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Financial Information Failure and Lawyer Responsibility [1]

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Abstract: When public firms collapse amid allegations of financial information failure—such as misleading financial statements—society looks beyond the role of accountants to see who else should be held responsible. Lawyers advising the firm increasingly are charged with responsibility, perhaps because modern financial and business complexities, as well as rules that make accounting determinations turn in part on legal conclusions, have blurred the boundary between legal and accounting duties. Lawyers should want to satisfy this responsibility not only to avoid liability but also to safeguard their reputation and integrity. The difficult question, which this article attempts to answer, is what that responsibility should be.

INTRODUCTION

Accounting responsibility is not always viewed as resting exclusively with accountants. This is especially the case when public firms collapse amid allegations of

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financial information failure, most notably misleading financial statements.[3] This failure not only can contribute to the collapse but also can mislead investors who, but for the failure, would not have invested in the troubled firm.[4] Society then looks beyond the role of accountants to see who else might, or should, have been in a position to prevent the failure.[5] The need to find others responsible is even more urgent when the accountants have insufficient deep pockets to pay injured investors.

Lawyers are the obvious targets.[6] They advise the firm and, in securities offerings, have long been regarded as acting—and to some extent have a statutory role to act[7]—as gatekeepers.[8] Lawyers also are relatively easy targets because the public distrusts them.[9]

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[3] *See infra* notes 22-23 and accompanying text (discussing financial statements). Financial information failure thus includes accounting failure.

[4] *See, e.g.,* Frank Partnoy, *Lessons from Enron, How did Corporate and Securities Law Fail? A Revisionist View of Enron and the Sudden Death of May*, 48 VILL. L. REV. 1245, 1249–51 (2003) (discussing causal relationship between Enron's financial information failure, which enabled it to obtain large amounts of funding, and its eventual collapse).

[5] *See, e.g.,* John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403 (2002). *Accord*, Lincoln Sav. & Loan Ass'n v. Wall, 743 F. Supp. 901, 905-06 (D.D.C. 1990) ("The questions that must be asked are: … Where … were the outside … lawyers when these transactions were effectuated?") (Sporkin, J).

[6] *See, e.g.*, Damian L. Halstad, *The Tao of Litigation*, 19 J. LEGAL PROF. 93, 94 (1995) (observing that lawyers are the object of distrust and contempt, and the public blames them for many societal ills). *See also* Susan P. Koniak, *Law and Truth: Roundtable: The Lawyer's Responsibility to the Truth*, 26 HARV. J.L. & PUB POL'Y 195, 195 (2003) (arguing that lawyers deserve the "lion-sized portion of blame" for the Enron debacle).

[7] *See In re* Carter, Fed. Sec. L. Rep. (CCH) P 82, 847, at 84, 172–73 (Feb. 28, 1981) (explaining that, under SEC Rule 2(e)(1)(ii), "[w]hen a lawyer with significant responsibilities in the effectuation of a company's compliance with the disclosure requirements of the federal securities laws becomes aware that his client is engaged in a substantial and continuing failure to satisfy those disclosure requirements, his continued participation violates professional standards unless he takes prompt steps to end the client's non-compliance") (internal citations omitted).

[8] Coffee, *Understanding Enron, supra* note 5, at 1405, (defining gatekeepers as "reputational intermediaries who provide verification and certification to investors," and stating that lawyers can be considered gatekeepers in that they lend "their professional reputations to a transaction").

[9] *See, e.g.*, Jonathan R. Macey & Geoffrey P. Miller, *Kaye, Scholer, FIRREA, and the Desirability of Early Closure: A View of the Kaye, Scholer Case From the Perspective of*

Thus, in one recent transaction, lawyers have been criticized and may be sued because investors claim that certain transfers of assets accounted for as sales should have been accounted for as loans.[10] In another transaction, a court refused to dismiss a lawsuit against a law firm that had issued legal opinions on bankruptcy matters, even though the damage claimed in the lawsuit was alleged to resulted from accounting failures.[11] And in two other transactions, a court refused to dismiss a lawsuit against a law firm and its partner that had created special-purpose entities later used by the client in alleged accounting frauds,[12] even though creating such entities does not in and of itself signal fraud.[13]

There probably would be many more examples of law firms being sued for accounting failures but for the fact that, at least until recently, lawyers—as secondary actors—could not be sued as aiders and abettors of securities fraud in private causes of action under the federal securities laws.[14] In the past several years, though, courts have

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Bank Regulatory Policy, 66 S. CAL. L. REV. 1115 (1993) (concluding that a federal agency commenced a regulatory action against lawyers because it "needed a convenient, unpopular scapegoat that it could confront with a dramatic gesture designed to help it regain its prestige").

[10] Nathan Koppel, *Wearing Blinders*, 26 AM LAWYER 75, 165-66 (July 2004) (discussing this controversy and suggesting that the lawyers deserve blame for failure to properly account for the transfers as debt). For examples of the distinction between sale and loan accounting, *see infra* notes 29-37 and accompanying text.

[11] *See In re* Enron Corp. Securities, Derivative & ERISA Litigation, 235 F.Supp. 2d 549, 586-89 (S.D. Tex. 2002). The court may well have misunderstood the causal connection between bankruptcy characterization and accounting. *See infra* note 115 (discussing why $\neg A \supset \neg B$ does not necessarily means that $A \supset B$).

[12] *In re* Parmalat Securities Litigation, 383 F. Supp. 2d 616 (S.D.N.Y. 2005).

[13] *See infra* note 70 and accompanying text.

[14] In Central Bank v. First Interstate Bank, 511 U.S. 164, 175 & 180 (1994), the Supreme Court held that only primary actors could be held liable as aiders and abettors in a private cause of action under §10(b) of the Securities Exchange Act of 1934 (15 U.S.C.A. §78j(b)) and Rule 10b-5 thereunder (17 CFR §240.10b-5). Therefore, only lawyers who act as primary violators, such as by employing a manipulative device or making a material misstatement or omission in connection with the sale of securities, would be subject to private lawsuits. 511 U.S. at 191. The SEC, though, is able to prosecute even secondary actors as aiders and abettors. [cite]

adopted various theories to begin allowing private lawsuits against secondary actors, such as lawyers. Under a "bright-line" theory, a lawyer or other secondary actor who makes a material misrepresentation or omission now may be as liable as a primary violator of securities law.[15] Under a separate "substantial participation" theory, the lawyer need only have substantially participated or been intricately involved in the preparation of fraudulent financial statements, even if he did not actually make the statements.[16] And, under a third "creation" theory suggested to the court by the SEC, a lawyer who creates a misrepresentation, whether acting alone or with others and irrespective of whether such lawyer's identity is disclosed to investors, can be liable as a primary violator under federal securities law provided the lawyer acts with the requisite scienter.[17] These theories illustrate a liberal trend toward making lawyers liable for financial information failure, thereby setting the stage for a potential flood of private securities-fraud lawsuits.[18] The SEC itself, which is not bound by the secondary-actor aiding-and-abetting constraint for private lawsuits,[19] also may start to more aggressively file civil charges against lawyers.[20]

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[15] Aegis J. Frumento, *Misrepresentations of Secondary Actors in the Sale of Securities: Does* In re Enron *Square with* Central Bank*?*, 59 BUS. LAW. 975, 980-81 (2004) (discussing the emergence of lower courts theories as to when primary liability can be imposed on secondary actors after the *Central Bank* opinion).

[16] Howard v. Everex System, Inc.*,* 228 F.3d 1057, 1061 n. 5 (9th Cir. 2000).

[17] *In re* Enron Corp. Securities, Derivative & ERISA Litigation, *supra* note 11 (denying a law firm's motion to dismiss complaint).

[18] *See, e.g.,* John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301 (2004) (observing, *id.* at 338, a "judicial shift—whether conscious or unconscious—toward imposing greater liability on gatekeepers," including lawyers, in financial frauds; and showing, *id.* at 340, that empirical data indicate, in financial frauds, "the risk for gatekeepers is real and growing").

[19] *See supra* note 14.

[20] *See* Carrie Johnson, *Lawyers in the Limelight, SEC Helps Police Their Misconduct*, WASH. POST, Nov. 20, 2004, at E01 (indicating that the SEC will more aggressively file civil charges against lawyers). Lawyers and other secondary actors who aid and abet securities fraud also could be held criminally liable. *See* 18 U.S.C. § 2 (imposing criminal liability of principal actors on aiders and abettors). *See also* 15 U.S.C. § 77t(e)(2000); *Central Bank,* 511 U.S. 164 at 190.

The increasing overlap of law and accounting, moreover, is exacerbating this trend towards lawyer liability.[21] Consider, for example, the duty of disclosing complex business or financial transactions. Federal securities law makes accountants responsible for redacting financial information into formalized financial statements, such as balance sheets and income statements, including the accompanying footnotes. These financial statements must comply with generally accepted accounting principles (GAAP), a set of standards[22] intended to ensure that financial statement disclosure provides the "credib[ility], transparen[cy], and comparab[ility]" needed for "the efficient functioning of the economy."[23] Accounting failures that result in misleading financial statements—the most prevalent form of financial information failure—can undermine these goals.

Lawyers also help their clients disclose material information to investors in the client's securities.[24] This disclosure often takes the form of narrative description in the

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[21] *Cf. infra* note 183 (observing that this overlap to some extent may mitigate investor harm).

[22] GAAP standards for financial accounting and reporting are promulgated by the accounting profession through its Financial Accounting Standards Board (FASB) pursuant to a delegation of power from the Securities and Exchange Commission (SEC). The SEC officially recognizes GAAP as authoritative. *See* Steven L. Schwarcz, *Private Ordering*, 97 NW. U. L. REV. 319, 320, 346-47 (2002) (discussing the SEC's delegation of disclosure power to the accounting profession through FASB). FASB also promulgates generally accepted auditing standards (GAAS) pursuant to this same delegation of power. FINANCIAL ACCOUNTING STANDARDS BOARD, FACTS ABOUT FASB 1 (2003-2004) (available at www.fasb.org) and SEC Financial Reporting Release No. 1, Section 101.

[23] FACTS ABOUT FASB, *supra* note 22, at 1. *But cf.* SAS 69, AU § 411.04(e) (financial statements must reflect the underlying transaction in such a way that it presents the financial position, result of operations, and cash flows within a range that is "reasonable and practical"); U.S. v. Simon, 425 F.2d 796, 805 (2d Cir. 1969) (questioning whether financial statements "fairly present the financial position [and] accurately report the operations" even though they technically comply with GAAP).

[24] This article's analysis applies even where the lawyers helping in the disclosure are not the same as those engaging in the underlying transaction. *See infra* note 38 (discussing the distinction between these roles and its significance).

prospectus or other offering documents used to sell the securities.[25] To the extent material financial information is disclosed in documents other than the financial statements and footnotes , there is potential overlap in accountant and lawyer responsibility.

