Financial Information Failure: Redrawing the Boundary Between Lawyer and Accountant Responsibility

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Financial Information Failure:
Redrawing the Boundary Between Lawyer and Accountant Responsibility

Steven L. Schwarcz

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. Increasingly, lawyers advising the firm are charged with responsibility, perhaps because modern financial complexity, as well as rules that make accounting determinations turn in part on legal conclusions, has 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. In that context, this article confronts the larger question: To what extent should non-experts monitor experts on matters of their expertise?

INTRODUCTION

1 Copyright © 2005 by Steven L. Schwarcz.
2 Stanley A. Star Professor of Law & Business, Duke University School of Law; Founding Director, Duke Global Capital Markets Center. E-mail: schwarcz@law.duke.edu. The author thanks, for their invaluable comments, George M. Cohen, Lawrence A. Cunningham, Sean J. Griffith, G. Mitu Gulati, Nancy B. Rapoport, Daniel Schwarcz, William H. Widen, …, and participants in faculty workshops at Duke Law School and Washington and Lee University School of Law. He also thanks Joan Magat for editorial assistance and John (“Jay”) Douglas, Eric S. Kronman, and Jesse H. Rigsby IV for research assistance. Although the author is consulting in a case involving certain aspects of the matters discussed herein, the views expressed in this article are entirely his own and intended to be impartial.
Accounting responsibility is not always viewed as resting exclusively with accountants. This is especially the case when public firms collapse amid allegations of financial information failure, such as misleading financial statements. 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. Society then looks beyond the role of accountants to see who else might, or should, have been in a position to prevent the failure. 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. They advise the firm and, in securities offerings, have long been regarded as acting—and to some extent have a statutory role to act—as gatekeepers. Lawyers also are relatively easy targets because the public distrusts them.

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3 See infra notes 21-22 and accompanying text (discussing financial statements). Financial information failure thus includes accounting failure.


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).


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
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. 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 resulted from accounting failures.

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. In the past several years, though, courts have 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

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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 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 26-33 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 notes 101-102 and accompanying text (discussing why \( \neg A \supset \neg B \) does not necessarily means that \( A \supset B \)).

12 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 and 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.
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. 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. 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. The SEC itself also may start to more aggressively file civil charges against lawyers.

This article examines, from a normative standpoint, the extent to which lawyers should be responsible for financial information failures. There is little question that lawyers should not knowingly facilitate these failures. Ambiguity arises, however, where the evolving interface of lawyers and accountants creates overlap in their respective roles.

13 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).
14 Howard v. Everex System, Inc., 228 F.3d 1057, 1061 n. 5 (9th Cir. 2000).
15 In re Enron Corp. Securities, Derivative & ERISA Litigation, supra note 11 (denying a law firm’s motion to dismiss complaint).
16 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 ___, a “judicial shift—whether conscious or unconscious—toward imposing greater liability on gatekeepers,” including lawyers, in financial frauds; and showing, id. at ___, that empirical data indicate, in financial frauds, “the risk for gatekeepers [including lawyers] is real and growing”).
Although lawyers traditionally leave accounting to accountants, this overlap suggests the lawyer may have an affirmative duty to inquire into the accounting treatment.

The potential for overlap can best be illustrated through the duty of disclosing complex financial transactions. Consider first the standard duty of disclosure. Lawyers help their clients disclose material information to investors in the client’s securities.\(^{18}\) This disclosure often takes the form of narrative description in the prospectus or other offering documents used to sell the securities.\(^{19}\) To the extent financial information is material, there is potential overlap in accountant and lawyer responsibility.\(^{20}\)

Federal securities law makes accountants responsible for redacting financial information into formalized financial statements, such as balance sheets and income statements. Accountants are required to comply with generally accepted accounting principles (GAAP) when they prepare financial statements. GAAP is a set of standards for financial accounting and reporting promulgated by the accounting profession through its Financial Accounting Standards Board (FASB). The Securities and Exchange Commission (SEC), which delegates this power to FASB, officially recognizes GAAP as authoritative.\(^{21}\) Compliance with GAAP is intended to ensure that financial statement

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\(^{18}\) See SEC Rule 10b-5, 17 C.F.R. 240.10B-5 (2000). 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 34 (discussing the distinction between these roles and its significance).

