Australian Journal of
Corporate Law

Volume 24 Number 3

July 2010

LEXISNEXIS
Sydney — Adelaide — Brisbane — Canberra — Melbourne — Perth
2010

Articles

The role of lawyers in the global financial crisis*

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In recent articles, the author has argued that the global financial crisis can be attributed in large part to three causes — conflicts, complacency and complexity — as well as to a type of tragedy of the commons. This article, which comprised the keynote address for the 2010 Corporate Law Teachers Association Conference, will focus on the failure of market observers, including corporate lawyers, to foresee or act on critical correlations that might have prevented, or at least mitigated, the crisis. Although conflicts, complacency, complexity and the tragedy of the commons can help to explain this failure, the goal will be less to tie the failure to these factors than to demonstrate that the same types of failures to see the same types of correlations have been responsible for many of the major financial crises of the past century, including the current crisis, the collapse of Enron, the meltdown of LTCM, and even the Great Depression. The article will also examine what the responsibility of corporate lawyers should be and how corporate lawyers can be better educated to help their clients try to see these correlations.

In a forthcoming article, Professor Iman Anabtawi and I argue that by perceiving and acting on certain critical correlations, market participants might have helped to avoid or at least mitigate the global financial crisis.[1] We also argue that these *same types of failures* to see *the same types of correlations* have been at least partly responsible for many of the other major financial crises of the past century, including the collapse of Enron, the meltdown of Long-Term Capital Management (LTCM), and even the Great Depression. Unfortunately, we find, there are limits on the ability and willingness of market participants to perceive and act on these correlations.

This article focuses on whether corporate lawyers should have some responsibility to help their market-participant clients identify and address these potentially harmful correlations. In answering that question, I engage the broader question of a corporate lawyer's duties to the public. In accordance with the conference theme, *Educating Corporate Lawyers: Better Counsel*

* This essay is based on the author's Keynote Address at the 2010 Conference of the Corporate Law Teachers' Association of Australia, New Zealand, and the Asia-Pacific Region.

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1 I Anabtawi and S L Schwarcz, 'Regulating Systemic Risk', draft on file with author. Iman Anabtawi is Professor of Law at the UCLA School of Law.

and Better Managers of the Corporate Legal Framework, I also examine how corporate lawyers could be better educated to meet their responsibility.

I Harmful correlations and their consequences

Professor Anabtawi and I identify two types of failures to see correlations: (i) the failure to see, or at least to fully appreciate, correlations between the risk of low-probability events (such as unlikely declines in collateral value) and institutional integrity; (ii) the failure to see or fully appreciate correlations in financial institution interrelatedness — viewing the term 'institution' broadly to include both firms and markets. We argue that these (otherwise independent) failures sometimes can combine to facilitate the transmission of systemic shocks. Let me explain this in the context of actual market crises.

A The Great Depression

Prior to the Great Depression, many banks engaged in margin lending to risky borrowers, securing the loans by shares of stock that the borrowers purchased with the loan proceeds. The value of the stock collateral started out being at least equal to the amount of the loan, and banks assumed that the stock market, which had been continuously rising in value for years, would continue to rise or would certainly not decline substantially in value. Most bankers believed that assumption was reasonable.

In August 1929, however, when an unanticipated decline in stock prices caused some of these margin loans to become undercollateralised, some banks that were heavily engaged in margin lending lost so much money on the loans that their institutions defaulted on their own debts.[2] This represented the first failure: a failure to see, or at least to fully appreciate, correlations between unlikely declines in collateral value and institutional integrity.

The Great Depression also involved the second failure: a failure to see or fully appreciate correlations in financial institution interrelatedness, in this case the prevalence of interbank loans and other advances linking banks together financially.[3]

What made the Great Depression so devastating was that these failures combined to facilitate the transmission of systemic shocks. As individual banks began defaulting because of margin-loan losses, their inability to repay interbank loans caused their creditor banks to suffer losses and begin defaulting, which in turn triggered a downward spiral of the banking system.[4]

B Long-Term Capital Management

Long-Term Capital Management (LTCM) was a large hedge fund that profited by using arbitrage-related trading strategies. In 1998, however, LTCM failed to foresee temporary market irrationality in bond pricing touched off by a default in Russian government bonds, causing LTCM to lose hundreds of

2 S Schwarcz, 'Systemic Risk' (2008) 97 *Georgetown LJ* 193 at 199–200, citing M Bordo, et al, *Real Versus Pseudo-International Systemic Risk: Some Lessons from History* 21 (Nat'l Bureau of Econ Research, Working Paper No 5371, 1995.