This overlap in the roles of lawyers and accountants in disclosing financial information does not necessarily mean that lawyers should be responsible for financial information failure. Investors look primarily to financial statements for financial information,[26] and financial statements are the responsibility of accountants.[27] The growing complexity of financial and business transactions, however, has further blurred

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[25] Although offering documents typically include the financial statements in addition to the narrative description, firms are independently required to issue their financial statements to the public. Securities Exchange Act of 1934 § 12, 15 U.S.C. § 78l(b)(1) (2000). Disclosure in the form of narrative description also may be provided in periodic reporting, such as the reporting required by § 13 of the Securities Exchange Act (which is provided in practice through SEC-required forms 10-K for annual, 10-Q for quarterly, and 8-K for defined-event reports).

[26] JAMES C. FREUND, ANATOMY OF A MERGER 254-55 (1975). *See also* THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 610 (4th ed. 2002) (observing that the "securities laws underscore the importance of financial[-information] disclosures through the requirement that there be [accountant-]audited financial statements"). This article's normative analysis assumes this existing reality: that financial statements prepared by accountants are the primary source of financial information for investors. Although another article might discard that assumption and re-think from the ground up what should be the primary source of financial information, normative articles often begin with certain real-world assumptions. *See, e.g.,* Lucian A. Bebchuk, [cite his article, analyzing bankruptcy reorganization, that explicitly acknowledges he is making a normative analysis based on an observable, real-world, assumption].

[27] *See supra* notes 22-25 and accompanying text (observing that accountants disclose by preparing a firm's financial statements in accordance with GAAP, whereas lawyers help their client-firms disclose by describing, in narrative form in offering documents and periodic reporting, information that may be material to investors). *See also* E-mail from William Widen, Associate Professor, University of Miami School of Law, & former Partner, Cravath, Swaine & Moore, to the author (July 21, 2005) (observing that although lawyers help with disclosure generally, which includes disclosure of financial information, "it was quite common, in [his] experience, for lawyers to exclude financial statement information from the scope of the negative assurance given to underwriters in a 10b-5 letter," thereby illustrating the "tension … between the role of [lawyer as] overall advisor on disclosure and the tendency to sharply delineate areas of [lawyer] responsibility").

the boundary between these legal and accounting duties by making it difficult to assess the nature of the transaction, which has both legal and accounting consequences.[28]

For example, in determining the appropriate accounting treatment for transfers of financial assets, it is often difficult to assess whether complex financial transactions constitute sales of transferred assets or whether they are loans secured by those assets.[29] If the former, the transaction (barring other factors) would not be accounted for as a liability on the firm's balance sheet ("off-balance-sheet financing"[30]). If the latter, the transaction (again, barring other factors) would be accounted for as a liability and booked as indebtedness. Firms generally prefer to book transactions as sales, not loans,[31] because doing so does not increase (and indeed sometimes can decrease) their balance-sheet leverage.[32] Booking a loan transaction as a sale, however, can mislead investors.[33]

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[28] The boundary between these duties always has been slightly blurred. *See* HAZEN, THE LAW OF SECURITIES REGULATION, *supra* note 26, § 12.9[9], at 610-11 (attempting to reconcile how "[a]ccountants have their own definition of materiality in the context of the presentation of financial information" even though "materiality [of financial information] under the securities laws is determined by the same test of materiality that applies to other disclosure issues").

[29] *Cf*. Uniform Commercial Code (UCC) § 9-109 & Official Comments and Official Comment No. 2 to pre-revision UCC § 9-102.

[30] *See* Steven L. Schwarcz, *Rethinking the Disclosure Paradigm in a World of Complexity*, 2004 U. ILL. L. REV. 1 (2004) (discussing complex off-balance-sheet financing transactions).

[31] This assumes the sale does not have to be accounted for as a loss.

[32] Accounting for a transaction as a sale instead of a loan has a direct impact on the debt-equity, or "leverage," ratio, which in its most common form is determined by total liabilities divided by total equity. Increasing debt raises that ratio, making the firm appear less stable. Sales, in contrast, do not increase leverage, and, indeed, firms can reduce leverage by using the proceeds of sales to repay existing debts. CLYDE P. STICKNEY & ROMAN L. WEIL, FINANCIAL ACCOUNTING: AN INTRODUCTION TO CONCEPTS, METHODS, AND USES 273 (10th ed. 2003). *See also id.* at 535 (noting that firms often attempt to structure their financing to keep debt off the balance sheet, thereby showing lower liabilities and improving the debt ratios that analysts use to assess financial risk).

[33] Unwary investors may invest at a lower rate of return than the underlying risk would warrant. *Id*. at 535.

Recent changes to GAAP deepen the ambiguity. Financial Accounting Standard No. 140 ("FAS 140")[34]—the provision of GAAP most widely referenced in legal scholarship on financial information failure[35]—makes accounting treatment turn, in part, on legal conclusions of true-sale and non-consolidation under bankruptcy law.[36] As a result, commentators suggest lawyers should be ultimately responsible for accounting determinations under FAS 140. Professor Simon, for example, contends that the decision by Enron's principal outside counsel to

> not reconsider, or "second guess," Arthur Andersen's accounting judgments … was remarkable [because] under the relevant accounting standard, the most important determinant of accounting treatment was the extent to which Enron had retained control of rights and financial interests in [certain] partnerships' assets. This was, as the accounting standard explicitly recognized, a legal question.[37]

That GAAP sometimes turns on legal conclusions therefore makes it even easier to blame lawyers for financial information failure when public firms collapse. This allocation of

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[34] Statement of Financial Accounting Standards No. 140 (Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities).

[35] *See, e.g.,* Symposium, *Enron: Lessons and Implications*, 8 STAN. J. L. BUS. & FIN. 39, 64 (2002) (arguing that FAS 140 makes it difficult to determine the true value of assets); Peter Jeffrey, *International Harmonization of Accounting Standards, and the Question of Off-Balance Sheet Treatment*, 12 DUKE J. COMP. & INT'L L. 341, 343 (2002) (arguing that FAS 140 results in funding and assets being omitted from financial statements); Symposium, *Threats to Secured Lending and Asset Securitization*, 25 CARDOZO L. REV. 1655, 1741 (2004) (arguing that nomenclature of "true sale opinions" under FAS 140 causes difficulties for sellers of receivables); Symposium: Albert A. Destefano Lecture on Corporate Securities & Financial Law Panel Discussion, *Enron: What Went Wrong*, 8 FORDHAM J. CORP. & FIN. L. 1, 14 (2002) (arguing that FAS 140 obscures asset reporting, and is incomprehensible); John R. Kroger, *Enron, Fraud, and Securities Reform: An Enron Prosecutor's Perspective*, 76 U. COLO. L. REV. 57, 137 (2005) (arguing that FAS 140 gave a "green light" to the SPE manipulations in Enron).

[36] FAS 140 ¶¶ 9.a & 27. *See also* American Institute of Certified Public Accountants AU 9336 ("Using the Work of a Specialist") (interpreting ¶¶ 9.a & 27 of FAS 140).

[37] William H. Simon, *Wrongs of Ignorance and Ambiguity: Lawyer Responsibility for Collective Misconduct*, 22 YALE J. REG. 1, 5-6 (2005). Although the "relevant accounting standard" referred to in the above quotation would have been FAS 125, the predecessor to FAS 140, the differences between the two are irrelevant to this discussion.

blame is all the more appealing when lawyers are intimately involved with a transaction, leading third parties to believe they are familiar with all its aspects.[38] That intimate involvement also appears to create an economy of scope, giving lawyers an advantage in monitoring non-legal (i.e., accounting) elements of the transaction.[39]

For all these reasons, there is a strong public perception, corresponding to a norm, that lawyers should have some responsibility for preventing financial information failure.[40] Lawyers themselves should want to fulfill this perceived responsibility, if only out of concern for their integrity and reputation.[41] The difficult question is what this responsibility should be.

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[38] This raises a potential distinction between the responsibility of transactional counsel, who help structure and document the deal, and that of securities-law counsel, who only help in the disclosure. This article's thesis, that (business) lawyers should be educated to spot and resolve warning signs that might signal accounting fraud or other problems, would apply to counsel in both such capacities.

[39] *Cf.* Ronald Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L. J. 239, 298 (1984) (arguing that because business lawyers already play an important legal role in transactions, "economies of scope should give them an advantage in performing the [non-legal] aspects of transaction structuring as well"). Economies of scope represent the savings resulting from having the same investment support multiple profitable activities less expensively in combination than separately. CAMPBELL R. HARVEY, HYPERTEXTUAL FINANCE GLOSSARY, *available at* http://www.duke.edu/~charvey/Classes/wpg/bfglose.htm (visited Nov. 23, 2005).

[40] *Cf.* 148 CONG. REC. S6551 (daily ed. July 10, 2002) (statement of Sen. Edwards, that when "accountants are breaking the law, you can be sure that part of the problem is that the lawyers who are there and involved are not doing their jobs"). Notwithstanding this public perception, there is as yet no norm *within the legal profession* that lawyers should have this responsibility. *See* E-mail from William Widen, *supra* note 28 (observing that, "[a]mong lawyers the tendency is to avoid responsibility for financial statements, even in a negative assurance context (and the community of lawyers does not really fault another lawyer for missing an accounting point). … Maybe there should be such a norm—certainly the more general public might hold such a view as you indicate.").

[41] *Cf.* Steven L. Schwarcz, *The Limits of Lawyering: Legal Opinions in Structured Finance*, 84 TEX. L. REV. 1 (2005), at 2, 18.

There is little question that lawyers should not knowingly facilitate these failures.[42] Many commentators believe, however, that lawyers should be proactively responsible for preventing financial information failure. Professor Koniak, for example, argues that Enron's lawyers had an affirmative responsibility to ensure that Enron's SPEs were not used for fraudulent accounting purposes.[43] Professor Simon suggests that lawyers should have a duty to second-guess certain accounting determinations.[44] Professor Cunningham contends the mandate that lawyers may not "assist a client, in conduct that … is criminal or fraudulent" requires active attention to client actions, especially those relating to accounting.[45] Cunningham even suggests the possibility that accounting be regarded, at least for public companies, as the functional equivalent of public law because "Congress empowers the SEC to establish accounting principles and the SEC does so by recognizing FASB and guiding its promulgation [and] [d]epartures from GAAP expose citizens to jail time, cash fines and other discipline."[46] If accounting is so regarded, he maintains, "why not say lawyers have a responsibility for knowing what they are talking about when advising clients on matters concerning financial

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[42] *See, e.g.,* Stephen M. Bainbridge, *The Tournament at the Intersection of Business and Legal Ethics*, 1 U. ST. THOMAS L. J. 909, 915 (2004) (observing that scholars need not focus on "whether lawyers should be allowed to actively assist—or, for that matter, participate in—fraud by a client" because "[t]he law has long prohibited such conduct"); Robert W. Gordon, *A New Role for Lawyers?: The Corporate Counselor After Enron*, 35 CONN. L. REV. 1185, 1195 (2003) ("It is clear that the lawyer may not actively help clients engage in what he knows to be a crime or a fraud."). *Cf.* Model R. of Prof. Conduct 1.2(d) (ABA 2002) (providing in relevant part that "[a] lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent ….").

[43] Susan P. Koniak, *When the Hurlyburly's Done: The Bar's Struggle with the SEC*, 103 COLUM. L. REV. 1236, 1240-41 (2003).