\(^{19}\) 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).

\(^{20}\) Cf. infra note 167 (observing that this overlap to some extent may mitigate investor harm).

\(^{21}\) 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)
disclosure provides the “credibility, transparency, and comparability” needed for “the efficient functioning of the economy.” Accounting failures that result in misleading financial statements—the most prevalent example of financial information failure—can undermine these goals.

This overlap 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, and financial statements are the responsibility of accountants. The increasing complexity of financial transactions, however, has further blurred the boundaries between these legal and accounting duties by pursuant to this same delegation of power. The SEC officially recognizes GAAP and GAAS as authoritative. Financial Accounting Standards Board, Facts About FASB 1 (2003-2004) (available at www.fasb.org) and SEC Financial Reporting Release No. 1, Section 101.

Facts About FASB, supra note 21, 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).

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].

See supra notes 21-19 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).
making it difficult to assess the nature of the transaction, which has both legal and accounting consequences.\textsuperscript{25}

For example, it is often difficult to assess whether complex financial transactions constitute sales of transferred assets or whether they are loans secured by those assets.\textsuperscript{26} 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”\textsuperscript{27}). 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, because doing so does not increase (and indeed sometimes can decrease) their balance-sheet leverage.\textsuperscript{28} Booking a loan transaction as a sale, however, can mislead investors.\textsuperscript{29}

\textsuperscript{25} The boundary between these duties always has been slightly blurred. See Hazen, The Law of Securities Regulation, supra note 23, § 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”). 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”).

\textsuperscript{26} Cf. Uniform Commercial Code (UCC) § 9-109 & Official Comments and Official Comment No. 2 to pre-revision UCC § 9-102.


\textsuperscript{28} 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
Recent changes to GAAP deepen the ambiguity. Financial Accounting Standard No. 140 ("FAS 140")—the provision of GAAP most widely referenced in legal scholarship on financial information failure—makes accounting treatment turn, in part, on legal conclusions of true-sale and non-consolidation under bankruptcy law. 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.

Unwary investors may invest at a lower interest rate than the underlying risk would warrant. Id. at 535.


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).

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 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.\(^{34}\)

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.\(^{35}\) Lawyers themselves should want to fulfill this responsibility, if only out of concern for their integrity and reputation.\(^{36}\) The difficult question is what this responsibility should be.

Many commentators believe 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

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\(^{34}\) 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. Although the extent to which securities-law counsel should have a duty to consult with transactional counsel is beyond this article’s scope, that duty appears implicit where the same law firm acts in both capacities. \textit{Cf.} Coffee, \textit{Gatekeeper Failure and Reform, supra} note 16, at ___ (suggesting that lawyers could avoid conflicts of interest, and thus function more effectively as gatekeepers, where transactional counsel and securities-law counsel are different law firms).

\(^{35}\) Notwithstanding this public perception, there is as yet no norm \textit{within the legal profession} that lawyers should have this responsibility. \textit{See} E-mail from William Widen, \textit{supra} note 25 (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.”).

\(^{36}\) \textit{Cf.} Steven L. Schwarcz, \textit{The Limits of Lawyering: Legal Opinions in Structured Finance}, forthcoming 84 \textit{Tex. L. Rev.} (Fall 2005), at ___.
used for fraudulent accounting purposes.\textsuperscript{37} Professor Simon suggests that lawyers should have a duty to second-guess certain accounting determinations.\textsuperscript{38} 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.\textsuperscript{39} Cunningham even additionally 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.”\textsuperscript{40} 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 statement reliability [and] why not make that concept an active one rather than a passive one—even if there are costs associated with it?”\textsuperscript{41} Professor Warren likewise maintains that lawyers should take the initiative in thwarting revenue recognition fraud.\textsuperscript{42} 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.\textsuperscript{43}

\textsuperscript{37} Susan P. Koniak, \textit{When the Hurlyburly’s Done: The Bar’s Struggle with the SEC}, 103 COLUM. L. REV. 1236, 1240-41 (2003).
\textsuperscript{38} Simon, \textit{Wrongs of Ignorance and Ambiguity}, supra note 33, at 5-6.
\textsuperscript{40} E-mail from Lawrence A. Cunningham, Professor of Law & Business, Boston College Law School, to the author (Aug. 19, 2005).
\textsuperscript{41} \textit{Id}.
\textsuperscript{43} 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, \textit{The Limits of Lawyering: Legal Opinions in Structured Finance}. This “circle” also has been described in Cunningham, \textit{Sharing Accounting’s Burdens}, supra note 39, at 1454: a
In contrast to such proactive lawyer-monitoring,\(^4^4\) 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.

