

Articles

Regulatory Arbitrage

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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

I. 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 proposal 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. “[M]any of the most influential and most highly remunerated members of the bar,” 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

1. Remarks on the Financial Crisis Responsibility Fee, 2010 DAILY COMP. PRES. DOC. 20 (Jan. 14, 2010).

2. See Dan Wilchins, *Banks, Experts Eye Possible Ways Around Obama Fee*, REUTERS (Jan. 14, 2010), <http://www.reuters.com/article/idUSTRE60D6D120100114> (describing potential ways to work around bank fees).

3. See John S. Watterson III, *Political Football: Theodore Roosevelt, Woodrow Wilson and the Gridiron Reform Movement*, 25 PRESIDENTIAL STUD. Q. 555, 559–60 (1995).

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 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 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 our

4. Theodore Roosevelt, At the Alumni Dinner of Harvard University (June 28, 1905), in *MESSAGES AND PAPERS OF THE PRESIDENTS: A COMPILATION OF THE MESSAGES AND SPEECHES OF THEODORE ROOSEVELT* 646–47 (Alfred Henry Lewis ed., 1906).

5. *Id.* at 647.

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 regulations 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) (2006).

8. See Partnoy, *supra* note 6, at 238 (explaining that derivatives trading and financial transactions can give rise to regulatory-arbitrage opportunities).

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. Bruce Bartlett, *How Excessive Government Killed Ancient Rome*, 14 *CATO J.* 287, 300–01 (1994). 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. *Id.* at 301; Aurelio Bernardi, *The Economic Problems of the Roman Empire at the Time of Its Decline*, in *THE ECONOMIC DECLINE OF EMPIRES* 16, 49 (Carlo M. Cipolla ed., 1970); see also *id.* at 57 (“[T]he revenue of the State shrivelled 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

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. 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.¹⁴ 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.¹⁵

This theory of regulatory arbitrage provides the missing link in our understanding of why deals are structured the way that they are. The

59 (“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.”); Michael S. Knoll, *The Ancient Roots of Modern Financial Innovation: The Early History of Regulatory Arbitrage*, 87 OR. L. REV. 93, 97 (2008) (tracing the roots of put–call parity, a specific regulatory-arbitrage technique, to ancient Israel and Medieval England).

10. See Remarks on the Financial Crisis Responsibility Fee, *supra* note 1 (condemning financial institutions’ reckless behavior); Roosevelt, *supra* note 4, at 646–47 (recognizing that helping clients evade regulatory law is a “highly remunerative task” for attorneys).

11. See *infra* subsection II(C)(2)(a).

12. See *infra* section II(C)(3).

13. See *infra* section II(C)(5).

14. See *infra* subpart II(B).

15. See *infra* subpart II(C).

cornerstone of academic analysis of the legal infrastructure of transactions is the principle that contracts are designed to minimize Coasean transaction costs.¹⁶ 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,¹⁷ but such explanations rarely hold up in the context of highly sophisticated parties interacting with large amounts of money at stake.¹⁸ As I show in detail below, these deals 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 (nonregulatory) efficiency. A corporation that needs cash might minimize transaction costs by entering into a secured loan but instead decides that, in order to improve the cosmetics of the balance sheet, it will enter into an economically similar transaction to securitize the assets.¹⁹ 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

16. See Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 *YALE L.J.* 239, 255 (1984) ("I suggest that the tie between legal skills and transaction value is the business lawyer's ability to create a transactional structure which reduces transaction costs and therefore results in more accurate asset pricing.").

17. Adam J. Levitin, *Priceless? The Social Costs of Credit Card Merchant Restraints*, 45 *HARV. J. ON LEGIS.* 1, 42 (2008) ("[C]onfusing credit card disclosures about these costs to consumers appear to be designed to prey on consumers' cognitive biases by not explaining the billing practices that affect the potential cost of card usage."); Kimberly D. Krawiec, *Derivatives, Corporate Hedging, and Shareholder Wealth: Modigliani and Miller Forty Years Later*, 1998 *U. ILL. L. REV.* 1039, 1062 (identifying costs of transacting with a firm's risk-averse shareholders as an explanation for costly hedging transactions); W. Bradley Wendel, *Professionalism as Interpretation*, 99 *NW. U. L. REV.* 1167, 1222–23 (2005) (identifying opacity of legal disclosure in Enron SPE transactions as a troublesome sign that should alert ethical lawyers that "something is fishy").

18. Victor P. Goldberg, *Aversion to Risk Aversion in the New Institutional Economics*, 146 *J. INST. & THEOR. ECON.* 216, 223 (1990).

19. See, e.g., Floyd Norris, *Confronting High Risk and Banks*, *N.Y. TIMES*, Dec. 11, 2009, at B1 (discussing banks' use of trust-preferred securities as "capital arbitrage" and off-balance-sheet structured investment vehicles as a manipulation of the accounting rules).

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 the reason why lawyers, not bankers, serve the role of “transaction cost engineer[.]”²⁰ Because the lawyer plays an important role in regulatory structuring, Gilson explained, “economies of scope should cause the nonregulatory aspects of transactional structuring to gravitate to the lawyer as well.”²¹ The lawyer’s facility at both tasks—engineering transaction costs and regulatory costs—“should result in more optimal trade-offs between them.”²² 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 practitioners²³—has been largely overlooked by the legal academy. The academic literature generally assumes that deals are structured to minimize Coasean transaction costs,²⁴ 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 nontax 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 constraint on tax planning.²⁵ David Schizer, Dan Shaviro, Alex

20. Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 *YALE L.J.* 239, 296–97 (1984).

21. *Id.* at 298.

22. *Id.*

23. See, e.g., Peter C. Canellos, *A Tax Practitioner’s Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters*, 54 *SMU 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.”).

24. See, e.g., HENRY HANSMANN, *THE OWNERSHIP OF ENTERPRISE* 22 (1996) (arguing that the ability to minimize transaction costs determines whether organizational forms survive); R. H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386, 396 (1937) (using transaction costs to explain the boundaries of the firm); 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 *WIS. 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.”); Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: “Sacred Space” in Corporate Takeovers*, 80 *TEXAS 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.”).

25. MYRON S. SCHOLES ET AL., *TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH* 9 (3d ed. 2005).

Raskolnikov, Mitchell Kane, Michael Knoll, and other legal scholars have since examined different ways in which frictions affect tax planning, tax avoidance, and tax evasion.²⁶ Mihir Desai, Dhammika Dharmapala, and other finance and accounting scholars have generated theoretical models and empirical evidence that dovetail with the approach of legal scholars.²⁷

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.²⁸ 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.²⁹ I discuss charter competition, choice of entity, and

26. See Mitchell A. Kane & Edward B. Rock, *Corporate Taxation and International Charter Competition*, 106 MICH. L. REV. 1229, 1254 (2008) (comparing frictions that increase social value with those that incur social costs); Michael Knoll, *Regulatory Arbitrage Using Put-Call Parity*, 15 J. APPLIED CORP. FIN. 64, 73 (2005) (describing frictions as a hindrance to tax arbitrage); Alex Raskolnikov, *The Cost of Norms: Tax Effects of Tacit Understandings*, 74 U. CHI. L. REV. 601, 639–41 (2007) [hereinafter Raskolnikov, *Cost of Norms*] (discussing how frictions may increase reliance on social or contractual norms to facilitate preferred tax treatment); Alex Raskolnikov, *Relational Tax Planning Under Risk-Based Rules*, 156 U. PA. L. REV. 1181, 1239 (2008) [hereinafter Raskolnikov, *Relational Tax Planning*] (observing that changing the type of friction might be more effective than defending the current friction type); David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312, 1315–16 (2001) (contributing a methodology for determining whether frictions exist that could prevent or inhibit end runs around tax reforms); Daniel Shavero, *Risk-Based Rules and the Taxation of Capital Income*, 50 TAX L. REV. 643, 681–83 (1995) (noting that tax rules that attach significance to economic risk—“risk-based rules”—may create nontax frictions that inhibit taxpayers from choosing a tax-favored course). Michael Knoll cleverly frames the inquiry by turning the classic theorem of Modigliani and Miller upside down, explaining that if capital structure is irrelevant under four assumptions, the failure of one of those assumptions is the only way capital structure might create value: “the only ways that capital structure can increase value are by lowering taxes, providing access to cheaper borrowing, releasing valuable information, or improving cash flow.” Peter H. Huang & Michael S. Knoll, *Corporate Finance, Corporate Law and Finance Theory*, 74 S. CAL. L. REV. 175, 179 (2000).

27. See *infra* section II(C)(2).

28. Schizer, *supra* note 26, at 1329–30 (“[P]ursuit of the tax reducing strategy may require an organizational form that is less effective at constraining agency costs . . .”).

29. 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 (2000) (“Individuals and firms who have an incentive to minimize

executive compensation to show 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.

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 other firms 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 policy makers are so inclined. Any normative claim I might make about regulatory arbitrage necessarily depends on broader theories of regulation and public choice that go beyond the scope of this Article. While regulatory arbitrage is often privately beneficial and socially wasteful, 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. Regulation driven by interest-group

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 and fewer people and transactions.”).

lobbyists³⁰ or rent-seeking politicians³¹ may 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 summon 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 policy makers is a framework that identifies the conditions under which arbitrage occurs and what constraints, if employed, are likely to be effective.

This Article is organized in two main parts. Following this Introduction, Part II synthesizes theoretical and empirical findings from the finance and tax-planning literatures to set forth a theory of regulatory arbitrage. Subpart II(A) draws on interviews I conducted with lawyers to provide a richer description of the lawyer's role in regulatory arbitrage. Subpart II(B) describes the necessary conditions for regulatory arbitrage. Subpart II(C) describes the various constraints on arbitrage: (1) legal constraints, (2) Coasean transaction costs, (3) professional constraints, (4) personal ethical constraints, and (5) political constraints.

Part III explores three implications of this framework. Subpart III(A) examines how regulatory arbitrage can distort regulatory competition. Subpart III(B) examines the effect of regulatory arbitrage on the incidence of regulatory costs. Subpart III(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

30. See, e.g., George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3, 5 (1971) (arguing that an industry will support regulation that excludes others from entering).

31. See, e.g., Fred S. McChesney, *Rent Extraction and Interest-Group Organization in a Coasean Model of Regulation*, 20 J. LEGAL STUD. 73, 81 (1991) (contending that politicians can extract contributions by pursuing regulation); Fred S. McChesney, *Rent Extraction and Rent Creation in the Economic Theory of Regulation*, 16 J. LEGAL STUD. 101, 102 (1987) (contending that politicians can extract contributions by pursuing regulation).

32. For a general discussion of the positive effects of avoiding regulation through the choice of law, see ERIN A. O'HARA & LARRY E. RIBSTEIN, *THE LAW MARKET* (2009). O'Hara and Ribstein argue, "[Choice-of-law] clauses enable parties to protect themselves from state regulation that imposes costs in excess of its benefits to society." *Id.* at 8.

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.

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 2001–2003, co-teaching the Deals course with

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

II. 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

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 seek a random sample, I chose to interview lawyers at top firms in New York with whom I had a preexisting 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 N.Y.U. L. REV. 440 (2009) (examining how tax exemption for sovereign-wealth funds affects sovereign investment in U.S. financial institutions); Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1 (2008) (examining how tax treatment of carried interest differs from that of other forms of compensation); Victor Fleischer, *The Missing Preferred Return*, 31 J. CORP. L. 77 (2005) [hereinafter Fleischer, *Missing Preferred Return*] (examining how tax treatment of carried interest partially explains the absence of preferred-return hurdles in venture capital funds); Victor Fleischer, *Options Backdating, Tax Shelters, and Corporate Culture*, 26 VA. TAX REV. 1031 (2007) [hereinafter Fleischer, *Options Backdating*] (exploring the relationship between weak internal controls and regulatory noncompliance); Victor Fleischer, *The Rational Exuberance of Structuring Venture Capital Start-ups*, 57 TAX L. REV. 137 (2004) [hereinafter Fleischer, *Rational Exuberance*] (discussing how legal and business constraints explain the seemingly tax-inefficient structure of start-ups); David I. Walker & Victor Fleischer, *Book/Tax Conformity and Equity Compensation*, 62 TAX L. REV. 399 (2009) (examining how tax and accounting rules affect executive compensation design).

37. For a nontax example explaining the structure of the MasterCard IPO as an example of regulatory arbitrage in the antitrust context, see Victor Fleischer, *The MasterCard IPO: Protecting the Priceless Brand*, 12 HARV. NEGOT. L. REV. 137, 148–49 (2007).

