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INTRODUCTION

THIS PUBLICATION CELEBRATES the scholarship of the University of Virginia School of Law. Each year, the Virginia Journal presents in-depth intellectual profiles of three scholars, plus a survey of recent publications by the entire faculty.

The tradition began in 1998, with an inaugural issue honoring Kenneth Abraham, Michael Klarman, and Elizabeth Scott. The 1999 Virginia Journal featured Anne Coughlin, John Monahan, and G.E. White. Last year's Journal profiled Lillian BeVier, Barry Cushman, and Paul Stephan.

These choices reflect a wide variety of interests, perspectives, opinions, and methodologies, but a consistent dedication to excellence. Our goal is to maintain an intellectual community where the broadest range of opinion and debate flourish within a framework of common purpose. Every person honored by the Virginia Journal has contributed to that goal, not only by his or her published work, but also by constructive participation in our community of scholars.

This year's *Virginia Journal* presents three members of our faculty:

GEORGE TRIANTIS is one of the legal academy's leading scholars in the economic analysis of contracts and a co-editor of the Journal of Law & Economics. George's scholarship emphasizes the essential role of debt financing and bankruptcy in corporate governance. He has reformed the academic understanding of debt contracts by examining their impact on corporate flexibility, and has pioneered a new school of legal analysis that applies options theory to the management of flexibility in legal strategy and policy decisions. George's work has inspired students, scholars, and policy-makers to employ the techniques of options theory in analyzing decisions to begin, abandon, accelerate, or decelerate legal actions.

ANN WOOLHANDLER is a student of history and of federalism. Her scholarship offers a revisionist analysis of the role of the federal courts in enforcing constitutional constraints on government action. She has written a ground-breaking account of the history of habeas corpus and documented the surprising role of diversity jurisdiction in enabling Article III courts to protect constitutional rights. Recently, she has re-examined and reinterpreted the respective roles of judges and juries in the federal courts. In all these areas, Ann's scholarship relies on historically situated analysis of prior developments to shed light on current issues of judicial federalism.

GEORGE K. YIN is one of the nation's most creative and influential experts on tax policy. He began his career in private practice, then served as Tax Counsel to the Senate Finance Committee during the period leading up to the landmark Tax Reform Act of 1986. His scholarship reflects these experiences, combining theoretical insights with practical concerns and political considerations. Illustrative of George's approach is the work he did as co-reporter of an ALI project in which he developed a comprehensive plan to simplify and rationalize the taxation of millions of privately held businesses. He has offered other reform proposals on topics ranging from the taxation of public corporations to the earned income tax credit to the tax treatment of mergers and acquisitions. Not surprisingly, George's help is often sought by Congress and the Treasury, and he has been a valued advisor to numerous public and private committees and task forces.

John C. Jeffries, Jr
DEAN

GEORGE G. TRIANTIS

The Business of Contracting

After graduating from law school at the University of Toronto, George Triantis practiced corporate and bankruptcy law for two years. His decision to leave practice for academics was triggered by a joint frustration and fascination with boilerplate terms and precedents in transactional practice. "I wanted to know how they came into being, why they became boilerplate and why they didn't change much over time," he explains. "I began to see that academic theorizing offers an understanding of the legal world that would take years and years to acquire by experience in practice." Triantis has established himself as one of the country's premier legal scholars in the areas of contract theory and corporate finance.

Triantis's research focuses on the incentive and information problems that afflict contracting. In an ideal world, a contracting party would not only have superior information or expertise to undertake its designated task, but also have strong incentives to do it well. Unfortunately, as Triantis notes, the two often do not go together. The result is a trade-off in which the parties must decide how much authority or discretion to delegate to the person who has the information or expertise, but not the best incentives. For example, investors would like to fully exploit the experience and expertise of corporate managers.

However, managers do not have investor interests completely at heart. The investors may try to realign a manager's incentives through the structure of her compensation. However, they may also withhold some decision-making authority from the manager and constrain her discretion. Triantis elaborates this theory to explain the law relating to the boundaries of various legal organizations (such as corporations and trusts), to the design of hierarchical structures within organizations, and to simple contracts. In "Organizations as Internal Capital Markets" (Working Paper, U. Virginia 2002), he explores these mechanisms in both the commercial and charitable sector of the economy.

Triantis has also used this lens to explain the patterns and law of secured credit. Security interests constrain managerial discretion in many ways: with important exceptions, security interests prevent the disposal of collateral and inhibit the manager's access to future financing. But these constraints are partial, not total, and that fact is critical. If security interests completely tied a manager's hands, they would also waste the potential value of the manager's expertise. Triantis has argued that this trade-off explains the various exceptions to these restrictive features of security interests. For example, security interests do not follow collateral into the hands of buyers in the ordinary course, and a purchase money security interest may award higher priority to a creditor who finances a new acquisition. Triantis elaborates this analysis in several articles, including "A Free-Cash Flow Theory of Secured Debt and Creditor Priorities", 80 *Va. L. Rev.* 2155 (1994), and "Financial Slack Policy and the Laws of Secured Transactions", 29 *J. Legal Studies* 35 (2000). He also extends the theory to bankruptcy in "A Theory of the Regulation of Debtor-in-Possession Financing", 46 *Vand. L. Rev.* 901 (1993). A company undergoing reorganization in bankruptcy can obtain new financing through so-called debtor-in-possession lending, but only subject to the bankruptcy court's case-by-case approval. This provides the bankrupcy court a means of relaxing the restrictions on management in appropriate cases. Triantis recently collected his various insights on the effect of priority schemes on managerial decision-making in a book, *The Law and Finance of Secured Credit* (forthcoming Foundation Press 2003).

Triantis introduced real options analysis to the study of contract law in an article presented at a conference in 1991 on the treatment of contracts in bankruptcy, "The Effects of Insolvency and Bankruptcy on Contract Performance and Adjustment", 43 *U. Toronto L.J.* 679 (1993). Most prior scholarship on options considered traditional options on financial assets such as shares of stock. A real option, by contrast, is one in which the underlying asset is a "real" asset such as a business, a factory, a patent, or so on. Often, such an option is not a formal contract, but simply a way of characterizing a party's ability to defer a decision until more information becomes available. Flexibility of this type may arise in the form of a legal right.

Triantis observed that an executory contract enforceable by money damages has the characteristics of a real option. That is, the promisor can wait until the time for performance to decide whether to perform or pay damages. By that time, the promisor may have more information about the cost of performing. Thus, Triantis demonstrated that the value of a contract lies not only in the expected payoffs of the contracted-for exchange, but also in each party's option to breach and pay damages. Triantis noted that this option affects the promisor's incentives in various ways. For example, it may lead the promisor to take greater risks in structuring performance: after all, if a novel cost-saving technique fails miserably, the promisor can abandon it and pay damages rather than incur the high cost of performance. Triantis later collaborated with his brother, Alex, a finance professor at the University of Maryland, to analyze the conditions under which a promisor would exercise this option by repudiating before performance was due. They analyzed this decision as a product of a trade-off between the benefit from inducing the promisee to mitigate by repudiating, and the cost of extinguishing the valuable option to later perform. Their article, "Timing Problems in Contract Breach Decisions", 41 *J. Law and Econ.* 163 (1998), criticizes the doctrine of anticipatory repudiation for giving incentives to the promisor to repudiate prematurely, thereby undermining the value of the initial contract.

Triantis' recent projects employ the tools of information economics and real options to address issues raised in the new economy. In "Financial Contract Design in the World of Venture

Capital", 68 *U. Chi. L. Rev.* 305 (2001), he compared patterns of contracting in venture capital with the those of conventional bank loan contracts, and argued that the only significant innovation in venture capital contracts with start-ups is the use of convertible debt (or convertible preferred equity). He identifies, nevertheless, a number of significant benefits from using convertible securities that are unavailable to commercial banks because of federal regulation that restricts their ability to hold equity interests in their borrowers. Triantis' interest in convertible securities dates back to an earlier article, "Conversion Rights and the Design of Financial Contracts", 72 *Wash. U. L. Q.* 1231 (1994), coauthored with Alex Triantis. The article compared convertible debt with the rarer form of stock with an embedded put option that is redeemable for a note of the corporation. They demonstrated that, while the two types of instruments are effectively identical in the payoffs to the investor in different states of the world, they have distinct typical governance rights that explain why the conversion right is regulated by law when it exists in stock with a put option, but not in convertible debt. A holder of the former instrument cannot redeem her stock for cash or a note when the firm is undercapitalized, even if the conversion right is fully disclosed in financial statements.