3 Ibid, at 199.

4 Ibid.

millions of dollars and undermining its financial viability.[5] This represented the first failure: to fully appreciate a correlation between unlikely declines in collateral — or, in this case, asset — value and institutional integrity.[6]

LTCM's losses also implicated the second failure. Most market participants at that time failed to see the tight correlation in financial institution interrelatedness between hedge funds and banks, which were linked through derivatives-based hedging. The US Federal Reserve Board, however, realised that LTCM's collapse could have devastating consequences: LTCM's derivatives-counterparty banks would suffer serious losses, potentially causing them to begin defaulting and triggering a downward spiral of the banking system.[7]

To avoid this downward systemic spiral, the Fed proactively stepped in to broker a settlement of LTCM's debts.[8]

C Enron

Enron's primary and very profitable business was engaging as a derivatives counterparty. To continue in this business, Enron had to preserve its investment-grade rating. The main risk to this rating was the possibility that Enron's so-called 'merchant assets' might drop in value, requiring Enron to mark (down) to market those asset values.[9]

Enron sought to protect its rating by engaging in a series of structured transactions that effectively used Enron stock, which had an historically rising public-market price, as collateral to hedge the value of its merchant assets. But Enron's stock price subsequently fell to unanticipated levels, triggering a collapse of the hedging structure and a downgrading of Enron's investment-grade rating. Deprived of its primary business strategy, Enron had little choice but to file for bankruptcy. This represented the first failure: to see, or at least to fully appreciate, correlations between unlikely declines in collateral value and institutional integrity.

Enron's collapse did not, however, trigger broader systemic consequences because the collapse did not closely correlate with the viability of other financial institutions. There was, in other words, no 'second failure'.

D The recent global financial crisis

In recent years, many mortgage lenders made loans to risky borrowers secured by the homes that the borrowers purchased with the loan proceeds. These 'subprime mortgage loans' were then bundled together as collateral to partially support the payment of complex asset-backed securities that were

5 R Lowenstein, *When Genius Failed: The Rise and Fall of Long-Term Capital Management*, Random House, New York, 2000, at 144–6, 164, 169–70.

6 LTCM failed to take a long-term view of arbitrage risk, not dissimilar to how banks prior to the Great Depression failed to take a long-term view of collateral risk.

7 Lowenstein, above n 5.

8 Schwarcz, above n 2, at 201.

9 S Schwarcz, 'Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures' (2002) 70 *U Cin L Rev* 1309 at 1310–11.

sold to banks and other institutional investors.[10] These securities maintained their value so long as home prices appreciated, as they had been doing for decades. But market participants may have been too myopic and too conflicted to envision that home prices, and thus collateral values, could fall.[11]

When home prices began falling, some of these asset-backed securities began defaulting, requiring institutions heavily invested in these securities to write down their value, causing these institutions to appear, if not be, financially risky (counterparty risk).[12] This represented the first failure: to see, or at least to fully appreciate, correlations between unlikely declines in collateral value and institutional integrity.

The financial crisis also involved the second failure: a failure to see correlations in financial institution interrelatedness, in this case both the tight interrelatedness among not just banks but also non-bank financial institutions (such as Bear Stearns, Lehman Brothers, and AIG), as well as a failure to see the tight interrelatedness between financial firms and markets.

What made the recent financial crisis so devastating was that these failures combined to facilitate the transmission of systemic shocks. As counterparty risk increased, financial institutions stopped dealing with each other, reducing the availability of credit. Similarly, as securities backed by subprime loans began defaulting, investors stopped investing not only in those securities but also in securities backed by other types of collateral.[13] That, too, reduced the availability of credit. And the lack of credit devastated the real economy.

II Clients may not see or may lack incentive to avoid these types of harmful correlations

Professor Anabtawi and I demonstrate that market participants — a category that includes underwriters, investors, bond insurers, and other financial institutions and firms that lawyers represent — should have seen these harmful correlations but failed to do so, or at least failed to fully appreciate and act on the correlations. These failures were due to several factors: complacency, conflicts, complexity, as well as a type of tragedy of the commons.

For example, individuals employed by market participants can be complacent, judging events by one's experiences in the recent past, not by the worst-case scenarios. Monty Python recognised this in their skit, 'Nobody

10 See generally S Schwarcz, 'Keynote Address: Understanding the Subprime Financial Crisis' (2009) 60 *SC L Rev* 549.

11 S Schwarcz, 'Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown' (2008) 93 *Minn L Rev* 373 at 387, citing, among other sources, N Taleb, *The Black Swan: The Impact of the Highly Improbable*, Random House, New York, 2007, for the human tendency to fail to anticipate improbable events. Market participants also failed to observe the underlying correlation between the prices of subprime mortgage loans and of other non-subprime assets backing these securities.

