Regulatory Arbitrage

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Most of us share a vague intuition that the rich, sophisticated, well-advised, and politically connected somehow game the system to avoid regulatory burdens the rest of us comply with. The intuition is correct; this Article explains how it's done.

Regulatory gamesmanship typically relies on a planning technique known as regulatory arbitrage, which occurs when parties take advantage of a gap between the economics of a deal and its regulatory treatment, restructuring the deal to reduce or avoid regulatory costs without unduly altering the underlying economics of the deal. This Article provides the first comprehensive theory of regulatory arbitrage, identifying the conditions under which arbitrage takes place and the various legal, business, professional, ethical, and political constraints on arbitrage. This theoretical framework reveals how regulatory arbitrage distorts regulatory competition, shifts the incidence of regulatory costs, and fosters a lack of transparency and accountability that undermines the rule of law.

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"These new regulations will fundamentally change the way we get around them."

—NEW YORKER Cartoon, March 9, 2009

INTRODUCTION

In a speech announcing a new tax on banks aimed at recovering taxpayer money for the bailout, President Obama cajoled the banks to simply pay the tax rather than try to avoid it. "Instead of sending a phalanx of lobbyists to fight this bill, or employing an army of lawyers and accountants to help evade the fee," the President urged bank executives, "I suggest you might want to consider simply meeting your responsibilities."[1] Not likely.[2] Obama is not the first President to resort to moral suasion to address regulatory gamesmanship. Theodore Roosevelt did so in a speech at Harvard University in 1905. The speech is best remembered for Roosevelt's plea for fair play in college football, where brutality and unsportsmanlike conduct had led to dozens of deaths on the field.[3] But Roosevelt also had a few words about sportsmanship for the Harvard men heading off to law school. Many of the most influential and highly remunerated lawyers, he explained, "make it their special task to work out bold and ingenious schemes by which their very wealthy clients, individuals or corporate, can evade the laws which are made to regulate in the interest of the public the use of great wealth."[4] Harvard graduates should do better, he implored. "Surely Harvard has the right to expect from her sons a high standard of applied morality[.]"[5]

This sort of regulatory gamesmanship typically relies on *regulatory arbitrage*, a perfectly legal planning technique used to avoid taxes, accounting rules, securities disclosure, and other

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[1] *Remarks by the President on the Financial Crisis Responsibility Fee*, Jan. 14, 2010, available at http://www.whitehouse.gov/the-press-office/remarks-president-financial-crisis-responsibility-fee (site last visited Jan. 15, 2010).

[2] See Dan Wilchins, *Banks, Experts Eye Possible Ways Around Obama Fee*, REUTERS, Jan. 14, 2010 (wire service article posted less than seven hours after the President's speech, describing possible workarounds).

[3] John S. Watterson III, *Political Football: Theodore Roosevelt, Woodrow Wilson and the Gridiron Reform Movement*, 25 PRESIDENTIAL STUD. Q. 555 (1995).

[4] A COMPILATION OF THE MESSAGES AND SPEECHES OF THEODORE ROOSEVELT 646-47 (Alfred Henry Lewis, ed., 1917).

[5] Id. at 647.

regulatory costs. Regulatory arbitrage exploits the gap between the economic substance of a transaction and its legal or regulatory treatment, taking advantage of the legal system's intrinsically limited ability to attach formal labels that track the economics of transactions with sufficient precision.[6] This Article provides the first comprehensive theory of regulatory arbitrage, identifying the conditions under which arbitrage takes place and the various legal, business, professional, ethical, and political constraints on arbitrage. This theoretical framework reveals how regulatory arbitrage undermines the efficiency of regulatory competition, shifts the incidence of regulatory costs, and fosters a lack of transparency and accountability that undermines the rule of law.

Some arbitrage techniques are pervasive and grudgingly accepted as part of the system, like firing employees and re-hiring them as independent contractors to avoid employment regulation, or harvesting tax losses at year-end by holding the winners in one's stock portfolio while selling the losers and replacing them with similar stocks.[7] But the most effective techniques are more pernicious, crafted by lawyers to meet the letter of the law while undermining its spirit, successful only until the government discovers and closes the loophole. While the use of derivatives and the development of new financial products have facilitated new regulatory arbitrage techniques,[8] the phenomenon dates back thousands of years.[9] Regulatory arbitrage is an intrinsic part of

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[6] Frank Partnoy uses a narrower definition: "Regulatory arbitrage consists of those financial transactions designed specifically to reduce costs or capture profit opportunities created by differential regulation or laws." Frank Partnoy, *Financial Derivatives and the Costs of Regulatory Arbitrage*, 22 J. CORP. L. 211, 227 (1997).

[7] The wash sale rules prevent tax loss harvesting only if the replacement stock is "substantially identical" to the stock sold. I.R.C. § 1091(a).

[8] Partnoy, *Financial Derivatives*, supra note 6.

[9] Bruce Bartlett cites an example from Ancient Rome where small landowners burdened by heavy taxation would sell themselves into slavery (slaves were exempt from taxes) and place themselves under the protection of a landlord, continuing to farm the lands as before. Emperor Flavius Julius Valens shut down the technique in 368 A.D., declaring it illegal to renounce one's liberty in order to place oneself under the fiscal protection of a landlord. Bruce Bartlett, *How Excessive Government Killed Ancient Rome,* CATO JOURNAL (1994); Aurelio Bernardi, *The Economic Problems of the Roman Empire at the Time of its Decline* 49, in THE ECONOMIC DECLINE OF EMPIRES (Carlo M. Cipolla ed., 1970). See also Bernardi at 57 ("[T]he revenue of the State shriveled because the big men resorted to evasion or enjoyed immunity, which is legalized evasion, while the small men in many cases had nothing with which to pay …."); id. at 58 ("neither was there lack of legal expedients to evade taxes. One consisted in paying the taxes for property that was situated in diverse provinces in the lump in the district of one's own choosing, obviously in that district in which an obliging collector was in office."). See also Michael Knoll, *The Ancient Roots of Modern Financial Innovation: The Early History of Regulatory Arbitrage,* 87 OREGON L. REV. 29 (2008).

our legal system and cannot be eliminated, although we could do a better job of constraining the planning techniques that undermine the intent of Congress.

Regulatory arbitrage is too easily shrugged off as the inevitable byproduct of high-priced lawyering.[10] For those concerned with the effects of arbitrage on the integrity of the legal system, moral suasion is obviously not enough. By paying close attention to how regulatory arbitrage occurs in real world deals, we can find patterns that explain more precisely how and why arbitrage occurs, what its effects are, and what should be done about it. Much of the empirical data conforms with common intuition. For example, well-established companies with strong governance structures engage in more aggressive regulatory planning than start-ups or closely-held firms.[11] Large companies that can afford elite law firms employ more aggressive deal structures that push the regulatory frontier.[12] And the politically well-connected can bargain more effectively with congressional staffers and agency lawyers over the regulatory treatment of a deal.[13] By examining these phenomena more closely, this Article helps explain *how* the rich, sophisticated, well-advised, and politically-connected avoid regulatory burdens the rest of us comply with.[14] And while the populist intuition that the rich get away with murder is hardly new, a more precise understanding of when and how gamesmanship occurs allows us to address the problem in a targeted fashion that avoids sweeping, overbroad reforms that do more harm than good.

Briefly, the theoretical framework is as follows. I define regulatory arbitrage as the manipulation of the structure of a deal to take advantage of a gap between the economic substance of a transaction and its regulatory treatment.[15] Regulatory arbitrage opportunities, under this broad definition, are pervasive. But the arbitrage only works if the lawyers involved can successfully navigate a series of planning constraints: (1) legal constraints, (2) Coasean transaction costs, (3) professional constraints, (4) ethical constraints, and (5) political constraints.[16]

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[10] See Obama, supra note 1; Roosevelt, supra note 2.
[11] See infra part I.C.2 (discussing agency costs).
[12] See infra part I.C.3.
[13] See infra part I.C.5.
[14] See infra part II.B (describing the effect of regulatory arbitrage on the incidence of regulatory costs).
[15] See infra part I.B (defining regulatory arbitrage).
[16] See infra part I.C (providing a taxonomy of arbitrage constraints).

This theory of regulatory arbitrage provides the missing link in our understanding of why deals are structured the way that they are. The cornerstone of academic analysis of the legal infrastructure of transactions is the principle that contracts are designed to minimize Coasean transaction costs. These costs include search costs, information costs and adverse selection, negotiation and drafting costs, behavioral costs like agency costs, moral hazard, and shirking, and monitoring and enforcement costs. This transaction-cost-economics framework is analytically useful but incomplete. The problem is that it doesn't fit comfortably with what we observe in real world deals: Many sophisticated deals exhibit high levels of Coasean transaction costs and seemingly puzzling structures. Cognitive bias, risk aversion, and poor lawyering are sometimes identified as factors, but such explanations rarely hold up in the context of highly sophisticated parties interacting with large amounts of money at stake.[17] As I show in detail below, such structures look the way that they do because sophisticated lawyers at elite law firms consciously tweaked the structure of the deal to minimize regulatory costs.

The critical analytic insight is that deal lawyers face a tension between reducing regulatory costs on the one hand and increasing Coasean transaction costs on the other. Deal lawyers routinely depart from the optimal transaction-cost-minimizing structure even though restructuring the deal reduces its (non-regulatory) efficiency. A corporation that needs cash might minimize transaction costs by entering into a secured loan, but instead, in order to improve the cosmetics of the balance sheet, enters into an economically similar transaction to securitize the assets.[18] A company that would minimize agency costs by incorporating in Delaware decides that, to save on taxes, it will instead incorporate in Bermuda. So long as the regulatory savings outweigh the increase in transaction costs, such planning is perfectly rational. As a result, the conventional view that deals are efficiently structured to minimize transaction costs is incorrect, or at least a little misleading.

I am not the first to recognize a trade-off between regulatory costs and ordinary transaction costs. Indeed, in his seminal YALE LAW JOURNAL article, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, Professor Gilson identified regulation as

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[17] Victor Goldberg, *Aversion to Risk Aversion in the New Institutional Economics*, 146 J. INST. & THEOR. ECON. 216 (1990).

[18] See, e.g., Floyd Norris, *Confronting High Risk and Banks*, NEW YORK TIMES, Dec. 11, 2009 (discussing banks' use of trust preferred securities as "capital arbitrage" and off balance sheet structured investment vehicles as manipulation of accounting rules).

the reason why lawyers, not bankers, serve the role of "transaction cost engineer."[19] Because the lawyer plays an important role in regulatory structuring, Gilson explained, "economies of scope should cause the non-regulatory aspects of transactional structuring to gravitate to the lawyer as well."[20] The lawyer's facility at both tasks—engineering transaction costs and regulatory costs—"should result in more optimal trade-offs between them."[21] Gilson thus identified the trade-off between regulatory costs and transaction costs. But since that trade-off was merely an aside and not the focus of Gilson's article, this important insight—one that is well understood by practitioners[22]—has been largely overlooked by the legal academy. The academic literature generally assumes that deals are structured to minimize Coasean transaction costs,[23] treating regulatory costs as exogenous and fixed rather than engineered.

The one exception is the tax planning literature, which brings the interaction of tax costs and non-tax business considerations—known as "frictions"—into the spotlight. Myron Scholes and Mark Wolfson's business school textbook TAXES AND BUSINESS STRATEGY first emphasized the notion of frictions as a

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[19] Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L. J. 239 (1984).
[20] Id.
[21] Id.
[22] See, e.g., Peter C. Canellos, *A Tax Practitioner's Perspective on Subtance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters*, 54 S.M.U. L. REV. 47, 55 (2001) ("The choice of form may involve balancing business, legal, and financial constraints (including the desire for simple structures) against tax benefits.").
[23] See Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937); Henry Hansmann, THE OWNERSHIP OF ENTERPRISE 22 (1996) (arguing that ability to minimize transaction costs determine whether organizational forms survive); Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: Sacred Space" in Corporate Takeovers*, 80 TEX. L. REV. 261, 269 (2001) ("The goal of transaction-cost economics is easily stated: align transactions with governance structures in a manner that minimizes transaction costs."); Richard A. Epstein, *Let "The Fundamental Things Apply": Necessary and Contingent Truths in Legal Scholarship*, 115 HARV. L. REV. 1288, 1304 (2002) (noting how legal scholarship has incorporated Coase's insight that we can understand the structure of firms, partnerships and other voluntary associations by understanding the devices they use to minimize transaction costs); Juliet P. Kostritsky, *Taxonomy for Justifying Legal Intervention in an Imperfect World: What to Do When Parties Have Not Achieved Bargains or Have Drafted Incomplete Contracts*, 2004 WISC. L. REV. 323, 363 ("Understanding the purposeful desire of parties to minimize transaction costs permits legal decision-makers to understand why parties would structure their economic dealings and trades in particular ways and how parties would react to certain legal interventions.")

constraint on tax planning.[24] David Schizer, Dan Shaviro, Alex Raskolnikov, Mitchell Kane, and other legal scholars have since examined different ways in which frictions affect tax planning, tax avoidance, and tax evasion.[25] Mihir Desai, Dhammika Dharmapala, and other finance and accounting scholars have generated theoretical models and empirical evidence which dovetails with the approach of legal scholars.[26]

The thrust of this tax planning literature is that frictions can be a powerful constraint and should be used as a regulatory tool to combat wasteful tax planning. A less-noticed finding from this literature is that aggressive tax planning is profitable—that is, it increases firm value—only for firms that have low agency costs and strong governance structures.[27] It follows that firms that can best manage these transaction costs can effectively engage in more aggressive planning. By analyzing frictions as Coasean transaction costs, this Article is able to synthesize these two strands of literature—the traditional transaction-cost economics literature on deal structuring and the newer tax planning literature—to provide a comprehensive theory of regulatory arbitrage. The Article then uses this framework to offer three additional contributions to the academic literature.

First, the trade-off between regulatory costs and transaction costs undermines the usual assumption in the corporate law literature that regulatory competition creates legal forms that reflect efficient, transaction-cost minimizing goals.[28] I discuss charter competition, choice of entity, and executive compensation to show

[24] Myron Scholes et al., TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH (2d ed. 2002).
[25] See David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312 (2001); Daniel Shaviro, *Risk-Based Rules and the Taxation of Capital Income*, 50 TAX L. REV. 643 (1995); Alex Raskolnikov, *Relational Tax Planning Under Risk-Based Rules*, U. PA. L. REV. (2008); Alex Raskolnikov, *The Cost of Norms: Tax Effects of Tacit Understandings*, 74 U. CHI. L. REV. 601 (2007); Michael Knoll, *Regulatory Arbitrage Using Put-Call Parity*, 15 J. APPLIED CORP. FIN. 64 (2005); Mitchell A. Kane & Edward B. Rock, *Corporate Taxation and International Charter Competition*, 106 MICH. L. REV. 1229 (2008).
[26] See infra part I.C.2.
[27] Schizer, *Frictions*, supra note 25, at 1329-30 ("pursuit of the tax reducing strategy may require an organizational form that is less effective at constraining agency costs").
[28] See, e.g., Erin A. O'Hara & Larry E. Ribstein, *From Politics to Efficiency in Choice of Law*, 67 U. CHI. L. REV. 1151, 1163 ("Individuals and firms who have an incentive to minimize their transaction and information costs and an ability to choose legal regimes that accomplish this goal over time may cause the law to move toward efficiency, if only because inefficient regimes end up governing fewer people and transactions.");

how regulatory arbitrage can distort the choice of legal form in a way that increases, rather than minimizes, transaction costs.

Second, the trade-off between regulatory costs and transaction costs reveals a new insight about the incidence of regulatory costs. Regulatory arbitrage makes many regulatory schemes—broad swaths of antitrust, banking, securities, and tax law—effectively optional for sophisticated clients. Well-governed firms, because they manage transaction costs effectively, engage in more aggressive regulatory planning and thus bear a lower incidence of regulatory costs than firms that face high transaction cost barriers, such as entrepreneurial firms, family-owned businesses with outside financing, and small business generally. This distribution of regulatory burdens is unintended, inefficient, and unjust under any plausible theory of distributive justice.

Third, the regulatory arbitrage framework reveals the importance of managing political costs. Regulatory costs are fluid, not fixed; firms that can manage political costs effectively have more freedom to exercise the "planning option" and avoid regulatory costs the rest of us must bear. Recent case studies reveal that the regulatory treatment of a deal is often a negotiated point. Institutional analysis helps explain why this is the case. Two groups within the administrative state, congressional staff members and agency lawyers, together provide another constraint on gamesmanship by interpreting ambiguous statutes and conveying the unwritten rules to interested parties. Because the interpretation of new deal structures is not fixed ex ante, staffers and agency lawyers often consult with deal lawyers, and such meetings are not immune from the usual political force of interest groups and their lobbyists. Increasingly, as other constraints have proven ineffective, more discretion has come to rest with congressional staff members and agency lawyers drawing regulatory lines on a deal-by-deal basis, subject to pressures more characteristic of politics than the rule of law.

This Article focuses on how regulatory arbitrage works and what constrains it. I do not make a prescriptive claim about what should be done, although I do suggest what reforms might be more effective if policymakers are so inclined. The reason I duck the normative[29] question is that it's more complicated than it might seem, and we can't gain traction on the prescriptive question of

[29] If Newton were to present a theory of gravity at a law faculty workshop, he'd be accused of avoiding the important normative questions of whether gravity is good and what Congress should do about it.

what to do about regulatory arbitrage until we've established more clearly what it is, exactly, that we are talking about.

