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Sharing Accounting's Burden:

Business Lawyers in Enron's Dark Shadows

*Lawrence A. Cunningham**

"To paraphrase Clemenceau on war and generals, accounting has become just too important to be left to the accountants."¹ That comment was made in 1975 by Jim Freund, renowned M&A lawyer at Skadden, Arps in his classic book *Anatomy of a Merger*. He justified the threatened invasion by lawyers of the accounting and auditing professions, in part, because newly-adopted rules on business combinations effectively inserted accounting treatment into merger negotiations.² While repeal of the old pooling/purchase rules is being

*** Professor of Law and Business, Boston College. ©2002 Lawrence A. Cunningham. All rights reserved. Thanks to my colleagues Scott FitzGibbon and Judith McMorrow; to my editor Ira Breskin; my research assistant Justin Belair; my assistant Anne Marie Dolan; and my editor at West Group, Staci Herr, for help researching the publishing history of accounting books for law school use.**

¹ James C. Freund, *Anatomy of a Merger* (1975), 94.

² These rules distinguished between pooling and purchase accounting according to a 12-point list of structural and transactional requirements to achieve pooling. Accounting Principles Board Op. Nos. 16, 17 (1970). Most managers doing deals prefer pooling. M&A lawyers worth their salt knew the list by heart and knew how to negotiate using it. See Ted J. Fiflis, *Accounting for Mergers, Acquisitions and Investments, in a Nutshell: The Interrelationships of, and Criteria for, Purchase or Pooling, the Equity Method, and Parent-Company-Only and Consolidated Statements*, 37 *Bus. Law.* 89 (1981); Lawrence A. Cunningham, *Introductory Accounting and Finance for*

phased in as of mid-2002, numerous accounting concepts so directly affect the structuring of deals, their disclosure, the form and amount of consideration, and other aspects of negotiations and compliance, that the Clemenceau quip has become more apt in the nearly 30 years since Freund wrote it.³

Sharing accounting's burden isn't one of the leading lessons to learn from the Enron debacle and the problems it epitomizes.⁴ Instead, dozens of other lessons are drawn by a

Lawyers (2d ed. 1999), ch. 12.

³ Ted Fiffis used the quip as well, without the nod to Clemenceau, in his call for enhanced teaching of accounting in law schools. Ted J. Fiffis, Thoughts Evoked by "Accounting and the New Corporate Law," 50 Wash. & Lee L. Rev. 959, 970 (1993).

⁴ Enron was a large energy, commodities and services company, marketing electricity and natural gas, and providing financial and risk management services around the world. It became clear in late 2001 that it had failed during the preceding four years to make proper disclosure concerning various "related party transactions" and properly to account for "off-balance sheet" transactions that ended up costing billions. These terms refer to a series of deals Enron made with several partnerships it created in which both Enron and top Enron executives held interests. The relationships were not disclosed and Enron's interest in the partnerships were so substantial that they should have been treated as consolidated entities on its books, rather than as minority investments.

The initial consequences were staggering, and only worsened. Twenty percent of Enron's shareholders' equity was wiped out—a total of \$2.2 billion. The company restated its financials for the preceding four years, producing a 20% reduction to reported cumulative net income of nearly \$600 million (\$96 million in 1997, \$113 million in 1998, \$250 million in 1999 and \$132 million in 2000). On the balance sheet, consolidation increased debt by approximately \$628 million in 2000 and like amounts in earlier years.

wide variety of critics, regulators, and legislators, who offer a stunning range of incompatible prescriptions. Enron's cacophonous commentators share the trait of the proverbial man with a hammer, to whom every problem looks like a nail. Advocates of stricter auditing standards see a system-wide breakdown in audit quality,⁵ devotees of corporate social responsibility cite Enron to support their cause. Those on the left use it to bolster their case that more regulation is needed, while those on the right point to insufficient market competition as the cause of the failure.⁶

These disclosures were the beginning of the end, starting with a failed merger/bailout with Enron's crosstown rival Dynergy, then Enron's bankruptcy, then the collapse of its outside auditor, Arthur Andersen. Throughout the process, media coverage was intense, mudslinging fierce, Congressional hearings televised, and such mischief as document shredding, and managerial sales of stock during its downward spiral capturing the attention of the least business-minded American citizens. Hurt in the process were hundreds of thousands of people, most especially Enron shareholders and employees.