38. See Gilson, *supra* note 20, at 243–44 (advancing the theory that business lawyers increase the value of their clients' transactions); see also Nestor M. Davidson, *Values and Value Creation in Public-Private Transactions*, 94 IOWA L. REV. 937, 942 (2009) (examining how transactional lawyers involved in public-private partnerships create value by advancing public policy goals in addition to minimizing transaction costs); George W. Dent, Jr., *Business Lawyers as Enterprise Architects*, 64 BUS. LAW. 279, 281 (2009) (evaluating the value-creating activities business lawyers perform outside of the mergers and acquisitions context); Steven L. Schwarcz, *Explaining the Value of Transactional Lawyering*, 12 STAN. J.L. BUS. & FIN. 486, 487–88 (2007) (suggesting that transactional lawyers create value in ways other than simply reducing transaction costs).

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 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

39. In an 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, 272–74 (John C. Coffee, Jr. et al. eds., 1988). Professors Gilson, Scholes, and Wolfson argued,

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 costs to becoming informed that result in information asymmetries and create the potential for problems of moral hazard and adverse selection.

Id. at 272. They continued,

Empirically, we observe 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.

Id. at 273–74.

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 seismic events. I think when it gets confused, it kind of runs home to Mama.”).

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 that 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.

1. *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 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.⁴⁴

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 the deal. The lawyers will consider alternative structures that may produce regulatory-cost savings, and they may suggest modifications to the deal structure.⁴⁵ If those modifications increase transaction costs, the lawyers may suggest further changes to manage those costs.

43. E.g., David M. Schizer, *Sticks and Snakes: Derivatives and Curtailing Aggressive Tax Planning*, 73 S. CAL. L. REV. 1339, 1350 (2000) (summarizing the conditions under which the planning option is valuable to taxpayers).

44. See *id.* at 1349–50 (referencing the costs associated with tax avoidance).

45. 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

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."⁴⁶ Lawyers often describe the process of structuring or planning as guiding their clients through the regulatory maze or "morass."⁴⁷ 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.

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.⁴⁸ The economic relationship between the parties may or may not fit neatly into the "little boxes" that the legal rules have in mind.⁴⁹ And there may be multiple legal forms that 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.⁵⁰ 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 among 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.⁵¹ 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-

guy?" I take what he wants to do and try to come up with the most tax-efficient structure.

Interview with Lawyer 1, in N.Y.C. (Sept. 12, 2007).

46. Interview with Lawyer 2, in N.Y.C. (Sept. 12, 2007).

47. Interview with Lawyer 3, in N.Y.C. (Sept. 12, 2007).

48. See generally Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5 (2000) (describing a common law doctrine that requires nontax economic substance to qualify for favorable tax treatment).

49. Cf. Herwig J. Schlunk, *Little Boxes: Can Optimal Commodity Tax Methodology Save the Debt-Equity Distinction?*, 80 TEXAS L. REV. 859, 863–73 (2002) (analogizing tax treatment for commodities to grouping dissimilar types of fruit into a finite number of "little boxes").

50. Treas. Reg. § 301.7701-3 (as amended in 2006).

51. See Peter H. Huang, *A Normative Analysis of New Financially Engineered Derivatives*, 73 S. CAL. L. REV. 471, 477 (2000) (discussing the benefits of financial engineering).

negotiation model is fundamentally flawed.⁵² 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."⁵³ Through a tax 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."⁵⁴

Regulatory arbitrage is a professional skill specific to lawyers, as it involves the exercise of professional lawyerly judgment under conditions of uncertainty.⁵⁵ 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.⁵⁶ Lawyers must have the ability not just to identify possible analogies but also to distinguish good analogies from bad ones.⁵⁷

52. One lawyer explained, "There are three parties at the table, the buyer, the seller, and the IRS." Interview with Lawyer 1, *supra* note 45. Another stated, "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." Interview with Lawyer 4, in N.Y.C. (Sept. 12, 2007).

53. Interview with Lawyer 4, *supra* note 52. 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. *Id.* The joke rings true because so many of the arguments about which party should bear a particular business risk are old hat. See JAMES C. FREUND, ANATOMY OF A MERGER: STRATEGIES AND TECHNIQUES FOR NEGOTIATING CORPORATE ACQUISITIONS 269–72 (1975) (discussing representations and warranties); Gilson, *supra* note 20, at 250–51 ("In a world in which assets are valued according to any version of capital asset pricing theory, there is little role for business lawyers. Because capital assets will be priced correctly as a result of market forces, business lawyers cannot increase the value of a transaction."). Once the purchase price has been set, negotiating the scope of representations and warranties, indemnities, and other contractual provisions becomes a tiresome zero-sum game. See FREUND, *supra*, at 229 (positing that such provisions tend to become a "nit-picker's delight, a forum for expending prodigious amounts of energy in debating the merits of what sometimes seem to be relatively insignificant items").

54. Interview with Lawyer 3, *supra* note 47 ("A big percentage of what I do is guiding the client to structure operations and transactions to minimize the tax leakage.").

55. 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 you \$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.

Id.

56. The lawyer further stated,

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

2. *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 disclosure obligations and indemnities to regulatory risks.⁵⁸ 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.⁵⁹ 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.⁶⁰

in situations that aren’t covered by direct authority, it’s “what’s the analogy.” This is like x, or this is like y.

Id.

57. 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 with Lawyer 1, *supra* note 45.

58. 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, 305–06 (1995) (highlighting attorneys’ role in gathering, assembling, and interpreting data that becomes the “informational bundle” used to value a company).

59. Regulatory expertise, standing alone, is not what clients are looking for. Rather, the “value comes from synthesizing issues related to different disciplines.” Interview with Lawyer 5, in N.Y.C. (Sept. 11, 2007). Lawyers have an “information transmission” role. *Id.* The firm provides a coordinated team effort that cannot be supplied by multiple firms. *Id.* 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.” *Id.* Another added,

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.

Interview with Lawyer 3, *supra* note 47.

60. 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 with Lawyer 3, *supra* note 47.

Corporate lawyers tend to emphasize deal management as the reason that clients hire them. “We provide turnkey service,” one partner explained.⁶¹ “Bring this transaction here and it will close. Whatever issues there are, it will close.”⁶² The corporate lawyer running the deal is at the center of the hub of activity, calling on others for whatever expertise might be needed.⁶³ Other lawyers emphasize the sheer size of the large firms, which allows for a greater number of specialists.⁶⁴ 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 time frame to allow the deal to close.⁶⁵ Elite law firms also provide an intangible value to the deal through the traditional role of having a calm and rational, “lawyerly” demeanor.⁶⁶

Empirical comparison of the value created for the client through each of these lawyerly functions—regulatory arbitrage, transaction-cost engineering, and quarterbacking the deal—is difficult.⁶⁷ Professor Steven Schwarcz has looked to survey data to support the view that regulatory arbitrage drives value creation,⁶⁸ but further empirical research would be helpful. The

61. Interview with Lawyer 1, *supra* note 45.

62. *Id.*

63. 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.” *Id.*

64. *E.g.*, Interview with Lawyer 2, *supra* note 46; Interview with Lawyer 4, *supra* note 52.

65. Interview with Lawyer 1, *supra* note 45.

66. 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.” Interview with Lawyer 6, in N.Y.C. (Sept. 11, 2007). “Sometimes it’s the lawyer’s traditional role of being the calm and rational one.” *Id.* Clients do not 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. *Id.* While others could, in theory, provide this service, it continues to be lawyers who provide it. 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 do not necessarily require a law degree. *Id.*

67. Anecdotally, one can identify several law firms that seem to have leveraged regulatory expertise to bolster their transactional practice. McKee Nelson, which started out as a tax boutique in Washington, D.C., leveraged its regulatory expertise into a thriving capital markets practice. Nathan Carlile, *McKee Nelson: The Richest Guys in Town*, LEGAL TIMES (Aug. 13, 2007), <http://www.law.com/jsp/nlj/PubArticleNLJ.jsp?id=900005488500&slreturn=1&hbxlogin=1> (describing how McKee built its capital markets practice in New York). 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 D.C.-based firm. *Id.* 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. See *Schulte Roth & Zabel*, EXCITE, http://www1.excite.com/home/careers/company_profile/0,15623,1149,00.html (summarizing the growth of the firm). Below, I discuss Skadden Arps, which uses an extensive network of contacts in D.C. to complement its always-strong transactional practice in New York. See *infra* subpart III(C).

68. See Steven L. Schwarcz, *To Make or Buy: In-House Lawyering and Value Creation*, 33 J. CORP. L. 497, 561 (2008) (disclosing survey data tending to indicate increasing reliance on in-house

problem is that measuring the activity is exceedingly difficult.⁶⁹ 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 oncologist who kept the cancer from returning.⁷⁰ 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 “[t]he simultaneous purchase and sale of the same, or essentially similar, security in two different markets for advantageously different prices.”⁷¹ 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; or
- An asset with a known price in the future trades at a price that differs from its future price discounted to present value.⁷²

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.⁷³

counsel for their superior knowledge of “regulatory, organizational, and operational issues that impact the company’s transactions”).

69. Cf. Raskolnikov, *Relational Tax Planning*, *supra* note 26, 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.”).

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

71. WILLIAM SHARPE & GORDON J. ALEXANDER, *INVESTMENTS* 795 (4th ed. 1990).

72. See ZVI BODIE ET AL., *INVESTMENTS* 325 (8th ed. 2009) (explaining the law of one price).

73. See Ronald J. Gilson & Reineir H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 554–55 (1984) (observing that arbitrage opportunities disappear when prices fully reflect all available information, as is the case in efficient markets). 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

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.⁷⁴

a. 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.

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

asset on the market 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. See Roberta Romano, *A Thumbnail Sketch of Derivative Securities and Their Regulation*, 55 MD. L. REV. 1, 13–14 (1996) (explaining how a futures contract holder may profit from a difference between the spot-market price and the futures-contract price at the time that the contract expires).

74. See, e.g., 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).

become stale, failing to keep up with the development of new financial products and innovative financial techniques.⁷⁵

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 that are treated differently for tax purposes and bank regulatory purposes. In a typical structure, the bank issues securities that have enough debt-like attributes to qualify as debt for tax purposes while still qualifying as Tier 1 capital for bank regulatory purposes.⁷⁶ 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.⁷⁷ Other examples include other debt–equity hybrid securities (debt for tax purposes versus equity for accounting purposes) and securitization vehicles (loan for tax purposes versus sale for bankruptcy purposes and accounting purposes).⁷⁸

The 2007 IPO of the Blackstone Group, a private equity firm, provided a high-profile example of the arbitrage of two different regulatory regimes.⁷⁹ The Blackstone IPO used an innovative structure to go public, selling limited partnership units to investors rather than common stock.⁸⁰ The arbitrage involved an inconsistency between the tax code and the Investment Company Act of 1940.⁸¹ For tax purposes, Blackstone retained partnership tax status, preserving the advantageous tax rate on carried interest and avoiding corporate-level tax.⁸² 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.⁸³ For tax purposes, then, Blackstone ensured that most of its income was passive investment income in the form of dividends, interest, and capital gains, setting up a blocker corporation to help

75. See *infra* text accompanying notes 79–87.

76. See Schizer, *supra* note 26, at 1338 n.85 (describing how banks lobbied the Federal Reserve to allow tax-deductible trust-preferred securities to qualify as Tier 1 Capital).

77. See *id.* at 1338 (“[T]ough regulatory treatment ensures the solvency of regulated institutions . . .”).

78. Jalal Soroosh & Jack T. Ciesielski, *Accounting for Special Purpose Entities Revised: FASB Interpretation 46(R)*, CPA J., July 2004, at 30, 30, available at <http://www.nysscpa.org/printversions/cpaj/2004/704/p30.htm>.

79. See Susan Beck, *The Transformers*, AM. LAW., Nov. 2007, at 94, 94 (describing Blackstone structure and similar structure first employed by Fortress Investment Group); Victor Fleischer, *Taxing Blackstone*, 61 TAX L. REV. 89, 99–101 (2008) (describing the regulatory arbitrage of Blackstone structure).

80. Fleischer, *supra* note 79, at 95.

81. *Id.* at 99–104.

82. *Id.* at 101.