The new economy is founded on human capital. As financial markets developed and opened new access to financial capital, the contract between a firm and its human capital gained increasing prominence. Triantis coauthored a working paper with Alex Triantis and Eric Posner of the University of Chicago, "Investing in Human Capital: The Role of Covenants Not To Compete" (U. Virginia Working Paper), that examined the role of covenants not to compete in these contracts. The conventional wisdom views these covenants as mechanisms preventing employees from leaving and competing against their employers. However, employees (or their new employers) frequently buy themselves out of the restrictive covenant. The authors demonstrated that this renegotiation allows the employer to recover the value of its investment in the employee, which may be socially desirable if that investment is useful in the new employment, but bad otherwise. The prospect of excessive investment by employers may be additional justification for the judicial reluctance to enforce covenants not to compete.

Triantis' current work on contracting behavior concerns the use of vague contract terms. Conventional economic analysis of contracts suggests that parties avoid vague terms because they invite costly litigation and uncertainty over their application by future courts. Yet contracts in the real world regularly invoke vague standards such as commercial reasonableness. As a result, there is a significant gap between theoretical predictions and commercial practice. Triantis provided some justification for such terms in "The Efficiency of Vague Contract Terms", 1065 *La. L. Rev.* 62 (2002). This article was a first step in a broader effort to examine how contracting parties anticipate future litigation strategies and outcomes in their original contract. Triantis subsequently coauthored an innovative paper with his colleague, Chris Sanchirico, suggesting that parties may deliberately agree to contract terms that invite fabricated evidence at a future trial. In "Evidence Arbitrage: the Fabrication of Evidence and the Verifiability of Contract Performance" (U. Virginia Working Paper 2002), the authors defend the counterintuitive idea that contracting parties may prefer that each have the opportunity to present false evidence. Triantis and Sanchirico note that the parties might not be concerned that a court will err in its fact-finding because the prospect of fabrication might actually enhance the parties' incentives to perform their obligations while reducing expected litigation costs.

In a seminar that Triantis teaches with colleague and former Dean Robert Scott, the students are encouraged to test various theoretical propositions by examining contracts and contracting patterns in the real world. This is an onus that Triantis firmly believes academics should carry, particularly in the area of private law. His belief is borne out in his teaching, research, and in his capacity as an editor of the *Journal of Law & Economics*. "Our work should explain the world we live in first, before recommending how it ought to be improved," Triantis argues. "If we cannot succeed in the former task, there is no point moving to the latter." Triantis came to academia in search of explanations for what he observed in the patterns of corporate practice. Now, he and his students seek to return to the real world as a testing ground for his theoretical contributions.

EXCERPT FROM:

Timing Problems in Contract Breach Decisions

Alexander J. Triantis, University of Maryland and George G. Triantis, University of Virginia

Timing Problems in Contract Breach Decisions
61 *J.L.&Econ.* 163 (1998)

II. THE REAL OPTION TO BREACH

THE VALUE OF A *PRESENT* EXCHANGE to one party is the difference between the value of what is received (which we call the price, P) and the cost of what is given (C). Thus, the net value from the exchange (P - C) may be positive (profit) or negative (loss). If the price is greater than the cost, the exchange yields a profit that may be as high as the price itself (if the cost is zero). If the cost is greater than the price, the exchange produces a loss (if the cost of performance is unbounded on the upside, so is the potential loss). Contract law enforces and thereby enables an *executory* contract: promises to complete an exchange at some time in the future. We assume that P is constant (that is, a fixed price with no possibility of default by the promisee) and that the cost of performance, C, is a random variable that determines the profitability of the exchange to the promisor.[13] At the time of the contract, the promisor faces a distribution of possible net payoffs from the future exchange that range from infinitely large losses to a profit equal to the contract price. Our assumption that the promisor faces variable cost of performance and a fixed payment from the promisee can easily be flipped to allow for the promisor to owe a fixed payment and be entitled to performance from the promisee of variable value.

The usual mode of enforcement of promises in common-law jurisdictions is the sanction of damages. As a consequence, a promisor usually holds an option to breach and pay money damages (D) to the promisee.[14] In fact, the cost of breaching is usually higher than damages and includes the cost of litigation and reputational sanctions for breaching. To keep the discussion simple, however, we assume that the option to breach may be exercised simply by paying damages. Courts usually award expectation damages: an amount that puts the promisee in as good a position as if the promise were performed. If the loss from executing the promised exchange is greater than the damages, the promisor will exercise its option to breach. Thus, the promisor's payoff from the exchange is P - C, except that the promisor can never be worse off than to lose the amount of damages (- D). Options theory allows us to frame the promisor's option in several ways. For expositional purposes, we analyze the value of the executory contract to the promisor as equal to the value of the exchange in the absence of breach (P - C) plus the value of a call option on the cost of performance (C). The call option on C has an exercise price equal to the contract price plus the damages ($P + D$): when the promisor breaches, she forgoes the right to collect the contract price (P) and is liable to pay damages (D).[15] Given assumptions of fully compensatory expectation damages, perfect enforcement, and no insolvency, the value of the option at the time it is exercised is the difference between the cost of performance to the promisor and the value of the promise to the promisee ($P + D$).

The breach option is an American option: the promisor can exercise the option by repudiating at any time between the contract and the date set for performance. By its very nature (bounded downside risk), an option's value varies with the length of time during which it can be held. Therefore, as a general matter, the holder of an American option should hold the option to maturity. A promisor might choose to repudiate early in order to compel the promisee to mitigate and thereby reduce the promisor's liability for breach. In our options framework, the exercise price of the breach option is the sum of the contract price and money damages. Therefore, a promisor might be tempted to exercise before maturity because, by requiring the promisee to mitigate, she can hold down the exercise price of her call option and thereby increase the option's value. Thus, the trade-off defined in the introduction can be restated as follows. At any time before the date set for performance, the promisor chooses between exercising its breach option early at a more favorable strike price or later at a less favorable strike price.

IV. OPTIONS TO BREACH AND THE EFFICIENCY OF ABANDONMENT DECISIONS

Throughout the discussion thus far, we have implicitly assumed a unilateral option: the promisor holds an option to breach while the promisee is certain not to breach. In reality, however, a contract is often executory on both sides and either party may breach. Both parties hold options to breach. Moreover, the exercise of one party's option effectively terminates the other party's options. As we noted above, the value of an option varies with the time to maturity of the option. In the unilateral option case, the maturity date is fixed by contract at the date set for performance. In a bilateral option case, the maturity date of one party's option is the earlier of the contract performance date and the termination decision of the other party. This makes it more difficult for a party to value the remaining life of an option at any point in time and therefore to decide whether to repudiate.

Consider a firm whose research and development activity has yielded the design of a novel product for sale to consumers. To exploit this opportunity, the firm must first design and build a machine to manufacture the product. The firm enjoys flexibility in the timing of its investment. In particular, the firm can decide to accelerate or delay the construction of the machine. Each time the firm considers its option to invest, its decision depends on the expected cost and value of the machine. The value of the machine is the present value of the expected revenue from sales of the consumer good less the manufacturing and selling costs. The cost of building the machine is uncertain because it is a function of changing technology and input prices. The value of the machine is also uncertain because it varies with, for example,

consumer tastes. The ability to defer construction and wait for the resolution of some uncertainty is valuable. Even if the machine has a positive net present value at a given point in time, the firm may be better off waiting. Its susceptibility to fluctuations in the cost and value of the machine is skewed because of the firm's ability to walk away from the project if it is expected to result in losses. Indeed, it is only because there are countervailing costs to waiting that firms invest in opportunities at all rather than defer indefinitely.

Perhaps the most obvious cost to deferring construction of the machine is the time value of money: a dollar of profit tomorrow is worth less than a dollar of profit today. There are significant other costs such as the decision of a competitor to exploit the same or a rival opportunity. Thus, in choosing whether to invest or defer, the firm must weigh these costs against the value of holding on to its option. There is another type of cost to holding on to an option. It includes the cost of retaining technical expertise on the payroll and of updating information concerning technology or consumer demand. Indeed, the presence of these irrecoverable costs suggest that the choice of the firm is not simply whether or not to exercise its option to invest but also whether to abandon it. The firm should abandon the option when its value is lower than the cost of preserving it. In reality, the choices of the firm may not be as discrete as we have just stated. A firm may adjust the rate at which it exploits an opportunity by accelerating or decelerating its investment. As the rate decreases below a certain level, the option is extinguished and can be resurrected only at substantial cost. Thus, if a firm observes unfavorable information about a project's payoffs, it may avoid at least some of the downside by abandoning the project even after it has started investing in it.[32] Our focus in this article is on this abandonment decision and its contracting parallel, the repudiation decision.