12 Schwarcz, above n 10, at 553.

13 Schwarcz, above n 11, at 395. See also S Schwarcz, 'Regulating Complexity in Financial Markets' (2009) 87 *Wash U L Rev* 211 at 216–20 (observing that although these (ABS CDO) securities were backed by what appeared to be significantly diverse assets, there was an underlying correlation in the subprime mortgage loans backing many of those securities).

expects the Spanish Inquisition!'[14] Failures to take a sufficiently long view of risk also can reflect a behavioural bias, such as herd behaviour. Thus, before the Great Depression, most thought or assumed that stock prices would continue to rise as in the recent past; before Enron's collapse, many thought that Enron's stock price would continue to rise as in the recent past; and before our financial crisis, most believed that housing prices would continue to rise as in the recent past.

Individuals employed by market participants may also be conflicted. I have argued, for example, that secondary managers of financial institutions are often conflicted because they are normally paid based on short-term deal performance and are rarely effectively penalised for long-term deal failure.[15]

Complexity exacerbates these problems. As the complexity of financial products increases, for example, disclosure can become inherently inadequate — either too lengthy and complicated for most to understand or too simple to explain all nuances.[16] Complacency then can kick in, whereby individuals employed by market participants may make oversimplifications, usually on the optimistic side when an economy is expanding. Thus, these individuals will overrely on rating-agency ratings for complex securities and on over-simplified mathematical risk models such as value-at-risk (VaR).[17]

Finally, markets participants are subject to a 'type' of tragedy of the commons.[18] Because the benefits of exploiting finite capital resources accrue to individual market participants whereas the costs of exploitation, which affect the real economy, are distributed among an even wider class of persons, I have argued that market participants have insufficient incentive to internalise their externalities.[19]

I next examine the responsibility of lawyers to their clients, as well as to the public, to help identify and address harmful correlations.

III The role of lawyers

What responsibility, if any, should lawyers have to help their market-participant clients identify and address harmful correlations? A threshold question is whether lawyers — assuming they had some responsibility in this regard — would add any value. I believe they would.

Being outsiders,[20] lawyers could help counter the complacency of individuals employed by market-participant clients, such as by asking, 'Is this really the worst-case reasonable scenario?', or by questioning whether the

14 *Monty Python's Flying Circus: The Spanish Inquisition*, BBC television broadcast, 22 September 1970.

15 See S Schwarcz, 'Conflicts and Financial Collapse: The Problem of Secondary-Management Agency Costs' (2009) 26 *Yale J on Reg* 457.

16 S Schwarcz, 'Disclosure's Failure in the Subprime Mortgage Crisis' (2008) *Utah L Rev* 1109 (making these and other arguments for why disclosure failed); S Schwarcz, 'Rethinking the Disclosure Paradigm in a World of Complexity' (2004) *U Illinois L Rev* 1.

17 Schwarcz, above n 13, at 231–2.

18 I call this a 'type' of tragedy of the commons because it is not strictly a tragedy of the commons in which all parties involved commonly suffer the externality they cause.

19 Schwarcz, above n 2, at 206.

20 This sentence pertains more to outside counsel, less to inhouse lawyers. For a discussion of the shifting boundaries and responsibilities of inhouse and outside lawyers, see S Schwarcz 'To Make or to Buy: In-House Lawyering and Value Creation' (2008) 33 *J Corp L* 497.

client is engaged in herd behaviour.[21] Being independent,[22] lawyers would be less conflicted than individuals employed full-time by their clients, such as secondary managers of financial institutions.[23] Also, to the extent lawyers are intimately involved in the design of financial products (as I was when practising law), their independent perspective and trained attention to detail might help to counter the over-simplifications sometimes made about financial products by individual employees of market participants.[24] Moreover, lawyers could at least theoretically help to counter the tendency of some clients to externalise costs onto the public.[25]

My analysis first focuses on the responsibility of lawyers to their clients, thereafter focusing on the responsibility of lawyers to the public. My perspective is that client actions may help to facilitate or transmit systemic shocks large enough to bring down the financial system. The analysis assumes that sometimes these client actions will actually violate law, and sometimes they won't. Although my analysis is primarily normative, I will mention certain aspects of US law and ethics as a comparative baseline.