83. *Id.*

transform its active fee income into passive dividends.⁸⁴ 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.⁸⁵ 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.⁸⁶

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,⁸⁷ a decision that allows Delaware law to govern the internal affairs of the corporation.⁸⁸ 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 location of the corporation's economic activity and the location of its legal 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.⁸⁹ 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.⁹⁰

84. *See id.* at 102 (describing a blocker entity as “an LLC that elects to be treated as a corporation and pays entity-level tax” and noting that Blackstone used such an entity as part of its regulatory arbitrage).

85. *Id.* at 102.

86. *See id.* at 104 (“Blackstone performs *active* services for 1940 Act purposes but remains *passive* for tax purposes.”). Some political lobbying also helped. *See infra* section II(C)(5) (describing typical uses of lobbying). 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. Fleischer, *supra* note 79, at 100–01. 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.

87. *See* Frederick Tung, *Before Competition: Origins of the Internal Affairs Doctrine*, 32 J. CORP. L. 33, 42 (2006) (“Delaware is the leading supplier of corporate charters for publicly traded companies in the United States.”).

88. *See id.* at 39 (“The internal affairs doctrine is a choice of law rule . . . that selects the law of the incorporating state to govern disputes over the corporation's internal affairs.”).

89. 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 firm's ownership remains the same after the reincorporation. I.R.C. § 7874(b) (2006). 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*, BLOOMBERG (Sept. 18, 2009), <http://www.bloomberg.com/apps/news?pid=21070001&sid=aaWcVXTC4SLw> (reporting that Treasury officials were aware of materials promoting such transactions).

90. Mihir A. Desai & James R. Hines, Jr., *Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions*, 55 NAT'L TAX J. 409, 416, 421–22 (2002).

Congress enacted legislation in 2004 to discourage reincorporations,⁹¹ 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.⁹² For example, if Airbus, a French company, builds a plane and leases it to American Airlines for ninety-nine 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.⁹³

b. 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.⁹⁴

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.⁹⁵ To get around the tax, some foreign investors will instead enter into a total-return swap with an investment bank.⁹⁶ 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

91. American Jobs Creation Act of 2004, Pub. L. No. 103-357, § 801(a), 118 Stat. 1418, 1562–63 (codified at I.R.C. § 7874 (2006)).

92. See Claire A. Hill, *Is Secured Debt Efficient?*, 80 TEXAS L. REV. 1117, 1128 n.46 (2002) (defining a “double dip transaction” in the leasing context).

93. Diane M. Ring, *One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage*, 44 B.C. L. REV. 79, 112–13 (2002) (analyzing a similar hypothetical transaction).

94. For an example in the consumer context describing restructuring of two-to-four week payday loans into twenty-week “installment loans” to avoid state regulation, see Nathalie Martin, *Payday Lending Legislation From the Ground Up: A Customer’s View of What Works and What Doesn’t* 20–21 (Jan. 24, 2010) (unpublished manuscript) (on file with Texas Law Review). 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 GEO. 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).

95. I.R.C. § 871(a) (2006).

96. See Jeffrey M. Colón, *Financial Products and Source Basis Taxation: U.S. International Tax Policy at the Crossroads*, 1999 U. ILL. L. REV. 775, 823 (discussing the popularity of total-return swaps as a tool for foreign investors to avoid withholding tax).

applied.⁹⁷ Similarly, hedge funds have used swaps to avoid disclosure obligations under the Williams Act or to hijack corporate proxy voting.⁹⁸

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 employee stock ownership plan, or ESOP.⁹⁹ 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.¹⁰⁰ Finally, because Zell would not hold common stock in the Tribune until he exercised the options, he instead entered into a voting agreement that effectively gave him control over the company and its board.¹⁰¹ 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.¹⁰²

c. 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 2011.¹⁰³ While

97. See Anita Raghavan, *Happy Returns: How Lehman Sold Plan to Sidestep Tax Man: Hedge Funds Use Swaps to Avoid Dividend Hit; IRS Seeks Information*, WALL ST. J., Sept. 17, 2007, at A1 (detailing why no withholding tax is applied).

98. See, e.g., Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625, 640–42 (2008) [hereinafter Hu & Black, *Empty Voting II*] (describing how hedge funds use swaps); Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 816–17 (2006) [hereinafter Hu & Black, *Empty Voting I*] (giving an example of how swaps enable empty voting).

99. 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, 551–52 (2009).

100. *Id.* at 552.

101. See Richard Siklos, *For Zell, More Tribune Hell*, CNNMONEY.COM (Sept. 22, 2008), http://money.cnn.com/2008/09/19/magazines/fortune/zell_suit_siklos.fortune/index.htm (stating that the transaction put Zell in “effective control” of the company).

102. See Knoll, *supra* note 99, at 554 (“[T]he S ESOP blocks the Tribune’s tax consequences from being passed through to the participants until they withdraw their assets.”). The Tribune filed for bankruptcy in 2008. Michael J. de la Merced, *Tribune Files for Bankruptcy*, DEALBOOK (Dec. 8, 2008), <http://dealbook.blogs.nytimes.com/2008/12/08/tribune-files-for-bankruptcy/>. 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.

103. Marshall Loeb, *Estate-tax Uncertainty Will Drag for a While*, MARKETWATCH (Sept. 13, 2010), <http://www.marketwatch.com/story/estate-tax-uncertainty-will-drag-for-a-while-2010-09-13>.

legislators have pledged to reenact the tax retroactively to the beginning of 2010,¹⁰⁴ there is considerable uncertainty about whether this will occur, what exemption levels might be, and what rates would apply.¹⁰⁵ From a planning perspective, it would be convenient to die in 2010.¹⁰⁶ 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.

In an infamous paper, Joel Slemrod and Wojciech Kopczuk illustrated that death is elastic; it responds to incentives.¹⁰⁷ Slemrod and 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.¹⁰⁸ The precise cause is uncertain. Some people appear to will themselves to hang on a bit longer.¹⁰⁹ Heirs may shape life support decisions to minimize taxes.¹¹⁰ It is also possible that the results demonstrate “not a real death elasticity, but instead ex post doctoring of the reported date of death to save on taxes.”¹¹¹

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.¹¹² In a typical backdating scenario, imagine that a CFO verbally

104. *Id.*

105. *Id.*

106. For example, it has been reported that former New York Yankees owner George Steinbrenner saved his heirs an estimated \$500 million by dying in 2010. Brad Hamilton & Jeane Macintosh, *Death's Perfect Timing: Saves Kin Half-Bil in Taxes*, N.Y. POST (July 14, 2010), http://www.nypost.com/p/news/local/death_perfect_timing_NusLyGIMu8cn8kyepprVJP.

107. Wojciech Kopczuk & Joel Slemron, *Dying to Save Taxes: Evidence from Estate Tax Returns on the Death Elasticity*, 85 REV. ECON. & STAT. 256 (2003).

108. *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%”).

109. *Id.* at 257 (“Altruistic individuals should consider adjusting the timing of their death if by so doing it will benefit their heirs.”).

110. *Id.* (“Decisions about prolonging the life of a critically ill person (e.g., regarding whether to continue with life support) are often made not by the dying person but by others, including the potential heirs themselves.”).

111. *Id.* at 264.

112. 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) (explaining pre-2005 GAAP rules). “Section 162(m) limits the corporate deduction for non-performance-based compensation paid to certain senior executives to \$1 million per year” but counts at-the-money stock options (but not in-the-money options) as performance-based pay. *Id.* at 569; see also, e.g., I.R.C. § 162(m)(1) (2006); Fleischer, *Options Backdating*, *supra* note 36 at 1039–42 (discussing the tax consequences of options backdating).

accepted a job with an Internet company on 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 treatment¹¹³), 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, and the SEC investigated dozens more¹¹⁴—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.

Original Issue Discount (OID) bonds provide 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 developed

113. See Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges Former Chairman and CEO of Brooks Automation in Stock Option Fraud (July 26, 2007), available at <http://www.sec.gov/news/press/2007/2007-146.htm> (accusing the CEO of Brooks Automation of approving "the issuance to company executives and employees of stock options that were backdated to earlier dates on which the stock's market price was lower").

114. See *Spotlight on Stock Options Backdating*, U.S. SECURITIES AND EXCHANGE COMMISSION, <http://www.sec.gov/spotlight/optionsbackdating.htm> (July 19, 2010) (collecting press releases, criminal complaints, speeches, testimony, and letters related to options backdating going back to 2006); see also, e.g., Press Release, Dep't of Justice: U.S. Attorney S. Dist. of N.Y., Former Chief Financial Officer of Safenet, Inc. Charged in Connection with Backdating of Stock Options (July 25, 2007), available at <http://www.justice.gov/usao/nys/pressreleases/July07/argosafenetindictmentpr.pdf> (describing a particular indictment in the options-backdating enforcement).

a financial product—an OID bond—that paid no nominal interest.¹¹⁵ 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, ten 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 rules¹¹⁶ in the tax code.¹¹⁷

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.¹¹⁸ 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, and how it should be accounted for and to monitor the security. The swap introduces new counterparty credit risk to the transaction—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.

115. See SCOTT BESLEY & EUGENE F. BRIGHAM, *ESSENTIALS OF MANAGERIAL FINANCE* 226 & n.7 (14th ed. 2008) (describing OID bonds, equating them with zero coupon bonds, and noting their development by Salomon Brothers in the early 1980s).

116. I.R.C. §§ 1271–75 (2006).

117. See Peter C. Canellos & Edward D. Kleinbard, *The Miracle of Compound Interest: Interest Deferral and Discount After 1982*, 38 *TAX. L. REV.* 565, 568–70 (1983) (comparing the 1982 changes to earlier regulation of OID bonds).

118. See Gunter Dufey & Florian Rehm, *An Introduction to Credit Derivatives* 4 (Univ. of Mich. Bus. Sch., Working Paper No. 00-013, 2000), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=249155 (describing a total-return swap).

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.

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,¹¹⁹ many planning techniques are variations on a theme: move nominal ownership of the asset in the hands of the party that can incur 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—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

119. See Hu & Black, *Empty Voting I*, *supra* note 98, at 823–24 (explaining how ownership of the economic returns from stock shares can easily be decoupled from full ownership, which includes voting rights, through the use of derivatives).

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 “antiabuse” 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.

a. Rifleshot Antiavoidance Rules.—Many regulatory statutes have “rifleshot” antiavoidance rules in the statutory text.¹²⁰ 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.¹²¹ Section 710 would not change the tax treatment of a general partner’s actual financial investment in the partnership; such investments could still generate capital gains or losses.¹²² 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 in the fund.¹²³ 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 that would treat debt-financed investments in the partnership by general partners as if it were carried interest.¹²⁴

Many corporate tax sections have a familiar structure designed to both grant relief to appropriate transactions and curb abusive transactions. Against the backdrop of a broad realization rule that defines any “sale or other disposition” as a taxable event,¹²⁵ several Subchapter C provisions grant relief from the broad rule by designating transactions as nonrecognition

120. See, e.g., I.R.C. § 1(g) (2006) (providing that the unearned income of certain children is taxed as if it was their parents’ income in order to prevent families from shifting unearned income to their children and lowering the total amount of tax paid by the family); I.R.C. § 102(c) (2006) (providing that amounts given to employees by employers cannot be excluded from gross income as gifts so as to prevent employers from characterizing employee compensation as gifts).

121. H.R. 1935, 111th Cong. § 2 (2009) (proposed § 710(a)(1)(A)).

122. *Id.* (proposed § 710(c)(2)(A)).

123. David J. Herzig, *Carried Interests: Can They Effectively Be Taxed?*, 4 ENTREPRENEURIAL BUS. L.J. 21, 26–27 (2009) (explaining the congressional intent behind § 710 as wanting to prevent individuals from using the capital gains tax rate on the functional equivalent of carried interest).

124. H.R. 1935 § 2 (proposed § 710(c)(2)(D)).

125. I.R.C. § 1001 (2006).

events.¹²⁶ These nonrecognition rules, however, can lead to creative tax planning that goes beyond what Congress intended.¹²⁷ And so Congress has enacted additional rules that limit planning techniques.

Section 351(a), for example, allows for nonrecognition when a shareholder contributes property to a corporation, if the shareholder receives only stock in exchange and controls the corporation immediately after the exchange.¹²⁸ Section 351(b) provides limited relief for boot received in the exchange.¹²⁹ 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.¹³⁰ 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 that 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 antiplanning constraint on the use of redeemable debt-like "nonqualified preferred stock."¹³¹ Similar riflshot rules can be found in the reorganization rules, spin-off rules, and distribution rules.¹³²

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.¹³³ 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.¹³⁴ Similarly, Rule 506 of Regulation D under the Securities Act of 1933 establishes safe harbor rules for a private-offering exemption. Rule 506 limits

126. *See, e.g.*, I.R.C. §§ 351, 354 (2006) (granting certain exceptions to the broad rules governing realization events).