A firm decides not only when, but also how—or by what governance structure—to exploit the available project. In particular, it must choose the extent to which it will integrate production within the firm and the extent to which it will contract with outside entities. For example, the firm may contract to purchase the machine from a supplier who undertakes to design and construct the machine. The firm will then manufacture the consumer product, market it, and sell it. If the firm decides to purchase the machine, it will likely enter into an executory contract in order to encourage valuable reliance (or relationship specific) investments: for example, the seller may design and build a prototype of this specialized machine, and the buyer may retain technicians who will be trained and ready to service the machine when it arrives. The division of the investment opportunity by contract also splits the abandonment decision between the parties and thereby has an adverse impact on the timing of abandonment.

To many economists, the integration (or make-or-buy) decision is a choice between governance structures.[33] Contracts within a firm have different governance characteristics than external contracts. In particular, employer-employee contracts are thought to be categorically different from relations with contractors outside the firm, even though they both provide labor to the production process.[34] A similar contrast exists in connection with the financing of production. When production is integrated in a single firm, the entrepreneur must usually obtain external financing through debt or equity contracts (financial contracts). If the task—such as the construction of the machine described above—is contracted out to a supplier, this "real" contract includes an implicit financing component as well. The seller must expend resources before recovering the contract price from the firm. In the case of financial contracts, agency problems arise because of the separation of decision-making authority and risk bearing. In the case of "real" contracts, decision-making control is instead shared between the contracting parties who also split the payoffs from the project. This sharing also gives rise to agency problems. In the discussion that follows, we discuss and contrast both types of agency problems as they affect decisions to abandon projects over time.

Financial agency theory has established that the decision of a single firm to exploit an opportunity is affected by its capital structure. In particular, a levered firm controlled by shareholders has the incentive to forgo (or abandon) some profitable opportunities of low risk, because the payoffs from the project will be captured by its debtholders in the event of insolvency.[35] At the same time, the firm's shareholders may induce the firm to continue to

invest large sums to preserve a very risky option whose value is less than the cost of keeping it alive.[36] Thus, financial agency theory predicts that the division of payoffs from an investment opportunity between active and passive investors can lead to inefficient decisions to exploit or abandon the opportunity. When the variance of a project is high, a leveraged firm controlled by its shareholders will tend to pursue projects beyond the time at which efficiency dictates abandonment. In short, they may "overinvest" by failing to discontinue at the optimal time. Conversely, when the variance is small, they may "underinvest" by abandoning the project too early in order to move into riskier projects. Lenders and borrowers therefore structure their agreements (maturity, collateral, events of default) in order to redress some of the distortion of incentives. These contracting measures reduce but do not eliminate agency costs because of the impact of transaction costs, the bounded rationality of the parties, and the surrounding conditions of uncertainty.

A firm might instead share the investment project with another entity who does more than provide financing: a "real" contractual arrangement that exploits, for example, economies of specialization, scale, or scope of the other firm. By contracting out the construction of the machine, the firm decides to share with its supplier the decision to accelerate or decelerate the exploitation of the opportunity and, in particular, the decision to abandon the investment option. This division of payoffs and of decision-making authority raises concerns that are similar to the financial agency problems referred to in the preceding paragraph. And, as in financial contracts, the parties have incentives to structure their agreements so as to minimize these agency costs. The expectation measure of damages in contract law does not compensate a promisee for the loss of the time value of its option to breach caused by the repudiation of the promisor. The absence of such compensation leads to inefficient repudiation decisions, which cause contracting parties to abandon some investment opportunities earlier than a single firm (with a single owner) would have. As a result, there is a significant agency cost to contracting that is comparable to the financial agency costs that arise when a project is exploited in a single, leveraged firm.

FOOTNOTES

13 We include in the cost of performance the value of the best available nonexclusive opportunities to deal with another party that are necessarily forgone when the promisor performs. The cost of performance is bounded at the top by the cost of procuring substitute performance in the market, if such substitute is available.

14 See Oliver Wendell Holmes, Jr., The Common Law 300-301 (1991); *Globe Refining Co. v. Landa Cotton Oil Co., 190 U.S.* 540, 543 (1903) (Holmes, J.) (promisors may elect between performing or paying damages). Holmes's characterization of contract breach has attracted considerable criticism from contract theorists. See, for example, P. S. Atiyah, *Essays on Contract* 60-66 (1986); J. Finnis, *Natural Right and Natural Law* 324 (1980); Steven Walt, "For Specific Performance under the United Nations Sales Convention," *26 Texas Int'l L. J.* 211, 239-49 (1991).

15 Alternatively, the contract can be looked at as a certain liability to pay damages plus a put option on the level of the cost of performance, with an exercise price equal to the sum of the contract price (P) plus the damages (D). The two descriptions of the interest of a contracting party are equivalent according to what is known as put-call parity. See, for example, Hans R. Stoll, "The Relationship between Put and Call Option Prices," 24 *J. Fin.* 801 (1969).

32 The decision to abandon a project was first modeled in Alexander A. Robichek & James C. Van Horne, "Abandonment Value and Capital Budgeting," 22 *J. Fin.* 577 (1967). It was later analyzed using an options pricing framework in Michael J. Brennan & Eduardo S. Schwartz, "Evaluating Natural Resource Investments," 58 *J. Bus.* 135 (1985); Avinash K. Dixit, "Entry and Exit Decisions under Uncertainty," 97 *J. Pol. Econ.* 620 (1989); Stewart C. Myers & Saman Majd, "Abandonment Value and Project Life," 4 *Advances Futures Options Res.* 1 (1990). The abandonment of projects involving gradual or sequential investments is modeled in Kevin Roberts & Martin L. Weitzman, "Funding Criteria for Research, Development and Exploration Projects," 49 *Econometrica* 1261 (1981); Saman Majd & Robert S. Pindyck, "Time to Build, Option Value, and Investment Decisions," 18 *J. Fin. Econ.* 7 (1987); and Avinash K. Dixit & Robert S. Pindyck, *Investment under Uncertainty* 319-56 (1994).

33 See, for example, Oliver E. Williamson, "Transaction Cost Economics: The Governance of

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34 See, for example, R. H. Coase, "The Nature of the Firm," 4 *Econometrica* 386 (1937); Armen A. Alchian & Harold Demsetz, "Production, Information Costs and Economic Organization," 62 *Am. Econ. Rev.* 777 (1972); Benjamin Klein, "Vertical Integration as Organizational Ownership: The Fisher Body-General Motors Relationship Revisited," 4 *J. L., Econ. & Org.* 199 (1988).

35 This is known as the underinvestment problem. Myers, *supra* note 11, at 147.

36 This is an instance of the overinvestment problem, which stems from the interest of shareholders in increasing the riskiness of a levered firm. Michael C. Jensen & William H. Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs, and Ownership Structure," 3 *J. Fin. Econ.* 305, 333-37 (1976).

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George G. Triantis

Illuminating the Federal Courts

After graduating from law school in 1978, Ann Woolhandler moved back to her home state of Louisiana, practicing civil rights law in a small office with only two other lawyers. She admits it was a bit of a shock at first, noting "'overhead' was not a word I had heard much at Harvard." Nevertheless, she stayed for almost a decade, working on school desegregation, voting rights, first amendment, and employment discrimination cases as well as criminal appeals and developing the substantive interests that have guided her academic career. Woolhandler began teaching law at the University of Cincinnati College of Law before moving back to New Orleans to teach at Tulane. After visits at Virginia, Harvard, and Boston University Law Schools, she joined the Virginia faculty last year.

Woolhandler's practice involved traditional federal courts issues regarding the availability of federal jurisdiction and the amenability of government and its officers to suit, which reinforced the interest in federal courts she first developed as a law student and maintains in her scholarship. Her first article, "Patterns of Official Immunity and Accountability," 37 *Case W. Res. L. Rev.* 396 (1987), explored the history of governmental officers' common-law immunities from lawsuits. Although writing about issues that had been central to her prior career, Woolhandler managed to avoid the partisan advocacy that is a constant temptation for scholars newly arrived from the world of practice. The article noted that the modern law of officer immunity represents an intermediate position between two strands of thought that had each, at different times, been dominant. The first focused principally on the harm to the citizen and the legality of the officer's action, and supported broad official liability. The second focused on the "chilling effect" that liability has on official decision-making, and supported broad official immunity. Woolhandler argued that modern good faith immunity serves as a compromise of these two extremes.