Why is the normative question complicated? Because the optimal amount of regulatory arbitrage is not zero. Whether a particular regulatory arbitrage technique is good or bad necessarily depends on a prior question of whether a particular regulation enhances social welfare. Lawmakers sometimes regulate in the public interest, but sometimes don't. There are few easy cases. To be sure, it is hard to justify brazen tax dodges—but even then plenty of well-paid lawyers and lobbyists manage to do so with a straight face, often in terms of incentivizing Congress to write better rules. There are also regulations driven by interest-group lobbying[30] or rent-seeking politicians[31] that likely reduce overall social welfare, in which case the welfare effects of regulatory arbitrage are likely to be positive,[32] or at least indeterminate.[33] While I make no secret of my view that several specific examples in this paper shift regulatory burdens in unjust ways, one could easily pick out innocuous examples. In sum, there is a spectrum of arbitrage techniques, some good, some bad, and drawing the line between them is beyond the scope of this Article. Instead what this Article provides to scholars and policymakers is a framework that identifies the conditions under which arbitrage occurs and what constraints, if employed, are likely to be effective.

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This Article is organized in two main parts. Following this Introduction, Part I synthesizes theoretical and empirical findings from the finance and tax planning literatures to set forth a theory of regulatory arbitrage. Part I.A. draws on interviews I conducted with lawyers to provide a richer description of the lawyer's role in regulatory arbitrage. Part I.B. describes the necessary conditions

[30] See, e.g., George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971).
[31] See, e.g., Fred S. McChesney, *Rent Extraction and Rent Creation in the Economic Theory of Regulation*, 16 J. LEGAL STUD. 101 (1987); Fred S. McChesney, *Rent Extraction and Interest-Group Organization in a Coasean Model of Regulation*, 20 J. LEGAL STUD. 73 (1991).
[32] For a general discussion of the positive effects of avoiding regulation through choice-of-law, see Erin A. O'Hara & Larry E. Ribstein, THE LAW MARKET (2009); id. at 8 ("[Choice-of-law] clauses enable parties to protect themselves from state regulation that imposes costs in excess of its benefits to society.").
[33] An avoidance strategy may have a positive effect on social welfare, standing alone, but in the aggregate these strategies tend to have a corrosive effect on the rule of law.

for regulatory arbitrage. Part I.C. describes the various constraints on arbitrage: (1) legal constraints, (2) Coasean transaction costs, (3) professional constraints, (4) personal ethical constraints, or (5) political constraints.

Part II explores three implications of this framework. Part II.A. examines how regulatory arbitrage can distort regulatory competition. Part II.B. examines the effect of regulatory arbitrage on the incidence of regulatory costs. Part II.C. examines how sophisticated parties manage political constraints on arbitrage.

I draw extensively on examples from tax planning, case studies from my Deals course,[34] interviews with tax lawyers,[35] and from my previous tax scholarship.[36] But the theory I present here also helps explain why, when and how regulatory planning occurs in other doctrinal subject areas, such as securities law, accounting, antitrust, and banking law.[37]

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[34] My Deals course, which I have taught at Columbia, UCLA, Georgetown, Colorado, and [NYU], is modeled on the course, "Deals: The Economic Structure of Transactions and Contracting," pioneered by Ron Gilson and Vic Goldberg at Columbia. I served as the Director of the Transactional Studies Program at Columbia from 2001-03, co-teaching the Deals course with David Schizer. For a discussion of the Columbia program, see Victor Fleischer, *Deals: Bringing Corporate Transactions into the Law School Classroom*, 2002 COLUM. BUS. L. REV. 475.

[35] I interviewed about a dozen tax and corporate lawyers for this article. Rather than seeking a random sample, I chose to interview lawyers at top firms in New York with whom I had a pre-existing relationship and who were willing to speak freely. The interviews are not intended as empirical data, but merely to add a touch of real world flavor to the theoretical framework of this Article, and to show that the framework is consistent with the views of at least some New York practitioners.

[36] See Victor Fleischer, *A Theory of Taxing Sovereign Wealth*, 84 NYU L. REV. 440 (2009) (examining how tax exemption for sovereign wealth funds affects sovereign investment in U.S. financial institutions); David Walker & Victor Fleischer, *Book/Tax Conformity and Equity Compensation*, 61 TAX L. REV. 399 (2009) (examining how tax and accounting rules affect executive compensation design); Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 NYU L. REV. 1 (2008) (examining how tax treatment of carried interest differs from other forms of compensation); Victor Fleischer, *Options Backdating, Tax Shelters, and Corporate Culture*, 26 VA. TAX REV. 1031 (2007) (exploring relationship between weak internal controls and regulatory compliance); Victor Fleischer, *The Missing Preferred Return*, 31 J. CORP. L. 77 (2005) (examining how tax treatment of carried interest helps explain absence of preferred return hurdles in venture capital funds); Victor Fleischer, *The Rational Exuberance of Structuring Venture Capital Start-Ups*, 57 TAX L. REV. 137 (2004) (examining how legal and business constraints explain seemingly tax-inefficient structure of start-ups).

[37] For a non-tax example, see Victor Fleischer, *The MasterCard IPO: Protecting the Priceless Brand*, 12 HARV. NEG. L. REV. 137 (2007) (explaining structure of MasterCard IPO as an example of regulatory arbitrage in the antitrust context).

I. A THEORY OF REGULATORY ARBITRAGE

A. The Lawyer as Regulatory Arbitrageur

In Professor Gilson's model of the deal lawyer as transaction cost engineer, lawyers create value by identifying barriers to contracting, such as asymmetric information, agency costs, and strategic behavior, and by designing contractual solutions to help their clients overcome those barriers.[38] This Article's attention to regulatory arbitrage suggests a friendly amendment to this model: Deal lawyers engineer regulatory costs as well as Coasean transaction costs, balancing the two against the shifting backdrop of legal, business, ethical, professional, and political concerns. I doubt that Professor Gilson would disagree with this assessment, although we might disagree about the relative importance of regulatory costs.[39] Just as Gilson's views were shaped by his experience as a corporate lawyer, my own pattern recognition skews to that of a tax lawyer and scholar, like a computer discovering whatever it was programmed to find.[40] But there is also some reason to think that regulatory arbitrage is more important than it used to be. In the twenty-five years since Gilson

[38] See Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing,* 94 YALE L.J. 239 (1984). See also George W. Dent, Jr., *Business Lawyers as Enterprise Architects*, 64 BUS. LAW. 279 (2009) (evaluating a broader range of business lawyer activity); Steven L. Schwarcz, *To Make or to Buy: In-House Lawyering and Value Creation*, 33 J. CORP. L. 497 (2008); Nestor Davidson, *Values and Value Creation in Public-Private Transactions*, 94 IOWA L. REV. 937 (2009).

[39] In a little-noticed and underappreciated essay, Professors Gilson, Scholes and Wolfson explored the trade-off between transaction costs and tax costs in the context of corporate acquisitions, finding that transaction costs typically dominate. See Ronald J. Gilson, Myron S. Scholes, Mark A. Wolfson, *Taxation and the Dynamics of Corporate Control: The Uncertain Case for Tax-Motivated Acquisitions*, in KNIGHTS RAIDERS AND TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER 271, 272 (John C. Coffee Jr. et al. eds., 1988) ("Any tax gain that would result from an acquisition must be reduced by the transaction and information costs associated with effecting the acquisition. And here we have in mind more than just the legal and investment banking fees, however substantial, associated with making the deal. Additionally, and more significantly, there are substantial cost of becoming informed that result in information asymmetries and create the potential for problems of moral hazard and adverse selection.").; id. at 273-74 ("Empirically, we observed that far less than all potential tax gains are achieved, thus providing support for our conclusion that transaction and information costs are pervasive and have first-order effects on the choice among alternative ways to achieve tax gains, including the choice of 'standing pat,' rationally leaving apparent gains on the table.").

[40] See THE HUNT FOR RED OCTOBER (Paramount Pictures 1990) ("SEAMAN JONES: When I asked the computer to identify it, what I got was magma displacement. You see, sir, the SAPS software was originally written to look for sesmic events. I think when it gets confused, it kind of runs home to Mama.")

wrote his article, the administrative state has increased substantially, and the amount of time lawyers devote to regulatory matters has grown apace.[41] The complexity of the modern administrative state provides more opportunities for regulatory arbitrage—another form of value creation for the client—than ever before.[42]

Three parties at the table. On the surface, a typical business deal has only two parties: the buyer and the seller. But conceptually there are three parties, not two, at the negotiating table: the buyer, the seller, and the government (typically acting through statutes and regulations written in advance of the deal). The government imposes regulatory costs on transactions in the form of taxes, securities law disclosure requirements, antitrust constraints, environmental compliance obligations, and so on. As the buyer and seller conduct deal negotiations, the government is hindered by the fact that it has no actual seat at the negotiating table. Rather, the government is normally bound to specific courses of action based on the language of the statutes, regulations, administrative rulings, and how it has treated previous transactions with similar formal structures. Private parties can plan the form of the transaction to minimize regulatory costs, and the government cannot normally respond by changing the rules in the middle of the game. If a formal change to the structure of the deal reduces regulatory costs—the government's share of the transaction—the new surplus can be divided between the buyer and seller. Restructuring the deal to reduce regulatory costs does

[41] The increased importance of regulatory expertise helps explain various institutional details about the legal profession, such as what gives large law firms a comparative advantage over in-house counsel or cheaper law firms and why legal work at the regulatory frontier commands a price premium. It also helps explain why certain law firms—specifically, the elite law firms who compensate their partners in lockstep fashion—appear to be less likely to shirk their professional duty to serve as "gatekeepers" in favor of aggressive regulatory gamesmanship. Conversely, the decline of the lockstep compensation model helps explain the decline of professional constraints on arbitrage.

[42] A note on terminology. Lawyers who help their clients engage in regulatory arbitrage do not often use the word "arbitrage." Tax lawyers prefer the term "planning," presumably because arbitrage can carry the connotation of unseemly or improper gamesmanship—something which only fairly applies to more aggressive structures, and which in any event is rarely present in the eyes of the lawyers involved. To sidestep this semantic quagmire, I sometimes used the value-neutral terms "regulatory engineering" or "regulatory craftsmanship" when discussing this planning process with the lawyers involved, reserving the term arbitrage (which I also view as value neutral on its face, although sometimes socially undesirable as applied) for detached evaluation of the techniques. In most cases, lawyers engaging in regulatory arbitrage are simply fulfilling their professional and ethical obligations to the client.

not create new value; it merely shifts value from the government to the private parties.

This sort of restructuring is sometimes called exercising the "planning option."[43] Parties have the option of complying with regulatory mandates and bearing the costs, or they may plan around the regulatory mandate by restructuring the deal. Like any option, there are costs associated with exercising the planning option, including an increase in transaction costs associated with the deal.

The structuring of the transaction occurs early in the life of a deal but may be revisited as facts change. The process typically begins with a phone call. A client calls her lawyer with a business deal in mind, and often with the basic economic terms of the deal already sketched out. Investment bankers, accountants, rating agencies, and other outside consultants weigh in. The client may even have a pretty good idea of the information and documents that will need to be produced to execute the deal. But outside legal counsel still plays a critical role in designing and implementing the structure of a deal. The lawyers will consider alternative structures that may produce regulatory cost savings, and they may suggest modifications to the deal structure.[44] If those modifications increase transaction costs, the lawyers may suggest further changes to manage those costs.

Lawyers don't have to press clients to recognize the value of this activity. As one corporate lawyer explained, "It's the instinct of every business person to minimize the harmful impact of regulation."[45] Lawyers often describe the process of structuring or planning as guiding their clients through the regulatory maze or "morass."[46] But there is also an opportunity to extend the lawyer's professional comparative advantage over bankers, accountants, and consultants by exploring new ways to change the legal structure of the deal.

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[43] David M. Schizer, *Sticks and Snakes: Derivatives and Curtailing Aggressive Tax Avoidance*, 73 S. CAL. L. REV. 1339, 1350 (2000) (describing the planning option and constraints).

[44] One lawyer explained,

> The client will come in and will have concocted some structure which only by randomness might achieve the result they want. So I stop them and say, "There's something you are trying to achieve. What is it? What deal did you cut with the other guy?" I take what he wants to do and try to come up with the most tax-efficient structure.

Interview #1.

[45] Interview #2.

[46] Interview #3.

These regulatory planning opportunities arise when lawyers identify gaps between legal form and economic substance. Business deals are primarily motivated by economic relationships between parties or their assets—the economic substance of the deal. The economic relationship between the parties may or may not fit neatly into the "little boxes" that the legal rules have in mind.[47] And there may be multiple legal forms which accomplish similar economic objectives, making some regulatory treatment elective. Some elections are explicit: A closely-held partnership or LLC may simply check a box to elect whether to be taxed as a partnership or a corporation. Other elections are implicit: By incorporating offshore, a business may effectively opt out of many domestic regulations. A party interested in the economic cash flow associated with an asset may be more or less indifferent between owning the asset outright, leasing the asset for a long period of time, entering into a forward contract to buy the asset, or buying a call option and writing a put option on the asset. Financial engineering allows the economic cash flow associated with assets to be carved up in any way imaginable to suit the particular preferences of investors, including risk preference, time preference, control preference, and so on. As a result, any business transaction of significant size presents deal lawyers and their clients with a menu of planning options to choose from.

Nowhere is this more obvious than in tax. The importance of tax planning suggests—at least to many tax lawyers—that Gilson's bilateral negotiation model is fundamentally flawed.[48] Practitioners familiar with Professor Gilson's model found it wanting. "The negotiation aspect," explained one former tax partner, "doesn't feel like it's very creative. Gilson's theory is based on a somewhat impoverished model."[49] Through a tax

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[47] See Herwig J. Schlunk, *Little Boxes: Can Optimal Commodity Tax Methodology Save the Debt-Equity Distinction?*, 80 TEX. L. REV. 859 (2009).

[48] One lawyer explained: "There are three parties at the table, the buyer, the seller, and the IRS." Interview #1. Interview #4. ("Gilson's bilateral negotiation model is flawed. Regulatory state is the third person at the table. In a cross-border deal, another government is the fourth player.").

[49] Interview #4. The negotiation part of being a deal lawyer, he explained, was like the joke where an old man and his two friends are enjoying their daily lunch at their favorite deli. To save time, they tell each other jokes by simply calling out numbers. "Five!" says the old man, and the other two laugh. "Sixteen!" says another, and they laugh uproariously. A tourist walking by decides to join in. "Thirty-two!" he says. Silence follows. "You didn't tell it right," explains the old man.

The joke rings true because so many of the arguments about which party should bear a particular business risk are old hat. See Gilson, supra note xx, at pin; James Freund, ANATOMY OF A MERGER, at pin. Once the purchase price has been set, negotiating the scope of representations and warranties, indemnities, and other lawyer's eyes, value is created by shifting value away from the government (in the form of taxes) so that more money can be divided amongst the other parties. The goal, as one lawyer put it, is to close the transaction while minimizing the "tax leakage."[50]

Regulatory arbitrage is a professional skill specific to lawyers, as it involves the exercise of professional lawyerly judgment under conditions of uncertainty.[51] At times, lawyers are simply helping their clients navigate the complex regulatory schemes that may apply to the transaction and explaining how they apply. But where guidance is less clear, the law must be discerned by analogy to precedent.[52] Lawyers must have the ability not just to identify possible analogies, but to distinguish good analogies from bad ones.[53]

Quarterbacking the deal. Deal structuring is just the beginning of the process. After the lawyers have settled on a structure, they shift back into Gilson's transaction cost engineering mode—negotiating who will bear various risks, ranging from

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contractual provisions becomes a tiresome zero sum game. The outcome turns at least as much on which party has better bargaining power as it does on creative arguments about who is the most efficient risk-bearer.

[50] Interview #3. ("A big percentage of what I do is guiding the client to structure operations and transactions to minimize the tax leakage.")

[51] Several practitioners mentioned judgment as a critical skill. It comes with experience, and it helps to have "self-awareness." One lawyer explained,

> I was generally more conservative at first. But clients don't pay me $900 an hour to tell them that they can do what it says in the regulations. When you start out, you want cases and regulations to rely on. But you come to realize that absence of authority isn't a bad thing. You can analogize to different situations. And then you apply your judgment about how a code section was intended to work. You get better at that as you gain more and more experience. You get more comfortable at giving that kind of advice.

Interview #3.

[52] One tax lawyer explained,

> There are still lots of situations where the black letter law is so complex that that's what you're doing for your client. Guiding them through the regulatory morass. But in situations that aren't covered by direct authority, it's 'what's the analogy.' This is like x, or this is like y.

Interview #3.

[53] One tax lawyer explained,

> There's a two step process. First, I get it to a tax-efficient structure. Show me the economic deal, and I'll come up with an efficient structure. Second, how do I feel about it. This is where judgment comes in. Reasoning by analogy, even if you don't realize you are doing it. Let me think about the court cases, look at the code and regs, and come up with my best judgment about what you can do.

Interview #1.

disclosure obligations and indemnities to regulatory risks.[54] Business considerations might introduce new changes to the structure of the deal—say, a new source of financing, a new promise to guarantee another party's debt obligation, or a shift in the mix of debt and equity used to finance the deal. This often requires the lawyers to shift back into regulatory arbitrage mode on-the-fly and make further changes to the structure or reassess whether the structure still "works" from a regulatory perspective. The activities of regulatory engineering and transaction cost engineering are thus intertwined.[55] Lawyers don't consciously separate out the two roles; indeed, doing so would do their clients a disservice. The lawyer's role is to synthesize information from a wide variety of sources and figure out how to keep the deal progressing towards closing.[56]

Corporate lawyers tend to emphasize deal management as the reason that clients hire them. "We provide turnkey service," one partner explained. "Bring this transaction here and it will close. Whatever issues there are, it will close."[57] The corporate lawyer running the deal is at the center of the hub of activity, calling on others for whatever expertise might be needed.[58] Other lawyers emphasize the sheer size of the large firms, which allows for a

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[54] In addition to managing transaction costs, lawyers act as information hubs, assembling massive amounts of documentation from the various parties involved in the deal. See generally Manuel A. Utset, *Producing Information: Initial Public Offerings, Production Costs, and the Producing Lawyer*, 74 OR. L. REV. 275 (1995).