⁵ Critics had a point about auditing deficiencies. The point was made the more ironic by the client flight from Enron's outside auditor, Arthur Andersen, as it was collapsing as a result of a Justice Department indictment which stemmed from investigations into its audit practices, particularly its shredding of Enron records. Its clients fled, of course, mainly to the other four big firms, operating pretty much in the same sort of culture. All firms had and have something to fear from what auditors call "scary" clients.

⁶ *Compare* Editorial, Cleaning Up the Boardroom, *The New York Times* (March 8, 2002) (criticizing Bush proposal to improve corporate governance in Enron's wake as halting and insufficient) *with* Editorial, Investigating Enron, *The Wall Street Journal*, November 30, 2001 (arguing that if Enron had faced less in the way of regulation, the scandal would have been averted). Stephen Labaton & Adam Clymer, Party Lines Begin to Emerge as Congress

A charitable view of this phenomenon—seeing what we want to see—is based on the fact that it is a natural cognitive bias, perhaps the sensible exercise of competency. Even so, care must be taken not to overemphasize the significance of one’s field or preexisting viewpoint in assessing new events.⁷ Bearing this wisdom in mind, any lawyer remotely interested in corporate governance and accounting must be able to appreciate that lawyers play a significant role when accounting fraud occurs and should consider the nature of that role and duties attendant to it. This appreciation shows that an important lesson from Enron is the danger that prevailing professional cultures create a crack between law and accounting that resolute fraud artists exploit, not cultures that emphasize the intersection of law and accounting that should foil would-be fraudsters.

The first part of this article puts Enron in perspective, suggesting that few of the various lessons being drawn by commentators are as sound as the one that lawyers doing Enron-like deals better know enough accounting to credibly contribute the value of that knowledge to other members of the deal team. The second part illustrates business lawyers in action, emphasizing that the intersection of law and accounting is central to business life and that competent business lawyers grasp rudimentary accounting principles. The next part shows a lamentable decline in the resources the legal academy has allocated to accounting pedagogy

Debates Enron, *The New York Times* (March 21, 2002).

⁷ Cf. Jerome N. Frank, Accounting for Investors, The Fundamental Importance of Corporate Earning Power, 68 J. Acct. 295, 300 (1939) (former SEC Commissioner discussing how accountants view their role and warning that, “Every man is likely to overemphasize and treat as fundamental those aspects of life which are his peculiar daily concern.”).

in the past 27 years. This embarrassment to the profession of legal education is particularly acute when you consider, as the section does, that knowing a little accounting is also essential to students learning basic corporate law. The final sections draw the chief normative implication, that the professional duty of competence should compel business lawyers to obtain a minimum level of accounting knowledge, and that it isn't difficult to do so.

I. Enron in Perspective

Before pursuing professional practice and ethics questions concerning business lawyers and accounting, let's put Enron in perspective. This will shed light not only directly on the law and accounting intersection, but also on the position of commentators drawing broader and potentially far-reaching lessons from the case. To put Enron in perspective, consider whether it is a debacle revealing systemic failure of seismic proportions—as the sheer dollar size, media coverage and political attention suggest—or an accounting scandal isolated in its causes and cures (though obviously bearing an enormous fallout).

Giant scandals of the current era that exhibited systemic infirmities include:

•*for the banking system*: Penn Square, the little Oklahoma bank that by the early 1980s had made more than \$2.5 billion in dubious loans it spread throughout the banking system that brought on the near-failure of Continental Illinois, then the 7th largest US bank, rescued only by a \$4.5 billion bailout;⁸

⁸ Phillip L. Zweig, Learning Old Lessons From a New Scandal, *The New York Times* (Feb. 2, 2002); Phillip L. Zweig, Belly Up: The Collapse of Penn Square Bank. Penn Square made loans to borrowers of dubious credit quality during the Texas oil boom, sold those loans to other banks, including Continental Illinois, and when the price of oil plummeted in the early 1980s, the collateral securing these loans fell along with it. Penn Square's CEO, Bill Patterson, spent two years in jail on banking law violations, and Continental Illinois was saved