Woolhandler has continued throughout her academic career to explore the history of key doctrinal features of the law of federal courts. For example, she provided an interesting reconsideration of the standard understanding of the history of administrative law in "Judicial Deference to Administrative Action—A Revisionist History," 43 *Ad. L. Rev.* 197 (1991). The article challenged the received wisdom that 19th-century federal courts deferred heavily to the actions of federal agencies, noting that the style and intrusiveness of review varied over time as theories of judicial review changed.

Woolhandler then turned to the history of the writ of habeas corpus in the Supreme Court in an article titled "Demodeling Habeas," 45 *Stan. L. Rev.* 575 (1993). At the time she wrote the article, there were two polar views of the historical record. Professor Paul Bator had argued that prior to the modern era, federal habeas relief had been limited to claims of jurisdiction, with some softening to allow for claims of conviction under unconstitutional statutes. The opposing view, reflected in the writings of Professor Gary Peller, was that habeas had traditionally been available for all types of fundamental legal error. The courts used these contrasting readings of history to support either restrictions or expansions of habeas review. Woolhandler's research indicated that contrary to the Peller view, the Court saw habeas as much more restricted than ordinary review for error. On the other hand, the review for unconstitutionality of statutes had much more significance for the scope of habeas than Bator seemed to give it. The concept of a constitutional violation during much of the 19th-century involved a claim

of statutory invalidity. As the concept of a constitutional violation expanded to include more official acts, the availability of habeas expanded as well. This analysis tended to suggest the propriety of fairly robust review of constitutional issues on habeas.

A more recent article, "The Common Law Origins of Constitutionally Compelled Remedies," 107 *Yale L.J.* 77 (1997), uses the history of federal jurisdiction to support a vigorous role for the federal courts in protecting not only typical federal civil rights claimants, but also out-of-state individuals and commercial entities from the local favoritism and redistributive tendencies of many state courts.

One pervasive view of the historical record is that the federal courts were relatively inactive in enforcing federal rights for much of the 19th-century. For example, because Congress did not grant the federal courts general federal-question jurisdiction until the waning days of Reconstruction, it is often assumed that federal trial courts must have had little to do with enforcing federal rights before then. In accordance with this view, Felix Frankfurter and James Landis wrote that with the 1875 grant of general federal-question jurisdiction, the federal courts "ceased to be restricted tribunals of fair dealing between citizens of different states and became the primary and powerful reliances for vindicating every right given by the Constitution, the laws and treaties of the United States."

Woolhandler interprets the history differently. Even without federal question jurisdiction, the federal courts were strong enforcers of federal rights from the outset. The federal rights at issue happened to be those no longer in the forefront of our concept of federal rights enforcement—for example, rights under the Contracts Clause and rights to avoid confiscations under treaties. Diversity jurisdiction was the principal vehicle for federal rights enforcement, and the framers and the Court saw diversity as intended to protect such rights. Indeed, even after the advent of general federal question jurisdiction in 1875, litigants continued to rely on diversity to raise constitutional issues, such as the due process issues surrounding business regulation that displaced Contracts Clause questions as the focus of constitutional litigation late in the 19th-century. These general law constitutional cases brought in diversity would eventually transform into modern federal question implied rights of action. The diversity tradition for raising constitutional rights remains important today, for it reminds us that the "activist" role of the federal courts in enforcing federal rights was fairly consistent. Unfortunately, Woolhandler argues, this tradition has been obscured by the tendency to separate modern civil rights from the more traditional concerns of the federal courts that involved protecting property and contract rights.

Woolhandler expanded the scope of this inquiry to federal court scrutiny of state administrative agency action in an article co-authored with Professor Michael Collins, "Judicial Federalism and the Administrative States," 87 *Cal. L. Rev.* 613 (1999). They find that historically, federal courts routinely reviewed state administrative action, even as to questions of state law. A similar examination of the federal courts in protecting federal rights led to another article with Collins, "The Article III Jury," 87 *Va. L. Rev.* 587 (2001), concerning federal judicial control of juries. It is commonly assumed that juries have lost power vis a vis federal judges over time, given the expansion of devices such as summary judgment. This assumption of broad jury discretion, however, seems inconsistent with federal courts' concern for protecting federal rights claimants. For example, there would be little use in the federal courts' protecting the right of out-of-state commercial interests to bring their contracts cases in federal courts if the courts merely handed over power to juries. In fact, Woolhandler and Collins found that early federal judicial control of juries, through elaboration of law, direction of verdicts, and liberal use of commentary on the evidence, likely exceeded the overall level of modern judicial control. This history has modern significance in that it indicates that enhanced judicial control of juries would be consistent with the Seventh Amendment.

Woolhandler continues to pursue her interests in the historical roots of modern federal courts doctrines. She is currently researching predecessors of modern standing doctrine, focusing in particular on early attempts by private parties to enforce public rights and public entities to enforce private rights. She hopes to provide a corrective to the view that standing only emerged as a constitutional concern in the early 20th-century.

EXCERPT FROM:

The Article III Jury

Ann Woolhandler, University of Virginia, and Michael G. Collins, Tulane University

III. Judicial Policing of Jury Rationality

A. The Article III Jury

1. The Centrality of the Article III Judge

The Article III Jury
87 *Va. L. R.* 588 (2001)

The Court's federalization of the availability of jury trials, as well as their incidents, through elaborations of law, directed verdicts, and commentary on the evidence, manifested a concept of Seventh Amendment rights in which the supervising Article III judge was a central part. As the Court eventually put it, the constitutional right to jury trial, was "a trial by a jury of twelve men, in the presence and under the superintendence of a judge empowered to instruct them on the law and to advise them on the facts."[263] Although this judge-centered version of the jury trial may have originally manifested a Federalist conception of the jury, the centrality of the Article III judge as part of the right to trial by jury did not alter significantly with changing personnel on the Court. Under Chief Justice Taney, Marshall's successor, the Court fostered the growth of equity and admiralty where jury trials were unavailable, and it promoted the use of jury control devices such as directed verdicts in actions at law. Despite the Jacksonian tenor of some of its decisions,[264] the Taney Court shared with earlier and later Courts the view that the federal courts' role was to protect property and the interstate flow of capital and that the federal judge was central to that role.[265] It therefore maintained an overall robust Contracts Clause jurisprudence[266] and deployed the general common law for commercial transactions[267] and suits against officers,[268] in addition to maintaining firm control of juries. Even beyond the Taney era, enhanced jury control continued to distinguish the federal courts from state courts well into the twentieth century.[269] In short, there was substantial continuity until the modern era in the federal courts' treatment of judge-jury relations.

The centrality of the Article III judge to federal jury trial rights[270] carried with it connotations of the role of the federal courts in reining in a host of alternative decision-makers. Protections of common-law interests in contract and property against unfair abrogation or confiscation—whether at the instance of state or federal legislatures, juries or state judges—inhered in this concept of the Article III judge. Rather than flowing from an explicit due process jurisprudence, these protections initially derived from the grant of a diversity forum, with its concomitant federal court determinations of federal law and the general common law, as well as use of federal procedures and the federal jury. Indeed, Article III's provision for diversity jurisdiction was occasionally referred to as a "constitutional right"[271] of nonresidents to a forum for the protection of common law and related constitutional interests.[272]

Throughout the nineteenth century and well into the twentieth, juries without supervision were seen as a threat to this protection of common-law interests in property and contract. Rather than offering encomiums to the abilities of juries, the Court alluded to their tendency toward irrationality. It was less inclined to extol the virtues of juries than of jury control.[273] Justice Samuel Miller observed in an 1887 article that without sufficient judicial instructions of law, the jury trial "is but little better than a popular trial before a town meeting,"[274] and that jury evaluation of fact as well as law was in need of guidance.[275]

The Court itself had noted that judicial comment on the evidence, including on credibility, was necessary to enable juries to discharge their function and to avoid "chance, mistake, or caprice."[276] The analogy to a town meeting implied that juries were bodies whose decisions partook more of the "will" of the legislature as opposed to the "reason" of the judiciary—at least when they operated without sufficient judicial guidance.[277] And while some scholars have doubted whether functional considerations as to whether judges or juries were better at deciding certain fact issues played much of a role in determining the scope of jury trial rights,[278] the inherent limitations of juries were sometimes cited as reasons for extensions of equity.[279]

Under this conception of the jury, rationality was thought to inhere not in the jury, but in the judge,[280] and particularly in the federal judge.[281] The federal judge supplied a law of reason by way of the general common law, and later, by way of substantive due process. This law reflected a notion of rationality that did not look to a balancing of competing interests[282] or some vaguer, more common sense notion within the knowledge of laypersons. Instead, it was one that took as its baseline the protection of property from transfer without fault, from regulation without public purpose, and from official invasions unjustified by statutory and constitutional authority.