[55] Regulatory expertise, standing alone, is not what clients are looking for. Rather, "[the] value comes from synthesizing issues related to different disciplines." Lawyers have an "information transmission" role. The firm provides a coordinated team effort that can't be supplied by multiple firms. The deal lawyer acts as "a conduit between the business guy and all the various legal specialties, from tax to '40 Act to IP to ERISA." Interview #5. See also interview #3. ("We provide value through an international network of lawyers, seamless advice in multiple practice areas, experience of deal flow, the number of different transactions we do—we're aware of the issues that come up. We know what the market standard rep or covenant is, how much you put in escrow. There's normally no mismatch of advisors – but there's an intangible element of advantage on deals where there's a mismatch and we're up against a second-tier firm.")

[56] One lawyer, echoing Gilson, explained the lawyer's role in terms of economies of scope:

> Lawyers have a comparative advantage here over investment bankers and accountants not just because they have regulatory expertise, but also because they are in charge of the documents that implement the transaction. Clients take comfort in knowing there's no disconnect between the structure and the documents that implement the structure.

Interview #3.

[57] Interview #1.

[58] One lawyer underscored the advantage of being a lockstep firm in this respect: "you get the guy who will do it better, whether it's your HSR, your environmental person, your ERISA person, instead of doing it yourself."

greater number of specialists. Deal flow allows the lawyers to develop human capital in the form of knowing market practice, and it also provides the understanding of the process that leads up to the closing and understanding how to bring all of the necessary expertise to the deal, in what order, and in what timeframe to allow the deal to close. Elite law firms also provide an intangible value to the deal through the traditional role of having a calm and rational "lawyerly" demeanor.[59]

Empirical comparison of the value created for the client through each of these lawyerly functions—regulatory arbitrage, transaction cost engineering, quarterbacking the deal—is difficult.[60] Professor Steven Schwarcz has looked to survey data to support the view that regulatory arbitrage drives value creation, but further empirical research would be helpful.[61] The problem is that measuring the activity is exceedingly difficult.[62] Billing rates and lateral moves provide some indirect evidence of the importance of regulatory expertise, but even tax and securities lawyers spend a lot of time managing ordinary transaction costs. Teasing out the marginal value attributable to each activity is challenging, like asking a cancer patient whether his life was saved by the radiologist who found the tumor, the surgeon who cut it out, or the

[59] Several lawyers pointed to personality traits associated with lawyers that clients appreciate. "Clients look to us," explained one tax lawyer, "for things that have nothing to do with risk management and risk assessment. Sometimes it's the lawyer's traditional role of being the calm and rational one." Clients don't look to the lawyers for the structuring so much as the "sophisticated conversation" about the nuances of the deal, and sophisticated, careful implementation of the deal. While others could, in theory, provide this service, it continues to be lawyers who provide. He pointed to the "crisis of talent in this country," suggesting that, for whatever reason, some of our most talented minds continue to become lawyers, and they are quite good at performing these roles which don't necessarily require a law degree. Interview #6.

[60] Anecdotally, one can identify several law firms that seem to have leveraged regulatory expertise to bolster transactional practice. McKee Nelson, which started out as a tax boutique in DC, leveraged its regulatory expertise into a thriving capital markets practice. Before the market crash in 2008, it competed with the heavyweights in New York, and its profits-per-partner and revenue-per-lawyer exceeded that of any other DC-based firm. Schulte Roth & Zabel, never known as an elite firm, leveraged its expertise in hedge funds and mutual funds to become a major player in New York and London. Below, I discuss Skadden Arps, which uses an extensive network of contacts in DC to complement its always-strong transactional practice in New York. See infra part II.C.

[61] Steven L. Schwarcz, *To Make or Buy: In-House Lawyering and Value Creation*, 33 J. CORP. L. 497 (2008).

[62] Cf. Raskolnikov, *Relational Tax Planning*, supra note 25, at 1230 ("Yet casual empiricism may be the best we can do in this area. I suspect that no database contains detailed quantifiable evidence of informal regulatory avoidance, so econometric analysis is likely to be out of the question.").

oncologist who kept the cancer from returning.[63] Whatever the relative value of the various activities, it suffices for present purposes to have established that regulatory arbitrage is a part of what business lawyers do.

B. Necessary Conditions

1. Defining Regulatory Arbitrage Opportunities

Regulatory arbitrage is a consequence of a legal system with generally applicable laws that purport to define, in advance, how the legal system will treat transactions that fit within defined legal forms. Because the legal definition cannot precisely track the underlying economic relationship between the parties, gaps arise, and these gaps create opportunities.

The phenomenon is analogous to inefficiencies in the capital markets. Financial arbitrage is defined as "the simultaneous purchase and sale of the same, or essentially similar, security in two different markets for advantageously different prices."[64] In informal terms, financial arbitrage is possible when any of three conditions is met:

- The same asset trades at different prices on different markets.
- Two assets with identical cash flows trade at different prices.
- An asset with a known price in the future trades at a price that differs from its future price discounted to present value.[65]

In each case, simple arbitrage techniques may be employed to take advantage of the pricing inefficiencies; in efficient markets, these pricing anomalies often become vanishingly small.[66]

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[63] The empirical challenge is especially daunting where the radiologist, surgeon, and oncologist are all the same person.

[64] William Sharpe & Gordon Alexander, INVESTMENTS (4th ed. 1990).

[65] See Zvi Bodie et al., INVESTMENTS 325 (8th ed. 2009) (explaining law of one price).

[66] Eugene Fama*, The Behavior of Stock Market Prices*, 38 J. BUS. 34 (1965); Ronald J. Gilson & Reineir H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984). Briefly, when the law of one price is violated, the arbitrageur can buy the asset on the market where the asset is cheap, short the asset on the market

Regulatory arbitrage opportunities can be framed in a similar fashion as financial arbitrage, taking place when one of three conditions are met:

- *Regulatory regime inconsistency:*
  The same transaction receives different regulatory treatment under different regulatory regimes.

- *Economic substance inconsistency:*
  Two transactions with identical cash flows receive different regulatory treatment under the same regulatory regime.

- *Time inconsistency:*
  The same transaction receives different regulatory treatment in the future than it does today.

As with financial arbitrage, each regulatory arbitrage opportunity can be exploited by simple planning techniques. And, as with financial arbitrage, the real world introduces a number of complexities that limit regulatory arbitrage.[67]

Regulatory regime inconsistency. Regulatory regime inconsistency creates value for the client by using a single transaction to exploit the difference between the way two different regulatory regimes treat that transaction. The inconsistency can arise through variations in the way that different doctrinal areas cover subject matters relevant to the same transaction, such as tax and financial accounting, or corporate law and bank regulatory rules. Or the inconsistency can arise when regulators in different jurisdictions address the same subject matter. Inconsistency among regulators often gives parties the ability to effectively choose which regulator has governing authority, such as banking regulators with overlapping jurisdiction, or when different sovereigns share jurisdiction over the transaction.

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where the asset is expensive, deliver the cheap asset to the expensive buyer and pocket the difference. Similarly, when assets with identical cash flows trade at different prices, the arbitrageur can buy the cheap asset, short the expensive asset, and pocket the difference; by assumption, the cash flows going forward will perfectly offset. Finally, if an asset with a known future price is mispriced, the arbitrageur may enter into a short or long forward contract to deliver or receive the mispriced asset in the future.

[67] See Andrei Shleifer & Robert W. Vishny, *The Limits of Arbitrage*, 52 J. FIN. 35, 40 (1997) (identifying agency costs between portfolio managers and investors as a constraint on arbitrage).

Doctrinal inconsistency is not always a mistake caused by inept legislative drafting. Different regulators may have different policy goals in mind. It may be important for securities regulators, who seek to protect investors, to define the meaning of "security," "dealer," or "sale" in a way that differs from the taxing authorities, who seek to raise money for the public fisc. Other times, however, doctrinal inconsistency arises when laws become stale, failing to keep up with the development of new financial products and innovative financial techniques.[68]

New financial products are engineered to meet specific regulatory goals, often involving an arbitrage of two or more regimes. For example, many bank holding companies issue hybrid securities which are treated differently for tax purposes and bank regulatory purposes. In a typical structure, the bank issues securities which have enough debt-like attributes to qualify as debt for tax purposes while still qualifying as Tier 1 capital for bank regulatory purposes.[69] Because Tier 1 capital is supposed to represent a reliable source of equity capital for the banks, the debt-like features of "trust preferred" and other hybrid securities are arguably inconsistent with the stability sought by bank regulators. Other examples include other debt-equity hybrid securities (debt for tax purposes vs. equity for accounting purposes), and securitization vehicles (loan for tax purposes vs. sale for bankruptcy purposes and accounting purposes).

The 2007 IPO of the Blackstone Group, a private equity firm, provided a high-profile example of the arbitrage of two different regulatory regimes.[70] The Blackstone IPO used an innovative structure to go public, selling limited partnership units to investors rather than common stock. The arbitrage involved an inconsistency between the tax code and the Investment Company Act of 1940. For tax purposes, Blackstone retained partnership tax status, preserving the advantageous tax rate on carried interest and avoiding corporate-level tax. Its tax status relied on a "passive income" exception to the publicly-traded partnership rules, which normally treat public companies as corporations for tax purposes. For tax purposes, then, Blackstone ensured that most of its income

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[68] See infra text accompanying note 70.

[69] See Schizer, *Frictions*, supra note 25, at 1338 & n.85 (describing how banks lobbied the Federal Reserve to allow tax-deductible trust-preferred securities to qualify as Tier 1 Capital).

[70] See Fleischer, *Taxing Blackstone*, supra note 36, at 99-101 (describing regulatory arbitrage of Blackstone structure); Susan Beck, *The Transformers*, AM. LAWYER, Nov. 2007, at 94 (describing Blackstone structure and similar structure first employed by Fortress Investment Group).

was passive investment income in the form of dividends, interest, and capital gains, setting up a blocker corporation to help transform its active fee income into passive dividends.[71] Meanwhile, in order to avoid the Investment Company Act of 1940, Blackstone held itself out as an active asset management and financial advisory services company, not a passive investment company that holds and trades securities like a mutual fund.[72] Thus, through careful structuring, Blackstone successfully held itself out as passive for tax purposes and active for securities law purposes, minimizing the costs of both regimes.[73]

The second form of regulatory regime inconsistency arises when two different sovereigns apply different rules. Corporate lawyers, of course, are accustomed to choosing Delaware as a state of incorporation, a decision that allows Delaware law to govern the internal affairs of the corporation.[74] For companies whose economic activity takes place outside of Delaware, the choice is a commonplace form of regulatory arbitrage, making use of the gap between the economic location of the corporation's activity and the legal location of its incorporation.

The ability to choose one's place of incorporation provides planning opportunities in the international context as well, of course. U.S. companies sometimes consider reincorporating in a tax haven jurisdiction.[75] Incorporating abroad allows multinationals to pay U.S. tax only on U.S. source income, and offers other opportunities to shelter U.S. income through transfer pricing, income stripping, and other techniques.[76]

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[71] See Fleischer, *Taxing Blackstone*, supra note 36, at 99-101.
[72] See id. at 100-101.
[73] Some political lobbying also helped. See infra Part II.C. This sort of doctrinal inconsistency can be innocuous; it is helpful to break down the inconsistency further into one or more economic substance inconsistencies. In the case of the Blackstone IPO, its treatment as an active management company was appropriate in light of the actual services performed by Blackstone. The heart of the arbitrage was the treatment of the firm as a passive conduit for purposes of the publicly-traded partnership rules. Thus while the doctrinal inconsistency flags a potential policy problem, further analysis of the economic substance of the deal is necessary before drawing any normative conclusions.
[74] Frederick Tung, *Before Competition: Origins of the Internal Affairs Doctrine*, 32 J. CORP. L. 33 (2006).
[75] Companies are still free to reincorporate offshore, but new rules treat the firm as if it were a U.S. firm if 80% of the firms's ownership remains the same after the reincorporation. Not surprisingly, bankers are now pitching reincorporation deals that would shift 21% ownership to a private equity fund, thereby avoiding the 2004 legislation. See Ryan J. Donmoyer, *IRS Moves to Keep Companies from Skirting Tax-Avoidance Law*, REUTERS, Sept. 18, 2009.
[76] Mihir A. Desai & James R. Hines, *Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions*, 55 NAT'L TAX J. 409 (2002).

Congress enacted legislation in 2004 to discourage reincorporations, but numerous cross-border tax arbitrage techniques remain. In a transaction known as a "double-dip lease," the deal is structured so that two different jurisdictions each treat a different taxpayer as the owner of the asset. For example, if Airbus, a French company, builds a plane and leases it to American Airlines for 99 years, it may be possible for Airbus, relying on formalistic French law, to take depreciation deductions in France, while American Airlines, relying on economic substance rules under U.S. tax law, takes depreciation deductions in the U.S. on the very same airplane.[77]

Economic substance inconsistency. Economic substance inconsistency, unlike regulatory regime inconsistency, can take place within a single regulatory regime. The ability to carve up economic cash flows in a variety of ways creates opportunities to reduce regulatory costs by changing the formal structure of the transaction while actually changing the underlying business deal as little as possible.[78]

One common example is the use of total return swaps to create a synthetic equity investment. When foreign investors receive dividends from a U.S. corporation, the dividend payments are subject to a 30% withholding tax.[79] To get around the tax, some foreign investors will instead enter into a total return swap with an investment bank. The total return swap is designed to mirror the (pre-tax) cash flows that the investor would have received had it held the stock directly. Because the investor receives a payment under the swap rather than a "dividend," no withholding tax is applied. Similarly, hedge funds have used

[77] Diane M. Ring, *One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage*, 44 B.C. L. REV. 79 (2002).

[78] For an example in the consumer context, see Nathalie Martin, *Payday Lending Legislation From the Ground Up: A Customers' View of What Works and What Doesn't* (forthcoming) (draft on file with the author) (describing restructuring of two to four week payday loans into twenty week "installment loans" to avoid state regulation). There are, of course, numerous examples of changing the structure of transactions to fall just outside a regulatory regime's arbitrary line. See, e.g., Paul Rose, *Sovereign Wealth Fund Investment in the Shadow of Regulation and Politics*, 40 GEORGETOWN J. INT'L L. 1207, 1232 (2009) (noting that sovereign wealth fund investments do not exceed 9.9% of the total stock outstanding to avoid filing requirements for 10% shareholders under Section 16 of the Exchange Act of 1934 and to stay below informal 10% threshold that increases likelihood of CFIUS investigation).

[79] Many investors can rely on a treaty to secure a lower rate.

swaps to avoid disclosure obligations under the Williams Act or to hijack corporate proxy voting.[80]

Investor Sam Zell's acquisition of the Chicago Tribune provides a more elaborate example of economic substance inconsistency. Rather than use a traditional leveraged buyout structure, Zell restructured the Tribune as an S Corporation controlled by an ESOP.[81] Because the ESOP held the equity of the Tribune, Zell needed another way to ensure the potential for economic gain in the transaction, which he acquired through a call option to acquire 40% of the equity in the Tribune. Finally, because Zell would not hold common stock in the Tribune until he exercised the options, he instead entered into a voting agreement which effectively gave him control over the company and its board. When the dust settled, the economics of the deal resembled an ordinary buyout, but, under the ESOP rules, neither the Tribune nor its shareholders would pay income tax on corporate earnings.[82]

Time inconsistency. The last type of regulatory arbitrage relies on an inconsistency in the regulatory treatment of a transaction across time. Legislative changes often provide planning opportunities, as parties can effectively elect whether to be covered under new or old law.

The recent sunset of the estate tax provides a somewhat gruesome example of a time inconsistency opportunity. Under legislation enacted in 2001, the estate tax, which normally taxes estates at rates up to 45%, disappeared in 2010, and is scheduled to spring back in 2011. While legislators have pledged to re-enact the tax retroactively to the beginning of 2010, there is considerable uncertainty about whether this will occur, what exemption levels might be, and what rates would apply. From a planning perspective, it would be convenient to die in 2010. Of course, on the surface, death would appear to be a powerful friction for this planning technique to overcome. But empirical data shows otherwise. While it is said that death and taxes are inevitable, the timing of each can be manipulated on the margins.

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[80] Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006); Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625 (2008).

[81] Michael S. Knoll, *Samuel Zell, The Chicago Tribune, and the Emergence of the S ESOP: Understanding the Tax Advantages and Disadvantages of S ESOPs*, 70 OHIO ST. L.J. 519 (2009).

[82] Tribune went bankrupt in 2009. The problem was not that it paid too much income tax, but rather that it didn't have any income. Regulatory arbitrage can save taxes, but it can't save the newspaper industry.

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In an infamous paper, Joel Slemrod and Wojciech Kopczuk illustrated that death is elastic; it responds to incentives.[83] Slemrod & Kopczuk examine the death rate before and after changes in the estate tax rate, finding that, for individuals dying within two weeks of a tax change, tax savings slightly increases the possibility of dying in the period with lower taxes.[84] The precise cause is uncertain. Some people appear to will themselves to hang on a bit longer.[85] Heirs may shape life support decisions to minimize taxes.[86] It's also possible that the results demonstrate not real death elasticity, but ex post doctoring of the reported date of death to save on taxes.[87] Whatever the cause, the results suggest that for some people, the will to engage in regulatory arbitrage is even more powerful than the will to live.

