LAWYERS IN THE SHADOWS: THE TRANSACTIONAL LAWYER IN A WORLD OF SHADOW BANKING*

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This article examines how the role of transactional lawyers should change in the new world of shadow banking. Although transactional lawyers should consider the potential systemic consequences of their client's actions, their actions should be tempered by their primary duties to the client and by their responsibilities to the legal system more broadly.

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I. SHADOW BANKING AND DISINTERMEDIATION

The financial world has been rapidly changing, and disintermediation is a key feature of that change.

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"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 those funds to operate in the real economy. By bypassing banks, firms avoid the profit markup that banks charge on loans.

The disintermediated financial system is often referred to more colloquially as "shadow banking." Shadow banking’s funding already rivals that of bank-intermediated credit for households and businesses. The size of the worldwide shadow banking system was estimated to be $67 trillion in 2011.

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. This article focuses on one of those issues: to what extent should transactional lawyers address the potential systemic consequences of a client’s actions?

II. SYSTEMIC CONSEQUENCES

Although client actions could, theoretically, always have some potential systemic consequences to the financial system, disintermediation greatly increases that potential. By increasing complexity, disintermediation makes financial transactions and
products more difficult to disclose and understand.\textsuperscript{6} It also increases decentralization, which makes it more difficult for market participants to effectively process information.\textsuperscript{7} These information failures make panics more likely; they allow risks to accumulate undetected and unrestrained, causing market participants to panic when hidden risks suddenly materialize.\textsuperscript{8} Panics, in turn, often serve as a trigger for a chain of systemic failures.\textsuperscript{9}

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.\textsuperscript{10} These shifts not only further increase the likelihood of panics, as explained above,\textsuperscript{11} they also exacerbate the potential for systemic risk transmission by “increas[ing] the system-wide correlation among financial firms and markets.”\textsuperscript{12}

Disintermediation also increases the potential for agency failure, especially intra-firm conflicts between middle managers and the senior managers to whom they report.\textsuperscript{13} Middle managers will likely know more than senior managers about the complex and highly technical financial products that disintermediation makes available, creating difficulty for senior managers in monitoring middle

\begin{itemize}
  \item \textsuperscript{6} See, e.g., Steven L. Schwarcz, Disclosure's Failure in the Subprime Mortgage Crisis, 2008 UTAH. L. REV. 1109, 1113 & n.22 (asserting that even though the risks on mortgage-backed securities were disclosed in conformity with federal disclosure laws prior to the subprime mortgage crisis, the complexity of certain of those transactions made the disclosures insufficient, thereby contributing to the crisis).
  \item \textsuperscript{7} Schwarcz, Regulating Shadow Banking, supra note 1, at 628–29.
  \item \textsuperscript{8} See id. at 628–29 & n.41 (discussing Professor Dan Awrey's arguments in Complexity, Innovation and the Regulation of Modern Financial Markets, 2 HARV. BUS. L. REV. 235 (2012), that by increasing decentralization, disintermediation "creates market fragmentation, interconnectedness and opacity," making financial markets especially susceptible to endogenous shocks, such as panics).
  \item \textsuperscript{9} Steven L. Schwarcz, Systemic Risk, 97 GEO. L.J. 193, 214 (2008) [hereinafter Schwarcz, Systemic Risk] (stating that the theoretically ideal approach to regulating systemic risk, known as the “monetarist” approach, is “to eliminate the risk of systemic collapse, \textit{ab initio},” by preventing financial panics).
  \item \textsuperscript{10} See, e.g., Jerry W. Markham & Daniel J. Harty, For Whom the Bell Tolls: The Demise of Exchange Trading Floors and the Growth of ECNs, 35 J. CORP. L. 865, 866, 882-83 (2008) (describing the displacement of traditional exchange trading and arguing that the benefits of formal markets include greater transparency).
  \item \textsuperscript{11} See supra notes 8–9 and accompanying text (articulating how information failures allow risks to build up unnoticed, which causes panics when the accumulated risk suddenly emerges).
  \item \textsuperscript{12} Schwarcz, Regulating Shadow Banking, supra note 1, at 629–31 (noting that shadow banks provide financial products and services through the financial markets, thereby increasing the interconnectedness between financial firms and markets).
  \item \textsuperscript{13} See Steven L. Schwarcz, Conflicts and Financial Collapse: The Problem of Secondary-Management Agency Costs, 26 YALE J. ON REG. 457, 458–60 (2009) [hereinafter Schwarcz, Conflicts and Financial Collapse] (describing how middle managers are compensated based on performance of tasks rather than on the long-term impact those tasks have on the firm).
\end{itemize}
managers—especially when senior managers rely on simplifying heuristics, such as value-at-risk (VaR) models, to assess risk on those products. This increased potential for agency failure can increase systemic risk.