• *for the capital and corporate control markets*: the economy-wide leveraged buy-out (LBO) boom-to-bust cycle attributed to junk bond financing purveyed by Michael Milken and Drexel Burnham Lambert in the 1980s that bankrupted in the 1990s numerous companies with values in the tens of billions of dollars;⁹

• *for the integrity and security of our financial infrastructure*: BCCI (the Bank of Credit and Commerce International), which generated losses of \$10.5 billion when it was finally liquidated in January 1992 after years of deception by a complex and illicit world-wide web held together by rich Arab bankers and prominent Washington lawyers;¹⁰ and

• *for the savings and loan industry*: the industry-wide S&L crisis (scapegoated or epitomized by Charles Keating and Lincoln Savings and Loan), with origins in the 1970s that spanned through the late 1980s and early 1990s, due to poor legislative controls, weak regulatory oversight, shortsighted industry credit decisions, and aggressive accounting practices throughout the industry.¹¹

only by a \$4.5 billion US rescue package—then the largest ever.

⁹ *E.g., United States v. Milken*, 759 F. Supp. 109 (S.D.N.Y. 1990).

¹⁰ *E.g., United States v. BCCI Holdings*, 69 F. Supp. 2d 36 (D.D.C. 1999) (opinion, one of dozens the judge wrote in the 8-year case, begins “At last!”); *First American Corp. v. Sheiky Zayed bin Sultan al-Nahyan*, 17 F. Supp. 2d 10 (D.D.C. 1998).

¹¹ *E.g., Lincoln Sav. & Loan Ass'n v. Wall*, 743 F. Supp 901 (D.D.C. 1990). In the case of Lincoln, one failure among many were the judgments accountants made to book profits from purchase transactions in which their own funds were used to pay the purchase price. Said the court in concluding that the regulatory takeover of that thrift was proper:

Each of these monumental corporate failures carried specific causes, rogues, and consequences, with identifiable systemic significance—the banking system, the capital markets, the financial infrastructure and the S&L industry. In their wake followed major media coverage; Congressional hearings; and administrative, civil and criminal investigations. Post-scandal reforms usually are hotly debated for a few months, then often shelved as the debacle fades into the recesses of public memory, exactly what happened after Penn Square¹² and the LBO bust. In the latter case, Drexel’s bankruptcy and Milken’s jail time ended

What it is hoped the accounting profession will learn from this case is that an accountant must not blindly apply accounting conventions without reviewing the transaction to determine whether it makes any economic sense and without first finding that the transaction is realistic and has economic substance that would justify the booking of the transaction that occurred. Moreover, they should be particularly skeptical of any transaction where the audit trail is woefully lacking and the audited entity has failed to comply with the record keeping requirements established by a federal regulatory body.

Accountants must be particularly skeptical where a transaction has little or no economic substance. This is so despite the fact that the transaction might technically meet GAAP standards. In a paper prepared by Touche Ross & Company in 1975 the following poignant statement appears: "The goals of accounting are to measure, record and communicate economic reality. In the long run, these goals are necessities—both for accounting and for society. Can behavior be economically rational if not grounded on economic reality."

Id., at 913 (footnote format omitted).

¹² Zweig, *supra*.

the saga, despite flirtations to regulate junk bonds and LBOs out of existence.¹³ The other common upshot: enhancement of supervisory power of regulators, as happened after BCCI,¹⁴ or replacing one regulatory body with another, as happened after the S&L crisis.¹⁵

Contrast these seismic and systemic breakdowns with numerous significant accounting frauds at public companies, which occur regularly. Memorable accounting horror stories from the 1960s and 1970s

¹³ The junk bond market dried up due to its own success—too much leverage and associated high interest payments brought on numerous bankruptcies. One spectacular instance was the bankruptcy of Campeau Corp., which loaded up on debt to buy Allied Stores in a fierce bidding war with R. H. Macy & Co.—a deal that led observers later to ask how Campeau’s lawyers could have advised it throughout that process. A broader debate of the same type ensued, centered on the degree to which lawyers and clients are functionally one. *E.g.*, Richard W. Painter, *The Moral Interdependence of Corporate Lawyers and Their Clients*, 67 S. Cal. L. Rev. 507 (1994). The regulatory impulse was at first strong—with proposals to eliminate the deductibility of interest on debt, or eliminate the double taxation of corporations, to enhance disclosure of risk, to restrictions on the link between the fairness opinions bankers gave in these deals and their fees, to more aggressive plans to limit takeovers and LBOs. All were shelved. *See generally* Lawrence E. Mitchell, Lawrence A. Cunningham, and Lewis D. Solomon, *Corporate Finance and Governance* (2d ed. 1997), 1032-1036.