The options backdating scandal provides another example of time inconsistency arbitrage. In the dot com bubble of the late 1990s, tax and accounting rules still incentivized firms to issue at-the-money stock options.[88] In a typical backdating scenario, imagine that a CFO verbally accepted a job with an Internet company January 1, 1999, when the stock price was $100. On March 1, 1999, when the board approves the CFO's employment contract and authorizes a grant of stock options, the stock is trading at $150. By backdating the options to January 1, with a strike price of $100, the options appear to be at-the-money (and were typically reported as such to ensure favorable tax and accounting treatment), when in fact they were $50 in-the-money. While this time-inconsistency arbitrage did not actually "work"—several companies and executives were indicted for the practice,

[83] Wojciech Kopczuk & Joel Slemron, *Dying to Save Taxes: Evidence from Estate Tax Returns on the Death Elasticity*, 85 REV. ECON. & STAT. 256 (2003).
[84] Id. at 264 (finding that "for individuals dying within two weeks of a tax reform, a $10,000 potential tax saving (using 2000 dollars) increases the probability of dying in the lower-tax regime by 1.6%).
[85] Id. at 257 ("Altruistic individuals should consider adjusting the timing of their death if by so doing it will benefit their heirs.").
[86] Id. at 257 ("Decisions about prolonging the life of a critically ill person (e.g. whether to continue with life support) are often made not be the dying person but by others, including the potential heirs themselves.").
[87] Id. at 264.
[88] Prior to 2005, GAAP allowed companies to report only the intrinsic value of options as compensation expense; at-the-money options have no intrinsic value, thus allowing companies to maximize reported earnings. See David I. Walker, *Unpacking Backdating*, 87 B.U. L. REV. 561, 568 (2007). Section 162(m) limits the corporate deduction for non-performance-based pay to $1 million per year for certain executives, but counts at-the-money stock options (but not in-the-money options) as performance-based pay. See id. at 569; Fleischer, *Options Backdating*, supra note 36, at 1039-42.

and the SEC investigated dozens more—in house counsel must have viewed it as a legitimate regulatory arbitrage at the time.

Finally, time inconsistency opportunities arise through discount-rate arbitrage when regulatory regimes do not properly account for the time value of money. Tax deferral provides an obvious example. In a typical corporate acquisition, the selling shareholders would pay capital gains on the transaction if it were treated as a sale for tax purposes. If the transaction is structured as a tax-free reorganization, however, the selling shareholders receive stock of the buyer as acquisition currency, taking a carryover basis in the stock received. Gain, if any, is not recognized; instead it is deferred until the new stock is sold. The present value of the tax liability is, of course, lower if the gain is deferred until a future year.

2. Close Economic Substitutes

With this taxonomy of arbitrage opportunities in mind, we can now delve more deeply to explore the conditions under which arbitrage occurs. As should already be apparent, a regulatory arbitrage opportunity does not require economically identical transactions to work. In most cases, it is sufficient to have two transactions that are close economic substitutes for one another. Restructuring works only in situations where the modifications to the economics of the deal are minor, or at least small enough to be less than whatever regulatory cost savings the strategy may provide.

OID (original issue discount) bonds provides a clear example. Investors who buy a ten year bond paying 8% interest for $100 will receive $8 in interest payments per year. The interest is taxable, reducing the after-tax return to $4 for a taxpayer in a 50% bracket. Investment banks eventually developed a financial product – an original issue discount bond – which paid no nominal interest. Instead, the issue price was lower than the redemption price; instead of an 8% bond, an investor might buy a $100 bond that would be redeemed, 10 years later, for $200. Cash method taxpayers would not recognize the interest until redemption, while accrual method issuers would deduct the interest all along the way. The two bonds are not perfect economic substitutes; the first provides more liquidity. But the present value of the pre-tax cash flows is, by assumption, identical. In practice, the two products were nearly perfect substitutes for many investors, forcing Congress to enact the OID rules in the tax code.[89]

In fact, even deals that are carefully engineered with arbitrage in mind involve costs that make them close but not perfect substitutes. Consider again the example of the total return swap substituting for an investment in common stock. Recall that foreign investors are subject to a 30% withholding tax on dividends. If the foreign investor instead enters into a swap with an investment bank, the swap entitles the investor to a stream of dividend-equivalent payments and an additional payment (or obligation) equal to the gains (or losses) of market value of the firm. But there are some subtle differences in the economics of the two investments. The swap will require a fee to be paid to the investment bank. The investor must spend time and money to understand the financial product, how it works, how it should be accounted for, and monitoring the security. The swap introduces new counterparty credit risk to the transaction (i.e. the risk that the investment bank will default on its obligation to the investor). But so long as the two investments are close economic substitutes—meaning that the regulatory savings outweigh the additional costs—investors will replace the common stock with a swap, notwithstanding the small differences in the economics of the transaction.

3. Close Strategic Substitutes

It is not enough for two transactions to be close economic substitutes for one another; they must also be close strategic substitutes. The holder of an asset is often interested in more than cash flows. Investors may be interested in control rights, information rights, or synergistic benefits with other assets they hold.

The total return swap example again illustrates the point. Assume that an investor can manage the additional transaction costs associated with the swap, and that the regulatory savings outweigh the transaction costs. Why might some investors still prefer holding common stock? Because common stock, unlike a swap, typically carries voting rights that may be meaningful to certain investors, like activist investors or corporations making a strategic investment.

[89] I.R.C. §§ 1271-75.

Different legal forms alter the strategic value of an asset by altering control rights, voting rights, information rights, and oversight and accountability mechanisms. Because economic cash flows can easily be separated from legal ownership of an asset, many planning techniques are variations on a theme: move nominal ownership of the asset in the hands of the party that can incurs the lowest regulatory costs, and move economic ownership of the asset to the party that values it most highly. At times, however, legal ownership may be necessary to protect the economic cash flows that the acquirer seeks. Furthermore, at times an asset may be sought for its strategic value (i.e., to enhance the value of the buyer's other assets), such as when a trade buyer wants to integrate a start-up's technology or brand into its legacy assets.

The value of the strategic rights associated with different forms will obviously vary depending on the buyer. Many buyers—financial buyers—will be indifferent to the strategic rights, thus allowing more flexibility in planning.

C. Constraints on Regulatory Arbitrage

The necessary conditions for regulatory arbitrage—two transactions that are close economic and strategic substitutes but generate different regulatory outcomes—are not necessarily sufficient for arbitrage to take place. As with financial arbitrage, where availability of credit, agency costs, and other constraints limit arbitrage strategies, a variety of constraints limit regulatory arbitrage.

What follows is a taxonomy of regulatory arbitrage constraints: legal constraints, transaction costs, professional constraints, ethical constraints, and political costs. The list is not intended to convey a rank ordering of importance; indeed, two of the constraints (professional constraints and ethical constraints) have become almost trivial. Rather, the order reflects the process that deal lawyers go through when evaluating whether a proposed change in the deal structure "works."

1. Legal Constraints

Lawyers who identify regulatory arbitrage opportunities engage in a second level of legal analysis before considering transaction costs and other constraints. Many statutory schemes have anti-planning rules intended to backstop the policy goals of the statutory scheme. These rules range from specific prohibitions that make certain types of planning strategies ineffective to broad "anti-abuse" rules intended to reach strategies that lawmakers cannot yet envision. Because these legal constraints are imperfect, they are often underappreciated as a method of constraining arbitrage.

Rifleshot anti-avoidance rules. Many regulatory statutes have "rifleshot" anti-avoidance rules in the statutory text. When lawmakers can anticipate specific avoidance strategies that might render a regulatory provision ineffective, they write constraints into the statute. Where planning is unforeseen but deemed abusive once discovered, Congress will often amend the statute to shut down the planning.

For example, consider proposed Section 710 of the tax code, which would change the tax treatment of carried interest from capital gain to ordinary income.[90] Section 710 would not change the tax treatment of a general partners' actual financial investment in the partnership; such investments could still generate capital gains or losses.[91] Congress was concerned about an obvious planning technique; rather than receive carried interest, general partners could borrow 20% of the capital of the fund from the limited partners and invest directly into the fund. Absent a special rule, the two structures (carried interest and nonrecourse-debt-financed capital interest) would be close economic and strategic substitutes, but would generate different tax outcomes. Section 710 thus includes a provision which would treat debt-financed investments in the partnership by general partners as if it were carried interest.[92]

Many corporate tax sections have a similar structure designed to curb planning. Against the backdrop of a broad realization rule that defines any "sale or exchange" as a taxable event, several Subchapter C provisions grant relief from the broad rule by designating transactions as nonrecognition events. These nonrecognition rules, however, can lead to creative tax planning

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[90] See H.R. 1935, 111th Cong., Apr. 2, 2009 (proposed § 710(a)(1)(A)).
[91] See id. (proposed § 710(c)(2)(A)).
[92] See id. (proposed § 710(c)(2)(D)).

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that goes beyond what Congress intended. And so Congress has enacted additional rules that limit planning techniques.

Section 351(a), for example, allows for nonrecognition for a shareholder who contributes property to a corporation if the shareholder receives only stock in exchange and controls the corporation immediately after the exchange.[93] Section 351(b) provides limited relief for boot received in the exchange.[94] The obvious goal of the section is to provide relief from the realization rule when the transaction represents a mere change in form of the shareholder's investment in the property contributed to the corporation. If a shareholder contributes property in exchange for cash or debt rather than stock, the nonrecognition rules should not apply, at least to the extent of the boot. A planning opportunity then arises: is there a form of stock which is a close economic substitute for debt, thereby allowing the shareholder to effectively cash out of the investment? Section 351(g) then steps in to provide an anti-planning constraint on the use of redeemable debt-like "nonqualified preferred stock."[95] Similar rifleshot rules can be found in the reorganization rules, spin-off rules and distribution rules.[96]

In the securities context, statutory look-through rules often constrain obvious planning techniques. The Investment Company Act, for example, provides an exception to the definition of investment company for any issuer whose securities are held by fewer than 100 persons.[97] Absent additional limitations, one could shoehorn an infinite number of investors through this exception by stacking partnerships on top of one another, each with fewer than 100 owners. The statute shuts down this technique by "looking through" entities to the beneficial owners of the securities in situations where the vehicle is likely constructed merely to evade the 100 person limitation.[98] Similarly, Rule 506 of Regulation D under the Securities Act of 1933 establishes safe harbor rules for a private offering exemption. Rule 506 limits such offerings to 35 non-accredited investors, but looks through entities that were

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[93] I.R.C. § 351(a).
[94] I.R.C. § 351(b).
[95] I.R.C. § 351(g).
[96] See, e.g., I.R.C. §§ 306, 355, 368.
[97] 15 U.S.C. § 80a-3(c)(1).
[98] 15 U.S.C. § 80a-3(c)(1)(A) (providing general rule that a company is normally treated as a single person, but providing exceptions if a company owns ten percent or more of the voting securities of an investment company and the ten percent owner is an investment company or would be but for the 3(c)(1) or 3(c)(7) exceptions to the Investment Company Act).

formed for the specific purpose of purchasing the securities offered.[99]

Shotgun anti-abuse rules. Broader "shotgun" anti-abuse rules discourage regulatory arbitrage by targeting a class of transactions or disallowing transactions that are motivated by regulatory avoidance. Many such rules rely on frictions, market risk, holding periods, or other secondary factors to enforce the objective of the primary rule.[100] Other rules use sweeping anti-abuse language to prevent arbitrage.[101]

The passive loss rules provide an example of a frictions-based approach. In the 1970s and early 1980s, increasing numbers of individual taxpayers entered into tax shelters. In the typical tax shelter, a wealthy doctor, dentist, lawyer or small business owner would invest in a partnership which borrowed money and purchased depreciable property, like an alpaca farm. Because the interest expense and tax depreciation far exceeded the economic depreciation of the assets, the investment generated phantom tax losses, which were then allocated to the individual investors and used to shelter other income. To combat such shelters, section 469 limits losses generated from passive activities to the amount of passive income; excess passive activity losses are trapped until the investment is disposed of.[102]

Section 469 is effective because it introduces a new friction, active participation in the venture, which changes the attractiveness of the investment.[103] The basic individual tax shelter is to take two economically similar transactions—doing nothing vs. investing in a tax shelter—and exploit the different tax treatment (nothing vs. phantom tax losses). Introducing the requirement of active participation means that the two are no longer economic close substitutes. Spending 10 hours a month at an alpaca farm is not costless to a busy doctor or lawyer.

What makes the rule "broad" is that it is not targeted at a specific deal structure or type of investment. Rather, it targets all passive activity losses, however generated. Marvin Chirelstein and Lawrence Zelenak have proposed a similar approach to the corporate tax area; their rule would disallow all noneconomic losses

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[99] Rule 506.
[100] See, e.g., I.R.C. §§ 1260, 469, 1091.
[101] See, e.g., I.R.C. § 269.
[102] See I.R.C. § 469.
[103] Id.

not clearly contemplated by Congress.[104] Similarly, code provisions that basket together certain types of income and deductions can be highly effective at reducing arbitrage.[105] It might seem easier to simply focus on the taxpayer's motive. But experience shows that code sections that focus on an avoidance motive are often ineffective[106] and fall into disuse.[107]

General anti-abuse rules. General statutory anti-abuse rules are statutory rules designed to curb regulatory arbitrage without any particular transaction or strategy in mind. Countries as diverse as Canada, Australia, Sweden, Hong Kong, and Germany employ a general anti-avoidance rule (sometimes known as a GAAR), which provides that when a transaction is a avoidance transaction, the tax consequences will be re-determined to deny the tax benefit that would otherwise result from the transaction.[108] General anti-avoidance rules are thought by many to be a useful tool to combat abusive transactions, but, because of challenges in interpreting and applying the rule, are hardly a panacea.[109]

Neither the U.S. nor the U.K. has a general statutory anti-abuse rule.[110] The U.S. partnership tax rules, which are notoriously complex, contain an anti-abuse regulation promulgated by the Treasury which targets tax shelters and other transactions which abuse the partnership form.[111] The regulation is narrower than it first appears, however, and is widely viewed as having failed in its goal of curbing tax shelters that use the partnership vehicle.[112]

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[104] Marvin A. Chirelstein & Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939, 1955-56 (2005).
[105] See, e.g., § 163(d) (investment interest limitation); 183 (hobby losses). See generally Leandra Lederman, *Basketing and Corporate Tax Shelters* (working paper).
[106] See § 482 (transfer pricing).
[107] See § 269 (use of corporate form for avoidance of tax); § 446 (choice of accounting method must clearly reflect income).
[108] Graeme S. Cooper, *International Experience with General Anti-Avoidance Rules*, 54 S.M.U. L. REV. 83, 84 (2001); Tim Edgar, *Building a Better GAAR*, 27 VA. TAX REV. 851 (2008); Benjamin Alarie, *Trebilcock on Tax Avoidance* (forthcoming).
[109] Cooper, supra note 108, at 85 (arguing that "a GAAR will usually become just another part of the tax landscape … What is abundantly clear is that a GAAR does not suddenly embolden a reluctant judiciary to become highly interventionist. It neither unleashes a nuclear winter for advisors, nor serves as a panacea for tax authorities.").
[110] The U.K., like the U.S., relies on existing judicial anti-avoidance doctrines. Cooper, supra note 108, at 89.
[111] Treas. Reg. § 1.701-2(b).
[112] Andrea Monroe, *What's in a Name: Can the Partnership Anti-Abuse Rule Really Stop Partnership Tax Abuse?*, 60 CASE W. RES. L. REV. (2010).

While the U.S. has no general anti-avoidance rule, it does have a well-developed (if confusing) body of common law constraints on tax avoidance. These constraints include the related tax doctrines of substance over form, economic substance doctrine, business purpose doctrine, and the step transaction doctrine. Congress has considered codification of the economic substance doctrine, which would reduce some of the uncertainty associated with unpredictable judicial application. But practitioners question whether a codified economic substance doctrine would reach the intended target; they express similar skepticism about whether an anti-abuse rule would be effective.[113]

Scholarship on regulatory arbitrage—whether related to tax avoidance, derivatives regulation, or telecommunications—tends to focus on the limitations associated with legal constraints. Rifleshot approaches are reactive and difficult to draft effectively. Shotgun approaches may be overinclusive. Broad anti-abuse rules reduce certainty and may deter legitimate business transactions.

But the success stories are important too. Technocratic amendments that shut down abusive transactions are dull but usually effective. Tax rules that basket activities together are more effective than judicial tax avoidance doctrines.[114] While legal constraints are not perfect, further attention to designing effective statutory constraints is a worthy endeavor.

2. Transaction Costs

In 1981, economist Joseph Stiglitz identified four techniques that, assuming perfectly efficient capital markets, allowed investors to avoid not only all taxes on their investment income, but on their wage income as well.[115] The income tax, in other words, is optional—if it weren't for the heroic assumption about perfect capital markets.[116] As every deal lawyer knows, countless brilliant plans that reduce regulatory costs on paper have been discarded because of some real world problem related to transaction costs. In

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[113] Interview #1. ("An anti-abuse rule may not change things. If you are a responsible practitioner, you are applying it in your head anyway.").

[114] Lederman, Basketing.; Tim Edgar, *Building A Better GAAR*, 27 VA. TAX REV. 833, 871-82 (noting the underinclusiveness of judicial anti-avoidance doctrines with respect to transactional substitution techniques).

[115] Joesph E. Stiglitz, *Some Aspects of the Taxation of Capital Gains*, 21 J. PUB. ECON. 257, 259 (1983).

[116] The point of Stiglitz's paper, of course, is that any analysis of the effects of capital taxation must focus on imperfect capital markets. Id. at 257.

this context, I use transaction costs in the Coasean sense: the costs associated with market transactions, including search costs, asymmetric information between the buyer and the seller, bargaining costs, moral hazard and other instances of strategic behavior, and monitoring or enforcement costs. Thus, it's not strictly the explicit costs of the avoidance strategy, such as the fees to lawyers or investment bankers, that kill the deal. Rather, many arbitrage strategies increase other costs associated with the avoidance transaction by exacerbating agency costs between managers and shareholders, increasing information costs by creating more complexity in the corporate structure, or by creating new counterparty credit risk.

