant to the client's situation"); Simon, *supra* note 49, at 88 (arguing that lawyers should not participate in conduct that is "socially harmful").

[71] *The Role of Lawyers in the Global Financial Crisis*, *supra* note 1, at 224.

[72] Larry O. Natt Gant, II, *More than Lawyers: The Legal and Ethical Implications of Counseling Clients on Nonlegal Considerations*, 18 GEO. J. LEGAL ETHICS 365, 375 (2005) ("By affirming the importance of lawyers' moral autonomy, [the model rules] work to underscore the importance of nonlegal, particularly moral, counseling in the attorney-client relationship."); Michael S. McGinnis, *Virtue Ethics, Earnestness, and the Deciding Lawyer: Human Flourishing in a Legal Community*, 87 N.D. L. REV. 19, 26 ("[T]he lawyer also occupies a place of special authority with respect to the client's legal affairs. Not only does the lawyer have the already noted discretion as to the means to be considered and employed to achieve the client's objectives, but the lawyer generally possesses expertise and experience that makes his words highly influential on the client's decisions.").

[73] Chuck Klosterman, *The Ethicist: Tax Maven*, N.Y. TIMES, Mar. 24, 2013, at 13.

[74] *Id.*

[75] *Id.*

causing transactional lawyers to face an array of novel issues. I focus on one of those issues: To what extent should transactional lawyers address the potential systemic consequences of their client's actions? First, I show that the legal system itself inadvertently enables or requires firms operating as shadow banks to engage in uniquely risky behavior, without protecting against the resulting systemically risky externalities. That finding, in turn, broadens the legal ethics inquiry to two issues: what duty should transactional lawyers have to try to improve the legal system to protect against those externalities, and what duty should transactional lawyers have to try to prevent those externalities, assuming the legal system is not improved.