¹⁴ After BCCI, Congress adopted the Foreign Bank Supervision Enhancement Act (FBSEA) to bolster Federal Reserve regulatory oversight of foreign banks.

¹⁵ The major reform after the S&L crisis was the enactment of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"). Pub. L. No. 101-73, 103 Stat. 355. FIRREA abolished the Federal Savings and Loan Insurance Corporation ("FSLIC") and the Bank Board and replaced them with the Resolution Trust Corporation ("RTC") and the Office of Thrift Supervision ("OTS").

include Leasco, Penn Central, and National Student Marketing.¹⁶ By the late 1990s, the frequency of corporate accounting scandals had tripled.¹⁷ They include household names such as Aurora Foods;¹⁸ Cendant (CUC International);¹⁹ HBOC (McKesson);²⁰ Leslie Fay;²¹ Rite Aid;²²

¹⁶ These scandals and a dozen others were chronicled in classic, popular books written by Professor Briloff, the leading crusader for integrity in financial reporting, who called upon every profession, including lawyers, to aid the cause. *E.g.*, Abraham J. Briloff, *Unaccountable Accounting* (1972) and *More Debits Than Credits* (1976), xiii (noting also U.S. Financial, Lockheed, ITT, Kauman & Broad, Stirling Homex, Equity Funding and Robert L. Vesco). National Student Marketing is particularly notable in the context of the obligations of lawyers when it comes to accounting matters. It held liable prominent business lawyers who became aware of financial fraud at the closing of a merger through a required comfort letter. *SEC v. National Student Mktg. Corp.*, 457 F. Supp. 682 (D.D.C. 1978). They allowed the closing to proceed without disclosing the facts to shareholders, whose approval was required and had already been given. Reinterpretations of the story as a parable abound. *E.g.*, Arthur R.G. Solmssen, *The Comfort Letter*, in John T. Noonan, Jr. & Richard W. Painter, *Professional and Personal Responsibilities of the Lawyer* (1997), 123-142; James Freund, *Lawyering: A Realistic Approach to Legal Practice* (1979), 291-299 ("The Uncomfortable Comfort Letter").

¹⁷ Financial Executives International, *Financial Reporting Quality* (June 2001), reported in Jonathan Weil, "Restatement of Earnings Have Multiplied," *Wall St. J.* (June 7, 2001).

¹⁸ *United States v. Cummings*, 2002 WL 334902 (S.D.N.Y. March 1, 2002); *In the Matter of Mueller*, SEC (Jan. 24, 2001).

¹⁹ *In re Cendant Corp. Sec. Litig.*, 109 F. Supp. 2d 235 (D.N.J. 2000); *In re Hiznay*, SEC (June 14, 2000).

²⁰ *Ash v. McCall*, 2000 WL 1370341 (Del. Ch. 2000); *In re McKesson HBOC Sec. Litig.*, 126 F. Supp. 2d 1248 (N.D. Cal. 2000).

Sunbeam;²³ Waste Management;²⁴ Xerox²⁵ and on and on. They number more than 150 per year.²⁶

These scandals feature such accounting shenanigans as recognizing revenue prematurely, creating fictitious revenue through phony invoices and shipping documents, miscounting customer unit volume, inflating inventory, capitalizing expenses and other age-old bookkeeping tricks. The remedies are usually company-specific rather than industry-wide or system-wide—enhanced internal controls, removal of supine directors and filling vacancies with attentive ones, changing auditors, and greater scrutiny from watchdogs ranging from rating agencies and research analysts to the SEC.²⁷

²¹ *In re Leslie Fay Cos.*, 207 B.R. 764 (Bankr. S.D.N.Y. 1997).