The framework here is derived from the concept of "frictions" in the tax planning literature, first outlined in Scholes and Wolfson's *Taxes and Business Strategy*.[117] Scholes and Wolfson outline how market frictions impede taxpayers' ability to undertake tax arbitrage.[118] Such frictions most often arise because information is costly and not all taxpayers have the same information; such frictions include moral hazard, adverse selection, counterparty credit risk, search costs, risk aversion, concerns about organizational design, financial reporting concerns, and other regulatory costs.[119] David Schizer imported these insights into the legal literature and elaborated on the Scholes & Wolfson framework in an article suggesting that lawmakers think consciously about frictions as a constraint on tax planning.[120]

While the tax planning literature in both law and finance now includes a substantial body of work, there is still much to be gained by explicitly analyzing these frictions as Coasean

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[117] Myron S. Scholes et al., TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH 9 (2d ed. 2002) ("By frictions, we mean transaction costs incurred in the marketplace, which make implementation of certain tax-planning strategies costly.") The textbook, first published in 1992, synthesized much of Scholes' earlier scholarship on tax arbitrage. See Myron S. Scholes, G. Peter Wilson & Mark A. Wolfson, *Tax Planning, Regulatory Capital Planning, and Financial Reporting Strategy for Commercial Banks*, 3 REV. FIN. STUD. 625, 627 (1990 (finding that banks trade-off costs of reducing regulatory capital and financial reporting income against tax advantages); Scholes & Wolfson, *Taxes and Organization Theory* (working paper) 1987 (in designing an organization, tax considerations and information-related transaction cost considerations are often in conflict with one another); Myron S. Scholes & Mark A. Wolfson, *The Effects of Changes in Tax Laws on Corporate Reorganization Activity*, 63 J. BUS. 141, 144 (1990) (finding evidence of increased reliance on management buyouts and going-private transactions designed to reduce transaction costs enable tax benefits to be realized in a larger number of deals).

[118] Id. at 119.

[119] Id. at 119, 119-140.

[120] See Schizer, *Frictions*, supra note 25.

transaction costs. Doing so allows us to better understand why many deal structures fail to minimize transaction costs, and—because some firms are better positioned to manage transaction costs than others, allows us to draw some conclusions about the incidence of regulatory costs.

Agency costs. Recall that in financial arbitrage, agency costs constrain the ability of portfolio managers to execute arbitrage strategies, as the investors whose money they manage get nervous while waiting for the price differential to correct.[121] A similar dynamic constraints regulatory arbitrage. Regulatory avoidance strategies typically involve more complex structures than had been used previously, and the addition of more complex structures makes the performance of management more difficult for shareholders to understand. Furthermore, the opacity associated with regulatory arbitrage provides opportunities for accounting fraud, and can turn a sound investment into a "faith" stock.[122]

Recent contributions to the finance literature establish that agency costs influence whether tax avoidance strategies will be employed.[123] The foundational papers in finance, such as the Modigliani and Miller capital structure irrelevance theorem, treat taxes as an unavoidable exogenous environmental factor.[124] Tax

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[121] Vishny & Shleifer, supra note 67; Roger Lowenstein, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (2000).

[122] Enron was the extreme example. Its use of off-balance sheet securitization vehicles, which arbitraged gaps between the accounting rules and the economics of the underlying transactions, ultimately led to a loss of faith by investors and a collapse of the stock price. Agency costs failed to constraint planning in the short run, but worked in the long run, bankrupting the company before the accounting rules were changed.

[123] For a recent literature review, see Mihir A. Desai & Dhammika Dharmapala, *Earnings Management, Corporate Tax Shelters, and Book-Tax Alignment*, 62 NAT'L TAX J. 169 (2009) (discussing how corporate tax avoidance decisions fit within broader agency framework, and reviewing empirical evidence) (hereinafter Desai & Dharmapala, *Earnings Management*).

[124] Desai & Dharmapala, *Earnings Management*, supra note 123, at 169; see generally Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance, and the Theory of Investment*, 48 AMER. ECON. REV. 261 (1958) (offering theorem that capital structure should be irrelevant to the value of the firm and focusing attention on transaction cost factors that must explain structuring decisions). More recent finance papers explore firm-level characteristics that explain varied responses to regulatory incentives. See, e.g., Julie H. Collins, Douglas A. Shackelford & James H. Wahlen, *Bank Differences in the Coordination of Regulatory Capital, Earnings, and Taxes*, 33 J. ACCT. RES. 263, 289 (1995) ("Evidence presented in this paper supports the proposition that, despite their common production functions, banks vary in their ability and/or willingness to respond to capital, earnings, and tax incentives. In our sample, bank homogeneity is rejected consistently for capital and earnings management and in some cases for tax management.").

liability, however, is optional in the sense that corporate managers may avoid tax liability by restructuring transactions. Such transactions often involve structures that obfuscate the underlying economic substance of the transaction from the taxing authorities, and such obfuscation simultaneously shields other rent-extraction activities managers might engage in, such as earnings management.[125]

Mihir Desai and Dhammika Dharmapala highlight this tension between agency costs and tax avoidance strategies. Because managers can use complex transactions to simultaneously reduce taxes and extract rents from shareholders, they often capture a share of the tax savings—or all of it and then some—for themselves, rather than passing all the savings along to shareholders.[126] Tax avoidance strategies thus can actually reduce firm value by allowing managers to manipulate the share price or otherwise extract rents. Where managers have high-powered long-term equity incentives, better aligning their interests with shareholders, they tend to engage in fewer tax avoidance strategies than managers without such incentives.[127] In firms with strong corporate governance characteristics, however—where agency costs are low—managers can engage in more aggressive tax avoidance strategies without making shareholders nervous. High levels of institutional ownership, for example, predict an increase in firm value from tax avoidance strategies, controlling for other effects.[128]

Other empirical work in the finance literature shows that agency costs affect the profitability of tax avoidance. Michelle Hanlon and Joel Slemrod, for example, find that the stock price decline associated with tax avoidance is smaller for firms that have good governance (consistent with the idea that for these firms tax avoidance is less likely to trigger concerns about managerial rent-

[125] Desai & Dharmapala, *Earnings Management*, supra note 123, at 172. See also Mihir A. Desai & Dhammika Dharmapala, *Corporate Tax Avoidance and High Powered Incentives*, 79 J. FIN. ECON. 145 (2006) (describing earnings management and tax avoidance at Dynegy) (hereinafter Desai & Dharmapala, *Incentives*); Mihir A. Desai, *The Degradation of Corporate Profits*, 19 J. ECON. PERSP. 171 (2005) (describing similar strategies at Tyco and Parmalat); Mihir A. Desai, Alexander Dyck & Luigi Zingales, *Theft and Taxes*, J. FIN. ECON. 591 (2007) (describing international evidence of the synergy between tax avoidance and earnings management).
[126] Desai & Dharmapala, *Incentives*, supra note 125.
[127] Desai & Dharmapala, *Incentives*, supra note 125.
[128] Mihir A. Desai & Dhammika Dharmapala, *Corporate Tax Avoidance and Firm Value*, 91 REV. ECON. STAT. 537, 537-38 (2009) (using ordinary least squared regressions and instrumental variables strategy based on check-the-box regulations to find positive interaction between institutional ownership and tax avoidance).

seeking).[129] They also find that the stock price decline is steeper for firms in the retail sector, suggesting a branding interaction.[130] Similarly, Mihir Desai and James Hines have demonstrated that stock prices drop, on average, on the news that companies are expatriating, even though such news presages a reduction in worldwide tax liability.[131]

While it is clear that agency costs should constrain regulatory arbitrage, the extent to which it actually does constrain arbitrage is unclear. Agency costs do constrain some arbitrage; empirical work has shown that privately-held firms engage in more tax avoidance than public firms,[132] that family-owned firms with minority shareholders engage in less tax avoidance than firms with lower agency cost constraints,[133] and that private firms backed by private equity firms engage in more tax avoidance than management-owned private firms.[134] At the same time, many firms continue to engage in aggressive tax avoidance and other regulatory arbitrage even when it reduces firm value. It may be the case that the manager's private gains from engaging in tax avoidance—say, by manipulating accounting income at the same time to increase the short-term value of executive pay—proves irresistible even when shareholders bid down the value of the stock in the long run.

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[129] Michelle Hanlon & Joel Slemrod, *What Does Tax Aggressiveness Signal? Evidence from Stock Price Reactions to News About Tax Shelter Involvement*, J. Pub. Econ. (forthcoming).

[130] Id.; see also Fleischer, *Brand New Deal*, supra note 36.

[131] Mihir A. Desai & James R. Hines, Jr., *Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions*, 55 NAT'L TAX J. 409 (2002).

[132] M. Penno & D. Simon, *Accounting Choices: Public versus Private Firms*, 13 J. Bus. Fin. & Accounting 561 (1986); Anne Beatty & David Harris, *The Effects of Taxes, Agency Costs and Information Asymmetry on Earnings Management: A Comparison of Public and Private Firms*, 4 REV. ACCT. STUD. 299, 301 (1998) (finding that low-tax rate private banks realize more gains than high-tax rate banks, but finding no similar difference for public banks); K. Klassen, *The Impact of Inside Ownership Concentration on the Trade-Off Between Financial and Tax Reporting*, 72 ACCT. REV. 455 (1997) (firms with more concentrated ownership engage in more tax avoidance), M. Mikhail, *Coordination of Earnings, Regulatory Capital and Taxes in Private and Public Companies*, 1999 (working paper) (private vs. public insurance companies).

[133] S. Chen, X. Chen, Q. Cheng and T. Shevlin, *Are Family Firms More Tax Aggressive than Non-family Firms*? (working paper) (2008).

[134] Brad Badertscher, Sharon P. Katz & Sonja Olhaft Rego, *The Impact of Private Equity Ownership on Corporate Tax Avoidance* (working paper on file with the author) at 4; id. at 5 ("Our results suggest that on average, majority-PE backed firms pay 15 cents less income tax per dollar of pretax income than other privately-held firms, even after controlling for losses and debt tax shields.").

Information Costs and Counterparty Risk. Regulatory arbitrage strategies increase information costs. Each party must invest the time and effort to understand the structure and communicate with relevant stakeholders, such as customers, employees, and shareholders. Structures that use derivatives introduce new counterparty credit risk to the transaction, and the parties must assess this risk by acquiring information about the counterparty and monitoring the creditworthiness of the counterparty.[135]

The effect of information costs on regulatory arbitrage is best observed in low-information-cost environments. Recent work by Alex Raskolnikov illuminates how social norms can facilitate tax planning.[136] Loan syndication is a useful example. When loans are syndicated, hedge funds often form part of the loan syndicate. But the funds want to avoid being treated as originators of the loan for tax purposes; being in the business of loan origination would make the source of the income taxable income associated with a U.S. trade or business rather than a secondary market purchase that falls within the securities trading safe harbor.[137] From a business perspective, the hedge funds would like to acquire the loan tranches as soon as the loan is made.[138] In order to reduce taxes, however, the funds wait a couple of days. The hedge funds have no legally enforceable obligation to the bank originating the loan, but an informal tax-driven norm developed between the banks and the hedge funds: "unless something really catastrophic or unexpected happens in the intervening forty-eight hours, the hedge funds will buy, and the lead banks will sell, the loan participations on the same terms they would have accepted at the loan's origination."[139]

Raskolnikov describes similar tax-driven norms related to variable pre-paid forward contracts[140] and equity swaps.[141] In each case, the development of the tax-driven norm relies on repeat play, easy dissemination of accurate information, and a credible

[135] See Michael Knoll, *Put-Call Parity and the Law*, 24 CARDOZO L. REV. 61 (2002); Frank Partnoy, *Enron and Derivatives*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=302332; Peter H. Huang & Michael S. Knoll, *Corporate Finance, Corporate Law & Finance Theory*, 74 S. CAL. L. REV. 175 (2000)
[136] Raskolnikov, *Norms*, supra note 25.
[137] Id. at 616-17.
[138] Id. at 617.
[139] Id. at 618.
[140] Id. at 614-15.
[141] Id. at 618.

threat of informal sanctions.[142] These features, commonly associated with social norms, support the broader point that an environment with lower transaction costs facilitates aggressive regulatory planning. An unknown hedge fund with no-name counsel would not be invited into the loan syndicate, or it would have to enter into a forward contract to acquire the loans.

In a related paper, Raskolnikov shows how many risk-based tax rules can be avoided by substituting counterparty risk for market risk.[143] The wash sale rules, for example, prevent a taxpayer from taking a loss on securities that are repurchased within thirty days.[144] The idea is that the risk of a change in the market price of the security will serve as a friction to deter tax-motivated selling and repurchasing. But a taxpayer might avoid this market risk by selling the securities to a friend with an unwritten and legally unenforceable understanding that the friend will sell the securities back at the same price a month later.[145] Obviously, this strategy can only be accomplished if you have a friend—someone unlikely to engage in strategic behavior towards you—willing to take the other side of the trade.

Raskolnikov considers under what conditions counterparty risk might serve as a more effective friction than market risk. My point here is a smaller, descriptive one: These relational tax planning strategies are most effective for those with the lowest counterparty risk. Counterparty risk, in turn, depends on Coasean transaction costs such as asymmetric information and the risk of opportunistic behavior.[146]

Opacity Costs. Opacity costs are a subset of information costs associated with more complex avoidance strategies. Opacity costs generally limit the number of arbitrage techniques a company can employ. The horizontal double dummy structure, for example, is a commonly used merger structure that allows acquirers to offer more than 60% boot in a merger transaction without triggering gain recognition to target shareholders who receive stock. But the structure requires the creation of a new holding company and corporate structure. The changes are largely cosmetic, but implementing the changes can be time-consuming for internal personnel and confusing to both internal and external constituents.

[142] Id. at 621.
[143] Raskolnikov, *Relational Tax Planning*, supra note 25, at 1183.
[144] I.R.C. § 1091; Raskolnikov, *Relational Tax Planning*, supra note 25, at 1184.
[145] Raskolnikov, *Relational Tax Planning*, supra note 25, at 1184.
[146] Id. at 1185.

And so while the double dummy structure is popular, it is rarely used multiple times by the same acquirer.

There is no economy of scale in engaging in multiple regulatory avoidance strategies. Enron provides the paradigmatic example. As Enron repeatedly set up off-balance sheet securitization vehicles to exploit a gap between the accounting rules and the underlying economics of the transactions, the company eventually collapsed under the weight of its own gamesmanship. The accumulation of arbitrage strategies made it impossible for internal executives, let alone outside shareholders, to grasp the overall picture.

Opacity costs should be a significant constraint against excessive arbitrage. At the same time, the empirical story here is less compelling than transaction cost economics would predict. Shareholders don't seem to be as concerned about opacity as they probably should be. Enron had a long run before it collapsed. Similarly, the proliferation of mortgage-related securitizations and credit default swaps imposed enormous opacity costs, yet shareholders allowed financial institutions to stack derivative trades higher and higher, unaware of (or ignoring) the increased risk of bankruptcy.

Still, for many small businesses, opacity costs appear to be a powerful constraint. Venture capital-backed startups, for example, are normally organized as corporations rather than as partnerships for tax purposes, even though partnerships would appear to minimize tax liability. While much of the preference for the corporate form can be explained by legal constraints and institutional considerations that make the tax losses less valuable than they would appear on the surface, another factor is the complexity associated with operating a new business in partnership form. If a start-up is organized as a partnership, every equity holder becomes a partner in the business. One can replicate the economics of corporate stock options with partnership options or profits interests in the partnership, but maintaining capital accounts quickly becomes overwhelming for a small business, and the tax consequences can be murky.[147]

[147] See Raskolnikov, *Norms*, supra note 25, at 672 ("These uses of reputational capital are inefficient. Considerations that have nothing to do with maximizing the expected value of the contractual relationship skew the optimal allocation of formal and informal enforcement mechanisms. Apparently, the tax benefits exceed the costs of suboptimal contracting.").

3. Professional Constraints

Suppose now that a lawyer has identified an alternate method of achieving the business purpose of the deal which reduces regulatory costs. Assume the new structure is more aggressive and carries some risk that regulators will attack the transaction. The client, cognizant of the risk, prefers the more aggressive structure. The two alternatives are close substitutes economically and strategically, the transaction costs can be managed easily, and no additional statutory or anti-abuse constraints apply. The aggressive structure is, in the judgment of the lawyer, legal; if challenged in court, it would most likely stand up. Are there still reasons why the aggressive structure might not be adopted?

The question almost seems quaint. But there are still reasons, under some circumstances, why "perfectly legal" planning strategies are not executed. These constraints tend to blur together in the minds of the lawyers involved, but for ease of exposition, I separate these constraints into three categories: professional constraints, ethical constraints, and political constraints. Professional constraints are obligations specific to lawyers. These are not legal mandates or ABA guidelines, but rather institutional constraints that follow from being a member of the legal profession and a partner at a law firm. Ethical constraints, by contrast, are personal moral obligations specific to lawyers as individuals, separate from any professional or institutional pressures. Finally, political constraints are pressures not to proceed with the planning strategy separate from any legal, professional, ethical or moral concern.

Professional constraints are primarily driven by law firms' desire to build and preserve reputational capital. As increasing amounts of legal work move to in house legal teams, offshore legal services providers and outsourced temporary attorneys, law firms compete vigorously for work at the regulatory frontier, where the relevant statutes and regulations provide no easy answers. To capture this lucrative work, a firm must have the reputation for providing the right answer, not just the answer that any one client wants to hear. Firms with reputational capital are more respected by regulators; when individual partners with especially strong reputations bless a structure, it can have the effect of sprinkling holy water on the transaction. Knowledgeable clients are willing to pay premium billing rates for this advice. Elite law firms are concerned with maintaining the firm's reputation and maximizing the firm's billable rates, and partners monitor each other to make sure that the firm's reputational capital isn't blown on a transaction that crosses the line.[148]

The economic rents derived from reputational capital are strongest where the law is most complex and uncertain—the regulatory frontier. As one lawyer put it, "Clients don't pay me $900 an hour to tell them that they can do what it says in the regulations."[149] Rather, sophisticated clients seek counsel and judgment when there is no published guidance. What matters is knowing the market practice,[150] the industry lore, and having the ability to exercise sound professional judgment about whether a deal "works." Only large law firms that can call on a wide variety of specialized expertise can provide this service effectively. Knowledge of industry norms gives a lawyer an edge in negotiations, as it puts a party seeking to depart from those norms on the defensive.[151] Knowing market practice was also described, however, as a key element to regulatory planning. "Market practice is important in transactions that have something new," explained one tax lawyer.[152] He offered financial instruments as an example. "You had no tax rules at first. Firms that had a lot of that practice would talk to each other, figure out the rules." Only firms that practiced regularly in the gray area, where there was no published guidance had the confidence and expertise to offer credible advice to clients.[153]

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[148] See Scott Baker & Kimberly D. Krawiec, *The Economics of Limited Liability: An Empirical Study of New York Law Firms*, 2005 U. ILL. L. REV. 107, 148 (discussing concern with maintaining reputational capital)

[149] Interview #3.