A The responsibility of lawyers to their clients

What responsibility, if any, should lawyers have to their clients to help identify and address harmful correlations? That responsibility should turn in the first instance on whether the client's actions with respect to the correlations would actually violate law. If they would — as would be the case, for example, if a client failed to comply with a law to require at least two-to-one minimum collateral coverage for margin loans[26] — that is the easy case. In the United States, and I imagine in most other legal systems, lawyers have a duty to not engage or assist a client in performing an unlawful act.[27] The lawyer should try to persuade the client to comply with the law and, if unsuccessful, ultimately may have to resign.

If, however, the client's actions with respect to harmful correlations would not actually violate law, I do not see why a lawyer should have any duty *to the client, qua client*, other than — upon the lawyer becoming aware of possible harm to the client — informing the client of the potential harm.[28] Once so

21 See above nn 16–17 and accompanying text.

22 Again, this sentence pertains more to outside counsel, less to inhouse lawyers.

23 Cf above n 15 and accompanying text.

24 Cf above nn 16–17 and accompanying text.

25 See above nn 18–19 and accompanying text.

26 In the United States, Regulation U requires this of bank lenders. Regulation U addresses the correlation between collateral value and institutional integrity.

27 See, eg, Restatement (Third) of the Law Governing Lawyers § 16 cmt c (2000): 'A lawyer may not do or assist an unlawful act on behalf of a client . . .'; ABA Model Rule of Professional Conduct 1.2(d); W Ewald, 'Comparative Jurisprudence (I): What Was it Like to Try a Rat?' (1995) 143 *U Pa L Rev* 1889 at 2123 (discussing why lawyers typically rely upon black-letter rules of law). Enactment of the Sarbanes-Oxley Act clarified that this ethical obligation is mandatory law. Sarbanes-Oxley Act § 307.

28 I do not draw a distinction here between direct financial harm and indirect harm, such as reputational harm. Indirect harm could also, at least theoretically, include harm to the client caused by a systemic collapse.

informed, the client can decide whether to accept this harm as a cost of doing business.[29]

This discussion begs the question of who in an organisation is the 'client'. When I was a partner at Shearman & Sterling, we always told young lawyers that the institution, not the officers with whom the lawyer works, is the client; and that the lawyer has a duty to bring any wrongdoing that officers persist in to the attention of the client's more senior officers or, ultimately, the board of directors.

This was, and I believe remains, very good advice. Among other things, individual lawyers usually work on transactions with secondary managers of the client-institution, who often (and arguably increasingly) may have conflicts of interest with their firms in the way they are paid.[30] This institutional view of the client is now codified in the United States through both ethical rules and federal statute.[31]

B The responsibility of lawyers to the public

The discussion above examines lawyer responsibility to the client, *qua* client. I now examine whether lawyers should have a responsibility to the public — beyond their responsibility to the client — to help identify and address harmful correlations.

As before, that responsibility should turn in the first instance on whether the

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29 Cf R Uphoff, 'Who Should Control the Decision to Call a Witness Respecting a Criminal Defendant's Tactical Choices' (2000) 68 *U Cin L Rev* 763 at 768 (describing the client-centered approach to lawyering as identifying legal problems and presenting options to the client so that the client can ultimately select its course of action).

30 Schwarcz, above n 15.

31 Rule 1.13(b) of the ABA's *Model Rules of Professional Conduct*, for example, provides that:

> [i]f a lawyer knows that an officer, employee or other person associated with the organisation is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organisation, or a violation of law that reasonably might be imputed to the organisation . . . Unless the lawyer reasonably believes that it is not necessarily in the best interest of the organisation to do so, the lawyer shall refer the matter to higher authority in the organisation, including, if warranted by the circumstances, to the highest authority that can act on behalf of the organisation as determined by applicable law.

Federal statutory law similarly requires reporting up in at least certain circumstances. Pursuant to a mandate in § 307 of the Sarbanes-Oxley Act, the US Securities and Exchange Commission (SEC) promulgated federal administrative rules of professional conduct applicable to attorneys practising before the SEC in the representation of issuers of securities. Among other things, these rules require an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the issuer, or any agent thereof, to the chief legal counsel or the chief executive officer (or equivalent officer) of the issuer: Sarbanes-Oxley Act § 307(1). If such officer does not appropriately respond to the evidence (adopting, for example, any necessary and appropriate remedial measures), the attorney must report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of independent directors, or to the full board of directors: Sarbanes-Oxley § 307(2). Some argue that these SEC-promulgated reporting rules simply mirror existing requirements of the ethics rules. See, eg, R Cramton, G Cohen and S Koniak, 'Legal and Ethical Duties of Lawyers after Sarbanes-Oxley' (2004) 49 *Vill L Rev* 725 at 830. There nonetheless is acknowledgment that the new rules at least shift enforcement from state to federal law. See ibid, at 793; L Cata Backer, 'The Sarbanes-Oxley Act: Federalizing Norms for Officer, Lawyer, and Accountant Behavior' (2002) 76 *St John's L Rev* 897 at 923–4.