²² *Rite Aid Corporation v. Grass*, 2001 U.S. Dist. LEXIS 4669 (E.D. Pa. April 17, 2001).

²³ *In re Sunbeam*, SEC (May 15, 2001).

²⁴ *In re Waste Management, Inc.*, SEC (June 21, 2000).

²⁵ Floyd Norris and Claudia H. Deutsch, Xerox to Restate Results and Pay Big Fine, *The New York Times* (April 2, 2002).

²⁶ Some of these tales are catalogued in my book, *Introductory Accounting and Finance for Lawyers* (3d ed. 2002), ch. 15. To date less than 1% of public companies are forced to restate financials, though the US attorney and the SEC appear poised to pursue more cases. Colleen DeBaise, Manhattan U.S. Attorney's Office Chief Of Securities Fraud Expects Rise in Cases, *The New York Times*, March 13, 2002; Susan Pulliam, SEC Broadens Accounting-Practices Inquiry, *Wall. St. J.* (April 3, 2002).

²⁷ Some accounting aggressions appear to arise in particular industries and can be said to plague them, such as decisions relating to revenue recognition for software companies or the use of *pro forma* data by cash-driven businesses, but these plagues tend to migrate to other

Which is Enron more like? At the core of the Enron debacle are accounting chicanery related to off-balance sheet financing, related party transactions and colossal failures of board oversight.²⁸ In its penumbra are auditing conflicts of interest that may be pervasive, incentivized board members posing as independent directors who could be more widespread than is known, law firms apparently asleep at the deal, and political donations and influence-peddling that is almost certainly more common than polite politicians prefer to pretend.

Even if Enron is considered more of an accounting scandal than an indictment of corporate America, a more jarring characterization is appropriate. In its accounting aspects, Enron is both an isolated example of accounting fraud and the epitome of systemic failure in the financial reporting and disclosure regime. It is another accounting scandal added to the sum of accounting scandals that evidences a broader dysfunction. It is still not of the same class as a failure of the banking system, the capital markets, financial infrastructure or the S&L industry. Enron as an accounting scandal is akin to the straw that broke the camel's back, not a bull in a china shop.

industries in fairly short order (as with both these examples). See *infra* Part V.

²⁸ Enron, Form 8-K (Nov. 2001); Enron Press Release (Nov. 2001); William C. Powers, Jr.; Raymond S. Troub; & Herbert S. Winokur, Jr., Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp. (Feb. 1, 2002) (Counsel: Wilmer, Cutler & Pickering) (the "Powers Report"). The Powers Report details the actions of the Enron board in reviewing and approving various partnerships improperly accounted for. Though the report presents the action in somewhat sanitized and exculpatory fashion, it is hard to agree that a board presiding over the Enron mess discharged its oversight obligations as a practical matter.

The accounting camel's back has been broken before, in a similar way. The early 1970s were riddled with accounting horror stories.²⁹ The sense of systemic dysfunction at the time spawned a U.S. Senate Committee on Government Operations study entitled "The Accounting Establishment," an examination that led to enactment of the Foreign Corrupt Practices Act.³⁰ Before Enron, the current series of accounting debacles led the SEC, under Chairman Arthur Levitt in the late 1990s, to enact a broad array of new rules, principally designed to enhance the independence of auditors.³¹ The Levitt reforms took effect in 2000, after most of the fraud at Enron had already been perpetrated.³²

²⁹ *E.g.*, Briloff, *supra*.

³⁰ See *Accountancy and Society: A Covenant Desecrated* (testimony of Abraham J. Briloff before the United States Senate Committee on Banking, Housing, and Urban Affairs (March 2002) (noting also the creation of the SEC Practice Section of the AICPA and the inauguration of peer review procedures as responses to the widening scandals). The Foreign Corrupt Practices Act, which is by no means limited to foreign corrupt practices but rather addresses domestic accounting controls, is discussed further in Part IV.

³¹ Securities and Exchange Commission, *Revision of the Commission's Auditor Independence Requirements*, 17 CFR Parts 210 and 240 (2000).