[44] Simon, *Wrongs of Ignorance and Ambiguity, supra* note 37, at 5-6.

[45] Lawrence A. Cunningham, *Sharing Accounting's Burdens: Business Lawyers in Enron's Dark Shadow*, 57 BUS. LAW. 1421, 1450-51 (2002). *See also* Keith R. Fisher, *The Higher Calling: Regulation of Lawyers Post-Enron*, 37 U. MICH. J.L. REFORM 1017, 1037 (2004) (presenting argument that lawyers should assume greater responsibility for judging the ends proposed by clients).

[46] E-mail from Lawrence A. Cunningham, Professor of Law & Business, Boston College Law School, to the author (Aug. 19, 2005).

statement reliability [and] why not make that concept an active one rather than a passive one—even if there are costs associated with it?"[47] Professor Warren likewise maintains that lawyers should take the initiative in thwarting revenue recognition fraud.[48] According to these commentators, these steps, which in effect proactively monitor accountants and second-guess their determinations, will help avoid the possibility of a "perfect circle of lack of responsibility" between accountants and lawyers.[49]

This article examines, from a normative standpoint, the extent to which lawyers should be responsible for financial information failures. In contrast to the types of proactive lawyer-monitoring proposed above,[50] this article argues that a more passively responsive, or "reactive," lawyer-monitoring regime would be much less costly but almost equally effective, and that there are better solutions to the problem of financial information failure than lawyer monitoring, whatever its form.

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[47] *Id.*

[48] Manning Gilbert Warren III, *Revenue Recognition and Corporate Counsel*, 56 SMU L. REV. 885 (2003).

[49] Remarks of William H. Simon, Arthur Levitt Professor of Law, Columbia Law School, at March 21, 2005 Columbia Law School Symposium on the author's article, *The Limits of Lawyering: Legal Opinions in Structured Finance*. This "circle" also has been described in Cunningham, *Sharing Accounting's Burdens, supra* note 45, at 1454: a "familiar pass-the-buck pas de deux in deal meetings and conference calls occurs when the accountant says, after an impasse, 'that's a legal problem' while the lawyer says 'that's an accounting problem.'"

[50] Although there could be other approaches to proactive lawyer-monitoring, most would not represent advances over existing law. Professor Cohen, for example, suggests that to counter the rule-like nature of GAAP, a lawyer-monitoring regime could be "complementary" to the approach taken by accountants. E-mail from George Cohen, Professor of Law, University of Virginia School of Law, to the author (Aug. 29, 2005). Although the accounting authorities are to the contrary, there is judicial authority that accountants should deviate from GAAP rules as needed to fairly present financial information. *See infra* note 102 (discussing U.S. v. Simon). Another reviewer suggests a regime in which lawyers examine accountant-generated financial statements and then determine whether additional narrative disclosure is required for fair presentation. E-mail from Daniel Schwarcz, Climenko Fellow & Lecturer on Law, Harvard Law School, to the author (Oct. 18, 2005). Any such disclosure, however, would necessarily be second-best because investors look primarily to financial statements for financial information. *See supra* note 26.

ANALYSIS

Part I demonstrates that the costs of a proactive lawyer-monitoring regime would likely exceed its benefits. Part II then models a reactive lawyer-monitoring regime, again examining costs and benefits. Part III compares these regimes, showing that reactive lawyer-monitoring, while imperfect, appears preferable to a proactive regime. Finally, Part IV shows that lawyer monitoring, whatever its form, can only be a second-best solution to the problem of financial information failure. That Part also examines potentially more optimal solutions.

Part I: Analysis of Proactive Lawyer-Monitoring

Costs: Any proactive lawyer-monitoring regime—meaning one in which lawyers should be proactively responsible for second-guessing accounting determinations[51]—would be costly because lawyers lack both skills and knowledge for the task.[52] Accounting disclosure of financial information is governed by GAAP,[53] which is highly technical and voluminous.[54] FAS 140 alone is 156 single-spaced printed pages, not

[51] This article does not depend on this particular model of a proactive lawyer-monitoring regime or its later comparison to a proposed model of a reactive such regime. These models are used more as points of reference to help illustrate the possible functions and consequences of diverse lawyer monitoring regimes. *Cf. supra* note 50 (suggesting why other approaches to proactive lawyer-monitoring may not represent advances over existing law).

[52] *See, e.g.,* Bainbridge, *The Tournament at the Intersection of Business and Legal Ethics, supra* note 42, at 915 n. 44 (observing that "[i]t may often be the case that lawyers will lack the mathematical skills and accounting knowledge necessary to tell the difference between earnings management allowed by GAAP and illegal financial chicanery").

[53] *See supra* notes 22-26 and accompanying text.

[54] *See* Sofia Adrogue & Alan Ratliff, *Kicking the Tires after Kumho: The Bottom Line on Admitting Financial Expert Testimony*, 37 HOUS. L. REV. 431, 486-87 (2000) ("A consideration of the body of authority, guidance, and literature on accounting standards

including multiple separate updates and numerous cross-references to other accounting literature.[55] And GAAP itself can, and often does, "create a labyrinth of complex rules that only an experienced auditor could hope to understand."[56] For these reasons, knowledge about, much less expertise in, GAAP requires extensive and continuous training:

> Some suggest that lawyers should now become more active in client accounting and some advocate expanded accounting education for lawyers. … This essay argues for caution. While lawyers should develop enough knowledge to spot some accounting issues, it is unrealistic to suppose that attorneys will serve as extra, consulting accountants. That would require too much training and it would require lawyers to keep up with accounting developments as well as legal ones. Most attorneys would not have the time.[57]

Above and beyond this training cost, the legal and accounting cultures are so different that mere acquisition by lawyers of technical accounting knowledge would be insufficient. Accounting determinations under GAAP often turn, and indeed must turn, on formalisms, which are becoming increasingly alien to business lawyers as commercial and financial law embraces economic underpinnings.[58] Formalism is needed because

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… makes clear that, by any objective standard, understanding accounting issues involves technical and specialized knowledge.").

[55] *See* http://www.fasb.org/st/status/statpg140.shtml.

[56] David F. Birke, *The Toothless Watchdog: Corporate Fraud and the Independent Audit—How Can the Public's Confidence Be Restored?*, 58 U. MIAMI L. REV. 891, 904 (2004).

[57] William O. Fisher, *Where Were the Counselors? Reflections on Advice Not Given and the Role of Attorneys in the Accounting Crisis*, 39 GONZ. L. REV. 29, 103 & 103 n. 175 (2003/2004). Any attempt to require attorneys to second-guess accounting determinations would also likely create confusion. *See, e.g.*, e-mail from Richard Painter, Guy Raymond & Mildred Van Voorhis Jones Professor of Law, University of Illinois, and newly-appointed White House Chief Ethics Officer, to the author (Feb. 13, 2005) (observing that although the concept that a legal opinion should fairly present the situation is "sound in principle," it is "notoriously vague if used to impose liability on lawyers" and therefore might serve as a "definition of professionalism, but not as grounds for civil liability").

[58] *Cf.* MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 29 (2003) (explaining that contract law is, effectively, "design[ed] . . . according to the efficiency

accounting questions generally require black-and-white answers: a potential liability, for example, either should or should not be recorded on the firm's balance sheet.[59] Furthermore, to legitimize comparisons, different accountants applying the same GAAP rule ideally should come out with consistent answers.[60] GAAP sometimes provides highly formalistic metrics for attempting to provide these answers.[61]

Consider, for example, Financial Accounting Standard No. 13 ("FAS 13"),[62] which governs the determination of whether a lease is an operating lease, which is not accounted for as a liability on the lessee-firm's balance sheet, or a capital lease which must be accounted for as a liability. If the amount of minimum lease payments equals or exceeds 90% of the leased asset's fair value,[63] the lease is a capital lease (and therefore must be accounted for as a liability).[64] But if the amount of minimum leased payments equals 89.99999% of fair value, the lease may be an operating lease (and then need not be

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criterion"); RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW xx (6th ed. 2003) (including corporate law, contracts, and property rights in the "central areas of economic analysis of law").

[59] *See infra* notes 103-104 and accompanying text. *But cf. infra* notes 177-181 and accompanying text (discussing footnoted disclosure to financial statements).

[60] *See supra* note 30 and accompanying text (explaining that comparability of disclosure, one of GAAP's central goals, is needed for the efficient functioning of the economy). *See also* International Accounting Standards Board, "Frequently Asked Questions" (Aug. 25, 2004), observing that "[a]ccounting standards aim to promote comparability [and] consistency," which "not only promotes healthy financial markets [but also] helps to reduce the cost of capital because investors can have faith in companies' reports."

[61] *See* FACTS ABOUT FASB, *supra* note 22, at 1 (asserting that the FASB strives to develop "neutral standards that result in accounting for similar transactions and circumstances in a like manner"); William W. Bratton, *Shareholder Value and Auditor Independence*, 53 DUKE L.J. 439, 487 (2003) (stating that GAAP "governs homogenous, recurrent situations where the actors need ex ante instructions"). *Cf. infra* notes 103-104 and accompanying text (describing this as having to categorize shades of gray as being either black or white). Although GAAP's formalisms are commonly tempered by footnote disclosure, investors all too frequently ignore financial statement footnotes. *See infra* notes 177-181 and accompanying text.

[62] Statement of Financial Accounting Standards No. 13 (Accounting for Leases).

[63] Fair value being computed by subtracting any investment tax credit retained by the lessor.

[64] *See* FAS 13, ¶ 7.

accounted for as a liability).[65] Other provisions of GAAP are likewise written in this black-and-white fashion.[66]

These formalisms, moreover, are sometimes grounded in fictions that have little to do with economic realities.[67] Consider, for example, the previously discussed FAS 140,[68] which covers, among other things, GAAP accounting for securitization transactions. These are transactions in which firms (sometimes referred to as originators) originating financial assets[69]—such as accounts receivable, loans, or lease rentals—utilize special-purpose entities (SPEs, sometimes referred to interchangeably as special-purpose vehicles or SPVs) to facilitate the transaction.[70] One of FAS 140's key criteria

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[65] *Id.*

[66] Telephone Interview with Marshall Sterman, certified public accountant & partner, Weiser LLP (May 11, 2005). *See also* Office of the Chief Accountant & Office of Economic Analysis, Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System (2003), at http://www.sec.gov/news/studies/principlesbasedstand.htm (hereinafter "Study on Adoption of a Principles-Based Accounting System") (observing that GAAP rules "[c]ontain numerous bright-line tests"). *But cf.* e-mail from Lawrence A. Cunningham, Professor of Law & Business, Boston College Law School, to the author (Aug. 22, 2005) (contending that "[f]ormalism is actually quite rare in accounting").

[67] *See, e.g.,* Study on Adoption of a Principles-Based Accounting System, *supra* note 66, at _[cite]_ (observing that many question "whether technical compliance with U.S. accounting standards necessarily results in financial reporting that fairly reflects the underlying economic reality of reporting entities").

[68] *See supra* notes 34-36 and accompanying text.