127. *See* Raskolnikov, *Relational Tax Planning*, *supra* note 26, at 1194–95 (discussing the "drop-and-sell" sequence many taxpayers use to avoid taxation).

128. I.R.C. § 351(a).

129. *Id.* § 351(b).

130. Rev. Rul. 2003-51, 2003-21 C.B. 938.

131. I.R.C. § 351(g) (preventing the application of the § 351(a) nonrecognition provision if the transferor receives nonqualified preferred stock).

132. *See, e.g., id.* § 306 (dictating the tax treatment of the disposition of certain kinds of stock); *id.* § 355 (controlling the distribution of stock and securities of a controlled corporation); *id.* § 368 (setting out narrowly tailored definitions related to the tax treatment of corporate reorganizations).

133. 15 U.S.C. § 80a-3(c)(1) (2006).

134. *See* 15 U.S.C. § 80a-3(c)(1)(A) (providing the general rule that a company is normally treated as a single person but also providing exceptions if a company owns 10% or more of the voting securities of an investment company and the 10% owner is an investment company or would be but for the 3(c)(1) or 3(c)(7) exceptions to the Investment Company Act).

such offerings to thirty-five nonaccredited investors but looks through entities that were formed for the specific purpose of purchasing the securities offered.¹³⁵

b. Shotgun Antiabuse Rules.—Broader “shotgun” antiabuse 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.¹³⁶ Other rules use sweeping antiabuse language to prevent arbitrage.¹³⁷

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.¹³⁸ In the typical tax shelter, a wealthy doctor, dentist, lawyer, or small-business owner would invest in a partnership that borrowed money and purchased depreciable property, like an alpaca farm.¹³⁹ 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.¹⁴⁰ 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.¹⁴¹

Section 469 is effective because it introduces a new friction, active participation in the venture, that changes the attractiveness of the investment. The basic individual tax shelter is to take two economically similar transactions—doing nothing versus investing in a tax shelter—and exploit the different tax treatment (nothing versus phantom tax losses). Introducing the requirement of active participation means that the two are no longer economic close substitutes. Spending ten 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,

135. 17 C.F.R. § 230.506 (2010).

136. *See, e.g.*, I.R.C. § 469 (2006) (limiting passive-activity losses and credits); I.R.C. § 1091(a) (2006) (disallowing a loss deduction for a wash sale of stock of securities); I.R.C. § 1260 (2006) (governing the treatment of gains from constructive-ownership transactions).

137. *See, e.g.*, I.R.C. § 269(a) (2006) (empowering the Secretary of the Treasury to disallow deductions, credits, or other allowances from certain transactions by any person or corporation where the “principal purpose” of the transaction was “avoidance of Federal income tax”).

138. C. EUGENE STEUERLE, *THE TAX DECADE: HOW TAXES CAME TO DOMINATE THE PUBLIC AGENDA* 33 (1992).

139. *See, e.g.*, Stanley S. Surrey, *Federal Income Tax Reform: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Government Expenditures*, 84 HARV. L. REV. 352, 404–05 (1970) (describing a similar tax-shelter transaction in the real-estate context).

140. *Id.* at 405.

141. I.R.C. § 469.

however generated. Marvin Chirelstein and Lawrence Zelenak have proposed a similar approach to the corporate-tax area: their rule would disallow all noneconomic losses not clearly contemplated by Congress.¹⁴² Similarly, code provisions that basket together certain types of income and deductions can be highly effective at reducing arbitrage.¹⁴³ 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 ineffective¹⁴⁴ and fall into disuse.¹⁴⁵

c. General Antiabuse Rules.—General statutory antiabuse rules are statutory rules designed to curb regulatory arbitrage without any particular transaction or strategy in mind. Countries and regions as diverse as Canada, Australia, Sweden, Hong Kong, and Germany employ a general antiavoidance rule (sometimes known as a GAAR), which provides that when a transaction is an avoidance transaction, the tax consequences will be re-determined to deny the tax benefit that would otherwise result from the transaction.¹⁴⁶ General antiavoidance rules are thought by many to be a useful tool to combat abusive transactions but, because of challenges in interpreting and applying the rules, are hardly a panacea.¹⁴⁷

Neither the United States nor the United Kingdom has a general statutory antiabuse rule.¹⁴⁸ The U.S. partnership tax rules, which are notoriously complex, contain an antiabuse regulation promulgated by the Treasury that targets tax shelters and other transactions which abuse the partnership form.¹⁴⁹ The regulation is narrower than it first appears, however,

142. Marvin A. Chirelstein & Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939, 1951–61 (2005).

143. *E.g.*, I.R.C. § 163(d) (2006) (limiting the interest deduction allowed for investment interest); *id.* § 183 (2006) (limiting the deductions allowed for activities “not engaged in for profit”); see Leandra Lederman, *A Tisket, A Tasket: Baskets and Corporate Tax Shelters*, 88 WASH. U. L. REV. (forthcoming 2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1639557 (describing “basketing” as occurring in code provisions in which “particular types of deductions are grouped with the same type of income and are only allowed to be deducted to the extent of that income”).

144. See Robert J. Peroni, *A Policy Critique of the Section 469 Passive Loss Rules*, 62 S. CAL. L. REV. 1, 3–4 (1988) (arguing that section 469 generates “tremendous costs to the federal income tax system in terms of economic inefficiency, inequity, and complexity”).

145. See Charles I. Kingson, *The Foreign Tax Credit and its Critics*, 9 AM. J. TAX POL'Y 1, 6 n.14 (1991) (noting that section 269 is “becoming senile with disuse”).

146. Graeme S. Cooper, *International Experience with General Anti-Avoidance Rules*, 54 SMU L. REV. 83, 84 (2001); Tim Edgar, *Building a Better GAAR*, 27 VA. TAX REV. 833, 836 (2008); Benjamin Alarie, *Trebilcock on Tax Avoidance*, 60 U. TORONTO L.J. 623, 624–25 (2010).

147. Cooper, *supra* note 146, at 85 (“[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.”).

148. The United Kingdom, like the United States, relies on existing judicial antiavoidance doctrines. Cooper, *supra* note 146, at 89.

149. Treas. Reg. § 1.701-2(b) (1995).

and is widely viewed as having failed in its goal of curbing tax shelters that use the partnership vehicle.¹⁵⁰

While the United States has no general antiavoidance 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.¹⁵¹ Congress recently codified the economic-substance doctrine, which reduces some of the uncertainty associated with unpredictable judicial application.¹⁵² But practitioners question whether a codified economic-substance doctrine would reach the intended target; they express similar skepticism about whether an antiabuse rule would be effective.¹⁵³

Scholarship on regulatory arbitrage—whether related to tax avoidance, derivatives regulation, or telecommunications—tends to focus on the limitations associated with legal constraints.¹⁵⁴ Rifleshot approaches are reactive and difficult to draft effectively. Shotgun approaches may be overinclusive. Broad antiabuse 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.¹⁵⁵ 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.¹⁵⁶ The income tax, in other words, would be

150. Andrea Monroe, *What's in a Name: Can the Partnership Anti-Abuse Rule Really Stop Partnership Tax Abuse?*, 60 CASE W. RES. L. REV. 401, 407 (2010).

151. Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5, 5 (2000).

152. Health Care and Education Affordability Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409(a), 124 Stat. 1029 (to be codified at I.R.C. § 7701(o)).

153. See Interview with Lawyer 1, *supra* note 45 (“An anti-abuse rule may not change things. If you are a responsible practitioner, you are applying it in your head anyway.”).

154. See, e.g., SCHOLLES ET AL., *supra* note 25, at 137 (emphasizing rules and regulations applicable to arbitrage); see generally Knoll, *supra* note 26 (explaining how the put-call parity theorem has been used to circumvent legal restrictions); Howard E. Abrams, *Special Report: A Close Look at the Carried Interest Legislation*, 117 TAX NOTES 961 (2007) (exploring proposed code section 710 and the gaps in its coverage).

155. See Edgar, *supra* note 146, at 874 (noting the under inclusiveness of judicial antiavoidance doctrines with respect to transactional substitution techniques); Lederman, *supra* note 143 (accepting that basketing may be over inclusive but finding this preferable to the economic substance doctrine, which is subject to manipulable motive and purpose inquiries).

156. Joseph E. Stiglitz, *Some Aspects of the Taxation of Capital Gains*, 21 J. PUB. ECON. 257, 259 (1983).

optional—if it were not for the heroic assumption about perfect capital markets.¹⁵⁷ As every deal lawyer knows, countless brilliant plans that reduce regulatory costs on paper have been discarded because of some real-world problems related to transaction costs. In 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 is 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*.¹⁵⁸ Scholes and Wolfson outline how market frictions impede taxpayers’ ability to undertake tax arbitrage.¹⁵⁹ 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.¹⁶⁰ David Schizer imported these insights into the legal literature and elaborated on the Scholes and Wolfson framework in an article suggesting that lawmakers think consciously about frictions as a constraint on tax planning.¹⁶¹

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 transaction costs. Doing so allows us to better understand why many deal structures fail to minimize transaction costs

157. 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.

158. SCHOLES ET AL., *supra* note 25, at 9 (“By *frictions*, we mean transaction costs incurred in the marketplace that make implementation of certain tax planning strategies costly.”). The textbook, first published in 1992, synthesizes much of Scholes’s and Watson’s earlier scholarship on tax arbitrage. *See, e.g.*, Myron S. Scholes & Mark A. Wolfson, *The Effects of Changes in Tax Laws on Corporate Reorganization Activity*, 63 J. BUS. S141, S144 (1990) (finding evidence of increased reliance on management buyouts and going-private transactions designed to reduce transaction costs, thereby enabling tax benefits to be realized in a larger number of deals); 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).

159. SCHOLES ET AL., *supra* note 25, at 138–39.

160. *Id.* at 155–76.

161. Schizer, *supra* note 26, at 1314–17.

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.

a. 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.¹⁶² A similar dynamic constrains 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.¹⁶³

Recent contributions to the finance literature establish that agency costs influence whether tax-avoidance strategies will be employed.¹⁶⁴ The foundational papers in finance, such as the Modigliani and Miller capital structure irrelevance theorem,¹⁶⁵ treat taxes as an unavoidable exogenous environmental factor.¹⁶⁶ Tax 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.¹⁶⁷

162. See ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT 144 (2000) (describing investor panic after the Russian debt default in 1998); Shleifer & Vishny, *supra* note 74, at 36–37 (describing the source of constraints in financial arbitrage).

163. Enron was the extreme example. Its use of off-balance sheet securitization vehicles, which arbitrated 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 constrain planning in the short run but worked in the long run, bankrupting the company before the accounting rules were changed.

164. For a recent literature review, see generally Mihir A. Desai & Dhammika Dharmapala, *Earnings Management, Corporate Tax Shelters, and Book-Tax Alignment*, 62 NAT'L TAX J. 169 (2009).

165. See generally Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958).

166. Desai & Dharmapala, *supra* note 164, at 169. More recent finance papers explore firm-level characteristics that explain varied responses to regulatory incentives. See, e.g., Julie H. Collins et al., *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.”).

167. Desai & Dharmapala, *supra* note 164, at 172; see also Mihir A. Desai & Dhammika Dharmapala, *Corporate Tax Avoidance and High-Powered Incentives*, 79 J. FIN. ECON. 145, 146–47 (2006) [hereinafter Desai & Dharmapala, *Incentives*] (introducing a model to understand “what

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.¹⁶⁸ 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.¹⁶⁹ But in firms with strong corporate-governance characteristics—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.¹⁷⁰

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 seeking).¹⁷¹ They also find that the stock price decline is steeper for firms in the retail sector, suggesting a branding interaction.¹⁷² Similarly, Mihir Desai and James Hines have demonstrated that stock prices sometimes drop on the news that companies are expatriating, even though such news presages a reduction in worldwide tax liability.¹⁷³

While it is clear that agency costs should constrain regulatory arbitrage, the extent to which they actually do constrain arbitrage is unclear. Agency

induces firms and managers to engage in transactions exclusively designed to minimize taxes”); Mihir A. Desai, *The Degradation of Corporate Profits*, 19 J. ECON. PERSP. 171, 179–82 (2005) (describing similar strategies at Tyco and Parmalat).