It was the understood duty of the federal judiciary, moreover, to expand the realm of reason by expanding the realm of law, specifying its particular applications, and narrowing the more chaotic realm of fact. In the latter part of the century, for example, Oliver Wendell Holmes[283] and others[284] stated that it was the business of the courts to make law ever more specific. Otherwise, the courts would have to "confess their inability to state a very large part of the law which they required the defendant to know" and would leave the jury "without rudder or compass."[285] The sphere in which a judge should be able to rule without taking the opinion of the jury, therefore, "should be continually growing."[286] Judicial duties not only extended to providing ever-increasing guidance as to the law, but also to questions of fact through commentary on the evidence. Such guidance of juries in the interpretation of evidence to prevent capricious findings was, said the Court, among "certain powers inherent in the judicial office"—powers with which it was unclear that Congress could interfere.[287]

FOOTNOTES

263 *Capital Traction Co. v. Hof,* 174 U.S. 1, 13–14 (1899); see also *Crowell v. Benson,* 285 U.S. 22, 61 (1932) (quoting Hof); *Herron v. S. Pac. Co.*, 283 U.S. 91, 95 (1931) (same).

264 See, e.g., *Charles River Bridge v. Warren Bridge,* 36 U.S. (11 Pet.) 420 (1837) (indicating that monopolies would not be implied in state-granted charters); Horwitz, supra note 4, at 130–39 (discussing Charles River Bridge); Hovenkamp, supra note 63, at 2319 (characterizing the Jacksonian agenda as elimination of state-created privileges for entrepreneurial enterprises such as tax relief and monopolies).

265 See Tony Allan Freyer, *Forums of Order: The Federal Courts and Business in American History* 47–48, 82, 86–88 (1979) (noting that the Taney Court extended federal judicial power in favor of developing interstate business).

266 That is, apart from the Charles River Bridge line of cases, referred to supra note 264. See Wright, supra note 42, at 62–63 (characterizing the Taney period as one of consolidation rather than retrenchment under the Contracts Clause); cf. Hovenkamp, supra note 42, at 24–25 (noting that the Taney Court strictly construed grants of privileges in corporate charters, but had a high regard for the sanctity of private contracts); Stephen A. Siegel, "Understanding the Nineteenth Century Contracts Clause: The Role of the Property-Privilege Distinction and 'Takings' Clause Jurisprudence," 60 S. *Cal. L. Rev.* 1, 22 (1986) (observing that Jacksonian appointees did not undermine Federalist jurisprudence protecting ordinary contracts from debtor relief laws).

267 See, e.g., *Swift v. Tyson*, 41 U.S. (16 Pet.) 1, 19 (1842) (applying "the general principles and doctrines of commercial jurisprudence" rather than decisions of the state tribunal in a case involving a negotiable instrument).

268 See, e.g., *Deshler v. Dodge*, 57 U.S. (16 How.) 622, 634 (1853) (Catron, J., dissenting) (complaining that the majority, in allowing a suit against a state officer, had ignored state law requirements for replevin).

269 See Leon Green, *Judge and Jury* 379 (1930). "With few exceptions, practically every change in trial procedure in America during the nineteenth century meant more and more domination by the jury and less and less control by the trial judge; and in so far as trial courts in most states are concerned it probably is still true that juries exercise a dominant power in those cases in which they participate except in so far as trial judges exercise power by the grace of appellate courts. The contrast between state and federal courts in dealing with juries is so marked that attempts are constantly being made to reduce the trial judges of our federal courts to the same low state as the trial judges of our state courts, and this although federal trial judges themselves are by no means as unrestricted as were English common law judges."

Id. Green, however, believed that appellate judges had absorbed a great deal of power over jury trials. See id. At 390–91; see also Max Radin, *Handbook of Anglo-American Legal History* 217 (1936) (contrasting the federal courts to the state courts, where the position of judge vis a vis jury declined); Wigmore, supra note 172, at 473 (noting the abolition of comment on evidence except in a few states and in federal courts). Obviously, some states exceeded the federal judiciary in jury control devices, as indicated by the fact that the federal courts sometimes rejected state jury control devices. See, e.g., *Slocum v. N.Y. Life Ins. Co.*, 228 U.S. 364, 376–77 (1913), discussed supra Section II.B.2.c; see also supra note 106.

270 See, e.g., *Capital Traction Co. v. Hof,* 174 U.S. 1, 13–14 (1899).

271 See, e.g., *Cowles v. Mercer County,* 74 U.S. (7 Wall.) 118, 122 (1868).

272 See, e.g., *Reagan v. Farmers Loan & Trust Co.*, 154 U.S. 362, 391–92 (1894) (indicating that a diverse bond trustee had a federally protected right to file suit in federal court to contest the reasonableness of rates (which was not yet clearly a federal question) despite an attempt by the state to restrict review actions to courts of the state, and observing that "[a] State cannot tie up a citizen of another State, having property rights within its territory invaded by unauthorized acts of its own officers, to suits for redress in its own courts"); *Dodge v. Woolsey,* 59 U.S. (18 How.) 331, 356 (1855) (recognizing diversity jurisdiction in a shareholder action to challenge a state tax as violative of the Contracts Clause, reasoning that the case was appropriate for federal jurisdiction because it was brought by "[a] citizen of the United States, residing in Connecticut, having a large pecuniary interest in a bank in Ohio"); see also *Smyth v. Ames*, 169 U.S. 466, 516–17 (1898) (citing Reagan in rejecting an argument that a state could limit rate regulation challenges to its own courts).

273 See, e.g., Samuel F. Miller, "The System of Trial by Jury," 21 *Am. L. Rev.* 859, 862 (1887) (indicating the necessity of judicial supervision of juries); cf. Holmes, supra note 247, at 88–89 (noting that different results in jury cases

owing to different feelings of juries merely show that the law did not perfectly accomplish its ends of providing standards of general application).

274 Miller, supra note 273, at 862.

275 Miller thought that "the judge should clearly and decisively state the law, which is his peculiar province, and point out to the jury with equal precision the disputed questions of fact arising upon the evidence." Id. at 863. The judge should grant a new trial if the jury disregarded the law or in cases of gross disregard of the weight of the evidence. Id.

276 *Nudd v. Burrows*, 91 U.S. 426, 439 (1875), discussed supra text accompanying notes 245–46.

277 Analogizing juries to political branches in a sense comported with the Anti-Federalist view of juries as democratizing institutions of self-government. See supra note 39.

278 See Moses, supra note 2, at 239 (stating that functional considerations have never been a part of Seventh Amendment jurisprudence); see also Arnold, supra note 1, at 838 (claiming that no case of the early American period indicated that the chancellor was willing to assume jurisdiction due to a matter's being unsuitable for a jury); James, supra note 1, at 661 (stating that the line between law and equity had not been "altogether—or even largely—the product of a rational choice" of issues best suited to either). But cf. Arnold, supra note 1, at 838 (noting that nineteenth century courts sometimes said accountings were impracticable for juries); James, supra note 1, at 663 (noting that it would be a mistake "to suppose that chancellors were never concerned with the jury trial problem in taking or refusing jurisdiction").

279 See, e.g., Ex parte Young, 209 U.S. 123, 164 (1908) (justifying the exercise of equity jurisdiction in part because a jury "could not intelligently pass upon the matter"); James S. Campbell & Nicholas Le Poidevin, "Complex Cases and Jury Trials: A Reply to Professor Arnold," 128 *U. Pa. L. Rev.* 965 (1980) (arguing that there was historical support for an exception to jury trial rights in complex cases); cf. John Choon Yoo, "Who Measures the Chancellor's Foot? The Inherent Remedial Authority of the Federal Courts," 84 *Cal. L. Rev.* 1121, 1158 (1996) (noting Federalist writings to the effect that equity jurisdiction was necessary for matters too difficult for the jury); Note, "The Right to a Nonjury Trial," 74 *Harv. L. Rev.* 1176, 1190 (1961) (suggesting that many order-of-trial problems in mixed law and equity cases should be resolved based on relative competency).