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. Doing so, however, could externalize harm onto third parties. Conceptually, this is the fundamental source of systemic risk:

"No firm . . . has an incentive to limit its risk taking in order to reduce the [systemic] danger . . . for other firms." . . . As a result, there is a type of tragedy of the commons . . . . For these reasons, regulation of systemic risk appears not only appropriate, but necessary.

To be sure, bank-intermediated financing also can create externalities, which cause systemic failure. Bank failure—the poster child of systemic failure—was largely responsible for the Great Depression. But post-Depression regulation has curbed the risk of catastrophic bank failure. For example, banks are now widely

14. See Schwarcz, Regulating Shadow Banking, supra note 1, at 635 (explaining why the complexity of shadow banking, combined with the technology that enables it, can exacerbate the intra-firm agency failure).

15. Schwarcz, Conflicts and Financial Collapse, supra note 13, at 463–64.

16. Schwarcz, Regulating Shadow Banking, supra note 1, at 635.


18. Schwarcz, Systemic Risk, supra note 9, at 206 (first alteration in original) (quoting PRESIDENT'S WORKING GROUP ON FIN. MKTS., HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG TERM CAPITAL MANAGEMENT 31 (1999)). The reference 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.

19. See id. at 206 (articulating that the same lack of incentive to reduce systemic risk, and its accompanying externalities, holds true for banks as well because they "will protect themselves but not the stability of the banking system," absent regulation).

20. See, e.g., id. at 199–200 (describing the domino-like chain of bank failures that occurred during the Great Depression, resulting in an estimated two thousand bank failures per year between 1930 and 1933).

21. See id. at 210 ("Historically, regulation of systemic risk has focused largely on preventing bank failure. For example, federal insurance of bank deposits through the Federal Deposit Insurance Corporation ("FDIC") is intended to prevent bank runs by alleviating fear that banks will default on deposit accounts." (footnote omitted)).
subject to prudential regulation—such as limitations on bank capital ratios and liquidity protection—
to help prevent their failures, and government-deposit insurance helps, at least in the United States, to prevent bank runs. 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 to adequately addressing—shadow banking’s potential to cause externalities. Although laws such as the Dodd-Frank Act attempt to apply bank-style rules to shadow banking, they are 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


23. 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, 1156–58 (1988) (linking bank runs with depositor collective action problems). If there is insufficient cash to pay all withdrawal-demands, the bank will default. See R.W. Hafer, The Federal Reserve System: An Encyclopedia 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. See Chris Mundy, The Nature of Systemic Risk: Trying to Achieve a Definition, 12 Balance Sheet, no. 5, 2004, at 29, 29 (2004) (commenting that, given the speed and breadth of information transmission via the Internet, a single rumor could cause a collapse of confidence in the entire global banking system). 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, 63–64 (1986) (observing that government provision of deposit insurance has been more effective at preventing bank runs than privately-provided insurance, the “discount window” (lending from the government to cover large withdrawals), and the suspension of convertibility of deposits into currency).


25. See Schwarcz, Regulating Shadow Banking, supra note 1, at 639 (noting that the Dodd-Frank Act subjects some shadow banks to “capital requirements, limits on leverage and short-term debt, liquidity requirements and increased regulatory disclosures”).
investment banks—which operate as shadow banks. And, although bank runs cannot occur because these firms are not deposit-taking institutions, disintermediation can potentiate the equivalent of bank runs.

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 “[e]xternalities are fundamentally consequences, not causes, of failures.” Externalities cannot even “constitute a unique category of market failure because all market failures can result in externalities.” Describing externalities as a cause or category of market failure conflates cause and effect.

Most significantly, 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. Government

26. Id. at 623.
27. There is currently a debate as to whether prudential regulation should at least be applied to financial firms that are regarded as “systemically important financial institutions.” See id. at 639–40 (explaining that while the Dodd-Frank Act expands prudential regulation to systemically significant non-banks, there is also the argument that this will only create a “boundary problem” in determining which firms will be covered).
29. Schwartz, Regulating Shadows, supra note 17 (manuscript at 5).
30. Id.
31. Id. (manuscript at 18).
promulgates laws that enable, or even require, financial firms to engage in risky behavior—and risky behavior is the fundamental source of systemic risk. View government as a responsible party challenges the traditional paradigm of market failure, which assumes government action or inaction is not a cause of failure.