168. Desai & Dharmapala, *supra* note 164, at 183–84.

169. Desai & Dharmapala, *Incentives*, *supra* note 167, at 177.

170. See Mihir A. Desai & Dhammika Dharmapala, *Corporate Tax Avoidance and Firm Value*, 91 REV. ECON. STAT. 537, 537–38 (2009) (using a regression analysis and instrumental-variables strategy based on check-the-box regulations to find a positive and statistically significant relationship between institutional ownership and tax avoidance).

171. Michelle Hanlon & Joel Slemrod, *What Does Tax Aggressiveness Signal? Evidence from Stock Price Reactions to News About Tax Shelter Involvement*, 93 J. PUB. ECON. 126, 135–36 (2009).

172. *Id.*; see also Victor Fleischer, *Brand New Deal: The Branding Effect of Corporate Deal Structures*, 104 MICH. L. REV. 1591, 1616–20 (2006) (suggesting that although Steve Jobs’s cash salary of one dollar has positive incentive-based corporate governance implications, the precise dollar amount of the salary is “best explained by its branding effect” as an example of the positive, symbolic branding effect of certain corporate-deal structures).

173. See Mihir A. Desai & James R. Hines, Jr., *Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions*, 55 NAT’L TAX J. 409, 423 (2002) (analyzing the drop in Stanley’s stock price at the time of its expatriation announcement as an example of stock prices dropping on these announcements).

costs do constrain some arbitrage; empirical work has shown that privately held firms engage in more tax avoidance than public firms,¹⁷⁴ that family owned firms with minority shareholders engage in less tax avoidance than firms with lower agency-cost constraints,¹⁷⁵ and that private firms backed by private equity firms engage in more tax avoidance than management-owned private firms.¹⁷⁶ At the same time, many firms continue to engage in aggressive tax avoidance and other regulatory arbitrage even when it reduces firm value.¹⁷⁷ 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.

b. 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.¹⁷⁸

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.¹⁷⁹ Loan syndication is a useful example. When loans are syndicated, hedge funds often form part of the loan syndicate.¹⁸⁰ But the funds want to avoid being treated as originators of the loan for tax purposes; loan origination makes the source of the income taxable as income associated with a U.S. trade or business rather

174. See, e.g., Kenneth J. Klassen, *The Impact of Inside Ownership Concentration on the Trade-Off Between Financial and Tax Reporting*, 72 ACCT. REV. 455, 456 (1997) (finding that firms with more concentrated ownership engage in more tax avoidance); Michael B. Mikhail, *Coordination of Earnings, Regulatory Capital and Taxes in Private and Public Companies* 1 (May 1999) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=165010 (“[P]ublic companies leave tax benefits on the table while private companies do not.”).

175. Shuping Chen et al., *Are Family Firms More Tax Aggressive than Non-family Firms?*, 95 J. FIN. ECON. 41, 60 (2010).

176. Brad Badertscher, Sharon P. Katz & Sonja Olhoft Rego, *The Impact of Private Equity Ownership on Corporate Tax Avoidance* 3 (Harvard Bus. Sch. Acct. & Mgmt. Unit, Working Paper No. 1338282, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1338282 (“[W]e find that PE-backed firms pay 14.2 percent less income tax per dollar of adjusted pre-tax income than non-PE-backed private firms. . .”).

177. See Hanlon & Slemrod, *supra* note 171 (reporting stock price declines associated with tax avoidance).

178. See Colleen M. Baker, *Regulating the Invisible: The Case of Over-the-Counter Derivatives*, 85 NOTRE DAME L. REV. 1287, 1306 (2010) (describing the importance of counterparty credit risk).

179. Raskolnikov, *Relational Tax Planning*, *supra* note 26, at 1202–04.

180. Jenny Anderson, *As Lenders, Hedge Funds Draw Insider Scrutiny*, N.Y. TIMES, Oct. 16, 2006, at A15.

than a secondary-market purchase that falls within the securities-trading safe harbor.¹⁸¹ From a business perspective, the hedge funds would like to acquire the loan tranches as soon as the loan is made.¹⁸² In order to reduce taxes, however, the funds wait a couple of days.¹⁸³ 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.”¹⁸⁴

Raskolnikov describes similar tax-driven norms related to variable prepaid forward contracts¹⁸⁵ and equity swaps.¹⁸⁶ In each case, the development of the tax-driven norm relies on repeat play, easy dissemination of accurate information, and a credible threat of informal sanctions.¹⁸⁷ 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 risk-based tax rules can often be avoided by substituting counterparty risk for market risk.¹⁸⁸ The wash-sale rules, for example, prevent a taxpayer from taking a loss on securities that are repurchased within thirty days.¹⁸⁹ 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.¹⁹⁰ 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 thirty-one days later.¹⁹¹ 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.¹⁹² My point here is a

181. Raskolnikov, *Cost of Norms*, *supra* note 26, at 616–17.

182. *Id.* at 617.

183. *Id.*

184. *Id.* at 617–18.

185. *Id.* at 614–16.

186. *Id.* at 618–20.

187. *Id.* at 621.

188. Raskolnikov, *Relational Tax Planning*, *supra* note 26, at 1183.

189. *Id.* at 1184.

190. *See id.* at 1190 n.26 (recognizing that the waiting period in the wash-sale rule subjects investment decisions to market volatility).

191. *Id.* at 1184.

192. *Id.* at 1239–46.

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.¹⁹³

c. 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.¹⁹⁴ But the structure requires the creation of a new holding company and corporate structure.¹⁹⁵ The changes are largely cosmetic, but implementing the changes can be time consuming for internal personnel and confusing to both internal and external constituents.¹⁹⁶ And so while the double dummy structure is popular, it is rarely used multiple times by the same acquirer.¹⁹⁷

There is not always an economy of scale in engaging in multiple regulatory-avoidance strategies. Enron provides one 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.¹⁹⁸ The accumulation of arbitrage strategies made it impossible for internal executives, let alone outside shareholders, to grasp the overall picture.¹⁹⁹

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 do not seem to be as concerned about opacity as they probably should be. Enron had a long run

193. *Id.* at 1185; *see also* Thomas M. Palay, *Avoiding Regulatory Constraints: Contracting Safeguards and the Role of Informal Agreements*, 1 J.L. ECON. & ORG. 155, 157 (1985) (describing how informal contracting can be used to avoid regulatory frameworks).

194. Elizabeth MacDonald, *Double Dummy Beats IRS*, FORBES, Oct. 29, 2001, at 112, 114.

195. Lucian A. Bebchuk & Ehud Kamar, *Bundling and Entrenchment*, 123 HARV. L. REV. 1549, 1564 (2010).

196. *See* Igor Kirman & David M. Adlerstein, *Not For Dummies: Navigating the “Double Dummy” Merger Structure*, M&A LAWYER, Sept. 2008, *reprinted in* DOING DEALS 2010: UNDERSTANDING TRANSACTIONAL PRACTICE, at 36–41 (PLI Corp. Law and Practice, Course Handbook Series No. B-1797, 2010) (surveying the numerous considerations and complications attendant to the implementation of a double dummy merger, from the presigning phase through the postclosing phase).

197. *See id.* at 33 (noting that, while some of the most significant mergers in recent years have used the double dummy technique, it remains underutilized despite its attractive features).

198. *See* Geoffrey P. Miller, *Catastrophic Financial Failures: Enron and More*, 89 CORNELL L. REV. 423, 451 (2004) (postulating that the excessive complexity resulting from more than 3,000 off-balance-sheet arrangements at the time of Enron’s collapse contributed to its downfall).

199. KURT EICHENWALD, CONSPIRACY OF FOOLS 559–63 (2005).

before it collapsed.²⁰⁰ 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.²⁰¹

Still, for many small businesses, opacity costs appear to be a powerful constraint. Venture capital-backed start-ups, for example, are normally organized as corporations rather than as partnerships for tax purposes, even though partnerships would appear to minimize tax liability.²⁰² 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,²⁰³ 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.²⁰⁴ 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.²⁰⁵

3. *Professional Constraints.*—Suppose now that a lawyer has identified an alternate method of achieving the business purpose of the deal that 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 antiabuse 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

200. *Id.* at 33–34.

201. See FINANCIAL CRISIS INQUIRY COMM’N, PRELIMINARY STAFF REPORT, SECURITIZATION AND THE MORTGAGE CRISIS 18–21 (2010) (discussing the potential roles that increase in securitization played in the financial crisis).

202. See Fleischer, *Rational Exuberance*, *supra* note 36, at 137–38 (“Because a start-up typically is organized as a corporation, . . . its tax losses get trapped at the entity level and only can be carried forward as a net operating loss (NOL), which is less valuable.”).

203. See *id.* at 184 (concluding that the “key factors” contributing to the observed preference for the corporate form “are the limited ability of investors to use tax losses, agency costs, the tax treatment of gains, and the complexity of the pass-through structure”).

204. See *id.* at 167 (explaining that “[p]artnership tax law treats any employee with an equity stake as a partner, complicating compensation issues and increasing tax liabilities for the employees”).

205. See Raskolnikov, *Cost of Norms*, *supra* note 26, 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.”).

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 American Bar Association 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,²⁰⁶ 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.²⁰⁷

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.”²⁰⁸ Rather, sophisticated clients seek counsel and judgment when there is no published guidance. What matters is knowing the market practice, 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

206. See Larry E. Ribstein, *The Death of Big Law*, 2010 WIS. L. REV. 749, 760–61, 765–67 (listing the rise of in-house counsel and increased global competition from legal service providers in India and areas with lower labor costs among the pressures on the large law-firm model).

207. 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 the concern with maintaining reputational capital).

208. Interview with Lawyer 3, *supra* note 47.

norms on the defensive.²⁰⁹ 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.²¹⁰ He offered new 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.”²¹¹ 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.²¹²

Preserving this reputational capital can deter firms from getting too aggressive.²¹³ But there are several reasons why these professional constraints have less bite today.

a. 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.²¹⁴ There is pressure on lawyers to read the relevant regulations in a manner that favors their client and will help the deal close.²¹⁵ Every lawyer I spoke with acknowledged

209. See Interview with Lawyer 6, *supra* note 66 (stating that the primary value is “knowing market practice[,] [k]nowing the going rates for management fees, knowing how expenses are being whacked up, how people are thinking about industry terms”).

210. Interview with Lawyer 1, *supra* note 45.

211. *Id.*

212. *Id.* 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.” *Id.* Firms that have extensive practices in areas where the law is less settled or exceedingly intricate or both—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. See *id.* (“Market practice is important in transactions that have something new . . . the greater the uncertainty in the area, the more important the market practice.”). 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 one lawyer:

Here’s one data point. In London, a few lawyers are billing £1,000 an hour [over \$2,000 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 with Lawyer 4, *supra* note 52.

213. See Canellos, *supra* note 23, at 56 (“Practitioners who have a reputation for knowledge and experience in real transactions are, needless to say, given a warmer reception [by the IRS] than those who are less well known or are known for participating in tax shelter or other aggressive transactions.”).

214. See PATRICK SCHMIDT, *LAWYERS AND REGULATION: THE POLITICS OF THE ADMINISTRATIVE PROCESS* 195–96 (2005) (discussing the limited influence of lawyers on regulatory compliance culture); Ronald J. Gilson, *The Devolution of the Legal Profession: A Demand Side Perspective*, 49 MD. L. REV. 869, 900–01 (1990) (hypothesizing that increased client sophistication will reduce information asymmetry and dissipate lawyers’ power to act as gatekeepers).

215. See Marc Galanter & William Henderson, *The Elastic Tournament: A Second Transformation of the Big Law Firm*, 60 STAN. L. REV. 1867, 1907–13 (2008) (describing the

some degree of pressure that made it difficult to exercise sound professional judgment, although no one admitted to crossing the line.²¹⁶ In the old days, clients tended to rely on a single firm as outside counsel for most deals.²¹⁷ This is less true today. “Clients now use 100 different law firms. You have to fight for every piece of business.”²¹⁸ Clients sometimes exert pressure explicitly by threatening to take business elsewhere.²¹⁹ But other forms of pressure are more subtle. Clients also exert pressure by pointing to what other lawyers have advised.²²⁰

b. 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.²²¹

c. Decline of Lockstep.—Third, a shift away from lockstep compensation among law firm partners gives lawyers an increased financial

elastic tournament, marked by lateral mobility, as straining ethical decisions by large law-firm partners).