280 See Thayer, supra note 172, at 212, 249 (indicating that judges, not juries, had the responsibility for securing the observance of law and of "the rule of right reason"); cf. Holmes, supra note 247, at 95–96 (noting that the distinction between gross and mere negligence was meaningful when applied by a judge, but for a jury, "the word 'gross' is only a vituperative epithet").

281 See White, supra note 47 at 87, 145 (describing how commentators such as Peter DePonceau and Justice Joseph Story saw a rational or scientific approach to law as requiring familiarity with general jurisprudence and a nationalist orientation); Miller, supra note 273, at 862 (noting that due to popular and frequent elections and insufficient salaries, state judges in the courts in which he had practiced "were neither very competent as to their learning, nor sufficiently assured of their position," to exercise sufficient control over juries); cf. Wigmore, supra note 172, at 473–74 (arguing for the restoration of the practice of comment on the evidence, but noting that opposition to such commentary arose "partly because of the Bar's frequent lack nof respect for the opinion of a Bench that is too often occupied by the crude or mediocre nominees of local political committees").

282 See White, supra note 17, at 100–01 & n.35 (noting that the review of legislation for reasonableness in Justice Peckham's opinion in *Lochner v. New York,* 198 U.S. 45 (1905), did not involve balancing, but rather application of the anticlass principle, informed by the "free labor" theory); see also T. Alexander Aleinikoff, "Constitutional Law in the Age of Balancing," 96 *Yale L.J.* 943, 949 (1987) (noting that Justices Marshall, Story, and Taney recognized clashes of interest but resolved them in a categorical fashion); Kennedy, supra note 17, at 7 (noting that the judiciary had a concept of policeable boundaries).

283 See Holmes, supra note 247, at 89 (referring to tort law).

284 See Thayer, supra note 172, at 207–08 ("In the exercise of their never-questioned jurisdiction of declaring the common law... there has arisen constant occasion for specifying the reach of definite legal rules, and so of covering more and more the domain of hitherto unregulated fact."); see also id. at 208 n.3 (noting judicial development of new doctrines of law to keep the jury within the bounds of reason); Thayer, supra note 259, at 172 (arguing that the growth of law at the hands of judges is a desirable and necessary

feature of our judicial system).

285 Holmes, supra note 247, at 89; see also *Balt. & Ohio R.R. Co. v. Goodman*, 275 U.S. 66, 70 (1927) (Holmes, J.) (holding that there was contributory negligence as a matter of law where the injured party did not get out and check to assure that there was no train coming when the view was obstructed); *S. Pac. Co. v. Berkshire*, 254 U.S. 415, 417 (1921) (Holmes, J.) (stating that the court should determine whether there was negligence as a matter of law where the conduct concerned a permanent condition at various places); G. Edward White, *Tort Law in America: An Intellectual History* 58 & n.239 (1980) (noting that Holmes as a judge "enjoyed taking negligence cases away from juries," and citing Goodman).

286 Holmes, supra note 247, at 99; see Horwitz, supra note 191, at 129–30 (observing that Holmes, in *The Common Law*, manifested the view that law proceeded according to functional rationality, but that he later saw law as the product of social struggle).

287 *Nudd v. Burrows*, 91 U.S. 426, 442 (1875).

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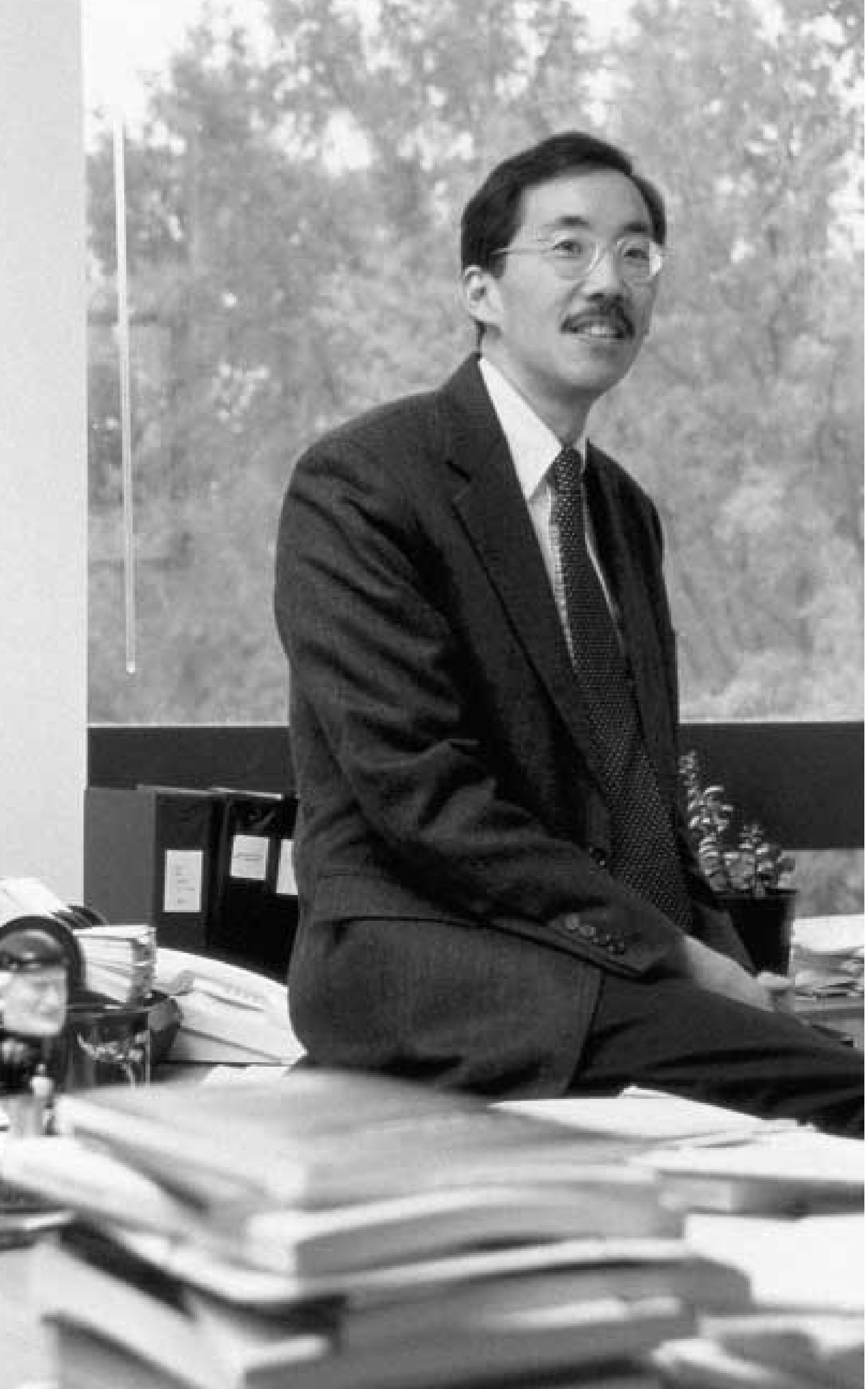

Improving the Design and Structure of Tax Law

Tax scholars frequently use insights from economic theory and political science. But lawyers bring another critical ingredient to policy debates—an understanding of the institutional structures within which tax enforcement and compliance take place. George Yin, recently named chief of staff to Congress's Joint Committee on Taxation, brings a formidable mix of theoretical and institutional perspectives to his scholarship after leaving private practice to serve as Tax Counsel for the U.S. Senate Finance Committee. Yin notes, "Given our self-assessment system, it is critical in shaping a law to take account of the likely response of taxpayers, their advisors, and the government. What design will facilitate taxpayer compliance? How can we prevent taxpayers from achieving results unintended by the legislature? What design will facilitate enforcement but also curb governmental overreaching? How might taxpayer and government responses thwart the policy makers' allocative and other objectives?"

Yin's scholarship has focused on trying to answer such questions in several different areas of tax law. One example is the work he did as reporter to the American Law Institute's five-year project on the taxation of private business enterprises. The starting policy goal was to collect a single tax on the income of such businesses. The difficult issue was choosing among the many possible designs.