For example, corporation laws require maximizing shareholder value, notwithstanding the risk to third parties. Because the managers of most firms have obligations under existing law solely to the firms' shareholders, 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, be viewed as causing the responsibility failure by mandating that risky behavior while inadequately protecting 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. In contrast, firms that

32. See infra notes 34–35 and accompanying text (noting that under corporate law, firm managers usually have a fiduciary duty to maximize shareholder value, regardless of third-party harm). 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 6–16 (explaining the systemic consequences of disintermediation).

33. Schwarcz, Regulating Shadows, supra note 17 (manuscript at 20).
34. See, e.g., John R. Boatright, Fiduciary Duties and the Shareholder-Management Relation: Or, What's So Special About Shareholders?, 4 BUS. ETHICS Q. 399, 395 (1994) (observing that under common law, officers and directors have a fiduciary duty to shareholders and, consequently, corporations have sharply-limited social responsibility).

35. See id. (stating that the sole responsibility of a corporation “is to make as much money for the shareholders as possible”).

36. See ANDREAS A. 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”).

37. 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 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 (8th Cir. 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 . . . .” (emphasis added)); see also Julie A.D. Manasfi, Systemic Risk and Dodd-Frank's Volcker Rule, 4 WM. & MARY BUS. L. REV. 181, 204 (2013) (citing an instance in which certain commercial banks breached their fiduciary duties to their depositors by referring the depositors to the banks' own investment affiliates). But see 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.” (footnote omitted)).
operate as shadow banks are more likely to be corporations or similar entities, such as limited liability companies that adopt corporate governance standards and are subject to a comparatively unrestricted obligation to maximize shareholder value. Moreover, banks are subject to prudential regulation intended to protect them from failures resulting from their risky actions. In contrast, it would be impractical to impose prudential regulation on all of the firms that operate as shadow banks.

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. Because those investors are not financially responsible for the liabilities of their firms, their interests may conflict with their firms' interests 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.

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

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. The primary investors therefore have strong incentives to take risks with the firm that could generate large profits. This is radically unlike the management incentives in large firms, such as

38. See Peter Conti-Brown, Elective Shareholder Liability, 64 STAN. L. REV. 409, 459-60 (2012) (observing that most investment banks are now run as corporations, rather than partnerships).
39. See supra notes 22–23 and accompanying text (identifying limitations on bank capital ratios, liquidity protection, and government deposit insurance as types of prudential regulations in place for banks).
40. See supra notes 26–27 and accompanying text (listing the myriad types of shadow banking entities).
42. Schwarz, Regulating Shadows, supra note 17 (manuscript at 25–26).
43. See, e.g., Conti-Brown, supra note 38, at 459–60 (noting that the partnership model of investment banks has been rendered extinct by these banks' conversion to the corporate model).
44. Schwarz, Regulating Shadows, supra note 17 (manuscript at 26 & nn.119–20).
45. Id. (manuscript at 26).
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's viability). 46

Because these (and similar) laws enable or require firms operating as shadow banks to engage in risky behavior without protecting against the resulting externalities, 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. 48 Thereafter, I examine what duty transactional lawyers should have to try to prevent client-caused externalities, assuming those laws are not improved. 49

IV. LAWYER RESPONSIBILITY

For purposes of this analysis, I will make two assumptions: that the client-firm's actions do not actually violate law and that those actions cause harm only to third parties. 51 I therefore focus on the responsibility of transactional lawyers to the public without needing to examine their responsibility to clients, qua clients. 52

46. Id. (manuscript at 26-27).
47. Such as the laws discussed that require maximizing shareholder value and limit liability. Supra notes 34-35, 41 and accompanying text.
48. See infra Part IV.A (discussing a lawyer's public duty to ensure good legal rules).
49. See infra Part IV.B (discussing a lawyer's public duty to prevent client-caused externalities).
50. In the United States, 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 . . ."); MODEL RULES OF PROF'L CONDUCT R. 1.2(d) (2013) ("A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent . . ."). The lawyer should try to persuade the client to comply with the law and, if unsuccessful, ultimately may have to resign.
51. 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 the course of action).
52. 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.
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. 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. In recent years, however, 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." Moreover, whatever this public duty may now be, it appears at most to be morally desirable, not ethically required.