216. Interview with Lawyer 3, *supra* note 47; Interview with Lawyer 4, *supra* note 52; Interview with Lawyer 6, *supra* note 66.

217. Gilson, *supra* note 214, at 901 n.69.

218. Interview with Lawyer 6, *supra* note 66.

219. 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 with Lawyer 4, *supra* note 52.

220. *Id.* This lawyer explained the Peter Canellos syndrome: “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?’” *Id.* (Canellos is a well-regarded tax lawyer at Wachtell, Lipton, Rosen & Katz.) See Interview with Lawyer 1, *supra* note 45 (“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?”).

221. “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.” Interview with Lawyer 4, *supra* note 52.

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.

Id.

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 with Lawyer 1, *supra* note 45.

incentive to be aggressive. Financial incentives influence lawyers' willingness to take aggressive positions. The largest New York firms tend to be compensated lockstep or within a narrow band. This takes away "the greed incentive."²²² The elite firms focus on building and maintaining long-term reputational capital; there is no incentive to be aggressive because you don't want to "screw the golden goose."²²³ Furthermore, a few firms are still general partnerships, which adds the possibility of putting partners' personal assets at risk.²²⁴

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.²²⁵ Even tax partners, who were traditionally thought of as service providers to the corporate partners, feel increasing pressure to create a book of business.²²⁶ "There's an incentive to make more money," one lawyer explained, "to get into the gray area."²²⁷ The financial incentive isn't likely to turn good lawyers into scofflaws but may shape subconscious decisions and temperament.²²⁸

222. Interview with Lawyer 5, *supra* note 59; *see also* Interview with Lawyer 7, in N.Y.C. (Sept. 12, 2007) ("Firms are more aggressive when they are not on lockstep. People are looking for the business.").

223. Interview with Lawyer 5, *supra* note 59.

224. Interview with Lawyer 2, *supra* note 46 ("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.").

225. *See* MILTON C. REGAN, JR., *EAT WHAT YOU KILL: THE FALL 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 215, at 1910 (observing that firms evaluate partners' profitability primarily based on billed hours and fees). *See generally* Robert W. Hillman, *Professional Partnerships, Competition, and the Evolution of Firm Culture: The Case of Law Firms*, 26 J. CORP. L. 1061, 1067 (2001) ("The most dramatic evidence of the changing times is the reallocation of a firm's income in favor of partners with loyal client bases, an event that often is combined with a consolidation of management in the hands of these same lawyers.").

226. One lawyer stated,

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 with Lawyer 3, *supra* note 47.

227. Interview with Lawyer 4, *supra* note 52.

228. *See* REGAN, *supra* note 225, at 7 ("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."). One tax lawyer stated,

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 ten years, fifteen 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.

Interview with Lawyer 1, *supra* note 45; *see also supra* text accompanying note 225.

d. 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.²²⁹ As competitive pressures have increased, lateral mobility has increased, as firms seek to acquire lawyers or practice groups with expertise in lucrative fields.²³⁰ Lawyers at the top of the game have a powerful economic incentive to move laterally and capture the economic benefits of their expertise.²³¹ On a darker note, law firms are more likely to fire underperforming partners.²³² Preserving the reputational capital of one's firm may appear less compelling if one's future with the firm is uncertain.

e. Changes in Legal Education.—Fifth, changes in legal education have affected how lawyers read statutes. Several tax lawyers felt that changes in legal education have made lawyers overly aggressive in how they interpret statutes.²³³ It's difficult to overstate the importance of statutory interpretation to tax law. Transactions often fall into gaps where the Internal Revenue Code provides no clear guidance, and practitioners must do the best they can.²³⁴ For many years, tax lawyers practiced purposive statutory interpretation.²³⁵ 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.²³⁶ When combined with the heavy doses of legal

229. See William D. Henderson & Leonard Bierman, *An Empirical Analysis of Lateral Lawyer Trends from 2000 to 2007: The Emerging Equilibrium for Corporate Law Firms* 30–31 (Ind. Univ. Maurer Sch. of Law–Bloomington, Research Paper No. 136, 2009), available at <http://ssrn.com/abstract=1407051> (discussing Cravath, Swaine & Moore's practice of promoting from within the firm).

230. REGAN, *supra* note 225, 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.”).

231. 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 nonlockstep firms. *Cf.* Henderson & Bierman, *supra* note 229, 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.”).

232. See *id.* at 14–15 (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).

233. See Joseph Bankman, *The Business Purpose Doctrine and the Sociology of Tax*, 54 SMU L. REV. 149, 151–52 (2001) (postulating that law schools’ renewed emphasis on textualism is partially responsible for young tax lawyers’ text-based statutory interpretation, which conflicts with senior tax lawyers’ standards-based statutory interpretation).

234. Interview with Lawyer 6, *supra* note 66 (“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.”).

235. See Bankman, *supra* note 233, at 150–51 (observing that many tax lawyers who graduated from law school between 1936 and 1956 favored a nontextual method of interpreting tax statutes).

236. See Noël B. Cunningham & James R. Repetti, *Textualism and Tax Shelters*, 24 VA. TAX REV. 1, 4 (2004) (voicing concern that tax lawyers are using the textualism movement to create tax shelters).

realism and critical legal theory received in law school, this creates a recipe for aggressive, self-serving statutory interpretation.²³⁷ “Since there’s no right answer anyway,” one lawyer explained, “I might as well choose the most favorable meaning for my client.”²³⁸

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, ancillary evidence in the regulations, and legislative history, not deeper questions of public policy.²³⁹ Furthermore, lawyers feel obligated to defer to the client’s wishes, and they worry that 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.’”²⁴⁰ But clients focus on the bottom line—it’s a “should” level opinion—rather than the risks detailed in the opinion.

f. 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.²⁴¹ One tax lawyer was concerned about “excessive specialization.”²⁴² There is an “element of drinking the Kool-Aid.”²⁴³ “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.”²⁴⁴ Several lawyers explained the practice of options backdating in this way.²⁴⁵ A lot of lawyers “go native,” one noted.²⁴⁶

237. See *supra* note 234 and accompanying text.

238. Interview with Lawyer 8, in N.Y.C. (Sept. 11, 2007); see also Interview with Lawyer 6, *supra* note 66 (“Excessive literalism, combined with nihilism, produces a result that’s absurd. There’s too much willingness to think that there’s no best answer.”).

239. See Interview with Lawyer 3, *supra* note 47 (“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.”).

240. Interview with Lawyer 4, *supra* note 52.

241. See, e.g., Deborah L. Rhode & Paul D. Paton, *Lawyers, Ethics, and Enron*, 8 STAN. J.L. BUS. & FIN. 9, 19–21 (2002) (discussing the conflict of interest inherent in the external review of Enron’s transactions conducted by Vinson & Elkins, LLP, Enron’s primary outside counsel).

242. Interview with Lawyer 6, *supra* note 66; see also REGAN, *supra* note 225, 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 from the firm as a whole.”).

243. Interview with Lawyer 6, *supra* note 66; see also REGAN, *supra* note 225, at 41 (“Both professional training and psychological tendencies incline many lawyers to identify strongly with their clients.”).

244. Interview with Lawyer 6, *supra* note 66.

245. See, e.g., Interview with Lawyer 4, *supra* note 52 (“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.”).

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.²⁴⁷ Law firms continue to review legal opinions by committee, ensuring that multiple partners sign off on new structures.²⁴⁸ Some firms retain lockstep (or modified lockstep) compensation.²⁴⁹

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.²⁵⁰ Other scholars question whether such a golden age ever existed.²⁵¹

Few lawyers today feel any responsibility to consider ethical questions beyond delivering 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 her clients with all the relevant legal options and to let them choose; her personal moral views are thought to be irrelevant.²⁵²

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

246. *Id.* (“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.”).

247. See Elizabeth Chambliss, *The Professionalization of Law Firm In-House Counsel*, 84 N.C. L. REV. 1515, 1517 (2006) (noting that a number of general counsels at large firms were promoted from within); Carolyn Kolker, *Making Partner Less Likely as Big Law Firms Face Cash Crunch*, BLOOMBERG BUSINESSWEEK (Feb. 17, 2010), <http://www.businessweek.com/news/2010-02-17/making-partner-less-likely-as-big-law-firms-face-cash-crunch.html> (indicating that although firms are less inclined to promote from within, firms have still promoted associates to partners).

248. See Norman Field et al., *Law Office Opinion Practices*, 60 BUS. LAW. 327, 330–31 (2004) (outlining the various roles that opinion committees play in law firms).

249. James D. Cotterman, *Lockstep Compensation. Does it Still Merit Consideration?*, LAW PRACTICE TODAY (Aug. 2007), <http://www.abanet.org/lpm/lpt/articles/fin08071.shtml>.

250. See REGAN, *supra* note 225, 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.’”).

251. 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.”).

252. Several lawyers emphasized that clients shared responsibility for aggressive regulatory stances. For example, one stated, “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.” Interview with Lawyer 3, *supra* note 47. He noted that many in-house tax departments are run by former New York tax partners. *Id.*

regulatory-cost savings because 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 lawyer's 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.²⁵³ This is not because lawyers are dishonest people but rather because they are honest 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.²⁵⁴ "That's not the business that I'm in."²⁵⁵

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 customers.²⁵⁶ 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.²⁵⁷ But executives find wrestling with the political branches tiresome and a distraction from the core business, and political

253. See *supra* notes 1–2 and accompanying text.

254. Interview with Lawyer 3, *supra* note 47.

255. *Id.*

256. See generally Michele DeStefano Beardslee, *Advocacy in the Court of Public Opinion Installment One: Broadening the Role of Corporate Attorneys*, 22 GEO. J. LEGAL ETHICS 1259, 1279–80 (2009) (describing how corporate attorneys manage legal public relations); *id.* at 1300 ("[A]t times, a lawyer may not be able to provide competent legal advice without taking into account the media ramifications."). 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.").

257. See, e.g., David Frisch, *Rational Retroactivity in a Commercial Context*, 58 ALA. L. REV. 765, 765–66 (2007) (discussing the "traditional disrepute" in which retroactive legislation has been held); Alison L. LaCroix, *Temporal Imperialism*, 158 U. PA. L. REV. 1329, 1335 (2010) (noting common law attitudes and scrutiny of retroactive legislation).

enemies can use weakness on one regulatory issue to extract gains on other issues.²⁵⁸

Lawyers I spoke with noted a difference in risk tolerance between public and private deals. In public deals, one lawyer noted, “structures are usually vetted openly by several law firms,” and disclosure serves as an ethical safety valve.²⁵⁹ But perhaps more importantly, in private deals, the buyer is normally a financial buyer who is laser-focused on after-tax financial returns.²⁶⁰ 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.”²⁶¹

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.”²⁶² Firms build up political capital in a variety of ways, including soft-money campaign contributions, issue ads, and lobbying expenditures.²⁶³

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,²⁶⁴ firms dependent on government policy,²⁶⁵ diversified firms,²⁶⁶ and

258. See Matthew T. Bodie, *Mother Jones Meets Gordon Gekko: The Complicated Relationship Between Labor and Private Equity*, 79 U. COLO. L. REV. 1317, 1350 (2008) (acknowledging unions’ ability to leverage support for their issues by “dangling [their] support (or opposition)” for issues the corporation deems a priority).

259. Interview with Lawyer 5, *supra* note 59; see also Interview with Lawyer 4, *supra* note 52 (“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.”).

260. Interview with Lawyer 2, *supra* note 46 (“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.”).

261. Interview with Lawyer 4, *supra* note 52.

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

263. See *id.* at 1504 (highlighting FedEx’s investment in political capital through soft money, PAC disbursements, and lobbying expenditures).

264. Amy J. Hillman et al., *Corporate Political Activity: A Review and Research Agenda*, 30 J. MGMT. 837, 839 (2004).

265. Amy J. Hillman & Michael A. Hitt, *Corporate Political Strategy Formulation: A Model of Approach, Participation, and Strategy Decisions*, 24 ACAD. MGMT. J. 825, 829 (1999).

266. *Id.* at 829–30.

firms with high levels of managerial slack²⁶⁷ 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.²⁶⁸ 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, by 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.²⁶⁹ I discuss this process in more detail in subpart III(C) below.