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 potential more optimal solutions.

“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.’”

\(^4^4\) 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). Existing law, however, has long required accountants to deviate from GAAP rules as needed to fairly present financial information. See infra note 88 (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). To some extent, this approach again mirrors existing law, since counsel who believe that material financial information is not adequately disclosed in financial statements may well be obligated to disclose such information through narrative discussion. See supra note 19. That disclosure, however, is always second-best because investors look primarily to financial statements for financial information. See supra note 23.
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—would be costly. Accounting disclosure of financial information is governed by GAAP, which is highly technical and voluminous. FAS 140 alone is 156 single-spaced printed pages, not including multiple separate updates and numerous cross-references to other accounting literature. And GAAP itself can, and often does, “create a labyrinth of complex rules that only an experienced auditor could hope to understand.” 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

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45 This article does not depend, however, 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 a point of reference to help illustrate the possible functions and consequences of diverse lawyer monitoring regimes. Cf. infra note 44 (suggesting why other approaches to proactive lawyer-monitoring may not represent advances over existing law).
46 See supra notes 21-23 and accompanying text.
48 See http://www.fasb.org/st/status/statpg140.shtml.
with accounting developments as well as legal ones. Most attorneys would not have the time.  

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. Formalism is needed because accounting questions generally require black-and-white answers: a potential liability, for example, either should or should not be disclosed on the firm’s balance sheet. Furthermore, to legitimize comparisons, different accountants applying the same GAAP rule ideally should come out with consistent answers. GAAP provides formalistic metrics for attempting to provide these answers.

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50 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”).


52 See infra notes 89-90 and accompanying text. But cf. infra notes 161-165 and accompanying text (discussing footnoted disclosure to financial statements).

53 See supra note 27 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.”

54 See FACTS ABOUT FASB, supra note 21, at 1 (asserting that the FASB strives to develop “neutral standards that result in accounting for similar transactions and
Consider, for example, Financial Accounting Standard No. 13 ("FAS 13"),\footnote{Statement of Financial Accounting Standards No. 13 (Accounting for Leases).} which governs the determination of whether a lease is an operating lease, which is not disclosed as a liability on the lessee-firm’s balance sheet, or a finance lease which must be disclosed. If the amount of minimum lease payments equals or exceeds 90\% of the leased asset’s fair value,\footnote{Fair value being computed by subtracting any investment tax credit retained by the lessor.} the lease is a finance lease (and therefore must be disclosed as a liability).\footnote{[cite relevant subpart of FAS 13]} But if the amount of minimum leased payments equals 89.99999\% of fair value, the lease is an operating lease (and need not be disclosed).\footnote{Id.} Many other provisions of GAAP are likewise written in this black-and-white fashion.\footnote{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”).\footnote{See, e.g., Study on Adoption of a Principles-Based Accounting System, supra note 59, at ___ (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”).} These formalisms, moreover, are sometimes grounded in fictions that have little to do with economic realities.\footnote{[cite relevant subpart of FAS 13]} Consider, for example, the previously discussed FAS 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 89-90 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 frequently ignore financial statement footnotes. See infra notes 161-165 and accompanying text.\footnote{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”).}\footnote{See, e.g., Study on Adoption of a Principles-Based Accounting System, supra note 59, at ___ (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”).}
which covers, among other things, GAAP accounting for securitization transactions. These are transactions in which firms (sometimes referred to as originators) originating financial assets—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. One of FAS 140’s key criteria 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) “has the right to pledge or exchange” those securities. 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

the 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

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61 See supra notes 30-32 and accompanying text.
62 Steven L. Schwartz, *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. Schwartz, *The Alchemy of Asset Securitization*, 1 STAN. J. L., BUS. & FIN. 133 (1994); Steven L. Schwartz, *Structured Finance, A Guide to the Principles of Asset Securitization* (2003 & supps.). For a discussion of other (including inappropriate) uses of SPEs, see Steven L. Schwartz, *Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures*, 70 U. CIN. L. REV. 1309 (2002).
63 [*cite*]
64 FAS 140 ¶ 9.b & Appendix E to FAS 140 (defining “beneficial interests” to include securities).
[who purchases assets] to pledge or exchange the transferred assets themselves.\(^65\)

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.\(^66\) This disclosure is not as bound by rigid formalisms of having to make black-and-white determinations,\(^67\) such as having to decide whether to show 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\(^68\)—than form.