[150] Interview #6. (Primary value is "knowing market practice. Knowing the going rates for management fees, knowing how expenses are being whacked up, how people are thinking about industry terms.")

[151] The implicit assumption among lawyers is that when the business principals negotiated the deal, the principals assumed that the industry standard terms would apply to the transaction.

[152] Interview #1.

[153] Thus the emphasis in law firm marketing materials on "cutting-edge" deals. "The greater the uncertainty in the area, explained one tax lawyer, "the more important the market practice." Interview #1. Firms that have extensive practices in areas where the law is less settled and/or exceedingly intricate—capital markets, banking, and telecommunications come to mind—can develop a comparative advantage over other law firms. Similarly, in house counsel rarely sees enough deal flow to develop expertise. Practitioners point to having the expertise to structure deals in the "gray area" (i.e. without definitive written regulatory guidance, cases or rulings) as a critical element of what they bring to the table. Closely related is the access to regulators and the power of persuasion that experts in the field can provide. This structuring savvy is sometimes offered as an anecdotal explanation for why clients are willing to pay lawyers higher and higher fees. Explained an investment banker:

Preserving this reputational capital can deter firms from getting too aggressive.[154] But there are several reasons why these professional constraints have less bite today.

Opinion shopping. First, clients increasingly use multiple law firms as outside counsel, which can lead to "opinion shopping" and other pressures to take aggressive regulatory positions.[155] There is pressure on lawyers to read the relevant regulations in a manner that favors their client and will help the deal close.[156] Every lawyer I spoke with acknowledged some degree of pressure that made it difficult to exercise sound professional judgment, although no one admitted to crossing the line. In the old days, clients tended to rely on a single firm as outside counsel for most deals. This is less true today. "Clients now use 100 different law firms. You have to fight for every piece of business."[157] Clients sometimes exert pressure explicitly by threatening to take business elsewhere.[158] But other forms of pressure are more subtle. Clients also exert pressure by pointing to what other lawyers have advised.[159]

> Here's one data point. In London, a few lawyers are billing 1000 pounds an hour [over $2000 an hour at the time]. They are all tax lawyers. The premia flow to the specialists. It's not the negotiating skill, the identifying and allocating business risks that comes with experience. It's the structuring.

Interview #4.

[154] See Canellos, supra note 22, at 56 ("Practitioners who have a reputation for knowledge and experience in real transactions are, needless to say, given a warmer reception [by the I.R.S.] than those who are less well known or are known for participating in tax shelter or other aggressive transactions.").

[155] Patrick Schmidt, LAWYERS AND REGULATION: THE POLITICS OF THE ADMINISTRATIVE PROCESS 195-96 (2005) (discussing limited influence of lawyers on regulatory compliance culture); Ronald J. Gilson, *The Devolution of the Legal Profession: A Demand Side Perspective*, 49 MARYLAND L. REV. 869, 900-01 (1990) (add paren).

[156] Marc Galanter & William Henderson, *The Elastic Tournament: A Second Transformation of the Big Law Firm*, 60 STAN. L. REV. 1867, 1907-13 (2008) (describing elastic tournament, marked by lateral mobility, as straining ethical decisions by large law firm partners).

[157] Interview #6.

[158] More often the pressure is implicit. "You're not generally beholden to a client, but it can happen occasionally. Usually the pressure is much more subtle. It's wanting to make people happy. Desire to please." Interview #4.

[159] Interview #4.; "Then there's the Peter Canellos syndrome. [Canellos is a well-regarded tax lawyer at Wachtell.] You give the advice, and the client responds, 'well, I'm surprised, because X says it works.' Even if Peter didn't say that. The client says 'Peter is a smart guy. If he says it works, how can he be wrong?'" Interview #1. "When that happens, I feel the squeeze, but I'm not going to give somebody an opinion I'm not comfortable with. It might give me some real pause—why can this guy give the opinion if I can't?" Interview #1.

Internal Pressure. Second, significant pressure can arise within the law firm. Corporate lawyers, focused on getting the deal done, are not always fascinated by the intricacies of the Internal Revenue Code or the Investment Company Act. Furthermore, deals develop momentum, and it can be daunting for a tax lawyer or securities lawyer to step in and halt a deal with dozens of people working on it.[160]

Decline of lockstep. Third, a shift away from lockstep compensation among law firm partners gives lawyers an increased financial incentive to be aggressive. Financial incentives influence lawyers' willingness to take aggressive positions. The largest New York firms tend to be compensated lock step or within a narrow band. This takes away "the greed incentive."[161] The elite firms focus on building and maintaining long-term reputational capital; there's no incentive to be aggressive because you don't want to "screw the golden goose."[162] Furthermore, a few firms are still general partnerships, which add the possibility of putting partners' personal assets at risk.[163]

Most law firms, however, have evolved towards the Eat What You Kill model, where compensation is tied in significant ways to the amount of business a partner generates.[164] Even tax partners, who were traditionally thought of as service providers to the corporate partner, feel increasing pressure to create a book of

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[160] "Pressure also comes from the desire to close the deal that you started. Sometimes the facts change as the deal progresses. The ownership structure may shift subtly, or a client may shed some of the economic risk associated with holding a security." "Does it force people to cross the line? No. But there's more risk when they close the deal than when they started. A corporate lawyer will come in and say, "Are you really telling me that we can't close?" In a gray area, maybe it's hard to say that you can't close the deal." Interview #4. "Do corporate lawyers pressure you? Absolutely. The first thing the corporate lawyers says is "Really? Is this a real problem or are you just being an old lady about this?" Corporate lawyers push to find out just how much better it is from a tax perspective. As a tax lawyer, to the extent you have to change the deal, you act with restraint. They're going to ask why. And you have to explain it in technical terms. And you need credibility." Interview #1.

[161] Interview #5. See also interview #7. ("Firms are more aggressive when they are not on lockstep. People are looking for the business.").

[162] Interview #5.

[163] Interview #2. ("We're also a general partnership. This keeps us more conservative in our advice. LLPs may have reputational capital, but there's a difference between reputational capital and putting your personal assets at risk.").

[164] Milton C. Regan, Jr., EAT WHAT YOU KILL: THE FATE OF A WALL STREET LAWYER 7 (2004) ("Partners continue to compete for compensation, status, and job stability on an ongoing basis, with their ability to generate revenues serving as the primary scorecard."); Galanter & Henderson, supra note 156.

business.[165] "There's an incentive to make more money," one lawyer explained, "to get into the grayer area."[166] The financial incentive isn't likely to turn good lawyers into scofflaws, but may shape subconscious decisions and temperament.[167]

Lateral mobility. Fourth, a robust lateral partner market increases financial incentives to be aggressive in order to build a portable book of business. Traditionally, elite law firms promoted from within.[168] As competitive pressures have increased, lateral mobility has increased, as firms seek to acquire lawyers or practice groups with expertise in lucrative fields.[169] Lawyers at the top of the game have a powerful economic incentive to move laterally and capture the economic benefits of their expertise.[170] On a darker note, law firms are more likely to fire underperforming partners.[171] Preserving the reputational capital of one's firm may appear less compelling if one's future with the firm is uncertain.

Changes in legal education. Fifth, changes in legal education have affected how lawyers read statutes. Several tax

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[165] "The new law firm economic model puts pressure on tax partners. You're not just a service provider anymore. You have your own clients. To get to higher levels of compensation, you need a book of business. There's pressure to think about client relationships more. When you aren't in a lockstep system, and there's a lateral partner market out there, there's more incentive to be aggressive. On the other hand, a lot of us think long-term. Why risk it?" Interview #3.

[166] Interview #4.

[167] See Regan, supra note 164; Interview #1. ("It does help if you are lockstep, or modified lockstep with gates, where everyone makes the same amount for a few years, then you go up in lockstep provided you make the hurdle at 10 years, 15 years, and so on. Because then you are always doing what's in the best interest of the firm. Without lockstep, there is still personal integrity at work, but probably you are being swayed subconsciously by the economics.")

[168] William D. Henderson & Leonard Bierman, *An Empirical Analysis of Lateral Lawyer Trends from 2000 to 2007: The Emerging Equilibrium for Corporate Law Firms* (working paper on file with the author), at 30-31 (discussing Cravath system).

[169] Regan, supra note 164, at 35 ("As one partner puts it, 'The market is changing quickly. Firms can't develop resources organically fast enough to keep up. They have to go outside to get talent." … In contrast to a generation ago, an increasingly large percentage of law firm partners are not associates who are promoted from within, but arrivals from other firms.").

[170] The financial incentive to move laterally is muted at the most elite firms, which offer high compensation that is difficult to match even by high-producing lawyers at non-lockstep firms. Cf. Henderson & Bierman, supra note 168, at 12 (noting that single tier firms have less partner lateral movement than two-tier firms); id. at 14 ("This observation suggests that highly profitable firms—most of them single-tier—are not dependent upon lateral mobility to generate high profits.")

[171] See Henderson & Bierman, supra note 168, at 14 (finding empirical evidence of "deliberate shedding of partners who are in less lucrative practice areas or are perceived as underperforming" among firms in the middle of the profitability spectrum).

lawyers felt that changes in legal education have made lawyers overly aggressive in how they interpret statutes.[172] It's difficult to overstate the importance of statutory interpretation to tax law. Transactions often fall into gaps where the Code provides no clear guidance, and practitioners must do the best they can.[173] For many years, tax lawyers practiced purposive statutory interpretation. But younger lawyers increasingly embrace literalism as a method of statutory interpretation, relying on the plain meaning of the words to justify a favorable result. When combined with the heavy doses of legal realism and critical legal theory received in law school, this creates a recipe for aggressive, self-serving statutory interpretation.[174] "Since there's no right answer anyway," one lawyer explained, "I might as well choose the most favorable meaning for my client."[175]

Many tax lawyers try to be conscientious about adhering to Congressional intent. At the same time, their interpretation is focused on the language of the statute and ancillary evidence in the regulations and legislative history, not deeper questions of public policy.[176] Furthermore, lawyers feel obligated to defer to the client's wishes, and worry that the clients may listen selectively. "Part of the problem is you just want the client to make an informed decision. You tell them 'I'm giving you a should opinion, but it's got a lot of hair on it.'"[177] But clients focus on the bottom line—it's a "should" level opinion—rather than the risks detailed in the opinion.

Drinking the Kool-Aid. Finally, specialized practice can lead to specialized norms that strike outsiders as absurd. Enron and the other corporate governance scandals of recent years have shown that lawyers can get too close to clients and lose perspective. One tax lawyer was concerned about "excessive specialization."[178]

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[172] See Joseph Bankman, *The Business Purpose Doctrine and the Sociology of Tax*, 54 SMU L. REV. 149 (2001).

[173] "The only real constraint is what do you think Congress meant. What is the best account, using a theory of language. Otherwise it's nihilism." Interview #6.

[174] Interview #6.

[175] Interview #8. "Excessive literalism, combined with nihilism," another lawyer explained, "produces a result that's absurd. There's too much willingness to think that there's no best answer." Interview #6.

[176] Interview #3. ("I do think about whether I'm comfortable that the spirit of the law is on our side. If I write a "should" opinion, then I'm not comfortable unless the spirit of the law is there.").

[177] Interview #4.

[178] See Regan, supra note 164, at 8 ("[L]egal work continues to require more refined specialization. As a result, lawyers are likely to draw many of their norms and much of their practice culture from colleagues working in the same specialty, rather than the firm as a whole.").

There is an "element of drinking the Kool-Aid."[179] "If all you are doing is spouting market practice," he explained, you lose touch with what may be a gap between market practice and the right answer.[180] Several lawyers explained the practice of options backdating in this way.[181] A lot of lawyers "go native," one investment banker noted.[182]

Firms are aware of the pressures to be overly aggressive, and elite law firms employ several strategies to avoid overly aggressive gamesmanship and preserve their long-term reputational capital. While the lateral market is obviously more robust, many firms continue to cultivate talent internally and promote from within. Law firms continue to review legal opinions by committee, ensuring that multiple partners sign off on new structures. Some firms retain lockstep (or modified lockstep) compensation.

4. Ethical Constraints

Practitioners and academics often speak of a golden age when Wall Street lawyers served as the moral conscience of business. A sense of noblesse oblige and an absence of competitive pressure combined to produce legal advice that was conservative, sound, and mindful of the public interest.[183] Other scholars question whether such a golden age ever existed.[184]

What is clear is that today, few lawyers feel any responsibility to consider ethical questions beyond delivering

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[179] Interview #6.; see also Regan, supra note x, at 41 ("Both professional training and psychological tendencies incline many lawyers to identify strongly with their clients.").

[180] Interview #6.

[181] Interview #4. ("The first question that people ask is who else has done it. Then they ask how big are they, and what's their reputation. The problem is that it can lead to something like option backdating. People act like lemmings. If everyone is doing it, it must be okay. And regulators are less likely to do something retroactively. Most clients do not want to be first. Others like to get out front.").

[182] Interview #4. ("A lot of lawyers "go native." Tax lawyers can get too close to the client. Corporate lawyers too, who pressure tax lawyers to toe the line. In the heat of the moment, you resolve issues in favor of the client.").

[183] See Regan, supra note 164, at 30 ("As one Chase official said of Milbank partner Roy Haberkern, if something was 'legally feasible but risky, he would tell his partner that it was a dumb thing to recommend.'").

[184] See Deborah L. Rhode, *The Professionalism Problem*, 39 WM. & MARY L. REV. 283, 284 (1998) ("If ever there was a true fall from grace, then it must have occurred quite early in the profession's history.").

impartial advice to sophisticated, well-informed clients. Even if a lawyer feels ethical qualms about regulatory arbitrage—and I'm not sure I have ever met one who did—she likely views it as her responsibility to provide their clients with all the relevant legal options and to let them choose; her personal moral views are thought to be irrelevant.[185]

Most lawyers view themselves as ethically *obligated* to provide every legal alternative to their clients and to follow the client's lead. Clients, in turn, feel ethically obligated to minimize regulatory costs and maximize returns to shareholders. Expecting a lawyer to advise a client to forego regulatory cost savings because the she feels a little queasy about it is naive. While political costs, branding costs, and other factors might counsel against an aggressive regulatory strategy, the lawyers' personal morality is neither here nor there.

The kind of moral suasion employed by President Obama is thus a particularly ineffective constraint on regulatory arbitrage.[186] This is not because lawyers are bad people, but rather because they are professionals. Lawyers feel an overriding duty to their clients; their clients feel responsible to shareholders. Moreover, many lawyers feel that regulatory arbitrage opportunities, if contrary to Congressional intent, will be corrected by the political process in due course. "I don't spend a lot of time thinking about fairness and distributive justice," explained one tax lawyer. "That's not the business I'm in."[187]

5. Political Constraints

While President Obama's entreaty to bank executives was couched in moral terms, it is better understood as a political gambit—a calculated move to stake out the ethical and political high ground. Regulatory arbitrage can be constrained by political costs. Even if a planning technique is legal, executives may be concerned about the "optics" of the deal and how it will be viewed by politicians, regulators, employees, shareholders, and

[185] Several lawyers emphasized that clients shared responsibility for aggressive regulatory stances. "We're just advisors. It's like a criminal defendant's decision to take the stand – ultimately it's the client's decision. Our clients are very sophisticated consumers." He noted that many in-house tax departments are run by former New York tax partners. Interview #3.
[186] See Obama, supra note 1.
[187] Interview #3.

customers.[188] If a regulatory arbitrage technique goes too far, politicians may respond by enacting new legislation, regulators may focus more attention on the firm, and customers may take their business elsewhere. In theory, norms against retroactive legislation should minimize political constraints. But executives find wrestling with the political branches tiresome and a distraction from the core business, and political enemies can use weakness on one regulatory issue to extract gains on other issues.[189]

Lawyers I spoke with noted a difference in risk tolerance between public in private deals. In public deals, one lawyer noted, "structures are usually vetted openly by several law firms." Disclosure serves as an ethical safety valve.[190] But perhaps more importantly, in private deals, the buyer is normally a financial buyer who is laser-focused on after-tax financial returns.[191] Furthermore, as one lawyer noted, private deals have fewer people involved, and "you can make them fully informed without providing a roadmap for the regulators.[192]

Political costs are best understood in the context of corporations' long-term involvement in the political process. As Jill Fisch has explained, "corporate participation in politics extends beyond the purchase of political favors in a spot market."[193] Firms

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[188] Some have disputed whether engaging in tax avoidance activity—even aggressive tax shelter activity—is politically costly. See Joshua D. Blank, *What's Wrong With Shaming Corporate Tax Abuse*, 62 TAX L. REV. 539, 541 (2009) ("[L]ittle evidence supports the claim that publicity of a corporation's tax shelter activity would lead to ostracism of the Corporation. When the press has reported on high profile public tax shelter litigation in the past, the corporations involved have not suffered significant drops in stock price, consumer boycotts of their goods, or calls for management reform, even in cases where courts have issued resounding pronouncements in favor of the government."). is

[189] See Matthew T. Bodie, *Mother Jones Meets Gordon Gekko: The Complicated Relationship Between Labor and Private Equity*, 79 U. COLO. L. REV. 1317 (2008).