client's actions with respect to the correlations would actually violate law. If they would, the lawyer should have a duty to the public to not engage or assist the client; and, if unsuccessful in persuading the client to comply with the law, the lawyer ultimately may have to resign.[32] But if the client's actions with respect to harmful correlations would not actually violate law, the question of lawyer responsibility is less clear. How should we analyse that responsibility?

Normatively, I see two possible analytical approaches. One is to view this question of lawyer responsibility to the public as a subset of the broader normative question of whether lawyers and other professional '*gatekeepers*' should have a duty to the public. Much has been written on gatekeeping, focusing on the intrinsic monitoring role performed by these professionals in helping to facilitate financial transactions.[33]

The argument favouring a 'gatekeeper' duty of professionals focuses on integrity and costs. Professionals have standards of integrity at least different, if not sometimes higher, than that of their clients. Lawyers, for example, not only are bound to ethical standards[34] but also can be viewed as 'reputational intermediaries' who 'receive[] only a limited payoff from any involvement in misconduct' compared to the primary wrongdoer.[35] Furthermore, lawyers may have 'systematic opportunities to detect, prevent, and/or alert the public about risky corporate conduct or fraud'.[36] In contrast, governmental monitors, such as financial regulatory agencies, 'may be ill-equipped to screen gatekeepers' clients for illicit activity in a more nuanced way due to limits in oversight capabilities coupled with resource constraints'.[37]

There is little doubt that lawyers could perform a useful gatekeeping role, such as by helping to counter the complacency, conflicts of interest, over-simplification about financial products, and externalisation of costs previously discussed.[38] My concern, however, is whether they should have a legal responsibility to do so, punishable perhaps by penalties for failure. Furthermore, if lawyers should have a gatekeeping role, how exactly should they perform it? For example, if the client fails to conform to the gatekeeping

32 See above n 26–27 and accompanying text.

33 See, eg, J Coffee Jr, 'Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms' (2004) 84 *BUL Rev* 301; A Hamdani, 'Gatekeeper Liability' (2003) 77 *S Cal L Rev* 53; H Jackson, 'Reflections on Kaye, Scholer: Enlisting Lawyers to Improve the Regulation of Financial Institutions' (1993) 66 *S Cal L Rev* 1019; R Kraakman, 'Gatekeepers: The Anatomy of a Third-Party Strategy' (1986) 2 *JL Econ & Org* 53. See further, J Manns, 'Rating Risk After the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability' (2009) 87 *NC L Rev* 1011 at 1015 n 7 (broadening the concept of gatekeepers to include 'private actors whose role as suppliers or consumers of lawful goods or services provides them with the cost-effective ability to detect and potentially prevent wrongdoing', such as credit rating agencies).

34 See generally, Model Rules of Professional Conduct (MRPC), at <http://www.abanet.org/cpr/mrpc/mrpc_toc.html> (accessed 6 July 2010). In the United States, all states have adopted some form of a legal ethics code, a majority of which are based on the MRPC. In order to be admitted to the Bar in all but four US jurisdictions, applicants are required to receive a passing score on the Multistate Professional Responsibility Examination (MPRE). See <http://www.ncbex.org/multistate-tests/mpre/> (accessed 6 July 2010).

35 Coffee, above n 33, at 308–9.

36 Manns, above n 33, at 1022.

37 Ibid, at 1021.

38 See further above n 25 and accompanying text (explaining why lawyers could add value).

lawyer's advice, would it be sufficient for the lawyer to simply resign from representing the client, or should the lawyer have to do more, such as 'noisily withdrawing' by making some public announcement of the client's actions?[39]

The gatekeeping literature does not appear to adequately answer these questions, perhaps because that literature does not consistently address whether client actions would actually violate law. For example, that literature sometimes references 'misconduct'[40] or 'risky corporate conduct',[41] both terms including conduct that is not necessarily unlawful. Furthermore, that literature often discusses gatekeeper responsibility for client misconduct in terms of derivative liability: in order for a gatekeeper to be derivatively liable, the client would first have to have been found liable for a violation of law.[42] The existing gatekeeping literature therefore is not, and does not appear to even purport to be, dispositive of these questions.