For these functional reasons, lawyers and accountants speak fundamentally different languages. It is as if accountants are from Mars, lawyers from Venus.\(^69\) These professions’ irreconcilably different starting axioms would require proactively

\(^{65}\) FAS 140 ¶ 173. See also FAS 140 ¶ 198; STRUCTURED FINANCE, supra note 62, § 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 shown as a liability on the originator’s consolidated balance sheet. See STRUCTURED FINANCE, supra note 62, at 7-12 n. 43.


\(^{67}\) The only black-and-white disclosure determination that lawyers must make is a marginal one: whether to disclose the risk at all. See infra note 78.

\(^{68}\) See supra note 51.

\(^{69}\) 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 157 and following text.
monitoring lawyers to become indoctrinated in accounting lore, above and beyond mere technical training. 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.

Other cost increases are possible, as well. For example, requiring proactive lawyer-monitoring would aggravate legal uncertainty about corporate governance responsibilities. Corporation law presently requires a firm’s management to maximize existing shareholder value. GAAP, however, is more focused on achieving transparency for potential future investors in the firm’s securities. If lawyers were responsible for compliance with both corporation law and GAAP, they would have a duty to existing

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70 See infra notes 86-87 and accompanying text (examining how ignorance of accounting lore can increase the opportunities for information failure).
71 Cf. Fisher, Where Were the Counselors?, supra note 50, 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]
72 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 104-127 and accompanying text.
73 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)).
74 Cf. Facts About FASB, supra note 21, 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 73, at 1049-52.
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.\textsuperscript{75} Although this conflict would not radically increase uncertainty (because federal securities law, requiring disclosure of material risks,\textsuperscript{76} already preempts inconsistent state corporation law\textsuperscript{77}), it would increase uncertainty at the margins where there is ambiguity about materiality.\textsuperscript{78}

Benefits: Despite these costs, proactive lawyer-monitoring would appear to do little to curb financial information failures.\textsuperscript{79} 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.\textsuperscript{80} As shown

\textsuperscript{75} Temporal Perspectives, supra note 73 (discussing this temporal conflict). Future shareholders could be harmed if, after they purchase their shares, the undisclosed risk occurs, causing share price to fall.
\textsuperscript{76} Basic Inc. v. Levinson, 485 U.S. 224, 233-36 (1988).
\textsuperscript{78} 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 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.”).
\textsuperscript{79} 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 ….”).
\textsuperscript{80} 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).
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.\textsuperscript{81} 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.\textsuperscript{82} Furthermore, CPAs must “maintain total independence from the client at all times … and complete fidelity to the public trust.”\textsuperscript{83} 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 \textit{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.”\textsuperscript{84} 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.\textsuperscript{85}

\begin{itemize}
\item \textsuperscript{81} [cite]
\item \textsuperscript{82} Telephone Interview with Marshall Sterman, \textit{supra} note 59 (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, \textit{Sharing Accounting’s Burdens}, \textit{supra} note 43, at 1426.
\item \textsuperscript{83} 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.
\item \textsuperscript{84} \textit{See} text accompanying note 83.
\item \textsuperscript{85} 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.
\end{itemize}
Proactive lawyer-monitoring is similarly unlikely to reduce, at least materially, the level of mistake and misinterpretation. Lawyers well trained in accounting would not generally have the accounting expertise and experience of CPAs.\textsuperscript{86} Indeed, sometimes they might even confuse the CPAs, causing mistakes.\textsuperscript{87}

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.

The most likely reason for financial information failure may well be the third—that GAAP itself sometimes results in misleading financial statements.\textsuperscript{88} GAAP, or any

\textsuperscript{86} See supra note 49 and accompanying text.