[190] Interview #9. See also interview #4. ("Is there a difference between public and private deals? Yes. The first reason is nefarious – the transparency issue. My advice is that you shouldn't do it if you wouldn't want the IRS to see it. Assume everything is known. But not everyone is like that. Second, in public deals, it's hard for a board to have a high risk tolerance. You have to talk to investors, and they don't like uncertainty. Confusion.").

[191] Interview #2. ("Creative tax planning is more common in the less public deals, the private equity deals. Especially with financial buyers, who scrutinize the after-tax result. Private deals are more aggressive. They are financial buyers, and they don't have to follow a well-trodden path. In public deals, you are usually buying the entire company. In private deals where you are buying assets, or a division, you can get much more creative.").

[192] Interview #4.

[193] Jill E. Fisch, *How Do Corporations Play Politics? The FedEx Story*, 58 VAND. L. REV. 1495, 1499 (2005).

build up political capital in a variety of ways, including soft money campaign contributions, issue ads, and lobbying expenditures.

Firms with high amounts of political capital can more easily engage in regulatory arbitrage. Lobbying takes place on a deal-by-deal basis, as I discuss in more detail below. Firms that already have relationships with relevant staffers and legislators are in a better position to manage political costs associated with the deal.

Political capital is not distributed uniformly across firms. Larger firms,[194] firms dependent on government policy,[195] diversified firms,[196] and firms with high levels of managerial slack[197] are more likely to engage in long-term, proactive political activity. At the same time, these firms with high levels of political capital may be reluctant to spend that capital to reduce regulatory costs on a particular deal.

Political costs are fluid, not fixed. One might think that regulatory agencies would be relatively immune from political pressure. After all, the lawyers who interpret agency rules at the Treasury, SEC, IRS, and elsewhere often display attributes of nonpartisanship and allegiance to the integrity of the regulatory regime they are tasked with interpreting. At the same time, though, regulated companies can lobby by dealing directly with agency lawyers, having their lawyers talk to agency lawyers, and by lobbying the legislature or executive instead of the agency to produce a shift in regulatory policy.[198] I discuss this process in more detail in Part II.C. below.

II. IMPLICATIONS

This Part II draws on the theoretical framework of regulatory arbitrage to make three additional contributions to the literature. First, in Part A below, I show how the balancing of

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[194] Amy Hillman et al., *Corporate Political Activity: A Review and Research Agenda*, 30 J. MANAGEMENT 837, 839 (2004).

[195] A. Hillman & M. Hitt, *Corporate Political Strategy Formulation: A Model of Approach, Participation and Strategy Decisions*, 24 ACAD. MANAGEMENT REV. 825 (1999).

[196] Id.

[197] M. Menzar & D. Nigh, *Buffer or Bridge? Environmental and Organizational Determinants of Public Affairs Activities in American Firms*, 38 ACAD. MANAGEMENT J. 975 (1995)

[198] Guy L. F. Holburn & Richard G. Vanden Bergh, *Influencing Agencies Through Pivotal Political Institutions*, 20 J. L. ECON. ORG. 458 (2004).

transaction costs against regulatory costs can distort regulatory competition. Counter-intuitively, this effect should lead policymakers to consider decoupling regulatory regimes from one another. Second, in Part B, I show how regulatory arbitrage shifts the incidence of regulatory costs away from firms that can best manage transaction costs. Third, in Part C, I focus more closely on how political constraints can be manipulated.

A. Regulatory Competition

The literature on regulatory competition routinely assumes that parties choose regulatory regimes in order to minimize transaction costs,[199] which, in turn, is sometimes said to create a race to the top as regulators adopt more efficient laws.[200] But the presence of regulatory arbitrage distorts the process, leading to results that are inefficient in the short run and indeterminate in the long run.

Because parties may choose to adopt a legal form either because it minimizes transaction costs or because it minimizes regulatory costs, or some combination of both, it's difficult to know whether new legal forms increase or decrease the overall efficiency of the system. When new forms are chosen because they reduce transaction costs, legal innovation presumptively increases efficiency. But when new forms are chosen because they reduce regulatory costs and increase transaction costs compared to the old structure, we lose twice: efficiency is reduced by the increase in transaction costs, and the regulatory burden is shifted onto those who cannot engage in arbitrage. Worse yet, if everyone engages in the arbitrage, all we have done is increase transaction costs with no net change in the incidence of the regulatory burden. The proper response depends on the type of regulatory arbitrage taking place. In the case of economic substance inconsistency, all that can be done is to write rules that more closely track economic substance.[201]

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[199] Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985).

[200] Ribstein & O'Hara, supra note 28.

[201] Consider the effect of the debt-equity distinction on takeovers. As noted by Robert Bartlett, corporate law has not properly accounted for the distorting effect that tax can have on acquisition financing. See Robert P. Bartlett III, *Taking Finance Seriously: How Debt Financing Distorts Bidding Outcomes in Corporate Takeovers*, 76 FORDHAM L. REV. 1975, 1999-2000 (2008) ("[H]aving a tax-efficient capital structure does not necessarily mean a bidder is capable of putting a target's assets to the most productive use."). Because financial buyers (such as private equity funds) typically includes more debt in the acquisition financing than strategic buyers, and enjoy a

In the case of doctrinal inconsistency, the way out of this dilemma is to decouple the regulatory regimes from each other. This is counterintuitive. Rather than link multiple regulatory outcomes to the choice of a single legal form, each regulatory regime should use rules that attempt, as closely as possible, to track the economic substance of deals in accordance with the policy goals of that regime. So, rather than seek conformity in the tax, securities, and accounting treatment of a given security, we might actually be better off by having each regime operate on a separate track.[202]

Regulatory convergence, in short, is no panacea. While it is helpful in reducing regulatory arbitrage opportunities based on jurisdictional inconsistency, it is actually harmful in the case of doctrinal inconsistency. International financial accounting standards, for example, reduce jurisdictional inconsistency and mitigate the incentive to relocate for accounting purposes. Book/tax conformity, on the other hand, forces firms into trade-offs that can increase transaction costs. The same frictions touted as beneficial in deterring wasteful planning manifest as increased transaction costs when the planning takes place nonetheless.

Charter Competition. First, consider the race to the top said to occur when different jurisdictions compete to serve as the seat of incorporation. Many legal systems, including the United States, define a corporation's location for internal affairs and other legal purposes according to a formalistic place of incorporation rule.[203] If managers choose a jurisdiction on the basis of the set of background legal rules that will best minimize transaction costs for the firm, then we can expect such "open access" competition to produce an efficient result. But managers do not necessarily choose a jurisdiction that minimizes Coasean transaction costs. In some circumstances, managers will opt to minimize taxes by choosing a tax haven or tax-friendly jurisdiction, even if that jurisdiction is suboptimal from the standpoint of corporate law.[204] To preserve the benefits of regulatory competition, Mitchell Kane and Ed Rock argue that we should decouple the rule that governs where a corporation is located for corporate law purposes from the

larger tax deductions as a result, legal rules that encourage boards to sell to the highest bidder are not necessarily efficient. That is, the target's assets may not stand up in the hands of the buyer who would put those assets to their most productive use. Id. The only plausible fix, I think, would be to eliminate the disparate tax treatment of debt and equity.

[202] See Walker & Fleischer, supra note 36.

[203] Mitchell A. Kane & Edward B. Rock, *Corporate Taxation and International Charter Competition*, 106 MICH. L. REV. 1229, 1235 (2008).

[204] Id. at 1230.

rule that governs where a corporation is located for tax purposes. Specifically, they argue that for corporate law purposes, a corporation should be located by reference to its nominal place of incorporation, but that for tax purposes, a corporation should be located by reference to its real seat. By decoupling the two inquiries, tax no longer distorts the choice of where to incorporate, allowing the benefits of regulatory competition to accrue, and presumably allowing for the evolution of more efficient corporate law.

More broadly, doctrinal consistency is often offered as a solution to aggressive regulatory gamesmanship. If tax and financial accounting conform, managers can game the tax system, or the accounting rules, but they cannot do both at the same time.[205] But using one regulatory system as a friction against gaming another creates real transaction costs; in the absence of a compelling political economy justification, we would be better off decoupling the two regimes and allowing each regulatory scheme to operate on its own track.

Choice of Entity. The last 30 years has seen the creation of new business entities, including the LLP,[206] LLC,[207] and L3C,[208] and new financing entities, such as the SIV,[209] CDO,[210] CDO-squared and CDO-cubed.[211] Scholars who focus on the efficiency gains from the evolution of legal forms sometimes dismiss the actual motivation for the new form, which is often a desire to reduce regulatory costs.[212] Larry Ribstein, for example, focuses on the increased use of partnership-type forms as a method of reducing agency costs.[213] But the regulatory motive behind the choice of the partnership form (avoiding the corporate tax) makes it difficult to know whether the shift increases or decreases agency

205 Daniel Shaviro, *The Optimal Relationship Between Taxable Income and Financial Accounting Income: An Analysis and a Proposal*, 97 GEO. L.J. 423, 426-27 (2009) ("Absent our two-book system … corporate executives would often be forced to choose between the earnings management goal of increasing reported income and the tax planning goal of reducing it, rather than being able, in many cases, to enjoy the best of both worlds"); Mihir A. Desai, *The Degradation of Reported Corporate Profits*, 19 J. ECON. PERSP. 171, 171 (2005).
206 Limited Liability Partnership.
207 Limited Liability Company.
208 Low-Profit LLC.
209 f/k/a the SPV or SPE. See Frank A. Partnoy, *Shapeshifting Corporations*, 76 U. CHI. L. REV. 261, 284 (2009).
210 Collateralized Debt Obligations.
211 Try explaining these in terms of minimizing transaction costs.
212 Partnoy, supra note 209, at 284-85.
213 Larry E. Ribstein, *Partnership Governance of Large Firms*, 76 U. CHI. L. REV. 289 (2009).

costs. The structure of the Blackstone IPO, discussed above, can only be viewed as a method of reducing the tax owed by Blackstone on its carried interest distributions. Its use of the partnership form increased agency costs between managers and shareholders; without Blackstone's strong governance record, the structure never would have worked. Similarly, the S ESOP structure employed by Sam Zell in the Tribune buyout can only be explained by the projected tax savings, and the fact that the principal owner and agent-manager were one and the same (Zell). In each case, it is inconceivable that the principals would have designed a similar structure in the absence of regulatory considerations.

Decoupling tax and corporate law again holds promise. In the case of unincorporated entities, the tax regulations have already partially decoupled tax from corporate law. Prior to 1996, the tax classification of an unincorporated entity turned on a multifactor test that included such corporate law attributes as limited liability, centralized management, unlimited life, and free transferability of interest. Under the check-the-box regulations, most unincorporated entities may now elect whether to be treated as a partnership or a corporation for tax purposes. We still have a corporate tax; its boundaries are now effectively enforced by the publicly traded partnership rules rather than corporate law attributes.[214] By making the tax classification of unincorporated entities elective, tax no longer distorts an entrepreneur's decision whether to organize as a limited partnership, an LLC, or whatever new entity comes next.

Executive Compensation. Both the legal and finance literature generally assume that executive compensation is designed to minimize agency costs between managers and shareholders.[215] Compensation packages evolve to better meet the shifting needs of shareholders and the executives they employ through the firm. But even accepting that general framework as correct, the regulatory treatment of different forms of compensation distorts the composition of packages offered to managers. Indeed, in the context of executive compensation design, regulatory costs appear to dominate transaction costs.

[214] Section 7704 generally treats publicly-traded partnerships as corporations for tax purposes.

[215] Some legal scholars argue that executive compensation is also designed to camouflage managerial rent extraction. See Lucian Bebchuk & Jesse Fried, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004).

For many years, the accounting rules encouraged the use of stock options. Under the old rules, stock options were not treated as an expense on the income statement, unlike cash compensation. As a result, the use of stock options increased. In 2004, the accounting rules were revised to treat the current value of stock options as an expense, and the use of options has declined.[216] In this case, by focusing the accounting rules to match more closely the economics of the instruments offer to executives rather than the form, the regulatory arbitrage opportunity was closed.

But other opportunities remain. In the private equity context, a disparity exists between the tax treatment of management fees and carried interest. This creates two distortions. First, fund managers maximize the amount of compensation received in the form of carried interest, even at the expense of increasing agency costs.[217] In some cases, agency costs limit the ability of fund managers to take full advantage of the tax subsidy for carried interest.[218] In those cases, however, fund managers can still take advantage of the second technique. In a maneuver known as a management fee conversion, fund managers who are contractually entitled to a management fee at year-end will voluntarily give up that payment in early December in exchange for a priority share of carried interest the following year.[219] While one could gin up a transaction cost minimizing explanation—carried interest better aligns the incentives of the manager and investor under some circumstances—it is well understood that the transaction is tax driven and would not take place in the absence of the tax subsidy.

Most current distortions in executive compensation are caused by economic substance inconsistency, not doctrinal inconsistency. Decoupling will not help. As with the move to expensing stock options, policymakers who want to encourage the evolution of executive compensation in a way that maximizes shareholder value should adopt regulatory rules that more closely track the underlying economics.

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216 See Walker & Fleischer, supra note 36, at 403; David I. Walker, *Evolving Executive Compensation: The Limits of Optimal Contracting*, VAND. L. REV. (forthcoming).

217 Fleischer, *Missing Preferred Return*, supra note 36.

218 Id.

219 Gregg D. Polsky, *Private Equity Management Fee Conversions*, 122 TAX NOTES 743 (2009).

B. Incidence of Regulatory Costs

Others have observed that regulatory arbitrage is only available to the wealthy and sophisticated.[220] But it is not only the expensive lawyers and bankers that make regulatory arbitrage costly. Even among the well-heeled, firms and individuals vary in their ability to manage Coasean transaction costs. Firms that can better manage transaction costs can better manage regulatory costs, shifting the burden of those regulatory costs on to those that cannot.

Seasoned firms vs. Start-ups. Entrepreneurs and start-up firms operate in an environment with high transaction costs. In the venture capital context, unique contract structures have developed to overcome the problems of extreme uncertainty, asymmetric information, and double-sided moral hazard.[221] While venture capital contract structures are reasonably effective in facilitating investment, the need to adhere to the industry standard limits the structuring choices available to entrepreneurs. As I have noted elsewhere, venture capital-backed startups are almost always organized as corporations rather than as partnerships, even though partnerships would appear to be more tax efficient.[222] One reason is that, while it is technically feasible to organize a startup as a partnership, it can be cumbersome to operate a business in this form, particularly if you want to compensate employees with options.[223] Venture capital-backed start-ups, therefore, bear a higher incidence of corporate tax then other similar ventures, such as retail franchises (often organized as sole proprietorships or LLCs) or larger, private equity-backed portfolio companies (often organized as LLCs).

Rich vs. Poor. Wealthy parties are often in a better position to plan around the rules, thus reducing their own regulatory burden at the expense of others. An entrepreneur with appreciated stock from the technology company she founded may defer paying tax on the gains by entering into a variable prepaid forward contract or making other end runs around the constructive sale

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[220] See Knoll, *Put-Call Parity*, supra note x, at 63 ("Regulatory arbitrage is unfair because the less wealthy and less sophisticated often are unable to avail themselves of the arbitrage and so only they pay the higher regulatory cost.").
[221] Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067 (2003).
[222] Fleischer, *Rational Exuberance*, supra note 36.
[223] Id.

rules.[224] A corner grocer, by contrast, would find the legal and investment banking fees associated with these same strategies prohibitive. Beyond this relatively fixed cost of legal and investment banking advice, however, the advantage of the rich depends on whether they can better manage transaction costs. There is some reason to believe that they can. Relationships can often substitute for formal contractual obligations, and the rich are more likely to have relationships with the necessary counterparties.[225]

Country mouse and city mouse. Sophisticated parties shift the incidence of regulatory costs on to the unsophisticated in several ways. First, sophisticated parties know the value of, and can easily find, elite law firms to facilitate regulatory planning.[226] Second, sophisticated parties bear lower information costs in trying to understand new strategies.[227] Third, they may have relationships with counterparties that lower information costs and agency costs. This sort of regulatory planning shifts the incidence to those who cannot engage in the planning, as well as the

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[224] Schizer, *Frictions*, supra note 25; Dana L. Trier and Lucy W. Farr, *Constructive Sales under Section 1259: The Best is Yet to Come*, in 16 TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 1217, 1223 (2002) (describing methods of reducing market risk associated with constructive sale rules); Raskolnikov, *Norms*, supra note x, at 669-70 ("Large businesses and very wealthy individuals … should be expected to look for more complicated ways of reducing their tax liabilities.").

[225] Having said that, it is somewhat speculative to argue that, absent regulatory arbitrage, the poor would be any better off. David Weisbach, for example, has argued that there is no relationship between tax avoidance and progressivity. David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 240 (2002). If tax shelters (or, presumably, tax avoidance generally) were reduced, he argues, "the extra revenue could be used to reduce other taxes on the rich." Id. at 240. See also id. at 240 ("Therefore, the distributional consequences of shelters are basically independent of the efficiency consequences."). Weisbach notes, however, that attacks on tax shelters affect the elasticity of taxable income and thus the efficiency of the tax system overall. Id. at 240. If a regulatory arbitrage technique is shut down, the rich may be in a better position to lobby Congress to create a new exception to the rules. My only claim here is the more limited one that the rich are in a better position to engage in regulatory arbitrage.

[226] See, e.g., Raskolnikov, *Norms*, supra note 25, at 669 ("”For instance, a tax lawyer without special training may be simply unable to recognize the requirement that an NPC must provide for multiple payments. … Thus, it will often take sophisticated tax experts merely to discern how a tax-driven norm works.").

[227] Raskolnikov, *Norms*, supra note 25, at 668 ("For instance, to rely on the confidentiality norm, one must be aware, at a minimum, of the disclosure requirement in the Treasury regulations. While the requirement is quite straightforward, we can hardly presume that all (or most) business-people has a working knowledge of these regulations.")