There is, however, another analytical approach for inquiring into lawyer responsibility where client actions would fall short of actually violating law: to focus more fundamentally on externalities. Thus, what responsibility should a lawyer have where the client's actions create externalities that would not actually violate law?

All transactions create externalities.[43] Therefore, any time a lawyer helps a client facilitate a transaction, the lawyer is participating in creating externalities. However, a paradigm of social ordering is that, left to independent bargaining, parties work out arrangements that — except to the extent the arrangements create unlawful externalities — benefit the overall public good:

> [The] fact that parties in pursuit of self-interest agree to an exchange indicates that the exchange in question is likely to enhance allocative efficiency. Furthermore, the fine tuning arising out of the bargaining process serves the common good by assuring that increased value is purchased at the lowest possible expense. Reciprocity, then, not only permits the alignment of individual self-interest and the common good, but it does so in a manner that . . . is very reminiscent of Adam Smith's 'invisible hand'.[44]

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39 See further, ABA MRPC 1.13(c), which states (emphasis added) that if:

> (1) despite the lawyer's efforts . . . the highest authority that can act on behalf of the organisation insists upon or fails to address in a timely and appropriate manner an action or refusal to act[] that is *clearly a violation of law*, and (2) the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organisation, then the lawyer *may* reveal information relating to the representation . . . but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organisation.

40 See text accompanying n 35 above.

41 See text accompanying n 36 above.

42 See Coffee, above n 33, at 346–7 (discussing whether gatekeepers should be held strictly liable for client misconduct); Jackson, above n 33, at 1032 (suggesting derivative liability as an alternative source of legal obligations for counsel to regulated firms); Hamdani, above n 33, at 53, 63.

43 A Stone, *Regulation and Its Alternatives*, Congressional Quarterly Press, Washington DC, 1982, pp 91 and 97 (observing that '[s]trictly speaking, virtually every activity involves an externality').

44 M Rosenfeld, 'Contract and Justice: The Relationship Between Classical Contract Law and Social Contract Theory' (1985) 70 *Iowa L Rev* 769 at 847. See also R Posner, 'Wealth Maximization and Judicial Decision-Making' (1984) 4 *Int'l Rev L & Econ* 131 at 132

To the extent lawyers advise on whether arrangements are lawful and help to facilitate lawful arrangements, they therefore can be seen as social engineers contributing to this social-ordering paradigm.[45] If lawyers were constrained from helping to facilitate bargained-for lawful business transactions that nonetheless may cause externalities, they would be forced to substitute their judgment about externalities for that of their clients. To the extent clients have more or better information about the consequences of a business transaction (other than the transaction's legality),[46] they would be better positioned to make business decisions. If lawyers are specialists only in law, they would be ill-trained to assess and weigh the costs (including externalities) and benefits of business transactions they are helping to facilitate.[47] In another context, for example, I have asked how a lawyer asked to opine on a proposed break-up leveraged buyout could even attempt to balance costs and benefits where the resulting transaction creates a more efficient business but, in the process, costs a thousand jobs, impoverishes a community and destroys families. Imposing a duty on lawyers to second-guess or impede their clients' lawful business decisions would generally be inefficient.[48]

I recognise that in the precise scenario, there are practical limits on the ability and willingness of market participants to perceive and act on the correlations. It therefore is possible, for reasons already discussed,[49] that clients might not always have more or better information about consequences than their lawyers. Nonetheless, it would be impossible ex ante to know precisely when, or how often, lawyers would in fact have more or better

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(asserting that courts should use 'wealth maximization' as a guide to judicial action where 'the goal of such action is to bring about the allocation of resources that makes the economic pie as large as possible, irrespective of the relative slices'); A Smith, 'An Inquiry Into the Nature and Causes of the Wealth of Nations', in K Sutherland (Ed), *An Inquiry Into the Nature and Causes of the Wealth of Nations: A Selected Edition (Oxford World's Classics*, Oxford University Press, 1993, pp 291–2, 547–8 n 292 (1776):

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

45 S Schwarcz, 'The Limits of Lawyering: Legal Opinions in Structured Finance' (2005) 84 *Tex L Rev* 1 at 29.

46 Ibid.

47 Ibid.

48 See, eg, J Cohen, 'Lawyer Role, Agency Law, and the Characterization "Officer of the Court"' (2000) 48 *Buff L Rev* 349 at 387–8 (cautioning against '[c]laims that lawyers should be free to disobey the client's lawful instructions'); S Griffith, 'Afterward and Comment: Towards an Ethical Duty to Market Investors' (2003) 35 *Conn L Rev* 1223 at 1234 n 43 (cautioning that '[v]aguely defined duties to "the public" threaten to increase the agency costs of the legal representation as lawyers may seek to pursue their own ideological goals in favour of client interests').