\textsuperscript{87} Cf. The Limits of Lawyerying, supra note 36, at note 107 (observing that empowering lawyers to second-guess what constitutes fair presentation may well confuse investors). [Show why, taking into account the lawyer’s lower level of information but high persuasive power.]

\textsuperscript{88} 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. __ (2000), available at \url{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.
other accounting system that, like GAAP, redacts financial aspects of disclosure into formalized financial statements, necessarily requires accountants to sometimes make “exquisitely fine judgment calls—shades of gray that, for accounting purposes, must be rendered as black or white.” 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. No amount of lawyer monitoring, or second-guessing of accountants’ determinations under GAAP itself, can legitimately solve that problem.

Balancing costs and benefits of a proactive lawyer-monitoring regime: In general, then, it appears that proactive lawyer-monitoring would significantly increase costs but produce little benefit.

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[cite] This reluctance to deviate is not surprising, given that “fair presentation” is intrinsically subjective and GAAP is perceived as a safe harbor.

89 See supra note XX and accompanying text (describing this function of GAAP accounting).

90 Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures, supra note 62, at 1313.

91 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 raised “substantial accounting questions”). Accord, Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures, supra note 62, 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 Marianne 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).

92 I later examine, infra Part IV, other potential solutions to this problem.

93 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
This imbalance would obtain even in situations where GAAP accounting
determinations, such as whether a financial transaction should be accounted for as a sale
or a loan under FAS 140, rely in part on legal conclusions. Lawyers providing opinions
evidencing the requisite legal conclusions are responsible for ensuring the accuracy of
their opinions as to those legal conclusions. But that does not, and should not, make
them proactively responsible for second-guessing the ultimate accounting determination
that flows from those legal conclusions. Even after the legal conclusion as to sale, many
other factors unique to accounting affect that determination.

For example, although the “first requirement” under FAS 140 for surrender of
control and thus off-balance-sheet accounting treatment is “that there is presumptively a
bankruptcy [law] sale of the transferred assets,” there is a “second requirement for
surrender of control [which, as discussed, relies on an accounting fiction], that each
holder of beneficial interests in the qualifying SPE has the right to pledge or exchange
those interests”; and there is also a “third requirement for surrender of control, that the
originator not retain the ability to unilaterally cause the SPE to return specific assets other
than through a cleanup call.” Moreover, even if all these requirements—only the first of
which is evidenced through a legal conclusion—are met, FAS 140 imposes an
additional requirement for off-balance-sheet treatment: that “the special purpose vehicle

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94 See supra notes 32-33 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.
95 The Limits of Lawyering, supra note 36, at ___.
96 See supra notes 63-65 and accompanying text.
97 STRUCTURED FINANCE, supra note 62, § 7:3.1, at 7-5 – 7-6.
98 See AU 9336 (implementing FAS 140’s requirements).
to which the originator sold its assets be a qualifying SPE” as defined in detail thereunder.¹⁰⁰

Accounting determinations under GAAP are therefore ultimately accounting, not legal, conclusions, even if legal conclusions sometimes may be their starting point (in other words, the fact that FAS 140 or another statement of GAAP accounting may turn in part on legal conclusions does not make the GAAP accounting determination itself a legal conclusion).¹⁰¹ This merely reflects elementary logic: the truth of the proposition ¬A ⊃ ¬B (not-A implies not-B) does not necessarily mean that A ⊃ B (A implies B).¹⁰²

This split between law and accounting does not create a liability void. When the GAAP determination fails because the legal conclusion is incorrect, the lawyer, like any other lawyer issuing an incorrect legal opinion, would be liable.¹⁰³ When the GAAP determination fails because the accountant failed to properly apply GAAP to the legal conclusion, the accountant would be liable.¹⁰⁴ These professionals are fully responsible to fulfill their separate, although superficially overlapping, tasks.

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⁹⁹ Structured Finance, supra note 62, § 7:3.2.
¹⁰⁰ See FAS 140 ¶¶ 35-45.
¹⁰¹ I therefore disagree with Professor Simon’s suggestion, supra note 33 and accompanying text, 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.” This assumes, of course, that such counsel’s legal advice was correct. See supra note 95 and accompanying text (observing that lawyers are independently responsible for their legal conclusions).
¹⁰² Applying this principle 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.
¹⁰³ The Limits of Lawyering, supra note 36, at __.
¹⁰⁴ [cite]
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 (i.e., one that is passively responsive) should be less costly than a proactive regime but can provide 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 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 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.\(^{105}\) 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.\(^{106}\) Lawyers confronted with

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105 *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).