[69] The terms "financial assets" and "receivables" are often used interchangeably.

[70] Steven L. Schwarcz, *The Inherent Irrationality of Judgment Proofing*, 52 STANFORD L. REV. 1, 6 (1999). In a typical securitization transaction, the firm originating the financial assets (sometimes referred to as the "originator") sells rights to payment from those assets to a wholly-owned SPE, which in turn transfers these rights to an independent SPE, which in turn issues securities to capital-market investors. The independent SPE uses the proceeds of the issuance to pay the first SPE for the financial assets, and the first SPE then uses those proceeds to pay the originator. The investors, who are repaid from collections of the financial assets, buy the securities based on their assessments of the value of the financial assets. *Id.* For a more complete analysis of securitization, *see* Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J. L., BUS. & FIN. 133 (1994); STEVEN L. SCHWARCZ, STRUCTURED FINANCE, A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION (2003 & supps.). For a discussion of other (including

for treating securitization transactions as off-balance-sheet sales is that each investor in securities issued by an SPE that is a "qualifying" SPE (in practice, the issuing SPE is almost always intended to be a qualifying SPE[71]) "has the right to pledge or exchange" those securities.[72] From a legal standpoint, this criterion would be irrelevant: an investor's right to pledge or exchange securities says nothing about whether the SPE issuing the securities legally owns the transferred financial assets, much less whether the securities constitute ownership interests or debt. GAAP's emphasis on this criterion, however, reflects the accounting fiction that

> [t]he effect of establishing the qualifying SPE is to merge the contractual rights in the transferred assets and to allocate undivided interests in them [in the form of the securities]. Therefore, the right of holders to pledge or exchange those [securities] is the counterpart of the right of a transferee [who purchases assets] to pledge or exchange the transferred assets themselves.[73]

Legal advice, in contrast, usually focuses on explaining a nuanced range of likely consequences to clients, who then decide how to evaluate and act on the advice. Even in the disclosure context, legal advice is rarely black and white. When a risk is to be disclosed, the lawyer will advise the client to describe the nature and magnitude of the risk and the likelihood of its occurring.[74] This disclosure is not as bound by rigid formalisms of having to make black-and-white determinations,[75] such as having to decide

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inappropriate) uses of SPEs, *see* Steven L. Schwarcz, *Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures*, 70 U. CIN. L. REV. 1309 (2002).

[71] [cite]

[72] FAS 140 ¶ 9.b & Appendix E to FAS 140 (defining "beneficial interests" to include securities).

[73] FAS 140 ¶ 173. *See also* FAS 140 ¶ 198; STRUCTURED FINANCE, *supra* note 70, § 7:3.1, at 7-5. Paragraph 46 of FAS employs a similar fiction to mandate that debt of a qualifying SPE should not be accounted for as a liability on the originator's consolidated balance sheet. *See* STRUCTURED FINANCE, *supra* note 70, at 7-12 n. 43.

[74] Basic Inc. v. Levinson, 108 S. Ct. 978, 987 (1988) (generally requiring, under federal securities law, that risk be disclosed through a probability-magnitude approach).

[75] The only black-and-white disclosure determination that lawyers must make is a marginal one: whether to advise the client to disclose the risk at all. *See infra* note 86.

whether to account for the risk as a liability on the firm's balance sheet. Because of this flexibility, legal advice can, and often does, turn more on substance—particularly economic substance[76]—than form.

For these functional reasons, lawyers and accountants speak fundamentally different languages. It is as if accountants are from Mars, lawyers from Venus.[77] These professions' irreconcilably different starting axioms would require proactively monitoring lawyers to become indoctrinated in accounting lore, above and beyond mere technical training.[78] That indoctrination, however, would increase costs.

Training and indoctrination, moreover, would constitute only part of the overall costs. Monitoring time presumably would be billable, increasing transaction costs. Lawyers engaged in such monitoring also may have to raise their billing rates to compensate for higher liability insurance premiums.[79]

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[76] *See supra* note 58.

[77] *Cf.* JOHN GRAY, MEN ARE FROM MARS, WOMEN ARE FROM VENUS: A PRACTICAL GUIDE FOR IMPROVING COMMUNICATION AND GETTING WHAT YOU WANT IN YOUR RELATIONSHIPS (1985). As a young lawyer, I heard this explained through a joke. A pilot in a small plane loses visibility in dense fog, and—after long disorientation—is forced to make an emergency landing. Luckily, as the ground approaches he sees an empty highway, and manages to land safely. After a while a car pulls up, and the pilot asks where he is. The driver of the car, an accountant, responds that he is on a highway in the middle of a fog—information that is formally correct but not necessarily helpful to understanding the entire picture. I later discuss whether GAAP itself should be changed. *See infra* note 173 and following text.

[78] *See infra* notes 94-101 and accompanying text (examining how ignorance of accounting lore can increase the opportunities for information failure).

[79] *Cf.* Fisher, *Where Were the Counselors?*, *supra* note 57, 103 n. 175 (arguing that "lawyers would need to think very hard before taking actions that would cause them to voluntarily shoulder the liabilities, as well as the other 'burdens,' that accountants carry today"). [Examine the relative costs of accounting versus lawyer liability insurance; if the former is higher, it would clearly support the statement in the text. Even if it isn't, lawyer liability insurance premiums may well increase if lawyers are required to perform accounting as well as legal functions. cite]

Other cost increases are possible, as well. For example, requiring proactive lawyer-monitoring would aggravate legal uncertainty about corporate governance responsibilities.[80] Corporation law presently requires a firm's management to maximize existing shareholder value.[81] GAAP, however, is more focused on achieving transparency for potential future investors in the firm's securities.[82] If lawyers were responsible for compliance with both corporation law and GAAP, they would have a duty to existing shareholders not to disclose a marginal risk that, if disclosed, could reduce share price; but they also would have a conflicting duty to take that risk into account to the extent it is relevant to a GAAP determination.[83] Although this conflict would not radically increase uncertainty (because federal securities law, requiring disclosure of material risks,[84] already preempts inconsistent state corporation law[85]), it would increase uncertainty at the margins where there is ambiguity about materiality.[86]

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[80] I later suggest a less proactive monitoring approach that enables lawyers to help reduce accounting fraud and, perhaps, mistake and misinterpretation without imposing all these costs and uncertainties. *See infra* notes 117-141 and accompanying text.

[81] Steven L. Schwarcz, *Temporal Perspectives: Resolving the Conflict Between Current and Future Investors,* 89 MINN. L. REV. 1044, 1049 (2005) (demonstrating that "[d]irectors and management, at least in the United States, have a fiduciary duty *only* to investors holding an existing property right or equitable interest to support such a duty—i.e., current investors") (citing Simons v. Cogan, 549 A.2d 300, 304 (Del. 1988)).

[82] *Cf.* FACTS ABOUT FASB, *supra* note 22, at 1 (stating that accounting standards are "for the guidance and education of . . . users of financial information"). This perhaps reflects that GAAP, which (as mentioned) is a form of private ordering delegated by the SEC to the accounting profession, focuses more on securities law disclosure, which often favors future over current investors. *Temporal Perspectives, supra* note 81, at 1049-52.

[83] *Temporal Perspectives, supra* note 81 (discussing this temporal conflict). Future shareholders could be harmed if, after they purchase their shares, the undisclosed risk occurs, causing share price to fall.

[84] Basic Inc. v. Levinson, 485 U.S. 224, 233-36 (1988).

[85] *See, e.g.*, Conkling v. Moseley, Hallgarten, Estabrook, & Weeden, Inc., 575 F. Supp. 760, 761 (D. Mass. 1983) (noting that federal securities law "has largely superseded state regulation of securities transactions").

[86] *See, e.g.,* Joan Macleod Heminway, *Materiality Guidance in the Context of Insider Trading: A Call for Action*, 52 AM. U. L. REV. 1131, 1152-53 (2003) (observing that "applicable decisional law and scholarship often do not permit a definitive determination as to the materiality of facts or events, even if recurring," and that the materiality standard's "interpretation and application (both as a general matter and in specific factual

Benefits: Despite these costs, proactive lawyer-monitoring would appear to do little to curb financial information failures.[87] These failures can be divided into three categories: failures caused by fraud; failures caused by mistake or misinterpretation of GAAP; and situations where GAAP itself results in information failure.[88] As shown below, proactive lawyer-monitoring would likely produce only marginal benefits in the first two categories and no benefits in the third category.

Although proactive lawyer-monitoring theoretically could limit fraud, financial statements already must be certified by independent, certified public accountants (CPAs) as complying with GAAP.[89] CPAs rarely engage in or tolerate fraud "not only because fraud is a crime and CPAs engaging in it would lose their licenses but also because 'there's [already] a whole [accounting] monitoring system'" to protect against fraud.[90] Furthermore, CPAs must "maintain total independence from the client at all times … and

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scenarios) often are not clear"). *See also* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) ("The determination of materiality [and thus the obligation to disclose] requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him, and these assessments are peculiarly ones for the trier of fact.").

[87] *Cf.* William H. Widen, *Enron at the Margin,* 58 BUS. LAW. 961, 962 (2003) (arguing that "[t]he cultural problem revealed by Enron ultimately is not subject to correction by teaching lawyers more accounting ….").

[88] These categories are broad enough to include all forms of "earnings management" that result in information failure. *Cf.* Claire A. Hill, *Why Financial Appearances Might Matter: An Explanation for "Dirty Pooling" and Some Other Types of Financial Cosmetic,* 22 DEL. J. CORP. L 141, 160 (1997) (discussing off-balance-sheet financing and other forms of earnings management).

[89] [cite]

[90] Telephone Interview with Marshall Sterman, *supra* note 66 (observing that CPA fraud is "extremely unusual" for these reasons). The high visibility of a just a few cases has created an unjustified perception that accounting fraud is rampant. Currently, less than one percent of public companies are forced to restate financials, and of those restatements only a fraction result from fraud. Cunningham, *Sharing Accounting's Burdens*, *supra* note 49, at 1426.

complete fidelity to the public trust."[91] Because lawyers are not subject to this independence principle and, indeed, are seen as having a duty of loyalty to the client, there is nothing to suggest that lawyers are necessarily in a less conflicted position than CPAs to monitor fraud. Furthermore, even if lawyers *were to be subjected* to some form of independence principle, it is historically unrealistic to believe that principle would remotely resemble "total independence from the client."[92] Lawyers are thus much more likely than accountants to be "captured" by their clients. Proactive lawyer-monitoring's impact on reducing fraud therefore would be expected to be marginal.[93]

Proactive lawyer-monitoring is similarly unlikely to reduce, at least materially, the level of mistake and misinterpretation. Even lawyers who have accounting training would not generally have the accounting expertise and experience of CPAs,[94] so any such monitoring would be analogous to experts in other fields (or non-experts) monitoring experts in areas of their expertise.[95] Although it is possible that this monitoring can reduce errors, the studies appear to be indeterminate.[96] Furthermore, the underlying rationale for why this type of monitoring can reduce errors—that "[w]hen decisionmakers

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[91] U.S. v. Arthur Young & Co., 465 U.S. 805, 817 (1984). A detailed codification of this "independence" principle is monitored by the American Institute of Certified Public Accountants (AICPA). CPAs also are subject to monitoring by the Public Company Accounting Oversight Board (PCAOB) established by Sarbanes-Oxley. *See* www.pcaobus.org.