III. Implications

This Part III draws on the theoretical framework of regulatory arbitrage to make three additional contributions to the literature. First, in subpart A below, I show how the balancing of transaction costs against regulatory costs can distort regulatory competition. Counterintuitively, this effect should lead policy makers to consider decoupling regulatory regimes from one another. Second, in subpart B, I show how regulatory arbitrage shifts the incidence of regulatory costs away from firms that can best manage transaction costs. Third, in subpart 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,²⁷⁰ which, in turn, is sometimes said to create a “race to the top” as regulators adopt more

267. See Martin B. Menzar & Douglas Nigh, *Buffer or Bridge? Environmental and Organizational Determinants of Public Affairs Activities in American Firms*, 38 ACAD. MGMT. J. 975, 991 (1995) (discussing the role a firm’s top management philosophy plays in political activity).

268. See Daniel J. Gifford, *The Emerging Outlines of a Revised Chevron Doctrine: Congressional Intent, Judicial Judgment, and Administrative Autonomy*, 59 ADMIN. L. REV. 783, 790 (2007) (“[R]egulatory agencies were designed to weigh technical expertise over politics by insulating the agency from direct presidential control and ensuring that they were headed by persons representing both political parties.”); see also Marshall J. Breger & Gary J. Edles, *Established By Practice: The Theory and Operation of Independent Federal Agencies*, 52 ADMIN. L. REV. 1111, 1163–97 (2000) (summarizing internal agency procedures for independent agencies and discussing how this model should combat possible political pressures).

269. See Guy L. F. Holburn & Richard G. Vanden Bergh, *Influencing Agencies Through Pivotal Political Institutions*, 20 J.L. ECON. & ORG. 458, 478 (2004) (giving examples of situations where a company would choose to lobby the legislature or executive instead of an agency).

270. E.g., Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 249 (1985); see also William J. Carney, *The Political Economy of Competition for Corporate Charters*, 26 J. LEGAL STUD. 303, 304 (1997) (assuming that entrepreneurs and existing firms will migrate to the least costly regulatory system available).

efficient laws.²⁷¹ 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 increased 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.²⁷² 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.²⁷³

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

271. *E.g.*, O'Hara & Ribstein, *supra* note 29, at 1162–63.

272. 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 include more debt in the acquisition financing than strategic buyers and enjoy 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. The only plausible fix, I think, would be to eliminate the disparate tax treatment of debt and equity.

273. See Walker & Fleischer, *supra* note 36, at 443 (observing that increasing conformity may reduce the gaming of reported earnings but increase the gaming of corporate tax deductions).

jurisdictional inconsistency²⁷⁴ and mitigate the incentive to relocate for accounting purposes.²⁷⁵ Book/tax conformity, on the other hand, forces firms into trade-offs that can increase transaction costs.²⁷⁶ The same frictions touted as beneficial in deterring wasteful planning manifest as increased transaction costs when the planning takes place nonetheless.

1. *Charter Competition.*—First, consider the race to the top said to occur when different jurisdictions compete to serve as the seat of incorporation.²⁷⁷ 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.²⁷⁸ 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.²⁷⁹ 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 rule that governs where a corporation is located for tax purposes.²⁸⁰ Specifically, they argue that a corporation should be located by reference to its nominal place of incorporation for corporate law purposes but by reference to its real seat for tax purposes.²⁸¹ 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.²⁸²

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

274. See Janice Grant Brunner, *All Together Now? The Quest for International Accounting Standards*, 20 U. PA. J. INT'L ECON. L. 911, 912 (1999) (discussing the ability of international financial standards to reduce inconsistency between countries and thereby reduce transaction costs).

275. See Mitchell A. Kane & Edward B. Rock, *Corporate Taxation and International Charter Competition*, 106 MICH. L. REV. 1229, 1266–67 (2008) (discussing the incentive that the unique American taxation policy gives to firms to relocate to lower-tax jurisdictions).

276. See Walker & Fleischer, *supra* note 36, at 443 ("Any move might affect tax- and accounting-induced distortions in the selection of equity instruments.").

277. See Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 919–20 (1982) (arguing that Delaware's preeminence in incorporations is due to a "climb to the top" that maximizes shareholder wealth); Romano, *supra* note 270, at 226.

278. Kane & Rock, *supra* note 275, at 1235.

279. *Id.* at 1230.

280. *Id.* at 1283.

281. *Id.* at 1256.

282. *Id.* at 1251–52.

they cannot do both at the same time.²⁸³ 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.

2. *Choice of Entity.*— The last thirty years has seen the creation of new business entities, including the Limited Liability Partnership (LLP), Limited Liability Company (LLC), and Low-Profit LLC (L3C),²⁸⁴ and new financing entities, such as the Structured Investment Vehicle (SIV),²⁸⁵ Collateralized Debt Obligation (CDO),²⁸⁶ CDO-squared,²⁸⁷ and CDO-cubed.²⁸⁸ 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. Larry Ribstein, for example, focuses on the increased use of partnership-type forms as a method of reducing agency costs.²⁸⁹ But the regulatory motive behind the choice of the partnership form (avoiding the corporate tax)²⁹⁰ makes it difficult to know whether the shift increases or decreases agency 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

283. See Mihir A. Desai, *The Degradation of Reported Corporate Profits*, 19 J. ECON. PERSP. 171, 189–90 (2005) (“[S]uch a system would also remove a distinction that has served to enable opportunism.”); Daniel Shaviro, *The Optimal Relationship Between Taxable Income and Financial Accounting Income: Analysis and a Proposal*, 97 GEO. L.J. 423, 426–27 (2009) (“Absent our two-book system . . . [c]orporate 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.”).

284. See generally Carter G. Bishop, *The Low-Profit LLC (L3C): Program Related Investment by Proxy or Perversion?*, 63 ARK. L. REV. 243 (2010) (enumerating the common features and tax implications of L3C entities).

285. An SIV is frequently known as a Special Purpose Entity (SPE). See Frank A. Partnoy, *Shapeshifting Corporations*, 76 U. CHI. L. REV. 261, 268 (2009) (describing a structured investment vehicle as a “special purpose entity” that issues short- and medium-term debt to finance the purchase of long-term securities).

286. See Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1022 (2007) (defining a CDO as “a pool of debt contracts housed within [an SPE] whose capital structure is sliced and resold based on differences in credit quality”).

287. See *id.* at 1044 (reporting that CDO-squared transactions include assets consisting of a portfolio of other CDOs and asset-backed securities).

288. See *id.* (characterizing CDO-cubed transactions as those involving a portfolio of CDO-squareds).

289. Larry E. Ribstein, *Partnership Governance of Large Firms*, 76 U. CHI. L. REV. 289, 309 (2009).

290. Susan Pace Hamill, *The Limited Liability Company: A Catalyst Exposing the Corporate Integration Question*, 95 MICH. L. REV. 393, 394 (1997).

never would have worked.²⁹¹ 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.²⁹² 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.²⁹³ We still have a corporate tax; its boundaries are now effectively enforced by the publicly traded partnership rules rather than corporate law attributes.²⁹⁴ 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.

3. *Executive Compensation.*—Both the legal and finance literature generally assume that executive compensation is designed to minimize agency costs between managers and shareholders.²⁹⁵ Compensation packages evolve to better meet the shifting needs of shareholders and the

291. See Fleischer, *Taxing Blackstone*, *supra* note 79, at 99 (“The potential for conflicts of interest between public investors and other entities in the Blackstone structure is substantial.”); Ribstein, *supra* note 289, at 305 (“Blackstone Group unit-holders get almost no formal control rights.”).

292. Victor E. Fleischer, Note, “*If It Looks Like a Duck*”: *Corporate Resemblance and the Check-the-Box Elective Tax Classification*, 96 COLUM. L. REV. 518, 521 (1996) (detailing the factors for classifying an unincorporated entity, before enactment of the current check-the-box classification).

293. Treas. Reg. § 301.7701-3(a) (as amended in 2006).

294. Section 7704 generally treats publicly traded partnerships as corporations for tax purposes. I.R.C. § 7704 (2006).

295. See, e.g., Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSP. 71, 71 (2003) (explaining that much of the research on executive compensation schemes in publicly traded companies has focused on how such schemes can alleviate the “agency problem”); *Developments—Corporations and Society*, 117 HARV. L. REV. 2205, 2208 (2004) (stating that the traditional view on executive compensation has been that, “if wielded effectively, [it] is a tool that can minimize agency costs and maximize shareholder value”). Some legal scholars argue that executive compensation is also designed to camouflage managerial rent extraction. See, e.g., LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 67–70 (2004) (illustrating the incentive to adopt compensation packages that obscure the total amount of compensation in order to limit outside criticism); Jesse M. Fried, *Share Repurchases, Equity Issuances, and the Optimal Design of Executive Pay*, 89 TEXAS L. REV. (forthcoming 2011) (asserting that standard equity-based pay provides incentives to managers to engage in inefficient share repurchases and equity issuances).

executives they employ through the firm.²⁹⁶ 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.

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.²⁹⁷ As a result, the use of stock options increased.²⁹⁸ 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.²⁹⁹ In this case, by focusing the accounting rules to match more closely the economics of the instruments offered 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.³⁰⁰ 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.³⁰¹ In some cases, agency costs limit the ability of fund managers to take full advantage of the tax subsidy for carried interest.³⁰² 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.³⁰³ 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.³⁰⁴

Most current distortions in executive compensation are caused by economic substance inconsistency, not doctrinal inconsistency. Decoupling

296. See Sharon Hannes, *Compensating for Executive Compensation: The Case for Gatekeeper Incentive Pay*, 98 CALIF. L. REV. 385, 395 (2010) (describing the growth in executive pay and equity-based executive compensation since 1990).

297. 148 CONG. REC. 3,879 (2002) (statement of Rep. Staria).

298. Paul J. Carruth, *Accounting for Stock Options: A Historical Perspective*, J. BUS. & ECON. RES., May 2003, at 9, 9.

299. See Walker & Fleischer, *supra* note 36, at 403; David I. Walker, *Evolving Executive Compensation and the Limits of Optimal Contracting*, 63 VAND. L. REV. (forthcoming 2010).

300. Fleischer, *Missing Preferred Return*, *supra* note 36, at 109.

301. See *id.* at 79 (discussing how the disparate treatment of carry and management fees encourages fund managers to receive more compensation in the form of carry).

302. *Id.* at 114.

303. Gregg D. Polsky, *Private Equity Management Fee Conversions*, 122 TAX NOTES 743, 749 (2009).

304. See *id.* at 750 (“In fact, the odd design of the additional carried interest is entirely tax-driven.”).

will not help. As with the move to expensing stock options, policy makers 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.

B. Incidence of Regulatory Costs

Others have observed that regulatory arbitrage is only available to the wealthy and sophisticated.³⁰⁵ 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.

1. Seasoned Firms Versus Start-ups.—Entrepreneurs and start-up firms operate in an environment with high transaction costs.³⁰⁶ In the venture capital context, unique contract structures have developed to overcome the problems of extreme uncertainty, asymmetric information, and double-sided moral hazard.³⁰⁷ 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.³⁰⁸ As I have noted elsewhere, venture capital-backed start-ups are almost always organized as corporations rather than as partnerships, even though partnerships would appear to be more tax efficient.³⁰⁹ One reason is that, while it is technically feasible to organize a start-up as a partnership, it can be cumbersome to operate a business in this form, particularly if you want to compensate employees with options.³¹⁰ Venture capital-backed start-ups, therefore, bear a higher incidence of corporate tax than 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.³¹¹

305. See Knoll, *supra* note 26, at 65 (“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.”).

306. See Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 1010 (2006) (describing how angel investors pass along transaction costs to entrepreneurs in the form of investment terms).

307. Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1077 (2003).

308. See William A. Sahlman, *The Structure and Governance of Venture Capital Organizations*, 27 J. FIN. ECON. 473, 518 (1990) (exploring the constraints of venture capital industry standards).

309. Fleischer, *Rational Exuberance*, *supra* note 36, at 137; Joseph Bankman, *The Structure of Silicon Valley Start-Ups*, 41 UCLA L. REV. 1737, 1738 (1994).

310. See Fleischer, *Rational Exuberance*, *supra* note 36, at 171–72 (describing the complications surrounding employee options in partnerships).

311. Bankman, *supra* note 309, at 1756.

2. *Rich Versus 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 rules.³¹² 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.³¹³ On the other hand, the non-rich may have deep community-based relationships that can substitute for formal contract. And it's possible that the rich, as tempting political targets, simply have more need for the use of regulatory arbitrage techniques than other groups.