106 *See, e.g.*, Jeffrey J. Rachlinski, *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.”).
warning signs thus 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 such a warning sign is to speak with the relevant accountants. If discussions are insufficient, counsel would have to attempt to balance additional investigatory costs with the willingness of the client to pay for those costs. I would envision a relatively summary investigation performed by the transactional lawyer, rather than a district-attorney-style fraud investigation performed by litigators.\(^\text{107}\) If, notwithstanding these steps, the warning sign persists, or if other warning signs emerge, the lawyer should so inform the accountant and, in appropriate circumstances, withdraw from the representation.\(^\text{108}\) 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.\(^\text{109}\)

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

\(^{107}\) Cf. The Limits of Lawyering, supra note 36, at ___ (observing that no client would pay the costs of a district-attorney-style fraud investigation).

\(^{108}\) 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 105, at 1297 (arguing that securities lawyers should function as “gatekeepers”).

rudimentary understanding of accounting principles.\textsuperscript{110} In this regard, Professor Cunningham has aptly observed that

\begin{quote}
[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.\textsuperscript{111}
\end{quote}

Other examples of warning signs might include the discovery of undisclosed side-agreements\textsuperscript{112} or the failure to see a valid business purpose in a transaction.\textsuperscript{113} The latter depends on what constitutes a business purpose. Raising financing or reducing its cost always should be a good business purpose.\textsuperscript{114} So, too, should be shifting risk on assets to outside investors, or diversifying a firm’s funding sources.\textsuperscript{115} Mitigating taxes often has been viewed as a legitimate business practice.\textsuperscript{116} At least until recently, it even could be

\textsuperscript{110} For a discussion of why this understanding of accounting need only be rudimentary, see infra notes 122-123 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 86-87 and accompanying text (observing that even lawyers well trained in accounting might confuse accountants, causing mistakes).

\textsuperscript{111} Cunningham, \textit{Sharing Accounting’s Burdens}, supra note 43, at 1449.

\textsuperscript{112} See, e.g., Powers Report, supra note 91, 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).

\textsuperscript{113} See, e.g., Richard Acello, \textit{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.”).

\textsuperscript{114} \textit{The Limits of Lawyering}, supra note 36.

\textsuperscript{115} Id.

\textsuperscript{116} Id. (citing Chamberlain v. Commissioner, 207 F.2d 462, 468 (6th Cir. 1953)).
argued that achieving an accounting treatment permitted by GAAP was itself a legitimate business purpose.\textsuperscript{117}

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.”\textsuperscript{118} 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.\textsuperscript{119} For example, that a securitization transaction has loan-like economics even though it purports to be a sale 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.\textsuperscript{120} The presence of loan-like economics is therefore not determinative of sale or loan characterization.\textsuperscript{121}

\textsuperscript{117} In its June 15, 2005 report on off-balance sheet transactions, \textit{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 recommended, however, that “transactions and transaction structures primarily motivated by accounting and reporting concerns, rather than economics” be discouraged through a combination of changes to accounting standards by FASB and greater awareness by participants in the financial reporting process. \textit{Id.} at 3.

\textsuperscript{118} See 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).

\textsuperscript{119} \textit{Cf.} Jill E. Fisch & Kenneth M. Rosen, \textit{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]”).


\textsuperscript{121} Steven L. Schwarcz, \textit{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
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 observed warning signs, never triggering their duty to investigate. 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.\textsuperscript{122} Because even the most diligent lawyer monitoring can reduce financial information failure only marginally,\textsuperscript{123} 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.\textsuperscript{124}

\textit{Costs:} A reactive lawyer-monitoring regime should generate very low costs. Lawyers would be required to investigate precisely when investigation 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

\footnote{122}{Consider possible analogy to lawyer responsibility in underwriter due diligence under federal securities laws. cite}

\footnote{123}{See supra notes 79-91 and accompanying text.}

\footnote{124}{References in the following discussion to a reactive lawyer-monitoring regime mean the one described supra notes 106-123 and accompanying text.}
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.