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"? Some argue that tax lawyers have a public "duty to see that the tax system is meeting the needs of government." Others assert, etc...
however, that whatever is within the letter of the tax law should be permissible. 59

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." 60 This special knowledge, so the argument goes, "bring[s] special responsibilities which may not be passively discharged." 61 The few examples of how tax lawyers should discharge those responsibilities, however, appear to be limited 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. 62 The rationale is that these "transactions are shams because those employing the technique are able to claim substantial reductions in their U.S. tax liability without in substance affecting [their] ownership, headquarters, operations or business practices." 63 It is unclear, however, 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

59. See Moraine, supra note 57, at 190–91 (reciting the argument of some that tax lawyers have a duty to zealously advocate for their tax-payer clients).
61. Id.
62. Anthony C. Infanti, Eyes Wide Shut: Surveying Erosion in the Professionalism of the Tax Bar, 22 Va. Tax Rev. 589, 614 (2003) (arguing that there has been an erosion of professionalism in the tax bar and that the practice of law is becoming more of a business than a profession). Infanti focuses his analysis on outbound corporate inversions—which are "transaction[s] 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"—as an example of concrete evidence that the professionalism of the tax bar has diminished. Id. at 592, 614 (quoting Office of Tax Policy, U.S. Dep't of Treasury, Corporate Inversion Transactions: Tax Policy Implications 1 (2002)).
63. Id. at 608 (alteration in original) (internal quotation marks omitted).
of the general public interest. The difficulty is largely one of lack of experience, not lack of judgment or moral values.\(^6\)

Assuming, arguendo, that the special qualifications and expertise of tax lawyers should invest them with a special public duty,\(^6\) 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. Also, it is unclear how a lawyer might attempt to correct government-responsibility failure in a specific transactional context. Correcting government-responsibility failure requires engaging fundamental legal policies, such as whether managers should have a duty only to shareholders and whether limited liability should be absolute. As discussed, reforming fundamental legal policy may be better suited to public debate.\(^6\)

Moreover, whatever public duty transactional lawyers in the shadow-banking system should otherwise have, they must temper that duty with considerations for their client-firms. A lawyer may not, for example, take a position directly adverse to a current client during law-reform efforts.\(^6\) That conflicting duty could well impede the law-reform agenda of many transactional lawyers.

\section*{B. A Lawyer's Public Duty to Prevent Client-Caused Externalities}

The foregoing analysis focused on a lawyer's public duty to ensure good legal rules and governance. That analysis should be distinguished from the question of a lawyer's public duty to prevent

\begin{itemize}
  \item \textbf{64.} WOLFMAN \& HOLDEN, \textit{supra} note 58, at 216–17.
  \item \textbf{65.} \textit{Cf.} Larry E. Ribstein, \textit{Lawyers as Lawmakers: A Theory of Lawyer Licensing}, 69 \textit{Mo. L. Rev.} 299, 301–02, 327 (2004) (arguing that the lawyer-licensing system's exclusive grant to practice law in a particular state, paired with its broad qualification requirement, incentivizes lawyers to improve their states' laws in order to attract litigation and clients to their states and to improve their reputations).
  \item \textbf{66.} \textit{See supra} note 64 and accompanying text (implying that reforming fundamental tax-law policy is better suited to public debate because most tax lawyers lack the requisite experience to approach tax issues from a big-picture perspective rather than from a single-transaction perspective).
  \item \textbf{67.} \textit{See} \textit{MODEL RULES OF PROF'L CONDUCT} R. 6.4 cmt. (2013) (noting that Rule 1.7, which deals with representation adverse to a current client, applies to law-reform efforts); \textit{see also} 2 GEOFFREY C. HAZARD, JR. \& W. WILLIAM HODES, \textit{THE LAW OF LAWYERING: A HANDBOOK ON THE MODEL RULES OF PROFESSIONAL CONDUCT} §§ 6.4:101–103 (2d. ed. Supp. 1998) (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 benefited by a decision in which the lawyer participates); John S. Dzienkowski, \textit{Positional Conflicts of Interest}, 71 \textit{TEX. L. REV.} 457, 534–35 (1993) (suggesting that lawyers should be curbed in law-reform activities when it would harm the current representation of clients, but not when it would only affect future actions).
\end{itemize}
client-caused externalities enabled or required by bad legal rules and governance.\textsuperscript{68} 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, I observed that because all transactions create externalities, a lawyer is participating in creating externalities any time the lawyer helps a client facilitate a transaction.\textsuperscript{69} 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.”\textsuperscript{70}