3. *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.³¹⁴ Second, sophisticated parties bear lower information costs in trying to understand new strategies.³¹⁵ Third, they may

312. See Dana L. Trier & Lucy W. Farr, *Constructive Sales Under Section 1259: The Best Is Yet to Come* (describing methods of reducing market risk associated with constructive sale rules), in 16 TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 1217, 1223 (PLI Tax Law and Estate Planning: Tax Law and Practice, Course Handbook Ser. No. J-553, 2002); Raskolnikov, *Cost of Norms*, *supra* note 26, at 669–70 (“Large businesses and very wealthy individuals . . . should be expected to look for more complicated ways of reducing their tax liabilities.”); Schizer, *supra* note 26, at 1319 (discussing how wealthy individuals are capable of planning around tax rules).

313. 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.*; see also *id.* (“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.* 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.

314. See, e.g., Raskolnikov, *Cost of Norms*, *supra* note 26, at 668–69 (“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.”).

315. See *id.* 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 have a working knowledge of these regulations.”).

have relationships with counterparties that lower information costs and agency costs. This sort of regulatory planning shifts the incidence of costs to those who cannot engage in regulatory planning, as well as to “honest/irrational” actors that could engage in such planning but choose not to.³¹⁶

4. *The Politically Well-Connected.*—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.

5. *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 arguments 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 prior beliefs about whether regulation serves the public interest.³¹⁷ Indeed, the question is even more complicated because the public sector doles out benefits as well as burdens.³¹⁸ The distributive consequences of regulatory arbitrage are best evaluated in light of the distribution of benefits as well as the burdens; the distribution of social security, housing, health, and 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 policy makers 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

316. *Id.* at 643–44.

317. *See, e.g.,* O’HARA & RIBSTEIN, *supra* note 32, at 19–20 (advocating a “law market,” maintained via contractual choice-of-law clauses, as a means of mitigating burdensome state regulations that at best “suit the *average* citizen, not each individual citizen” they govern); O’Hara & Ribstein, *supra* note 29, at 1154, 1157–61 (arguing that efficiency dictates regulatory arbitrage where legislators and courts are subject to influences that undermine the public interest).

318. *See* James M. Buchanan, *Externality in Tax Response*, 33 S. ECON. J. 35, 36 (1966) (“Implicitly, excess-burden analysis assumes that taxes are collected from the economy in complete independence from the financing of public service benefits. By contrast, I shall assume that taxes are collected solely for the purpose of financing public-service benefits that are enjoyed by the same set of persons as those who pay the taxes.”).

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 that, because regulatory arbitrage is inevitable, we shouldn't bother trying to prevent it.³¹⁹ The 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.³²⁰ 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 the 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

319. Cf. Martin D. Ginsburg, *Making the Tax Law Through the Judicial Process*, 70 A.B.A. J. 74, 76 (1984) (“[E]very stick crafted to beat on the head of a taxpayer will, sooner or later, metamorphose into a large green snake and bite the Commissioner on the hind part.”); David Reilly, *Closing Lehman's Legal Loophole*, WALL ST. J., Mar. 13, 2010, at B16 (“Give Wall Street a rule and it will find a loophole. . . . Regulators and legislators should keep this in mind as they pursue financial overhaul.”). Professor Ginsburg was no regulatory nihilist. His point was that, when the government stretches tax policy to achieve a pro-government result, astute taxpayers will convert the rule into a pro-taxpayer strategy; the best government strategy is to stick to tax rules that more closely track underlying economics. I am indebted to Howard Abrams for this insight. See also Reilly, *supra* (“The lesson: Regulators should move toward a system where companies are judged by the substance of what they are trying to achieve, rather than meeting the definition of accounting rules.”).

320. See, e.g., David A. 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.”).

interpretation, constrain (or allow) arbitrage. And the agencies themselves are political institutions, sensitive to influence by congressional and White House staffers, private-sector lobbying, academic criticism, and media spin.³²¹

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.³²² “Educating staffers on behalf of clients named and unnamed.”³²³ When a transaction poses a new issue that staffers are not familiar with, they will call up the private-sector experts for a briefing.³²⁴

It helps to be known as an expert in the field. One tax lawyer explained, “Your reputation provides the credibility. Warmer reception, status. In order to properly serve your clients, you need credibility.”³²⁵ Another concurred: “Access matters—some regulators get starry-eyed. You want to have guys who can go over the wall.”³²⁶ The reputation of the law firm also carries weight. Regulators will at least stop and take a deep breath before shutting

321. See generally Rachel Barkow, *Insulating Agencies: Avoiding Capture Through Institutional Design*, 89 TEXAS L. REV. 15 (2010) (discussing theories of agency capture and ways to insulate agencies from outside influence).

322. Interview with Lawyer 9, in N.Y.C. (Sept. 11, 2007).

323. *Id.*

324. *Id.*

325. Interview with Lawyer 1, *supra* note 45.

326. Interview with Lawyer 4, *supra* note 52.

down a transaction with the imprimatur of an elite firm. “Many regulators are most interested in not being criticized,” explained one lawyer.³²⁷

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.³²⁸ 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. Schumer³²⁹ or Mr. Baucus,³³⁰ can be essential.

The 2008 merger of Wachovia and Wells Fargo provides a paradigmatic example of deal-specific lobbying.³³¹ In the fall of 2008, as the credit crisis deepened, Wachovia sought out a merger partner to help it absorb staggering losses.³³² After initial discussions with Morgan Stanley faltered,³³³ Wachovia courted Citigroup and Wells Fargo.³³⁴ Citigroup and Wachovia reached an “agreement in principle” backed by loss protection provided by the FDIC.³³⁵ The deal provided that Citigroup would acquire Wachovia’s banking, investment banking, and wealth management businesses, leaving Wachovia as a publicly traded company with Wachovia Securities and

327. *Id.*

328. See Eric Lipton & Raymond Hernandez, *A Champion of Wall Street Reaps the Benefits*, N.Y. TIMES, Dec. 14, 2008, § 1, at 1 (discussing lawyers’ successful lobbying of Senator Schumer to defeat an SEC initiative).

329. See *id.* (“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.”)

330. See Peter Lattman, Jenny Strasburg & Naftali Bendavid, *Congress Has Hedge Funds, Buyout Firms in Tax Sights*, WALL ST. J., Jan. 7, 2010, at C1 (discussing Senator Baucus’s opposition to carried-interest reform).

331. 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) (unpublished student paper) (on file with author).

332. Ben White & Andrew Ross Sorkin, *Morgan Stanley Considers Merger with Wachovia*, N.Y. TIMES (Sept. 17, 2008), <http://www.nytimes.com/2008/09/18/business/18morgan.html>.

333. Charlie Gasparino & Mary Thompson, *Morgan-Wachovia Deal Is Off the Table*, CNBC (Sept. 21, 2008), <http://www.cnbc.com/id/26827870>.

334. David Enrich & Dan Fitzpatrick, *Wachovia Chooses Wells Fargo, Spurns Citi*, WALL ST. J., Oct. 4, 2008, at A1.

335. *Id.*

Evergreen Asset Management as its two main operating subsidiaries.³³⁶ 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.³³⁷

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 acquirer's ability to use a target's net operating losses, or NOLs.³³⁸ Commentators noted that the Notice allowed Wells Fargo to shelter up to \$74 billion in taxable income.³³⁹ 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.³⁴⁰ Wells Fargo benefited from exquisite timing. On September 29, 2008, the House of Representatives rejected a proposed \$700 billion bailout plan, sending the stock market into a nosedive.³⁴¹ Secretary Paulson directed the Treasury to issue Notice 2008-83 the next day, thus making banks more attractive merger targets.³⁴² The Wells Fargo deal was announced three days later.³⁴³ 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 § 382.³⁴⁴

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.³⁴⁵ Lawyers

336. Alistair Barr & John Spence, *Citi to Buy Wachovia Banking Business for \$2.16 bln*, MARKETWATCH (Sept. 29, 2008), <http://www.marketwatch.com/story/citi-to-buy-wachovias-bank-biz-in-latest-government-backed-deal>.

337. See Enrich & Fitzpatrick, *supra* note 334.

338. See Amit R. Paley, *A Quiet Windfall for U.S. Banks*, WASH. POST, Nov. 10, 2008, at A1 (discussing lobbying efforts prior to the change in interpretation of section 382).

339. E.g., Guhan Subramanian & Nithyasri Sharma, *Citigroup-Wachovia-Wells Fargo* 6 (Harvard Law Sch., Case No. 10-03, 2010), available at <http://www.law.harvard.edu/faculty/faculty-workshops/subramanian.summer.2010.faculty.workshop.pdf> (noting that Wells Fargo was one of the banks who had sufficient profits to capitalize on Wachovia's \$75 billion in losses).

340. See Subramanian & Sharma, *supra* note 339, at 2, 6 (discussing Citigroup's losses and postulating that Wells Fargo was one of very few banks capable of capitalizing on Wachovia's estimated \$75 billion in built-in losses).

341. Carl Hulse & David M. Herszenhorn, *Defiant House Rejects Huge Bailout; Stocks Plunge; Next Step Is Uncertain*, N.Y. TIMES, Sept. 29, 2008, at A1.

342. See Lawrence Zelenak, *Can Obama's IRS Retroactively Revoke Massive Bank Giveaway?*, 122 TAX NOTES 889, 890-93 (2009) (arguing that lack of apparent statutory authority for Notice 2008-83 would permit retroactive revocation of the notice).

343. Enrich & Fitzpatrick, *supra* note 334.

344. I.R.S. Notice 2010-2, 2010-2 I.R.B. 251 (Jan. 11, 2010).

345. See Jeremiah Coder, *Treasury Inspector General Reviewing Bank Loss Notice*, 121 TAX NOTES 884, 884-85 (2008) (quoting Mark Prater, House Finance Minority Chief Tax Counsel, as explaining that "[t]he ruling is out there. Folks have relied on that. Deals have been done," and quoting House Ways and Means Majority Chief Tax Counsel John Buckley as saying "[w]e all have

sometimes refer to the tax version 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.³⁴⁶ 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.³⁴⁷

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.³⁴⁸ “Ninety percent of the work could be supplied by anyone,” explained one M&A lawyer.³⁴⁹ “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.”³⁵⁰

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.³⁵¹ Regulators can be persuaded, but it is 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 lawyer, “people like Fred Goldberg gave the IRS an advance look.”³⁵² They “took the temperature” of

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”).

346. Emily Parker, Acting Chief Counsel, Internal Revenue Serv., Address at the TEI/LMSB Financial Services Industry Conference 1–2 (Sept. 22, 2003), available at <http://www.irs.gov/pub/irs-utl/tei-92203.pdf>. 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. *Id.* at 2.

347. See Trier & Farr, *supra* note 312.

348. Interview with Lawyer 9, *supra* note 322.

349. Interview with Lawyer 5, *supra* note 59.

350. *Id.*

351. Interview with Lawyer 4, *supra* note 52 (“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.”).

352. *Id.*

the IRS before proceeding with the deal.³⁵³ The tax department of Skadden's D.C. office is particularly well-known for its ability to play inside baseball.³⁵⁴

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.

IV. 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 Article is primarily positive, focused on describing the phenomenon of regulatory arbitrage and how it works. Because not all regulatory arbitrage reduces social welfare, the Article makes no normative claims. But, of course, some regulatory arbitrage is likely to reduce social welfare, and policy makers may be interested in curbing regulatory arbitrage. If so, what lessons does this framework provide? While the prescriptive implications of this Article deserve fuller treatment in a future paper, some preliminary observations may be useful to policy makers.

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 policy makers to anticipate and address all possible responses, some of the most effective antiplanning techniques are the “silver bullet” responses that 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.³⁵⁵

353. *Id.*

354. See Marisa McQuilken, *Skadden Posts Huge Capital Gains*, LEGAL TIMES, May 5, 2008 (discussing Skadden's “insider access” across various regulatory agencies led by Fred Goldberg, Bob Bennett, and others).

355. Cf. Raskolnikov, *Relational Tax Planning*, *supra* note 26, at 1241–42 (noting that traditional market-risk-based backstops “actually used today are significantly more effective than relational ones”).

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 antiplanning 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 antiavoidance rules, the regulatory burden can be spread more evenly.

Third, policy makers 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 would not likely 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 antiavoidance constraints, while imperfect, is likely to be a more fruitful line of attack for policy makers. 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 are specifically tasked with reviewing legislation, 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.