**Benefits:** By the same token, it seems self-evident that a reactive lawyer-monitoring regime would likely generate fewer benefits than that of 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 would be difficult to determine precisely whether those benefits would exceed those costs.

Pragmatically, though, that precise determination is inconsequential. Lawyers are expected to perform some monitoring role because lawyer monitoring is seen as a social good, and lawyers will want to be seen as performing such a role to avoid being criticized and exposed to liability for a failure to monitor. Accordingly, it is a given

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125 *See supra* note 35 and accompanying text (observing the strong public perception, corresponding to a norm, that lawyers should have some monitoring responsibility). *See also supra* notes 37-43 and accompanying text (discussing commentator arguments urging lawyer monitoring). *Cf.* Coffee, *The Attorney as Gatekeeper, supra* note 105 (advocating a “gatekeeper” function for securities lawyers so as to diminish the harm of defective disclosures to the investing public).

126 *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?”).
that some lawyer monitoring regime will be imposed (and will impose costs). The relevant normative question for this article, therefore, is which lawyer monitoring regime—one that is proactive, or one that is reactive—is better. I next address this question.

Part III: Comparison of Proactive and Reactive Lawyer-Monitoring

Which lawyer monitoring regime is superior? A proactive 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 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 results causes the information failure.127 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.128 Teaching technical accounting principles would be insufficient; lawyers also would have to become indoctrinated in accounting lore.129 Furthermore, lawyer monitoring time presumably would be billable.130 Lawyers engaged in proactive monitoring also may have to raise their billing rates to compensate for higher

127 See supra notes 79-91, 123 and accompanying text (discussing, among other things, that GAAP may well be the most likely reason for financial information failure).
128 See supra notes 47-50 and accompanying text.
129 See supra notes 50-70 and accompanying text.
130 See supra notes 70-71 and accompanying text.
liability insurance premiums.\textsuperscript{131} Other cost increases might include aggravated legal uncertainty about corporate governance responsibilities.\textsuperscript{132}

The costs of a reactive lawyer-monitoring regime, though, would be relatively small. Lawyers would be required to investigate only when it is likely to produce benefits, and the little monitoring time this entails should rarely be billable.\textsuperscript{133} 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.\textsuperscript{134}

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 money saved by choosing a reactive, as opposed to proactive, lawyer-monitoring regime should exceed the absolute value of any benefits lost.\textsuperscript{135} A reactive lawyer-monitoring regime therefore should be economically superior to a proactive regime.\textsuperscript{136}

\begin{itemize}
\item \textsuperscript{131} See id.
\item \textsuperscript{132} See supra notes 72-78 and accompanying text.
\item \textsuperscript{133} See supra note 123 and following text.
\item \textsuperscript{134} Id.
\item \textsuperscript{135} 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 91 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.
\item \textsuperscript{136} 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.
The foregoing comparison, being economic, does not (at least explicitly) address from a jurisprudential standpoint whether a reactive lawyer-monitoring regime should be superior to a proactive regime if accounting is, as suggested by Professor Cunningham, the functional equivalent of law.\textsuperscript{137} One obligation of lawyers, after all, is to advise clients in complying with law. Why shouldn’t lawyers 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 not 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

\textsuperscript{137} See supra notes 40-41 and accompanying text.
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. Tax law is
simply too complex and different from other areas of law for non-tax lawyers to be
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. 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).

This article therefore views a reactive lawyer-monitoring regime as being superior
to one that is proactive. 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 such failure because lawyer monitoring indirectly affects the
primary actors giving rise to the failure—the firm, its accountants, and investors. 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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138 [cite]
139 See supra notes 83-84 and accompanying text.
140 See supra notes 79-91, 123 and accompanying text.
monitoring can supplement these other solutions. Where lawyer monitoring is employed, this article has shown that a reactive monitoring regime would 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.141

Part IV: Seeking Optimal Solutions

Optimal solutions to the problem of financial information failure should 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.