49 See above n 25 and accompanying text (discussing, among other things, that by being outsiders lawyers could help counter the complacency of, and that by being independent lawyers would not be conflicted like, employees of market participants).

information. Without that knowledge, the efficiency or inefficiency of imposing a *duty* on lawyers to second-guess or impede their clients' lawful business decisions cannot be determined.[50]

I therefore conclude, where the consequence of a client's action would be *harm that falls short of actually violating law*, that a lawyer should have no obligation to identify that consequence to the client or to resign from the engagement.

Some lawyers may nonetheless wish to inform the client of any such harmful consequences and to withdraw from the engagement if the client persists in its action. The lawyer's motivation may be aspirational, or it may even be practical. It can be risky to help facilitate transactions that violate norms even though the transactions would not actually violate law. If a transaction is later criticised, the lawyer can suffer reputational loss. Furthermore, when the public suffers harm, some prosecutors and judges may be tempted to apply a flawed syllogism: the public is harmed; the lawyer's action helped facilitate the transaction causing the harm, and the lawyer is a deep pocket; therefore, the lawyer should be liable for the harm.[51]

Nothing I say today should prevent a lawyer from having these rights, to inform the client of harmful consequences and to withdraw from the engagement if the client persists in its action[52] — provided that any such withdrawal is not 'noisy'.[53] A lawyer should have the option, in other words, to refuse to participate in conduct that may be socially harmful.[54] But individual lawyers should not have to decide, at the risk of liability, whether client actions are socially harmful where society itself has not made that explicit determination (by making the actions unlawful).[55]

50 Furthermore, any hard-and-fast rule imposing a duty on lawyers to second-guess or impede their clients' lawful business decisions might not work because a corporate lawyer's role is not strictly defined but depends on the scope of particular attorney-client relationship, as determined by the client. Some lawyers may be held to a narrow scope, focusing only on law; whereas others, such as lawyers deeply involved in helping their clients raise capital or engage in an initial public offering of stock, may become conversant in issues beyond those traditionally considered 'legal'. See Griffith, above n 48, at 1225 (showing how lawyers can exercise a significant degree of authorship over a particular transaction which may alter their traditional legal role).

51 See Schwarcz, above n 45, at 36–42 (examining what lawfulness should mean in a world of changing norms). See also ibid, at 37, citing J Macey and G Miller, *Banking Law and Regulation*, 2nd ed, Aspen Law & Business, New York, 1997, at 346 (suggesting that 'large [law] firms [are] the most appealing targets because they have the deepest pockets') and N Koppel, 'Partial Protection — Plaintiffs Face a Supreme Court Barrier When Suing Law Firms for Fraud', *Am Law*, July 2004, at 77 ('Law firms are an alluring deep pocket for defrauded investors.').

52 See further ABA MRPC 2.1 (providing that '[i]n rendering advice, a lawyer may refer not only to law but to other considerations such as moral, economic, social and political factors that may be relevant to the client's situation').

53 See further above n 39 (discussing noisy withdrawal).

54 See further W Simon, 'Earnings Management as a Professional Responsibility Problem: A Response to Steven Schwarcz's 'The Limits of Lawyering' (2005) 84 *Tex L Rev* 83 at 88 (arguing that lawyers should not participate in conduct that is 'socially harmful'). A lawyer also has the right to work for law reform to help ensure that actions that cause massive externalities will, in the future, be prohibited by law.

55 See S Schwarcz, 'Reply — We Are All Saying Much the Same Thing: A Rejoinder to the Comments of Professors Coffee, Macey, and Simon' (2005) 84 *Tex L Rev* 93 at 101–2

IV Educating lawyers

How should we, as corporate law professors, educate law students and lawyers (collectively, 'lawyers') to fulfill the responsibilities discussed above? Because the foregoing analysis should be generally applicable, in a commercial setting, to any client action that would cause harmful consequences, these responsibilities can generally be described as identifying client actions that would actually violate law, in order to try to persuade the client to comply with the law and, if unsuccessful, ultimately to resign; and trying to identify possibly harmful client actions that would not actually violate law in order to inform the client of the potential harm and to preserve the option, if the lawyer wishes, to withdraw from the engagement if the client persists in its action.