[92] *See* text accompanying note 91.

[93] In perspective, therefore, although proactive lawyer-monitoring might catch financial information failures at the margin, the cost of imposing proactive monitoring in all cases to prevent those failures would be very high.

[94] *See supra* note 56 and accompanying text.

[95] *But cf.* E-mail from Nancy B. Rapoport, Dean & Professor of Law, University of Houston Law Center, to the author (Aug. 19, 2005) (foreseeing a future in which law and business educations merge). In that hypothetical future, lawyer monitoring may well more closely resemble experts monitoring other experts in an area of joint expertise.

[96] *See, e.g.,* Stephen J. Choi & A.C. Pritchard, *Behavior Economics and the SEC*, 56 STAN. L. REV. 1, 37 (2003) ("Does introducing experts from different fields appreciably reduce the tendencies of specific experts to act with overconfidence and to misapply heuristics learned in one field more generally to other fields? We simply do not know the answers to these questions.").

are held accountable for their choices, their propensity to fall prey to psychological biases changes"[97]—does not appear compelling in our context. Accountants already are held accountable for and must justify their choices under their firms' internal quality monitoring programs.[98] Accounting failures also will subject accountants to negative career consequences, and possible liability.[99] Perhaps for these reasons, studies show that CPAs exhibit relatively little cognitive bias: "we see much less evidence of cognitive bias in studies of professional auditors, particularly in studies using more realistic judgment and decisionmaking tasks."[100] If anything, a proactive lawyer-monitoring regime might sometimes even increase errors by confusing the CPAs.[101]

It therefore appears that proactive lawyer-monitoring would produce only marginal benefits for the first two categories of financial information failure—fraud, and mistake and misinterpretation.

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[97] Mark Seidenfeld, *The Psychology of Accountability and Political Review of Agency Rules*, 51 DUKE L.J. 1059, 1061-68 (2001).

[98] *See supra* note 90 and accompanying text & *infra* note 117 and accompanying text.

[99] *Cf.* Seidenfeld, *The Psychology of Accountability and Political Review of Agency Rules, supra* note 97, at _[cite]_ (defining "accountability" as "a broad notion that describes any situation in which a decisionmaker believes that he must justify his decision to others and that failure to provide a satisfactory justification will cause the decisionmaker to suffer negative consequences").

[100] Gregory Mitchell, *Why Law and Economics' Perfect Rationality Should Not Be Traded for Behavioral Law and Economics' Equal Incompetence*, 91 GEO. L.J. 67, 115 n.144 (2002) (citing James F. Smith & Thomas Kida, *Heuristics and Biases: Expertise and Task Realism in Auditing*, 109 PSYCHOL. BULL. 472, 485-86 (1991) (which explains this result as follows: "For many audit judgments, the costs associated with certain risks are sufficiently large that they seem to significantly influence the nature of audit training and formalized audit procedures.").

[101] *See, e.g.,* Timothy F. Malloy, *Regulation, Compliance and the Firm*, 76 TEMP. L. REV. 451, 486 (2003) (arguing that there is a "particular danger" of confusion "where specialists in one field (such as … law) are working with specialists in another"). *Cf. The Limits of Lawyering, supra* note 41, at notes 106-08 and accompanying text (observing that empowering lawyers to second-guess what constitutes fair presentation may well confuse investors).

The most likely reason for financial information failure may well be the third—that GAAP itself sometimes results in misleading financial statements.[102] GAAP, or any other accounting system that, like GAAP, redacts financial aspects of disclosure into formalized financial statements,[103] necessarily requires accountants to sometimes make "exquisitely fine judgment calls—shades of gray that, for accounting purposes, must be rendered as black or white."[104] Any system in which gray must sometimes be described as black or white will be inherently misleading. This explains why most of the dubious Enron transactions technically appeared to comply with GAAP, even though Enron's financial statements were alleged to be misleading.[105] No amount of lawyer monitoring,

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[102] *See, e.g.,* James L. Cochrane, *Are U.S. Regulatory Requirements for Foreign Firms Appropriate?*, 17 FORDHAM INT'L L.J. 58, 66 ("The notion that U.S. GAAP presents a wonderfully clear snapshot is misleading almost to the point of being dangerous"); Paul Rosenfield, *What Drives Earnings Management? It is GAAP Itself*, 190 J. ACCT. _[cite]_ (2000), available at http://www.aicpa.org/pubs/jofa/oct2000/opinion.htm (observing that "earnings management results less from distortion of the *application* of GAAP than from the application of inherently *faulty* GAAP") (emphasis in original); George J. Benston, *The Regulation of Accountants and Public Accounting Before and After Enron*, 52 EMORY L.J. 1325, 1339-40 (2003) (suggesting that "the codification of GAAP [has] made financial statement manipulations easier to accomplish [because] [a]s GAAP became more rules-based …, it became increasingly feasible for opportunistic managers to meet bright-line requirements in order to inflate reported net income."); Manuel A. Rodriguez, Comment: *The Numbers Game: Manipulation of Financial Reporting by Corporations and their Executives*, 10 U. MIAMI BUS. L. REV. 451, 453 (2002) ("While fraud is often believed to be the single most prevalent factor in creating an environment of earnings management, ... strict compliance with [GAAP] standards is just as likely to produce misleading financial statements[] as they are to produce meaningful and transparent statements on which the public can place reliance"). Although accountants theoretically should deviate from GAAP where it does not produce a fair presentation (*see* U.S. v. Simon, 425 F.2d 796, 805 (2d Cir. 1969)), in practice that rarely happens. [cite] This reluctance to deviate is not surprising, given that "fair presentation" is intrinsically subjective and GAAP is perceived as a safe harbor.

[103] *See supra* note XX and accompanying text (describing this function of GAAP accounting).

[104] *Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures*, *supra* note 70, at 1313.

[105] *See, e.g.*, Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp. [William C. Powers, Jr., Chair] 83 (Feb. 1, 2002) (the "Powers Report") (observing that even Enron's troublesome hedging transactions merely

or second-guessing of accountants' determinations under GAAP itself, can legitimately solve that problem.[106]

Balancing costs and benefits of a proactive lawyer-monitoring regime: In general, then, proactive lawyer-monitoring would significantly increase costs but produce little benefit.[107] This imbalance obtains even where GAAP accounting determinations, such as whether a financial or business transaction should be accounted for as a sale or a loan under FAS 140, rely in part on a legal conclusion.[108] Lawyers are responsible for ensuring the accuracy of their legal conclusions.[109] But many factors unique to accounting affect the ultimate accounting determination, which merely starts with a legal conclusion.

Consider, for example, the FAS 140 sale-or-loan determination. Although the first requirement thereunder for sale treatment is a legal one—"that there is presumptively a

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raised "substantial accounting questions"). *Accord, Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures*, *supra* note 70, at 1313 (observing that Enron may well have complied with GAAP). Even Enron's reporting as income the present value of expected future payments under its energy contracts was done in accordance with a rule—EITF 98-10: Accounting for Contracts Involved in Energy Trading and Risk Management Activities—issued by FASB's Emerging Issues Task Force, on which the SEC's Chief Accountant acts as an observer. *See* http://www.fasb.org/facts/eitfinfo.shtml. *See also* Marrianne M. Jennings, *A Primer on Enron: Lessons From A Perfect Storm of Financial Reporting, Corporate Governance and Ethical Culture Failures*, 39 CAL. W. L. REV. 163, 175 (arguing that Enron's use of mark-to-market accounting was in full compliance with FASB 133).

[106] I later examine, *infra* Part IV, other potential solutions to this problem.

[107] These costs would increase even more if, to increase integrity, a proactive lawyer-monitoring regime were to change the traditional lawyer-client relationship to require independence of the type applicable to the accountant-client relationship. *See supra* note 91 and accompanying text (discussing this independence requirement).

[108] *See supra* notes 36-37 and accompanying text. The example in the text turns, in the first instance, on whether the transaction involves a sale or a loan under bankruptcy law. *Id*.

[109] *The Limits of Lawyering, supra* note 41, at 45 (discussing liability standards for incorrect legal opinions). *See also supra* note 109 and accompanying text (observing that lawyers are independently responsible for their legal conclusions).

bankruptcy [law] sale of the transferred assets"[110]—the other requirements rely entirely on formalisms grounded in accounting fictions: that "the special purpose vehicle to which the originator sold its assets be a qualifying SPE,"[111] a term importing detailed accounting intricacies[112]; and that "each holder of beneficial interests in the qualifying SPE has the right to pledge or exchange those interests."[113] Although the latter requirement might appear legal, it is purely an accounting determination that, if anything, is inconsistent with legal intuition:

> [The requirement that each holder of beneficial interests in the qualifying SPE has the right to pledge or exchange those interests] relies … on a fiction. Whereas its focus logically should be on whether the originator has surrendered control of receivables to the SPE, *thereby giving the SPE the right to pledge or exchange those assets*, its focus instead is on the right of [investors] to pledge or exchange [their] interests. FAS 140 justifies this focus by assuming that the receivables transferred to the qualifying SPE effectively become the assets of its [investors].[114]

Because the ultimate determination under FAS 140, while starting with a legal conclusion, turns on complex accounting considerations, lawyers could contribute little through monitoring to prevent financial information failures thereunder.[115] Their primary

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[110] *See* AU 9336, *supra* note 36 (implementing FAS 140's requirements).

[111] STRUCTURED FINANCE, *supra* note 70, § 7:3.2. The accounting rationale for requiring a "qualifying SPE" derives from a "custodian model: that a qualifying SPE is deemed to be a custodian passively holding financial assets on behalf of" investors. *Id.* § 7:4, at 7-12 n. 43.

[112] *See* FAS 140 ¶¶ 35-45.

[113] STRUCTURED FINANCE, *supra* note 70, § 7:3.1, at 7-5 – 7-6.

[114] *Id.* at 7-5 (citing FAS 140 ¶ 173) (emphasis in original). *Cf. supra* note 73 and accompanying text (also discussing this accounting fiction).

[115] Because accounting determinations under GAAP are ultimately accounting, not legal, conclusions, even if legal conclusions sometimes may be their starting point, I disagree with Professor Simon's suggestion that Enron's principal outside counsel should have second guessed Arthur Andersen's accounting judgments simply because, "under the relevant accounting standard, the … most important determinant of accounting treatment was … a legal question." *See supra* note 37 and accompanying text. Professor Simon's

responsibility should be to ensure that the starting legal conclusion is correct. This is, indeed, how the bifurcation of responsibility between lawyers and accountants presently works. If the GAAP determination fails because the legal conclusion is incorrect, the lawyer, like any other lawyer issuing an incorrect legal opinion, would be subject to liability.[116] If the GAAP determination fails because the accountant failed to properly apply GAAP to the legal conclusion, the accountant would be subject to liability.[117] These professionals are fully responsible to fulfill their separate, although superficially overlapping, tasks.