³² Arthur Andersen's position as the one Big Five firm that suffered its own meltdown from client accounting scandals may be a partial function of the cyclical nature of auditor discipline that proceeds from rebuke, reform to relapse. The other Big Five members faced rebuke during the latter 1990s while Andersen's wrists had not been slapped during that period of exuberance that made accounting scandals more likely to occur. See G. Peter Wilson, *Don't Throw Out the Reporting Baby with the Enron Bath Water: Crucial Considerations When Reforming the Reporting System* (manuscript March 2002) (copy on file with the author).

In terms of symptoms and scale, the nearest recent corporate calamity to Enron may be neither the seismic debacles nor the isolated accounting incidents but instead the case of Long Term Capital Management Co. (LTCM). This highly-leveraged hedge fund placed losing bets on a billion dollars worth of global financial instruments. Their mounting losses in late 1998 threatened to crater the world's financial system until a rescue brokered by the Federal Reserve averted that fate.³³

While LTCM was isolated, the crisis followed on the heels of a series of smaller but still substantial debacles in the global derivatives market place, including at Barings;³⁴ Gibson Greetings;³⁵ Orange County, California,³⁶ and Metallgesellschaft AG. The cases exposed systemic weaknesses and led to broad-gauged solutions. Reforms included enhanced transparency through disclosure, superior management controls, greater board oversight and more accurate accounting.³⁷

Similar sets of reforms are likely in the light of Enron. But in the case of financial

³³ See Lawrence A. Cunningham, *Outsmarting the Smart Money* (2002), ch.3; Roger Lowenstein, *When Genius Failed* (2000).

³⁴ See "The Collapse of Barings," *The Economist* (March 4, 1995).

³⁵ See *In re BT Sec. Corp.*, 58 SEC Docket 1145 (1994).

³⁶ See *Orange County Ch. 9 Bankruptcy* (Case No. SA 94-22272-JR), *N.Y.L.J.* (March 16, 1995)

³⁷ *E.g.*, The President's Working Group Report (May 1999); Derivatives Policy Group Report: Framework for Voluntary Compliance, CCH Fed. Sec. L. Rep. ¶ 86,607 (March 9, 1995); FASB Statement No. 133.

derivative instruments, these then-nonexistent regulations seemed an apt response. In the case of Enron, it is hard to see what new regulations are possible. After all, regulate what? Accountants? Auditors? Executives? Boards? Politicians? Regulations are all in place.³⁸ There are also criminal laws relating to accounting, auditing, and disclosure that landed in jail top executives at companies rocked by recent accounting scandals, along with hefty civil penalties for associated professionals.³⁹

Those with a deep desire to regulate in the wake of Enron found a stalking horse in the

³⁸ There is obviously room for vigorous debate concerning the contours of the Private Securities Litigation Reform Act of 1995 and the durability of *Central Bank v. First Interstate Bank*, 114 S. Ct. 1439 (1994), but these debates operate *within* a philosophy of accountability. They are not about foundational issues, but rather concern tilts in the power balance as shifted by tools such as pleading rules, burdens of proof, and selecting lead counsel.

³⁹ Holman W. Jenkins Jr., The New Business Casual: Pin Stripes, *Wall St. J.* (March 13, 2002); Big Six Have Paid \$1.7 Billion Since 1991 in Securities Fraud Cases, Study Finds, 27 *Sec. Reg. & L. Rep.* (BNA) 1723 (1995) (includes liability to private plaintiffs and to regulators); David R. Herwitz and Matthew J. Barrett, *Accounting for Lawyers* (3d ed. 2001), 248-249 (12% of audit industry revenues are absorbed defending and settling lawsuits and regulatory claims); Richard W. Painter and Jennifer E. Duggan, Lawyer Disclosure of Corporate Fraud: Establishing a Firm Foundation, 50 *SMU L. Rev.* 225, 227 (1996) (from 1989 to 1994 the largest six accounting firms paid nearly \$400 million to settle private class actions, and all firms as a whole paid nearly \$500 million). Among notable examples are the bankruptcy in 1990 of Laventhol & Horwarth (then the 7th largest accounting firm) and payments to regulators in 1992 by Ernst & Young of \$400 million, and in 1994 by Deloitte & Touche of \$312 million and by KMPG Peat Marwick of \$186.5 million. Herwitz and Barrett, *supra*.