Regulating the firm: Any examination of optimal solutions for financial information failures must start with the firm, effectively meaning its management. Recall that financial information failures can be divided into three categories, the first of which is fraud.142 Members of management are almost always the primary movers, if not the sole persons responsible, in this category,143 so regulation to prevent fraud should focus primarily on management. Pursuant to powers delegated under the Sarbanes-Oxley Act,144 the SEC recently has taken this approach, promulgating rules and regulations aimed at reducing agency costs.145

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141 See supra notes 125-126 and accompanying text.
142 See supra note 80 and accompanying text.
143 See supra note 82 and accompanying text (explaining why it is rare for CPAs to engage in or tolerate fraud).
145 [Briefly discuss SOX §§ 303, 307, SEC Rule 13b2-2, and other applicable regulations. cite]
To some extent, the increasing complexity of financial transactions has made it easier for management to disguise fraud, a problem that may require its own solutions. One possible solution is to limit complex financial transactions, although this would be inefficient. Another solution, though itself second-best, 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.

*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. In this regard, accountants play two separate roles: helping to structure transactions to achieve accounting goals under GAAP, and auditing transactions to confirm GAAP compliance.

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146 See *supra* notes 24-32 and accompanying text. My claim that the increasing complexity of financial 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 39, at 1426.

147 *Rethinking the Disclosure Paradigm in a World of Complexity, supra* note 27, at 21-23.

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

149 *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.

150 See *supra* note 80 and accompanying text.

151 [cite]
Accountants engaged in the first role act to some extent like managers, and thus their regulation may be informed by analyzing regulation of a firm’s managers. Accountants engaged in the latter role, as auditors, already are closely regulated. 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. 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.

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.

Fixing the accounting system: Most instances of financial information failure likely occurs in the third category—where GAAP itself fails. 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. 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

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152 Cf. e-mail from Professor Cunningham, supra note 59 (suggesting that any regulation of management “should include accounting managers”).
153 See supra notes 142-149 and accompanying text.
154 See supra notes 82-83 and accompanying text.
155 This approach was suggested by Professor Bill Widen in his e-mail, supra note 25.
156 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.
157 [cite and explain]
158 Supra note 88 and accompanying text.
159 Sarbanes-Oxley § 302.
(IAS). The costs and benefits of such a transformation are currently being hotly debated.160

Educating a 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 there most material financial information not already embodied in the financial statements themselves.161 The ultimate financial information failure is that of investors to read, much less study, these footnotes.162 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.163

Simply educating investors to read these footnotes carefully can contribute significantly to solving the problem of financial information failure.164 The good news is that, post-Enron, “no reasonable investor can claim ignorance of financial statement footnotes.”165

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160 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 59, at ___ (observing that “[r]ules-based accounting standards exacerbate the problems created by the complexity of business transactions”).
161 [cite]
162 [cite]
163 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….”).
164 See supra note 52.
CONCLUSIONS

In recent years, the increasing complexity of financial transactions and changes to generally accepted accounting principles, or GAAP, have blurred the boundaries between the roles of lawyers and accountants, creating a strong public perception that lawyers should have some responsibility for preventing financial information failures (such as misleading financial statements). The difficult question is what this responsibility should be. Answers to this question necessarily confront the more general question of the extent to which non-experts should monitor experts on matters of their expertise.¹⁶⁶

Commentators have argued that lawyers proactively should second-guess accounting determinations to prevent financial information failures. Any proactive lawyer-monitoring regime, though, would be extremely costly and probably would do little to curb these failures. Instead, a more passively responsive, or “reactive,” monitoring regime would be nearly as effective at a much lower cost. Under such a regime, lawyers would be educated to spot warning signs that might signal accounting fraud or other problems—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.

No lawyer monitoring regime, however, can fully solve the problem of financial information failure.¹⁶⁷ More effective solutions would need to directly address the

¹⁶⁶ Because this article addresses financial information failure (e.g., misleading financial statements), the expertise primarily at issue is accounting, as to which accountants are experts and lawyers are non-experts. [Expand discussion of the more general question in next draft; cite]
¹⁶⁷ 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
sources of the failure—GAAP itself, or the primary actors giving rise to the failure (such as the firm, its accountants, and investors). Lawyer monitoring nonetheless can—and, because it is presently seen as a social good, almost inevitable will—function as a supplement to these solutions.

_Burdens, supra_ note 43, 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 financial disclosure required under GAAP and securities law disclosure required under SEC Rule 10b-5. An investor who observes the disparity between such disclosure could, at least theoretically, investigate further to learn the truth.