There are therefore strong systemic reasons to believe that proactive lawyer-monitoring would not be an efficient solution to the problem of financial information failure.

Part II: Analysis of Reactive Lawyer-Monitoring

A reactive lawyer-monitoring regime, meaning one that is passively responsive, should be less costly than a proactive regime while providing many of its benefits. The precise costs and benefits depend on the nature of the regime. This Part first models such a regime, and then examines and balances its costs and benefits. I do not claim this model is the only or even necessarily the best reactive lawyer-monitoring regime, merely that it is a rational one.

Modeling a reactive lawyer-monitoring regime: Under a reactive monitoring regime, lawyers would respond to signs that might signal accounting fraud, mistake, or

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argument fails because the truth of the proposition $\neg A \supset \neg B$ (not-A implies not-B) does not necessarily mean that $A \supset B$ (A implies B)—or, applied to our facts, the truth of the proposition, "lack of a bankruptcy true-sale obviates an accounting sale," does not necessarily mean that the existence of a bankruptcy true-sale implies existence of an accounting sale.

[116] *See supra* note 109.

[117] [cite]

misinterpretation but would not otherwise attempt to second guess accounting interpretations. The rationale for such a regime is twofold. Ethically, lawyers confronted with warning signs should want to resolve any problems as a matter of personal and professional integrity.[118] Pragmatically too, lawyer conduct—like any other conduct—will be judged with hindsight bias, and people exaggerate the extent to which an event that has happened could have been anticipated in advance.[119] Lawyers confronted with warning signs would continue the representation at their peril unless the warning signs (which may well be ambiguous) can be dispelled.

The obvious first step to resolve warning signs is to speak with the relevant accountants. If discussions are insufficient, counsel would have to attempt to balance the costs of additional inquiry with the willingness of the client to pay for those costs. I would envision a relatively summary inquiry performed by the transactional lawyer,

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[118] The ethical rules governing lawyers do not currently require the lawyer to take any action in these circumstances. Rather, the lawyer's ethical duty is triggered only by actual knowledge of criminal or otherwise illegal conduct by the client or its representative. *See* ABA Model Rules of Professional Conduct, Rule 1.2(d) (lawyer shall not counsel or assist a client to engage in conduct the lawyer knows to be criminal or fraudulent); Rule 1.13(b) (lawyer shall take appropriate remedial action when the lawyer knows that a client is engaging or intends to engage in conduct which is illegal or a violation of a legal duty to the corporation and is likely to cause the corporation substantial harm). *But cf.* John C. Coffee, Jr., *The Attorney as Gatekeeper: An Agenda for the SEC*, 103 COLUM. L. REV. 1293, 1297 (2003) (arguing that securities lawyers should function as "gatekeepers"—a role borne by "independent professionals who are so positioned that, if they withhold their consent, approval, or rating, the corporation may be unable to effect some transaction or to maintain some desired status"—when they detect problems with a corporation's securities disclosure); Gordon, *A New Role for Lawyers?, supra* note 42, at 1196 (observing that "one of the lawyer's functions is to monitor compliance and head off wrongdoing—not just to put the best face on things if the client goes ahead and breaks the law").

[119] *See, e.g.,* Jeffrey J. Rachlinksi, *A Positive Psychological Theory of Judging in Hindsight*, 65 U. CHI. L. REV. 571, 572 (1998) ("In hindsight, people consistently exaggerate what could have been anticipated in foresight. They not only tend to view what has happened as having been inevitable but also to view it as having appeared 'relatively inevitable' before it happened.").

rather than a district-attorney-style fraud investigation performed by litigators.[120] If, notwithstanding these steps, the warning signs persist, or if other warning signs emerge, the lawyer should so inform the accountant and, in appropriate circumstances (such as unresolved suspicions of fraud), withdraw from the representation.[121] Whether the lawyer should have some additional duty to inform government regulators or otherwise "noisily withdraw," and the extent to which such a duty would conflict with the duty to keep client confidences, are issues beyond this article's scope.[122]

The viability of this regime turns on the ability of lawyers to identify warning signs, such as an accounting result that appears manifestly wrong. That in turn requires a rudimentary understanding of accounting principles.[123] In this regard, Professor Cunningham has aptly observed that

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[120] *Cf. The Limits of Lawyering*, *supra* note 41, at 34 (observing that no client would pay the costs of a district-attorney-style fraud investigation).

[121] *Cf.* Marshall L. Small, *An Attorney's Responsibilities Under Federal and State Securities Laws: Private Counselor or Public Servant?*, 61 CAL. L. REV. 1189, 1199 (1973) (arguing that when an attorney is "on notice of facts which, if inquired into, would disclose that he could not render an opinion, he may be guilty of such recklessness that his activities [in rendering a legal opinion] should be proscribed even if he was not a conscious or knowing participant in a violation of law"); Coffee, *The Attorney as Gatekeeper, supra* note 118, at 1297 (arguing that securities lawyers should function as "gatekeepers"). Lawyers would not ordinarily be in a position to resolve an accounting issue but should at least be able to confirm, through inquiry, that the accountants have focused on the issue, are aware of the facts, and consider the original accounting correct.

[122] *Cf.* Valerie Breslin & Jeff Dooley, *Whistle Blowing v. Confidentiality: Can Circumstances Mandate Attorneys to Expose Their Clients?*, 15 GEO. J. LEGAL ETHICS 719 (summer 2002) (outlining the controversy surrounding "noisy withdrawal" in the legal field).

[123] For a discussion of why this understanding of accounting need only be rudimentary, *see infra* notes 135-136 and related text. This rudimentary understanding contrasts with the much more sophisticated understanding of accounting that this article argues is appropriate for proactive lawyer-monitoring. Although one hypothetically could posit a proactive lawyer-monitoring regime also based on only a rudimentary understanding of accounting, such a regime would generate its own significant costs, requiring lawyers to actively second guess accounting determinations without a full understanding of what such determinations entail (and thereby increasing accountant and lawyer monitoring time and generating confusion). *Cf. supra* notes 94-101 and accompanying text

> [i]f business lawyers invariably confront questions of law and accounting in their practice, and it is difficult to understand core concepts and key cases in corporate law without a firm footing in accounting, it is incumbent upon the legal professorate to assure it provides adequate teaching.[124]

Other examples of warning signs might include the discovery of undisclosed side-agreements[125] or the failure to see a valid business purpose in a transaction.[126] The latter depends on what constitutes a business purpose. Raising financing or reducing its cost always should be a good business purpose.[127] So, too, should be shifting risk on assets to outside investors, or diversifying a firm's funding sources.[128] Mitigating taxes often has been viewed as a legitimate business practice.[129] At least until recently, it even could be argued that achieving an accounting treatment permitted by GAAP was itself a legitimate business purpose.[130]

(observing that even lawyers well trained in accounting might confuse accountants, causing mistakes).

[124] Cunningham, *Sharing Accounting's Burdens, supra* note 49, at 1449.

[125] *See, e.g.,* Powers Report, *supra* note 105, at 41-42, 49-50, 52 (observing that the financing structure Enron Corp. created for the Chewco SPE was at least 50% short of the required third-party equity need for accounting non-consolidation because a portion of such equity was protected by undisclosed reserve accounts funded by Enron)).

[126] *See, e.g.*, Richard Acello, *Enron Lawyers in the Hot Seat*, 90 ABA J. 22 (June 2004) (quoting Shaun Martin, legal ethics professor at University of San Diego, as stating: "If a lawyer can't come up with a good business reason for what she is doing, the lesson [of Enron] is to think twice about it.").

[127] *The Limits of Lawyering*, *supra* note 41.

[128] *Id.*

[129] *Id.* (citing Chamberlain v. Commissioner, 207 F.2d 462, 468 (6th Cir. 1953)).

[130] In its June 15, 2005 report on off-balance sheet transactions, *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers*, the SEC staff acknowledged that "many of the areas dealing with off-balance sheet arrangements involve significant use of accounting-motivated structured transactions." *Id.* at 3. The staff recommended, however, that such "transactions and transaction structures primarily motivated by accounting and reporting concerns, rather than economics" be discouraged in the future through a combination of

Ultimately, what constitutes warning signs is likely to build on a case-by-case basis, following the judicial litmus test of "we know it when we see it."[131] Courts should exercise caution against finding warning signs where none exist. To the extent lawyers begin treating almost anything as a warning sign, a reactive regime may begin to resemble a proactive one, increasing costs and making each warning less valuable.[132] For example, the fact that a securitization transaction is being accounted for as a sale even though it has loan-like economics should not, in and of itself, constitute a warning sign. Virtually all securitization transactions have loan-like economics because the same economic reality—the transferor wants to give as little away as possible, and the transferee wants to get as much as possible—underlies all transfers.[133] The presence of loan-like economics is therefore not determinative of sale or loan characterization.[134]

A potential drawback to a reactive-monitoring regime is that lawyers may claim—perhaps even with a pure heart (though an empty head)—that they never

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changes to accounting standards by FASB and greater awareness by participants in the financial reporting process. *Id.*

[131] *Cf.* Jacobellis v. Ohio, 378 U.S. 184, 197 (1964) (Stewart, J., concurring); Miller v. California, 413 U.S. 15, 24 (1973) ("whether 'the average person, applying contemporary community standards' would find that the work, taken as a whole, appeals to the prurient interest"); Roth v. United States, 354 U.S. 476, 489 (1957).

[132] *Cf.* Jill E. Fisch & Kenneth M. Rosen, *Is There a Role for Lawyers in Preventing Future Enrons?*, 48 VILL. L. REV. 1097, 1126-27 (2003) (arguing that Sarbanes-Oxley's "reporting up" requirement under § 307 may create a "classic 'noise' problem," under which attorneys "report all possible information related to actual, likely or even improbable wrongdoing to the board [of directors]").

[133] Steven L. Schwarcz, *Commercial Trusts as Business Organizations: Unraveling the Mystery*, 58 BUS. LAW. 559, 562-63 (2003).

[134] Steven L. Schwarcz, *Collapsing Corporate Structures: Resolving the Tension Between Form and Substance*, 60 BUS. LAW. 109 (2004) (explaining why loan-like economics is not, and should not be, a basis for recharacterizing a "sale" structure as a loan). Indeed, it is impossible to distinguish sales from loans on economics alone, and reference to other distinguishing features is needed. *See* STRUCTURED FINANCE, *supra* note 70, §§ 4:1-4:6 (discussing judicially-derived criteria for distinguishing sales from loans) & § 4:10 (normative discussion of criteria for distinguishing sales from loans).

observed warning signs, never triggering their duty to perform an inquiry. To avoid this rational-ignorance dilemma, lawyers should be held to a quasi-objective standard: to observe warning signs that a reasonable business lawyer *should* have observed at the time, given (perhaps) whatever minimum level of accounting knowledge is customary for similarly situated lawyers.[135] Because even the most diligent lawyer monitoring can reduce financial information failure only marginally,[136] that threshold of knowledge need be no more than a rudimentary level of accounting.