"honest/irrational members" of the group that could engage in the planning, but choose not to.[228]

The Politically Well-Connected. Finally, as I discuss in more detail below, the interpretation of regulatory rules often falls to agency lawyers and Congressional staffers. Individuals and companies that are politically well-connected can negotiate the regulatory treatment of a deal in a way that average Joes cannot.

Regulatory Nihilism. Few would attempt to justify a distribution of the regulatory burden that favors the rich, sophisticated, and politically well-connected at the expense of everyone else. Having said that, two common explanations for a laissez-faire attitude toward regulatory arbitrage should be addressed.

The first is often made by public choice theorists, who note that whether regulatory arbitrage is unjust depends on one's priors about whether regulation serves the public interest. Indeed, the question is even more complicated because the public sector doles out benefits as well as burdens.[229] The distributive consequences of regulatory arbitrage are best evaluated in light of the other side of the coin: the progressivity of the tax code, the distribution of welfare benefits, and the relative enjoyment of national security, parks, schools, and other public goods. The status quo, it might be argued, already reflects a political equilibrium that incorporates a high level of arbitrage by the firms most capable of employing those techniques. Shut down a tax loophole, and another will arise in its place.

This view of the regulatory system is too nihilistic by half. Regulatory arbitrage techniques are often unknown to policymakers and the public, and, like roaches, there are dozens hidden in the walls for each one caught in the light. In a world where information is costly to obtain, it seems unlikely that political retribution would find its intended target, or that, after the rules are changed, the political equilibrium settles in precisely the same spot as before. Market actors certainly do not behave as if they have nothing to hide.

The second argument is the argument that because regulatory arbitrage is inevitable, we shouldn't bother.[230] The

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[228] Raskolnikov, *Norms*, supra note 25, at 644.
[229] James M. Buchanan, *Externality in Tax Responses*, 33 S. ECON. J. 35 (1966).
[230] See Martin D. Ginsburg, *Making the Tax Law Through the Judicial Process*, A.B.A. J., Mar. 1984, at 74, 76 ("[E]very stick crafter to beat on the head of a

proposal to reform the tax treatment of carried interest, for example, has been met by the argument that tax lawyers will find a way around the new rules, whatever they are.[231] But legal constraints on arbitrage are, in fact, highly effective most of the time. It's just that the best rules, by effectively shutting down pointless restructuring, allow regulatory regimes to function and shift the attention of the planners and regulators alike to the next battleground.

C. The Politics of the Deal

In the simple three-party model of regulatory arbitrage (buyer, seller, government), regulatory arbitrage techniques rely on the fact that the government moves first. The government has no seat at the negotiating table; the buyer and seller plan around the statutes and regulations to minimize regulatory costs and divide the surplus. But what happens when the government moves second?

New deal structures raise novel questions of law. Statutory language is often ambiguous, and how a regulatory regime will treat a particular transaction is a question of interpretation for the lawyers and regulators involved. In such cases, the government can react to the transaction and interpret the law in such a way that denies the parties the regulatory treatment they sought. The government is still bound by precedent, of course, and it must determine the validity of a planning technique under accepted principles of statutory interpretation. Discretion is bounded, not limitless.

The government's process of interpretation is further constrained and shaped by the institutions in which the lawyers and regulators work. Agency lawyers, through their role in conveying the unwritten rules of agency interpretation, constrain (or allow) arbitrage. And the agencies themselves are political institutions, sensitive to influence by Congressional and White

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taxpayer will, sooner or later, metamorphose into a large green snake and bite the Commissioner on the hind part."), quoted in Schizer, *Sticks and Snakes*, supra, at 1341.

[231] See, e.g., David Weisbach, *The Taxation of Carried Interests in Private Equity*, 94 VA. L. REV. 715, 759 (2008) ("The exact avoidance strategies will depend on the precise legislation, if any, that is enacted, so it is difficult to make definite predictions. Nevertheless, it is clear that avoidance will be relatively easy because of the underlying theoretical problem: the difficulty of distinguishing labor and capital income.").

House staffers, private sector lobbying, academic criticism and media spin.

Under these conditions, the success of a regulatory arbitrage technique depends in part on the parties' ability to persuade regulators to accept a proposed interpretation of the statute and regulations. While this persuasion may involve the expenditure of political capital, it differs from the traditional K Street interest-group lobbying or agency capture. Deal participants spend political capital in a more focused fashion, with an eye towards ensuring the successful completion of a particular deal. My focus here, in other words, is on what happens when the regulatory treatment of a transaction becomes a negotiated deal point.

In many complex transactions, there will be some uncertainty about how the law applies. And even in cases where the application seems straightforward, friendly regulators may bend the interpretation to accommodate a particular transaction. Agency lawyers are on the front lines of interpretation. If a deal involves the issuance of securities, a hostile SEC lawyer can delay the deal for days or weeks—and time kills deals. Some deals require advance tax rulings, and IRS lawyers can make that process smooth, or not.

Sophisticated parties can create new regulatory arbitrage opportunities by influencing the interpretation of agency lawyers. This is not to say that agency lawyers are systematically captured by particular interest groups. Rather, clients employ deal counsel who can effectively use the power of persuasion, making sound and reasonable arguments to the agency lawyers involved. "The value comes from contacts," explained one securities lawyer. "Educating staffers on behalf of clients named and unnamed."[232] When a transaction poses a new issue that staffers aren't familiar with, they will call up the private sector experts for a briefing.[233]

It helps to be known as an expert in the field. Explained one tax lawyer, "Your reputation provides the credibility. Warmer reception, status. In order to properly serve your clients, you need credibility."[234] An investment banker concurred. "Access matters—some regulators get starry-eyed. You want to have guys who can go over the wall."[235] The reputation of the law firm also carries weight. Regulators will at least stop and take a deep breath

[232] Interview #9.
[233] Interview #9.
[234] Interview #1.
[235] Interview #4.

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before shutting down a transaction with the imprimatur of an elite firm. "Many regulators are most interested in not being criticized," explained one banker.[236]

Clients can exert pressure in other ways. The otherwise objective and reasonable analysis of agency lawyers can sometimes be constrained by political factors, whether from political appointees at high levels in the administration, or through congressional pressure. Agency lawyers care about the objective, theoretical question of what the law is, but they must also accommodate their supervisors' views, and they act in the shadow of what various members of Congress and their staffs might think. Just as district court judges don't like to get reversed, agency lawyers don't like to have their opinions reversed by someone higher up in the administration, or to have their views attacked by Congress, which can always change the law. Congressional staffers can shape the regulatory treatment of a deal if the deal concerns an area where the law is in flux. If a regulatory initiative would hamper a deal, having the ear of a critical Senator, such as Mr. Schumer[237] or Mr. Baucus,[238] can be critical.

The 2008 merger of Wachovia and Wells Fargo provides a paradigmatic example of deal-specific lobbying.[239] In the fall of 2008, as the credit crisis deepened, Wachovia sought out a merger partner to help it absorb staggering losses.[240] After initial discussions with Morgan Stanley faltered,[241] Wachovia courted Citigroup and Wells Fargo. Citigroup and Wachovia reached an "agreement-in-principle" backed by loss protection provided by the FDIC.[242] The deal provided that Citigroup would acquire

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[236] Interview #4.

[237] See Eric Lipton & Raymond Hernandez, *A Champion of Wall Street Reaps Benefits*, N.Y. TIMES, Dec. 13, 2008 ("Lee A. Pickard, a lawyer representing clients including the Bank of New York, whose employees have been significant donors to Mr. Schumer and other Senate Democrats, turned to Mr. Schumer last year to successfully beat back a regulatory initiative by the Securities and Exchange Commission. 'If you get Chuck Schumer on your side, you are O.K.,' he said.").

[238] See press account of Baucus stalling carried interest.

[239] I am indebted to three of my corporate tax students for their cogent analysis of this deal. See Brett Hudspeth, Jennifer Rhein & Kristen Spath, *Wells Fargo + Wachovia: Structure, Tax, and Politics* (Spring 2009 student paper, University of Illinois, on file with the author).

[240] Ben White & Andrew Ross Sorkin, *Morgan Stanley Considers Merger with Wachovia*, N.Y. TIMES, Sept. 17, 2008.

[241] Charlie Gasparino & Mary Thompson, *Morgan-Wachovia Deal is Off the Table*, CNBC, Sept. 21, 2008, http://www.cnbc.com/id/26827870.

[242] David Enrich & Dan Fitzpatrick, *Wachovia Chooses Wells Fargo, Spurns Citi*, WALL ST. J., Oct. 4, 2008, http://online.wsj.com/article/SB122303190029501925.html.

Wachovia's banking, investment banking, and wealth management businesses, leaving Wachovia as a publicly traded company with Wachovia Securities and Evergreen Asset Management as its two main operating subsidiaries.[243] While Citigroup and Wachovia struggled to resolve merger issues, Wells Fargo returned to the bargaining table with an offer to buy all of Wachovia for $15 billion.

Wells Fargo engineered its successful bid by lobbying the Treasury Department to issue a Notice changing its interpretation of section 382, which places limits on an acquiror's ability to use a target's net operating losses, or NOLs. Commentators noted that the Notice allowed Wells Fargo to shelter up to $74 billion in taxable income.[244] Citigroup, by contrast, had suffered massive losses of its own in the credit crisis, reducing its income tax liability to zero and thus reducing the potential value of Wachovia's NOLs. Wells Fargo benefited from exquisite timing. On September 29th, 2008, the House of Representatives rejected a proposed $700 billion bailout plan, sending the stock market into a nosedive. Secretary Paulson directed the Treasury to issue Notice 2008-83 the next day, thus making banks more attractive merger targets.[245] The Wells Fargo deal was announced three days later.[246] Citigroup would later secure its own favorable treatment in the form of Notice 2010-2, which allows government to unwind its $25 billion common stock investment through the Troubled Asset Relief Program without triggering an ownership change under section 382.[247]

Once deals are completed, the advantageous tax treatment is rarely overturned, even in cases where the legal argument is weak. In the case of Notice 2008-83, Congressional staffers noted that once parties have relied on a notice or similar guidance, it tends to have the effect of law.[248] Lawyers sometimes refer to the tax version

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[243] Hudspeth, supra note 239, at 5.

[244] Hudpseth, supra note 239, at 7, 21; Letter from Charles E. Grassley, Ranking Member, United States Senate Committee on Finance, to Robert King Steel, President and Chief Executive Officer, Wachovia Corporation (Nov. 18, 2008) (available at http://grassley.senate.gov/private/upload/120220082-2.pdf).

[245] See Lawrence Zelenak, *Can Obama's IRS Retroactively Revoke Massive Bank Giveaway?*, 122 TAX NOTES 889 (Feb. 16, 2009) (arguing that lack of apparent statutory authority for Notice 2008-83 would permit retroactive revocation of the notice).

[246] Hudspeth, supra note 239, at 22.

[247] See Notice 2010-2; Amy S. Elliot, Criticism of Citigroup Notice is Unfounded, Official Says, 125 TAX NOTES 1247 (Dec. 21, 2009) ("Just as some are now criticizing Treasury for supposedly issuing Notice 2010-2 to benefit Citigroup, others similarly alleged that Notice 2008-83 was tailored for Wells Fargo & Co.")

[248] See Jeremiah Coder, *Treasury Inspector General Reviewing Bank Loss Notice*, 121 TAX NOTES 884 (Nov. 19, 2008) (quoting Mark Prater, Finance minority chief tax

of the Wall Street Rule, where the IRS is viewed as having acceded to the proffered tax treatment of a deal structure once several deals using that structure have been completed.[249] Revenue Ruling 2002-31, for example, which provides favorable tax treatment for contingent convertible debt, is somewhat difficult to square with the statutory language and policy but was consistent with Wall Street practice prior to the ruling.[250]

Deal-specific lobbying is not performed by traditional lobbyists or government relations executives. Rather, the negotiation takes place lawyer to lawyer, and the private sector lawyer primarily relies on the power of persuasion, not the power of the purse. Because the questions of legal interpretation often require a thorough understanding of the underlying business deal, agency lawyers often consult with deal lawyers. This offers deal lawyers an opportunity to explain their view of the regulatory treatment of the deal in a favorable light.

Deal-specific lobbying is thus quite different from general industry group or even client-specific lobbying of K Street lawyers. It is often performed by Wall Street lawyers, or by the D.C. office of a New York firm. With so much at stake, clients value knowing how the deal will be received in D.C.[251] "Ninety percent of the work could be supplied by anyone," explained one M&A lawyer. "But the last ten percent is key. Access to lawyers, contacts, [knowing] what's new, what's the big transaction, [having a] relationship with regulators."[252]

Access to regulators is a key element to practice on the regulatory frontier. The next element is knowing what to do with the access once you have it. Part of it is knowing the market practice and developing the ability to make the most compelling arguments to regulators.[253] Regulators can be persuaded, but it is

counsel, as explaining that "The ruling is out there. Folks have relied on that. Deals have been done.", and House Ways and Means Majority Chief Tax Counsel John Buckley, "We all have personal views. It's somewhat irrelevant. I mean, they did it … I really think you have to see those regulations as at least temporarily having the effect of law.").

[249] The Treasury and the IRS, of course, disclaim the existence of any such rule, noting the limited resources of the regulators to examine every deal.

[250] See Trier & Farr, supra note.

[251] Interview #9.

[252] Interview #5.

[253] Interview #4 ("Part of it is experience. Knowing market practice Sometimes it's the attraction of a key player , an expert in tax, antitrust. Sometimes it's access to regulators. Managing regulatory risk. Making the most compelling arguments to the regulators.").

not enough just to show up and ask for a meeting. Firms often call on former regulators to reach out and get a sense of how a deal will be treated. In the Blackstone IPO, explained one investment banker, "people like Fred Goldberg gave the IRS an advance look." They "took the temperature" of the Service before proceeding with the deal.[254] The tax department of Skadden's D.C. Office is particularly well-known for its ability to play inside baseball.[255]

To address regulatory arbitrage, Congress may be tempted to expand the conditions in which the government gets to move second. Congress may write rules that give regulators broad discretion to interpret the law, or may empower regulators to act retroactively to shut down transactions that are deemed abusive in hindsight. The problem is that administrative agencies are political institutions and are responsive to political influences as well as legal precedent. As the Wachovia-Wells Fargo transaction demonstrates, expanding the role of politics in deals hinders transparency and accountability. Furthermore, because seasoned, sophisticated, well-managed firms are savvy about managing political constraints, politicizing deals hardly ensures a just distribution of regulatory burdens.

CONCLUSION

This Article has provided a theory of regulatory arbitrage that explains how regulatory arbitrage opportunities arise and what constraints firms face when considering those opportunities. As discussed above, these constraints do not affect firms uniformly. Firms that can more effectively manage the constraints can take advantage of more planning opportunities, and therefore face a lower regulatory burden than other firms.

This paper is primarily positive, focused on describing the phenomenon of regulatory arbitrage and how it works. Because not all regulatory arbitrage reduces social welfare, the paper makes no normative claims. But, of course, some regulatory arbitrage is likely to reduce social welfare, and policymakers may be interested in curbing regulatory arbitrage. If so, what lessons does this

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[254] Interview #4.

[255] Marisa McQuilken, *Skadden Posts Huge Capital Gains*, LEGAL TIMES, May 9, 2008 (discussing Skadden's "insider access" across various regulatory agencies led by Fred Goldberg, Bob Bennett, and others).

framework provide? While the prescriptive implications of this Article deserve fuller treatment in a future paper, some preliminary observations may be useful to policymakers.

First, legal constraints are often effective. It is worthwhile for lawmakers to consider likely planning responses and address obvious avoidance techniques. But because it is difficult for policymakers to anticipate and address all possible responses, some of the most effective anti-planning techniques are the "silver bullet" responses which either introduce highly effective frictions (like the passive loss rules or at-risk rules) or directly address the underlying economics, such as through rules that prohibit hedging to avoid risk-based rules.[256]

Second, there is no obvious reason why firms that can manage Coasean transaction costs effectively should bear a lower incidence of regulatory costs. It follows that broad anti-planning rules are likely to disproportionately benefit firms that face high transaction cost barriers, like new firms, entrepreneurial firms, and small business generally. By employing more effective anti-avoidance rules, the regulatory burden can be spread more evenly.

Third, policymakers should not rely on moral suasion or ethical or professional constraints on arbitrage. Lawyers have a professional obligation to help their clients manage regulatory costs, and the idea that lawyers would discourage their clients from engaging in behavior that is legal and profitable is not likely to be effective even if all lawyers were saints, which we are not.

Fourth, political costs are increasingly important as a constraint on arbitrage, making political threats against firms that engage in regulatory arbitrage a tempting political tool. But in the long run, the firms that can best take advantage of regulatory arbitrage opportunities are the very same firms that can best work the political system from the inside, lobbying legislators, staffers, and agency lawyers to preserve favorable outcomes on a deal-by-deal basis. Moreover, engaging regulatory arbitrage in the political arena rather than the legal arena undermines rule of law values such as transparency, accountability, and predictability.

In sum, enhancing legal anti-avoidance constraints, while imperfect, are likely to be a more fruitful line of attack for

[256] Raskolnikov, *Relational Tax Planning*, supra note 25, at 1241-42 (noting that traditional market-risk-based backstops "actually used today are significantly more effective than relational ones.")

policymakers. And while the staffs of Congressional committees who draft legislation already do an admirable job of addressing regulatory arbitrage where they can, it may be useful from an institutional perspective to have a few lawyers, perhaps in the Office of Information and Regulatory Affairs, the Government Accountability Office, or another agency, who were specifically tasked with reviewing legislation and anticipating planning responses, and suggesting effective modifications. Because industry responses change over time, it would be especially helpful if public-service minded private sector lawyers held this position for relatively short periods of time.