On a narrow basis, we should educate lawyers to be aware that client actions can cause harmful consequences that may not be immediately obvious. For example, the correlations discussed today between unlikely declines in collateral value and institutional integrity and the correlations in financial institution interrelatedness can sometimes combine to facilitate the transmission of systemic shocks.

On a broader basis, we should educate lawyers as to why market participants do not always see or appreciate the potential that their actions will cause harm. For example, herd behaviour may cause market participants to take an insufficiently long view of risk or to be complacent, judging events by one's experiences in the recent past, not by the worst-case scenarios.[56] We should help our students understand these rudimentary aspects of behavioural psychology that can distort strict economic rationality and foster complacency.

We also should educate lawyers that individual employees, such as the corporate officers whom we initially regard as the client, may be conflicted with the interests of their institution — such as where they are paid for booking a deal without being penalised for long-term deal failure. In these scenarios, the lawyer should recognise that the client is the institution, and that the lawyer may have a reporting-up responsibility to (ultimately) the client's board of directors.

Furthermore, we should educate lawyers that complexity exacerbates these concerns. It can undermine disclosure's adequacy. It also can tempt individuals to make oversimplifications, to overrely on heuristics such as rating-agency ratings and mathematical risk models. At the same time, however, lawyers should be taught to recognise that business people often have higher risk tolerances, as well as different, legitimate, pressures (eg, budgets), that tend to influence their decisions. To some extent, this could be

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(discussing the observation of legal ethicist Richard Painter that although it is 'sound in principal' for a lawyer to embrace aspirational goals, vague aspirational goals might serve as a 'definition of professionalism' but should not be used to 'impose liability on lawyers').

56 See further J Darley, 'The Cognitive and Social Psychology of Contagious Organizational Corruption' (2005) 70 *Brook L Rev* 1177 at 1183 (arguing that widespread corruption in organisations often has its origin in actions that are not corrupt; the pressure to make decisions quickly promotes actors to act intuitively and subjects those decisions to only dubious ethical analysis, with each subsequent actor rationalising that his conduct is not much different from the conduct that preceded it).

learned by mixing law students and MBA students together in some classes.

On the broadest basis, we should educate lawyers to better understand the core principles of corporate law and finance, thereby broadening their perspectives and enabling them to better identify and assess consequences.[57] Prior to going to law school, I was educated as an engineer. We learned that everything builds from first principles, even the most sophisticated structures. We need to stress this in our courses, to review basic concepts again and again in different contexts and from different perspectives so that students gain 'ownership' of the ideas.

To that end, we shouldn't artificially separate related areas of law, such as commercial law and insolvency law. In the real world, these are integrally related fields. In my courses, I teach commercial and insolvency law together, emphasising the relationships and tensions between them.

Finally, we should try to rejoin the link between theory and practice. Unless one is able to apply theory to real problems, one does not truly understand the theory or the problem. Furthermore, lawyers should focus on scenarios where theory breaks down.[58] We need to engage in more applied teaching, perhaps more along the lines of case studies used by business schools; indeed, I try to teach my courses at least partly in this fashion.[59] This also will help to develop the common sense and judgment that are so critical to being a good business lawyer, and to know that if a transaction 'smells' funny it may not withstand ultimate scrutiny.[60]

57 See further F Stevelman, 'Globalization and Social Responsibility: Challenges for the Academy, Future Lawyers, and Corporate Law' (2008/2009) 53 *N Y L Sch L Rev* 817 at 820 (emphasising the need to review basic financial principles as essential to teaching corporations and securities regulation). I would view fundamentals of accounting as included in these core principles. See further S Schwarcz, 'Financial Information Failure and Lawyer Responsibility' (2006) 31 *J Corp L* 1097 at 1113–19 (examining the extent to which lawyers should learn accounting principles).

58 V Fleischer, 'Deals: Bringing Corporate Transactions into the Law School Classroom' (2002) *Colum Bus L Rev* 475 at 482.

59 See, eg, <http://www.law.duke.edu/curriculum/courseinfo/course?> id=33, id=47, and id=80. See also Fleischer, above n 58, at 495–6 (promoting a pedagogical approach to introducing financial concepts to law students that involves both case studies and 'deals' theory); J Lipshaw, 'The Venn Diagram of Business Lawyering Judgments: Toward a Theory of Practical Metadisciplinarity' (forthcoming 2011; copy on file with author) (discussing interdisciplinary skills needed by business lawyers).

60 In engineering school, I was taught to always review answers from a common sense perspective; if the answer doesn't seem right, it probably isn't.