This article next examines and balances the costs and benefits of a reactive lawyer-monitoring regime as a means of comparing such a regime with proactive lawyer-monitoring.[137]

Costs: A reactive lawyer-monitoring regime should generate very low costs. Lawyers would be required to perform an inquiry precisely when the inquiry is likely to produce benefits—when, and only when, the lawyers observe sufficient warning signs. Monitoring time rarely should be billable because lawyers would need to be only passively alert to the presence of warning signs.

This regime also should not result in as high liability-insurance premium increases as a proactive regime. Furthermore, it should not aggravate legal uncertainty about corporate governance responsibilities. Such uncertainty occurs only at the margins, where there is ambiguity about the existence of materiality. Where warning signs trigger a lawyer's duty under a reactive monitoring regime, there is unlikely to be ambiguity about the existence of materiality.

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[135] [Consider possible analogy to lawyer responsibility in underwriter due diligence under § 11 of the Securities Act of 1933. cite]

[136] *See supra* notes 87-105 and accompanying text.

[137] References in the following discussion to a reactive lawyer-monitoring regime mean the one described *supra* notes 119-136 and accompanying text.

Benefits: A reactive lawyer-monitoring regime would likely generate fewer benefits, however, than those generated by a proactive lawyer-monitoring regime. Lawyers simply would not spot as many financial information failures, though it is impossible to quantify how many failures would be missed.

Balancing costs and benefits of a reactive lawyer-monitoring regime: The benefits of a reactive lawyer-monitoring regime hence would be low, but its costs likewise would be low. Without empirical data, it is difficult to determine precisely whether those benefits would exceed those costs.

Pragmatically, though, that precise determination is inconsequential. Lawyers should want to perform at least some monitoring role, not only because lawyer monitoring is seen as a social good[138] but also because it could help to blunt criticism and possible liability in the event of a financial information failure.[139] Accordingly, it is a given that *some* lawyer monitoring regime will develop.[140] The relevant normative

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[138] *See supra* note 40 and accompanying text (observing the strong public perception, corresponding to a norm, that lawyers should have some monitoring responsibility). *See also supra* notes 43-49 and accompanying text (discussing commentator arguments urging lawyer monitoring). *Cf.* Coffee, *The Attorney as Gatekeeper, supra* note 118 (advocating a "gatekeeper" function for securities lawyers so as to diminish the harm of defective disclosures to the investing public).

[139] *See, e.g., In re* Enron Corp. Securities, Derivative & ERISA Litigation, 235 F.Supp. 2d 549 (S.D. Tex. 2002) (denying a law firm's motion to dismiss complaint); Nathan Koppel, *Wearing Blinders*, supra note 10, at 166 (quoting Professor George Cohen of University of Virginia Law School as proposing that, whatever the accountant's role in a transaction, "it is the lawyers' obligation to ask, 'Is this fraudulent? Is this deal designed to mislead investors?'"). *See also* Lincoln Sav. & Loan Ass'n v. Wall, *supra* note 5 (referencing Judge Sporkin's clarion call, "Where … were the outside … lawyers when these transactions were effectuated?").

[140] This article is indifferent as to whether lawyer monitoring develops in a top-down fashion, such as by government imposing regulation requiring monitoring or by courts imposing liability for failure to adequately monitor; or in a bottom-up fashion, such as by lawyers fostering norms for monitoring through bar association pronouncements or by law firms internally adopting policies on monitoring.

question for this article, therefore, is *which* lawyer monitoring regime—one that is proactive, or one that is reactive—is superior.

Part III: Comparison of Proactive and Reactive Lawyer-Monitoring

At first glance, comparison appears difficult: a proactive lawyer-monitoring regime would be more beneficial but also more costly, a reactive one less costly but also less beneficial. Even the most proactive lawyer-monitoring regime probably would do little in absolute terms, however, to curb financial information failures. This is because lawyer monitoring would likely reduce information failure only marginally in the event of fraud, mistake, or misinterpretation, and would produce no benefits when GAAP itself causes the information failure.[141] Thus, although proactive lawyer-monitoring would produce relatively more benefits than a reactive regime, the benefits differential would likely be slight in absolute terms.

In contrast, the differential in costs between proactive and reactive lawyer-monitoring would likely be significant in absolute terms. A proactive lawyer-monitoring regime would be very costly. To become skilled in GAAP, lawyers would require extensive and continuous training.[142] Teaching technical accounting principles would be insufficient; lawyers also would have to become indoctrinated in accounting lore.[143] Furthermore, lawyer monitoring time presumably would be billable.[144] Lawyers engaged in proactive monitoring also may have to raise their billing rates to compensate for higher liability insurance premiums.[145] Other cost increases might include aggravated legal uncertainty about corporate governance responsibilities.[146]

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[141] *See supra* notes 87-105, 136 and accompanying text (discussing, among other things, that GAAP may well be the most likely reason for financial information failure).
[142] *See supra* notes 54-57 and accompanying text.
[143] *See supra* notes 57-78 and accompanying text.
[144] *See supra* notes 78-79 and accompanying text.
[145] *See id*.
[146] *See supra* notes 80-86 and accompanying text.

The costs of a reactive lawyer-monitoring regime, though, would be relatively small. Lawyers would be required to perform an inquiry only when it is likely to produce benefits, and the little monitoring time this entails should rarely be billable.[147] Nor would a reactive regime result in liability-insurance premium increases as high as those of a proactive regime or necessarily aggravate legal uncertainty about corporate governance responsibilities.[148]

The benefits differential between proactive and reactive lawyer-monitoring thus would likely be slight, whereas the costs differential between these regimes would likely be significant. Accordingly, the amount saved by choosing a reactive, as opposed to proactive, lawyer-monitoring regime should exceed the absolute value of any benefits lost.[149] A reactive lawyer-monitoring regime therefore should be economically superior to a proactive regime.[150]

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[147] *See supra* note 136 and following text.

[148] *Id.*

[149] Correlatively, the costs added by choosing a proactive, rather than reactive, lawyer-monitoring regime should exceed the benefits gained. Of course, if one of the marginal cases where proactive (though not reactive) lawyer-monitoring catches financial information failure is a future "Enron," the consequences would not be marginal. Catching a future Enron through lawyer monitoring, however, is unlikely. Even proactive lawyer-monitoring would not have caught Enron since most of the dubious Enron transactions technically appeared to comply with GAAP. *See supra* note 105 and accompanying text. Moreover, the possibility of catching a future Enron must be balanced against the certainty that a proactive lawyer-monitoring regime would itself impose consequential costs.

[150] A slightly analogous debate can be found in the corporate governance literature, over whether members of a corporation's board of directors should have a proactive duty to monitor employees for possible wrongdoing or whether board members should only have a reactive duty to monitor employees when on notice of misconduct. The Delaware Supreme Court took the latter position in Graham v. Allis-Chalmers, 188 A.2d 125 (Del. 1963), in which a company pled guilty for price fixing by mid-level employees. Plaintiff argued that board members should be liable for failing to implement a compliance program that would have detected and prevented this type of wrongdoing. The court disagreed, reasoning that directors may rely on the honesty of subordinates until they are put on notice of a problem (i.e., until there are warning signs). Professor Bainbridge has

The comparison of proactive and reactive lawyer-monitoring still needs to address Professor Cunningham's query whether lawyers should be responsible for accounting as the functional equivalent of law.[151] Lawyers, after all, advise clients in complying with law, so why shouldn't they also have an obligation to advise clients in complying with accounting "law"?

There are potentially two answers. The first is that accounting may not be the functional equivalent of law or, if it is, that the obligation of lawyers to advise on law may not extend to matters that are merely law's functional equivalents. I need not examine this answer because the second answer, below, is dispositive of the question. That answer is that, in highly specialized areas of law, non-expert lawyers are not, and should not be, obligated to monitor expert lawyers on matters of their expertise. Thus, a corporate lawyer working on a complex tax transaction would not be expected to proactively second-guess tax advice rendered by specialized tax counsel.[152] Tax law is simply too complex and different from other areas of law for non-tax lawyers to be

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argued in that context, as I do in this article's context, that this reactive approach is sensible because monitoring is costly. WILLIAM A. KLEIN, J. MARK RAMSEYER, & STEPHEN M. BAINBRIDGE, TEACHERS MANUAL FOR BUSINESS ASSOCIATIONS 230 (5th ed. 2003). In contrast, the Delaware Chancery Court has favored a more proactive monitoring regime in *In re* Caremark Int'l Inc. Derivative Litigation**,** 698 A.2d 959 (Del.Ch. 1996), involving court approval of a settlement of alleged criminal violations of a federal statute banning kickbacks for medical patient referrals. In approving the settlement, the court stated that board members have an affirmative duty to monitor employees regarding important aspects of a corporation's business, even absent notice of misconduct (i.e., absent warning signs). Irrespective of how this debate should be resolved, it is very different from, and thus only indirectly informs, the debate in my article. A board of directors manages the corporation, and management inherently involves initiative. Moreover, corporate compliance programs typically do not involve, as would lawyer monitoring of accounting, the high costs and only marginal benefits of non-experts monitoring experts. For these reasons, I strongly doubt that even the *Caremark* court would find that board members have a duty to hire lawyers to second-guess accounting determinations by certified public accountants.

[151] *See supra* notes 46-47 and accompanying text.

[152] [cite]

efficient monitors. By the same token, the tax counsel's expertise mitigates the need for such monitoring.

Similarly, even if accounting were the functional equivalent of law, that alone should not obligate lawyers to engage in proactive monitoring. Such an obligation would (as shown in this article) create economic inefficiencies, whereas an accountant's expertise mitigates the need for such monitoring. This approach is even more compelling for accountants than for tax lawyers because accountants are subject to a duty of independence and thus less subject to capture than tax lawyers.[153] Accordingly, to the extent accounting is the functional equivalent of law, accountants are at least the functional equivalents of specialized counsel (as to accounting matters).

On balance, then, a reactive lawyer-monitoring regime should be superior to one that is proactive. Lawyers at most should be watchdogs, not bloodhounds.[154] No lawyer monitoring regime, however, can be a full solution to the problem of financial information failure. Even the most proactive such regime would likely do little to curb information failure because lawyer monitoring only indirectly affects the primary actors giving rise to the failure—the firm, its accountants, and investors.[155] An optimal solution should directly address these actors or the underlying accounting system that permits financial information failure.

This article therefore finally explores—albeit briefly because the boundary between lawyer and accountant responsibility is not involved—possible optimal solutions to the problem of financial information failure. Although not itself optimal, lawyer

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[153] *See supra* notes 91-92 and accompanying text.
[154] *Cf. In re* Kingston Cotton Mill Co. (No. 2), 2 Ch 279 (Ct. App. 1896) (Eng.) (in the context of preventing accounting fraud, describing a watchdog's role as reacting only when there is something to "arouse [its] suspicion," contrasted with a bloodhound's role of "approach[ing] [its] work with suspicion or with a foregone conclusion that there is something wrong").
[155] *See supra* notes 87-105, 136 and accompanying text.

monitoring can supplement these other solutions. Where lawyer monitoring is employed, this article has shown that a reactive monitoring regime should be superior to one that is proactive. This article will not examine, however, whether lawyer monitoring *should supplement* other solutions; that is almost inevitable, given that lawyer monitoring is presently seen as a social good.[156]

Part IV: Seeking Optimal Solutions

Optimal solutions to the problem of financial information failure should, as observed, directly address the primary actors giving rise to the failure—the firm, its accountants, and investors—or the underlying accounting system that permits the failure. My examination below therefore starts with the firm, effectively meaning its management.