prominent rating agencies—such as Standard & Poor’s,⁴⁰ Moody’s, and Fitch—hauling them before Congress with threats to regulate their activities.⁴¹ Murmurs are heard to federalize corporate governance, to federalize the regulation of auditors, to hold CEOs personally liable for financial statements, eliminate directorial indemnification for fraud claims, and similar large-scale change.⁴² Others lay blame on such abstractions as shareholder wealth maximization norms, and argue that the norms should be jettisoned.⁴³

History offers no reason to expect that new rules will prevent a repeat of accounting

⁴⁰ In the interest of full disclosure, Standard & Poor’s is a division of McGraw Hill, publisher of some of my books.

⁴¹ *E.g.*, Richard A. Oppel Jr., Credit Raters Face Inquiry Over Enron, *The New York Times* (March 20, 2002). Included was the SEC, which simultaneously cautioned against regulations restricting auditors from the consulting business. Michael Schroeder, SEC Weighs Curbs on Credit-Rating Firms, *Wall St. J.* (March 21, 2002). This position is arguably parochial, and the rating agencies a scapegoat, given that the new SEC Chairman Pitt has close ties to the auditing industry and his predecessor Chairman Levitt made prohibiting auditors from consulting a top priority. The responses, across the board, reflect the perceived need among politicians and regulators to do something, to satisfy the public, and to demonstrate control. The only unregulated participant in the drama, the rating agencies, are an obvious, perhaps inevitable target of this behavioral impulse.

⁴² *E.g.*, *The New York Times* (Feb. 2002) (describing Treasury Secretary O’Neil’s proposal to prohibit insurance of CEOs for financial misstatements).

⁴³ William W. Bratton, The Dark Side of Shareholder Value, *Tulane L. Rev.* (forthcoming 2002).

scandals even of this large size or frequency.⁴⁴ On the contrary, even scandals of systemic dimensions, such as Penn Square, yield no fresh new regulatory strategies for frustrating the resolutely fraudulent or criminal. In the case of financial derivatives, LTCM occurred a couple of years after numerous regulations were adopted following the series of earlier crises. Thus there is a real risk of the potential for over-regulation in the post-Enron era.⁴⁵ At the broadest level, post-Enron policy discussion revived the old federalism debate in corporate law,⁴⁶ one

⁴⁴ See Lawrence A. Cunningham, *The Endless Quest for Integrity in Financial Reporting*, *PLI 30th Annual Institute on Securities Regulation* (November 1998). Though perhaps lamentable, this is neither defeatist nor nihilist, but reality. For parallel examples of reality, see, for example, these stories appearing on the same day in *The New York Times*: Eric Lipton and James Glanz, U.S. Report on Trade Center Fire Echoes Lessons of Past Disasters (April 2, 2002) (the engineering reality that no reasonable precautions could have prevented the World Trade Center complex from collapsing after being hit with commercial jet airplanes) and Nicholas D. Kristof, The Boomerang Syndrome, *The New York Times* (April 2, 2002) (quoting the Israeli newspaper *Haaretz* as opining that the Israeli military operation “will not end the confrontation [with Palestinians] and will not destroy terrorism”). The same can be said for the Bush-declared U.S. “war on terrorism.” But no politician can stomach such realities, or gain reelection agreeing with them, but must devise answers to prevent the most recent realized threat.

⁴⁵ The risk was so substantial that Federal Reserve Chairman Greenspan offered his sobering advice against indulging this risk. Greg Ip, “Greenspan Warns Against Too Much Regulation,” *Wall. St. J.* (March 27, 2002).

⁴⁶ Compare William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 *Yale L. J.* (1974) with Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 *J. Legal Stud.* 251 (1977); *Business Roundtable v. SEC*, 905 F.2d 406

that seemed resolved. Its revival confirms the risk of over-reaction.⁴⁷

There is no question that Enron is an accounting scandal and no doubt that accounting scandals have been on the rise. Whether reforms of accounting and auditing are overdue or other responses warranted, there is one other thing that is certain: business lawyers are present during most accounting frauds. That presence, coupled with a credible dose of accounting sense, will often enable a lawyer to discourage accounting fraud—and perhaps even, on rare occasions, prevent it. While lawyers face delicate issues of ethics relating to the preservation of client confidences in such settings, lawyers may not simply stand on the sidelines and allow accounting frauds to go forward.⁴⁸

In Enron's case, lawyers played a central role in the formation, structuring, and reporting of various partnerships treated as off-balance sheet to Enron. But under applicable

(D.C. Cir. 1990).