Yin and his co-reporter, David Shakow, with the assistance of consultants from practice, the academy, and government, began by comparing the benefits of "entity" versus "conduit" taxation of the enterprise. Under entity taxation, the business entity itself is subject to tax, much like the corporate tax under current law, but the owners are not subsequently taxed. Under conduit taxation, the entity is not taxed. Instead, the entity determines the amount of its taxable income and other tax items and passes through this information to its owners, who pay tax directly on their share of the enterprise's income. Initially, entity taxation seems far simpler because it focuses the tax collection responsibility on a single taxpayer—the entity—rather than dispersing it among multiple owners. But Yin and Shakow concluded that the simplicity of the entity approach was partly illusory because the proper tax liability would sometimes depend on the owners' individual tax situations. They also worried about the undesirable consequences of drawing a sharp line between sole proprietorships and two-person businesses, including partnerships, limited liability companies, and corporations.

The conduit approach, however, posed its own dilemma. Yin explains, "The most developed system of conduit taxation is partnership taxation under subchapter K of the Internal Revenue Code. Our experience with these rules suggested that they were too complicated for many taxpayers, yet imprecise enough to be manipulated by sophisticated taxpayers. Simplifying the rules would in many instances make them even less precise and more manipulable. Conversely, reforming the rules to prevent tax avoidance would make them even more complicated."

Under current law, this dilemma is increasingly resolved through the use of so-called "anti-abuse" rules, which treat taxpayers differently based upon their intent and other subjective factors. Yin and Shakow decided that less reliance on subjective factors would promote a more even-handed and predictable application of the law. Accordingly, they recommended enactment of two different forms of conduit taxation: a reformed version that prevented common manipulations, and a simplified version. The key feature was a set of eligibility rules that would prevent those taxpayers who could take undesired advantage of the less precise simplified system from using that system. The report was published in *American Law Institute, Federal Income Tax Project: Taxation of Private Business Enterprises, Reporters' Study* (1999) and Yin published a description of the basic theory and recommendations in "The Future Taxation of Private Business Firms," 4 *Fla. Tax Rev.* 141 (1999).

Yin has also addressed the structure of the earned income tax credit (EITC) program, which provides cash benefits to low-income working households. Eligible households claim the credit by filing a tax return. The credit reduces any income tax liability and the amount of the credit in excess of that liability is paid in cash to the household, either periodically during the year or as a lump sum at year-end. The EITC program is a major federal commitment, providing over $30 billion in benefits each year to households making up to approximately $32,000.

When the program was marked for significant expansion during the early 1990s, Yin led a group of researchers formed to scrutinize its administration. The researchers first estimated that between 75 and 86 percent of eligible households actually participated in the program in 1990. Second, they found that an extraordinarily low percentage of households that did participate—less than one-half of one percent—obtained the cash benefit throughout the year as opposed to receiving one lump sum at the end of the year. This arguably made the benefit more like a bonus to the recipients at the end of the year rather than a meaningful income support payment or work incentive. Finally, they reported a noncompliance rate for the program of about one-third, meaning that of the roughly 12 million credits granted in 1990, about four million were awarded to ineligible households. (Subsequent research performed by the IRS and the General Accounting Office indicates that there was little improvement in either the participation or compliance rates for the EITC program during the 1990s.) Yin and the other researchers reported their findings and set forth proposed reforms to the program in "Improving the Delivery of Benefits to the Working Poor: Proposals to Reform the Earned Income Tax Credit Program," 11 *Amer. J. Tax Policy* 225 (1994), and Yin was later invited to testify in Congress about proposals to reform the program. One of their most significant recommendations—a proposal to simplify the definition of a "child" for purposes of many tax provisions—was endorsed by the Treasury Department in 2002 and may make it into law in a future year.

In a separate article written with Jon Forman, Yin detailed a more expansive vision for reform of the EITC program. In "Redesigning the Earned Income Tax Credit Program to Provide More Effective Assistance for the Working Poor," 59 *Tax Notes* 951 (1993), the authors proposed to divide the program into its two principal components: an incentive for the working poor and a benefit provided to households with children. They argued that the program's "working poor" benefit, originally intended largely as a rebate of the Social Security taxes paid by low-income workers, could be provided much more efficiently by simply not collecting those taxes in the first instance. They proposed, therefore, to establish an exempt amount of wages below which no Social Security taxes would be due. To ease administration, the exemption would apply to the wages of *all* workers, whether or not low-income. The wage ceiling for middle- and upper-income wage earners would then be raised to recapture the benefits of the exemption from them. Once the "working poor" incentive was provided through the Social Security tax exemption, the authors recommended that the remaining benefit of the EITC program be provided through a tax credit for children (or, under current law, an expansion of the existing child credit).

The authors contended that such a revision of the program would help to remedy each of the administrative problems with the existing EITC program. For example, by providing the "working poor" incentive through a Social Security tax exemption, all eligible families would receive the benefit automatically in each paycheck. Beneficiaries would no longer need to obtain information, determine or assert eligibility, or even file a tax return. Nor would employers be burdened, except for the slight change to adjust for the exemption amount in calculating the amount of Social Security taxes to withhold. Moreover, the simplicity of the delivery system and the relative absence of any self-certifying features would almost assure a high level of compliance.

Despite these forays into the EITC and the taxation of private business entities, most of Yin's scholarship has been devoted to the tax rules relating to public corporations. For example, in

"Corporate Tax Integration and the Search for the Pragmatic Ideal," 47 *Tax L. Rev.* 431 (1992), he tried to identify the most practical way to eliminate the double taxation of corporate-source income and integrate the corporate and shareholder income taxes. Many policy analysts have recommended corporate tax integration, and it is a common feature of tax systems outside the U.S. In this country, however, integration proposals have been blocked by a range of objections, including concerns about its complexity and distortive effects.

In his article, Yin analyzed two recent proposals for integration: one contained in an *American Law Institute Reporter's Study* and the other included in a Treasury Department report. The *Reporter's Study* would have converted the existing corporate income tax into a withholding tax, which would effectively have made the shareholder-level tax the exclusive source of tax revenue from corporate-source income. In contrast, the Treasury Department proposal would generally have repealed the tax on dividends but kept the corporate income tax. Yin concluded that although each approach had its advantages, neither probably represented a satisfactory form of integration. The *Reporter's Study* failed to provide a secure means of collecting revenue from corporate-source income in the absence of several controversial (and unlikely) changes to the law (including the direct taxation of otherwise tax-exempt entities). The Treasury's approach offered a more secure method of obtaining that revenue, but in an inequitable and non-neutral manner.

Instead, Yin developed an intriguing and creative proposal to keep *both* the shareholder and corporate income taxes but to integrate them so that the total tax burden on corporate-source income is roughly comparable to that on noncorporate-source income. Yin argued, "What is important is the burden imposed, not the number of times a tax is levied." He argued that two low-rate taxes on the same income may be a more efficient and effective means of collecting the revenue from corporate-source income than any single tax. In particular, he recommended enactment of a low, flat-rate corporate-level tax and a progressive shareholder-level surtax applicable to higher-income investors. Counterintuitively, he proposed achieving integration through double taxation. Yin's proposals will be an integral part of the current debate on the Bush

Administration's recommendation to eliminate the tax on corporate dividends.

In recent years, Yin has focused in particular on corporate tax shelters. The current tax shelter phenomenon refers to aggressive and possibly illegal tax positions taken mainly by public corporations, as their corporate tax departments are increasingly viewed as additional profit centers. Many of the underlying transactions are contrived, in the sense that they serve no corporate purpose other than reducing taxes. The IRS has challenged a number of the tax positions, but most analysts believe they represent just the tip of the iceberg. In an effort to reverse the trend, the IRS has mandated greater disclosure requirements and the Treasury has requested legislation to do much more, possibly including enactment of a global anti-abuse rule.

In "Getting Serious about Corporate Tax Shelters: Taking a Lesson from History," 54 *SMU L. Rev.* 209 (2001), Yin reviewed the last "war" against tax shelters during the 1970s and 80s. He found that despite many changes in the law and the IRS's administrative practices, including changes similar to the ones currently being proposed by the government, shelters were not curbed until Congress enacted a broad, reasonably clear, outcomes-oriented set of rules known as the "passive activity loss" rules. By contrast, incremental reforms were counterproductive, involving small steps that simply led to more avoidance behavior and greater inefficiency. He therefore argued that if the corporate tax shelter problem is as serious as some claim, Congress should consider enacting a broad, outcomes-oriented rule that is unaffected by taxpayer purpose or intent or the other elements making up the taxpayer's transaction.