To the extent lawyers advise on whether arrangements are lawful and thus help to facilitate lawful arrangements, they can be seen as

\begin{itemize}
\item \textsuperscript{68} The analysis in this Part thus implicitly assumes that the client-firm’s actions that cause those externalities do not violate law. See supra note 50 and accompanying text (stating as an assumption for this analysis that the client-firm is not actually violating law and citing model sources for the proposition that lawyers have a duty to not engage in unlawful acts).
\item \textsuperscript{70} Michel Rosenfeld, Contract and Justice: The Relation Between Classical Contract Law and Social Contract Theory, 70 IOWA L. REV. 769, 847 (1985) (footnote omitted); 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 “[w]ealth maximization to guide judicial action, meaning courts should aim “to bring about the allocation of resources that makes the economic pie as large as possible, irrespective of the relative size of the slices”). Adam Smith notes:

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 maybe [sic] 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.

\textbf{ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 293 (Harriman House ed. 2007) (1776).}\
\end{itemize}
social engineers contributing to this social-ordering paradigm. 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 own judgment about externalities for that of their clients. To the extent clients have more or better information about the consequences of a business transaction (other than the transaction’s legality), they would be better positioned to make business decisions. Lawyers who are specialists only in law are ill-trained to assess the costs (including externalities) and benefits of the business transactions they help facilitate.

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.

71. Schwarcz, Limits of Lawyer ing, supra note 56, at 29.
72. But cf. E-mail from Paul Gowder, Assoc. Professor of Law, University of Iowa College of Law, to the author (May 26, 2013) (on file with author) (questioning whether clients generally have more or better information about the consequences of a business transaction—particularly the externalities that might result—than lawyers; and suggesting that primary investors of shadow-banking firms might be subject to “cognitive errors” such as “overconfidence biases, sunk cost fallacies, self-serving biases, etc.”).
73. 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) (stressing that a lawyer’s central role is that of an agent and 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 76 and accompanying text (noting that lawyers should withdraw from representation rather than engage in socially harmful conduct). 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) (on file with the author).
74. 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 & n.58 (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 should not be used to “impose liability on lawyers”). But cf. E-mail from
Some lawyers may nonetheless wish, for aspirational or even practical reasons, to inform the client of any such harmful consequences and to withdraw from the engagement if the client persists in its action. A lawyer 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—provided that any such withdrawal is not "noisy." 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.

A recent ethical query in The New York Times grapples with this very issue. 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.

Gowder, supra note 72 (arguing that if lawyers might have more or better information than clients about the consequences of a business transaction due to client cognitive errors, then requiring the lawyer to inform the client of consequences would "give[] the client more information," which would be "strictly better [because if] the client does care about the externalities and the lawyer sees them better than the client, the mandatory advice gives the client the opportunity to avoid them [and] [i]f not, then no harm is done"). That is true insofar as it goes; but making the advice “mandatory” could create harm, in the form of liability, to lawyers who fail to inform the client of consequences. For that reason, I argue for a compromise: that lawyers have the right, but not the obligation, to inform their clients of harmful consequences. See supra notes 75–76 and accompanying text.

75. 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 Schwarz, Limits of Lawyering, supra note 56, at 36–42 (examining what lawfulness should mean in a world of changing norms); see also id. at 37 n. 200 (suggesting that "large [law] firms [are] the most appealing targets because they have the deepest pockets" (citing JONATHAN R. MACEY & GEOFFREY P. MILLER, BANKING LAW AND REGULATION 346 (2d ed. 1997))); 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.").

76. See MODEL RULES OF PROF’L CONDUCT R. 2.1 (2013) (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 55, at 87–88 (arguing that lawyers should not participate in conduct that is “socially harmful”).

77. Schwarz, The Role of Lawyers, supra note 69, at 224.

78. See 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 (2011) ("[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... 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.").

in the tax legislation.”\textsuperscript{80} 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.”\textsuperscript{81}

**CONCLUSIONS**

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

\textsuperscript{80} Id.  
\textsuperscript{81} Id.