Regulating the firm: Recall that financial information failures can be divided into three categories, the first of which is fraud.[157] Members of management are almost always the primary movers, if not the sole persons responsible, in this category.[158] Regulation to prevent fraud therefore should focus primarily on management. Pursuant to powers delegated under the Sarbanes-Oxley Act,[159] the SEC has now taken this approach, promulgating rules and regulations aimed at reducing agency costs.[160]

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[156] *See supra* notes 138-139 and accompanying text.
[157] *See supra* note 88 and accompanying text.
[158] *See supra* note 90 and accompanying text (explaining why it is rare for CPAs to engage in or tolerate fraud).
[159] Public Company Accounting Reform and Investor Protection Act of 2002 ("Sarbanes-Oxley") (Pub. L. No. 107-204, 116 Stat. 745 (2002), codified at scattered sections of 15 U.S.C.).
[160] [Briefly discuss SOX §§ 303, 307, SEC Rule 13b2-2, and other applicable regulations. cite]

To some extent, the increasing complexity of financial and business transactions has made it easier for management to disguise fraud,[161] a problem that may require its own solutions. One possible solution is to limit complex financial or business transactions, although this would be inefficient.[162] Another solution, though itself second-best,[163] is to prohibit the conflicts of interest that (as in Enron) increase the likelihood that management may be engaging in overly complex transactions for ulterior motives.[164]

Regulating the firm's accountants: Accountants are primarily responsible for the secondary category of financial information failures—those caused by mistake or misinterpretation of GAAP.[165] In this regard, accountants play two separate roles: helping to structure transactions to achieve accounting goals under GAAP (and, in that connection, preparing financial statements to reflect those goals), and auditing financial statements to confirm GAAP compliance.[166]

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[161] *See supra* notes 27-36 and accompanying text. My claim that the increasing complexity of financial and business transactions has made it easier to disguise fraud should not be confused with unrelated observation (made by Professor Cunningham) that the greater the complexity of a fraud, the more likely it is to be caught. *Cf.* Cunningham, *Sharing Accounting's Burdens, supra* note 45, at 1426.

[162] *Rethinking the Disclosure Paradigm in a World of Complexity, supra* note 30, at 21-23.

[163] *Id.* at 37 & 37 n. 227 (suggesting that there may be no first-best solution to the problem of financial complexity).

[164] *Id.* at 31-36. The theory of this approach is that complexity undermines the disclosure paradigm in which sophisticated investors and securities analysts bring market prices into line with disclosure. Therefore continued reliance on disclosure would be justified only absent cost-effective supplemental protections. Although these protections might include governmental or private-sector certifications of securities quality or even direct or indirect guaranties of securities value, prohibiting these management conflicts of interest would be more optimal because, in the face of complexity, investors must rely not only on disclosure but also on the business judgment of management in setting up complex transactions for the company's benefit. To that end, the law similarly should focus, in addition to disclosure, on requiring management to be free of conflicts of interest that would affect management's judgment in those transactions. *Id.* at 36-37.

[165] *See supra* note 88 and accompanying text.

[166] *Cf. supra* note 22. This article has not previously emphasized these separate roles. Although accountants bear responsibility in both these roles, they more often face

Accountants engaged in the first role act to some extent like managers,[167] and thus their regulation may be informed by analyzing regulation of a firm's managers.[168] Sarbanes-Oxley also requires managers to impose internal corporate controls over the firm's financial reporting.[169]

Accountants engaged in the latter role, as auditors, already are closely regulated.[170] Auditing failures nonetheless could be addressed through non-traditional approaches, such as requiring firms to have two separate auditors—a system in which accountants watch the accountants.[171] Although this could be as costly as (if not costlier than) proactive lawyer-monitoring, accountants at least would have the requisite expertise to second-guess one another about GAAP.[172]

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liability in their role as auditors. [cite] This might appear to make it even more incongruous that lawyers are being subjected to liability for accounting failures, since their role—effectively helping to structure and document transactions—is more akin to structurers and preparers than to auditors. I do not suggest, however, that lawyer liability should turn on this distinction because I believe its premise is flawed: accountants as structurers and preparers should face greater liability than accountants as auditors because one who causes a problem is at least as culpable as, if not more culpable than, one who fails to catch it—even where there is a duty to try to catch it. Actual experience may be contra because of the technical legal hurdles to imposing aider-and-abettor liability (discussed *supra* note 14).

[167] *Cf.* e-mail from Professor Cunningham, *supra* note 66 (suggesting that any regulation of management "should include accounting managers").

[168] *See supra* notes 157-164 and accompanying text.

[169] Sarbanes-Oxley § 404.

[170] *See supra* notes 90-91 and accompanying text.

[171] This approach was suggested by Professor Bill Widen in his e-mail, *supra* note 28.

[172] Professor Widen argues that "[w]hen put this way, proactive monitoring by lawyers is seen in a dim light. The only reason to suggest such monitoring is that the lawyers are already on the scene and, thus, such monitoring might not seem to add the same degree of cost as a second accounting firm. However, if lawyers were to perform this monitoring task at all well (as they should want to for liability avoidance reasons), then the lawyers would need to become accountants and perform additional procedures (which might better be done by a second accounting firm)." *Id.*

More traditional regulatory approaches, such as imposing even stricter liability regimes or greater penalties for mistakes or failures, could also be applied to accountants in either of these roles. Sarbanes-Oxley already has taken steps in that direction.[173]

Fixing the accounting system: Most instances of financial information failure likely occurs in the third category—where GAAP itself fails.[174] Sarbanes-Oxley again has taken steps to correct this failure by requiring a firm's management to certify, without reference to GAAP, that financial statements are fairly presented.[175] Another possible solution is to improve GAAP, perhaps by transforming it into more of a principles-based, as opposed to rules-based, accounting regime, like International Accounting Standards (IAS). The costs and benefits of such a transformation are currently being hotly debated.[176]

Educating the firm's investors: Notwithstanding these solutions, some financial information failures inevitably will occur because investors are human. Government can mitigate the likelihood and impact of these failures, however, by educating investors to take into account all relevant sources of financial information. Ironically, the most important source for this information is the footnotes to financial statements. GAAP requires firms and their accountants to disclose, in these footnotes, most material financial information not already embodied in the financial statements themselves.[177] The ultimate financial information failure is that of investors to read, much less study,

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[173] [cite and explain]
[174] *Supra* note 102 and accompanying text.
[175] Sarbanes-Oxley § 302.
[176] *See, e.g.,* James D. Cox, *Regulatory Duopoly in U.S. Securities Markets*, 98 COLUM. L. REV. 1200 (1999); Study on Adoption of a Principles-Based Accounting System, *supra* note 66, at _[cite]_ (observing that "[r]ules-based accounting standards exacerbate the problems created by the complexity of business transactions"). *See also* G. Bennett Stewart III, *Why Smart Managers do Dumb Things*, WALL ST. J. A16 (June 2, 2003) (arguing that accounting standards reform is the most appropriate regulatory response to corporate accounting failures).
[177] [cite]

footnotes.[178] The footnotes to Enron's financial statements, for example, revealed many (if not all) of the troublesome potential liabilities that ultimately caused Enron to collapse.[179]

Simply educating investors to read these footnotes carefully can contribute significantly to solving the problem of financial information failure.[180] The good news is that, post-Enron, "no reasonable investor can claim ignorance of financial statement footnotes."[181]

CONCLUSIONS

In recent years, the increasing complexities of financial and business transactions, as well as changes to generally accepted accounting principles, have blurred the boundary between the roles of lawyers and accountants. As a result, there is a strong public perception that lawyers should have some responsibility for preventing information failures that can arise from these transactions, most notably misleading financial statements. This article examines what that responsibility should be.

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[178] Benjamin A. Templin, *Expensing Isn't the Only Option: Alternatives to the FASB's Stock Option Expensing Proposal*, 30 IOWA J. CORP. L. 357, 363-64 (2005)(decrying that "few investors read the detailed financial disclosures" in footnotes, and that "[c]onsequently, an investor might make a decision to buy or sell a stock based on imperfect information").

[179] *See* Anne Tergesen, *The Fine Print: How to Read Those Key Footnotes*, BUS. WK., Feb. 4, 2002, at 94, 94-95 (noting that investors "could have had a heads-up that all was not quite right at [Enron] long before the bad news broke in October. The source of this information? The footnotes companies are required to publish with their financial statements….").

[180] *See supra* note 59.

[181] Steven L. Schwarcz, *Securitization Post-Enron*, 25 CARDOZO L. REV. 1539, 1556 n. 87 (2004).

Commentators and scholars have argued that lawyers should be proactively responsible for preventing these failures, by monitoring accountants or reviewing their determinations. The implicit rationale for proactive monitoring is economic: that lawyers already are intimately involved in business transactions, giving them an advantage (through economies of scope) in monitoring the accounting elements in order to help prevent the information failures.

This article demonstrates, however, that there are strong systemic reasons to believe that any such proactive lawyer-monitoring regime—just like any regime in which non-experts attempt to proactively monitor experts in areas of their expertise[182]—would be inefficient, doing little (albeit, at great cost) to curb financial information failures. In contrast, this article argues that a more passively responsive, or "reactive," monitoring regime would be nearly as effective at a much lower cost. Under a reactive monitoring regime, lawyers would be educated to spot warning signs that might signal financial information failures—such as the absence of a valid business purpose for the transaction, or an accounting result that appears manifestly wrong. If a warning sign cannot be dispelled, or if other warning signs emerge, the lawyer should inform the accountant and, in appropriate circumstances, withdraw from the representation.

The article concludes that no form of lawyer monitoring can fully prevent financial information failures.[183] More effective solutions are needed to directly address

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[182] *See supra* notes 94-101, 151-152, and accompanying text (discussing that type of monitoring).

[183] Professor Cunningham appears to implicitly acknowledge this, observing that "[a]s a technical matter, the duty of competence may not call for a law firm's involvement in discussing appropriate accounting treatment." Cunningham, *Sharing Accounting's Burdens, supra* note 49, at 1455 (observing the positive-law duty of competence but not suggesting it should change). The practical possibility of there being a "perfect circle of lack of responsibility" also may be mitigated to some extent by the overlap between securities law disclosure and financial disclosure required under GAAP. An investor who observes the disparity between such disclosure could, at least theoretically, inquiry further to learn the truth.

the failures at their source.[184] Lawyer monitoring nonetheless can—and, because it is seen as a social good, inevitably will—complement those solutions, giving critical public import to this article's inquiry of how lawyers should perform that monitoring.

[184] The sources of financial information failures, the article argues, are the firm, its accountants, its investors, and GAAP itself. *See supra* notes 156-181 and accompanying text (examining solutions that address these sources of information failure).