The article briefly discussed possible reforms, one of which may well gain currency in light of subsequent corporate governance scandals. Yin suggested requiring that public companies keep a single set of books for both financial reporting and tax purposes. He noted that such a rule would create a desirable tension for public companies that ordinarily prefer to report higher earnings for financial reporting purposes and lower earnings for tax purposes. Yin hopes to develop this idea further in future research.

EXCERPT FROM:

Getting Serious About Corporate Tax Shelters: Taking a Lesson from History

George Yin, University of Virginia

"Getting Serious about Corporate Tax Shelters: Taking a Lesson from History," 54 *SMU L. Rev.* 209 (2001)

Suppose public corporations are taxed each year on the amount of income they report for financial accounting purposes, as adjusted by tax rules authorizing specific deviations from a book income tax base. Thus, the *starting* tax base for public corporations would be their reported book income, but specific provisions could modify that result. If, for example, Congress deemed it desirable to allow different depreciation rules for book and tax purposes, different consequences from the exercise of nonqualified stock options, different treatment of foreign income, or any other book-tax differences, Congress would simply have to enact the particular adjustment. In the absence of any adjustment, however, a public corporation would pay tax on its book income. The potential advantage of shifting to a book income tax base *with adjustments* is to improve the transparency of the tax base: intended deviations from book income, but *only* intended deviations, would be permitted in calculating taxable income... Some preliminary thoughts [about this idea] are outlined below.

1. EFFECT ON CORPORATE TAX SHELTERS

ACCORDING TO THE TREASURY DEPARTMENT, a principal characteristic of corporate tax shelters is inconsistent treatment for financial accounting and tax purposes of the items resulting from the shelter. A shelter might be designed, for example, to produce a tax loss without any corresponding book loss. Indeed, public corporations generally do not find appealing tax shelters which result in consistent book-tax treatment because of the adverse effect of such shelters on their reported earnings. Although there is limited disclosure required of book-tax disparities for both tax and accounting purposes, the great number of differences permits much shelter activity to remain hidden from view.

The entire class of shelters with this common characteristic would end if corporations were taxed on their adjusted book income. By linking taxable income to book income, Congress would eliminate the ability of corporations to explore unintended and undesirable deviations between the two measures. Congress would gain greater control over the corporate tax base; intended book-tax disparities could be specifically authorized but unintended ones would essentially end. The rule would have similar characteristics to [the passive activity loss rules]: it would be broad, reasonably clear, and very outcomes-oriented, with tax consequences literally being determined by the "bottom line." Tax results would not depend upon taxpayer intent, motive, or similar factors.

2. TAX POLICY CONSIDERATIONS

ASIDE FROM ITS POSSIBLE IMPACT on corporate tax shelters, is the rule consistent with sound tax policy? The rule requires public corporations to be taxed more closely on their economic income, if one assumes that income reported for financial accounting purposes is a closer approximation of that than taxable income. But how does the rule compare to current law from the standpoint of equity, efficiency, and administrative simplicity?

It is hard to assess the equity implications of the rule because they depend upon identifying who bears the burden of the corporate tax. For example, if corporation X pays more tax under the proposal than under current law, it is difficult

to determine whether that result is equitable without knowing who bears the burden of X's tax liability.

An efficiency objection arises if the rule is not evenhanded in its application. Because corporations to some extent can manage the amount of financial earnings they report in a given year, a tax base based on book income would seem to violate a neutrality objective. Such a rule could allow similarly situated corporations to pay different amounts of tax, depending upon the earnings they decide to report in a given year.

On the other hand, to the extent reported earnings make a difference to investors—obviously, an uncertain assumption—financial accounting policy should promote uniform treatment of corporations. Thus, although the amount of earnings are to some degree manipulable by corporate management, similarly situated corporations may have an equal opportunity to engage in such manipulations. If this is true, then part of the efficiency objection should disappear. A corporation's choice regarding how it balances its desire to report high financial earnings and low taxable income would be similar to other choices it faces in operating its business. Tax rates can be adjusted to raise the desired amount of revenue based on the amount of earnings reported.

To be sure, certain corporations, particularly those in different industries, would no doubt have differing abilities to engage in earnings management. Thus, a tax based on adjusted book income would cause some distortion and inefficiency. What is unknown is whether this distortion would be greater than that of current law, which also taxes some corporations in different industries in different ways.

Moreover, balanced against that inefficiency would be the potential simplification gain from a tax on adjusted book income. The planning, compliance and administration costs of the current corporate tax are quite high. Tying taxable income to the amount of book income, even with a number of authorized adjustments, could be a major simplification and result in a reduction in costs.

3. ACCOUNTING POLICY CONSIDERATIONS

A tax based on adjusted book income would motivate some corporations to report lower earnings simply to reduce their tax bill. Thus, the tax might have the adverse effect of degrading the quality of financial reporting. On the other hand, financial reporting is already degraded to some extent. Under current law, corporations obtain two different bites at the apple: they take advantage of ambiguities in the financial accounting rules to puff up the amount of their financial earnings, and take advantage of similar ambiguities in the tax rules to understate the amount of their taxable earnings. Further, they lobby Congress and the relevant administrative agencies to maintain and enlarge the ambiguities in each set of rules. Linking tax consequences more closely to book consequences eliminates one of those opportunities. Although adoption of the tax rule discussed here may ultimately result in lower reported earnings, it may be that such reports will represent more reliable assessments of the financial situations of the corporations than are currently provided.

4. LIMITATION TO PUBLIC COMPANIES

The tax on adjusted book income would only apply to public companies because of the potential discipline imposed by public markets on the amount of corporate earnings reported. But there is another reason to limit the proposal to public corporations—they probably represent the heart of the corporate tax shelter problem. According to the Treasury Department, the principal benefit of corporate tax shelters is the saving in corporate income taxes. Yet the very largest corporations, which are disproportionately public companies, pay the bulk of the corporate tax and therefore are likely to be the major players in corporate shelters. Private corporations taxed under subchapter C have many opportunities unavailable to public corporations to reduce or eliminate their corporate income by paying out their earnings in tax-deductible ways.

Moreover, under [existing tax] classification rules, new private ventures have an enhanced ability to avoid the corporate tax altogether in the future. This option is unavailable to public

firms. Thus, the existing difference between public and private companies for tax purposes affords an excellent opportunity to consider reforms that take advantage of the unique features of the firms in each sector to determine the simplest, most efficient way of raising taxes from that sector.

5. INTEGRATION

The proposed rule redefines the corporate tax base. Most major corporate integration proposals retain some form of corporate tax, with the shareholder tax being reduced or eliminated in some way. Thus, the proposal could be implemented consistently with almost any integration objective.

6. CROSS-BORDER CONSIDERATIONS

For U.S. corporations with foreign subsidiaries, the principal question will be how to reconcile the different consolidation standards that currently exist for tax and accounting purposes. The tax rules could be conformed to the accounting rules, in which case U.S. corporations would be taxed currently on the earnings of their foreign subsidiaries. Alternatively, a specific book-tax deviation could be enacted to continue the current U.S. tax treatment of those earnings.

Taxing foreign corporations with U.S. operations would be a little trickier. If the domestic operations were carried out through a separate subsidiary, the subsidiary could be required to prepare financial statements in accordance with U.S. financial accounting rules and report U.S. taxable income accordingly. The same requirement might be imposed even if the domestic operations were carried out through a U.S. branch. Alternatively, the foreign parent corporation might be required to report its earnings using international accounting standards, with the U.S. portion of those earnings then being taxed by the U.S.

7. SUMMARY

Much has been written about the evolution of the corporate tax department from being a mere part of the overhead to a prof-

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it center. In truth, well-run corporations have long viewed taxes as a cost which, within limits, should be minimized. Sharp tax accountants and lawyers have presumably always been valued corporate employees and advisors. What may be different, perhaps, is the extent to which corporations are now willing to go to achieve their tax minimization objectives. Fueled by rumors of a competitor's latest tax saving plan that aggressively exploits one of the many complex and possibly irrational features of the corporate tax law, corporate officers apparently feel more and more compelled to engage in the ["tax avoidance"] game. An adjusted book income tax may both simplify the law, thereby reducing the number of tax law opportunities that can be exploited, and make the remaining competition more open. Corporate executives would be able to have confidence that a competitor's reporting of higher earnings is not simply financed by some tax avoidance scheme not availed of by their own company; rather, the earnings would be accompanied by a tax bill commensurate to the amount reported.

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