⁴⁷ Part of that risk is the very fact that auditing and corporate law are regulated at local levels (particularly state and industry), and the threat of federal or other supervisory intervention is a powerful check against excess. Naturally checks do not always work, any more than the exercise of that threat would work. But that threat can be more powerful than its invocation. The shrewd among those stirring up the rhetorical threats are very likely aware of this effect.

⁴⁸ Lawyers well recall the notorious case of the U.S. Office of Thrift Supervision cracking down with a \$275 million enforcement action against venerable business law firm Kaye Scholer for its role in advising Lincoln Savings & Loan, a failed thrift. See Lester Brickman, Has the Office of Thrift Supervision Changed the Relevant Ethics Rules by its Actions in the Kaye, Scholer Matter, in *The Attorney-Client Relationship After Kaye, Scholer* 79 (PLI Corporate Law & Practice Course Handbook Series No. 779, 1992).

accounting rules, these special purpose entities were required to be shown on Enron's consolidated balance sheet (and therefore also subject to disclosure under federal securities laws). Questions concerning who knew what when remain unanswered, but with Enron in this perspective, prudence suggests that before regulating by adding new layers and monitors, active professionals should be required to beef up their accounting skills.

II. The Practice of Business Lawyers

The incentive for lawyers to become part-time accountants is by no means limited to helping clients steer clear of accounting irregularities or fraud, though that adds value.⁴⁹ It is an asset at the bargaining table and should be used as such.⁵⁰ Freund gives a good example

⁴⁹ *E.g.*, Lawrence A. Cunningham, *Preventive Corporate Lawyering: Averting Accounting Scandals*, *Cardozo Life* (Spring 1997).

⁵⁰ The emphasis on the importance of accounting to the business lawyer should not disguise the broader significance of accounting to lawyers. Accounting is pervasive in law, and life, and must be familiar to lawyers in a wide variety of practice areas: litigators calculating damages and structuring settlements; tax lawyers in virtually every professional setting; environmental lawyers handling cost allocations; labor lawyers dealing with profit sharing agreements; domestic relations lawyers addressing asset settlements and maintenance and alimony arrangements; regulatory lawyers involved with antitrust, health care, insurance, and public utilities; and so on. See Herwitz and Barrett, *Accounting for Lawyers*, *supra*, v-vi; Stephen A. Zeff, *Review: Accounting for Business Lawyers*, 46 *Tulane L. Rev.* 358, 362 (1971) ("Accounting is important to all lawyers, not to business lawyers alone."); *e.g.*, *Nardini v. Nardini*, 414 N.W.2d 184 (Minn. 1987).

Failure of lawyers to understand accounting can produce disastrous results. For example, a statute settling disputes among Alaska natives specified a resource sharing

(though one that is now moot because pooling is being repealed).⁵¹ Buyer and Seller have a tentative agreement to merge if pooling accounting treatment can be obtained. Seller is 85% owned by holders who favor the deal and 15% by those likely to oppose it. On corporate and tax levels, there is no problem: 85% is a sufficient majority for shareholder approval and a 15% dissent would not jeopardize tax-free treatment.⁵²

Pooling accounting treatment was only available, however, if at least 90% of Seller's shares are being acquired in the deal. So when Seller and the 85% group consult the 15% holder, care must be taken not to alert him to how important pooling is. Likewise, if you represent the 15% holder whose approval is sought, you suspect pooling is important and advise your client it has a very strong hand to play (e.g., as to registration rights and limiting your client's liability on Buyer's representations and warranties).⁵³ Scores of like illustrations of the importance of accounting knowledge to the M&A lawyer can be spun drawing on the

arrangement that pooled and reallocated resources based on "revenues" of each cooperative rather than based on "income"—as no doubt was intended. But failure to appreciate the difference led the legislation to continue rather than settle the dispute. Fflis, *Teaching Accounting, supra*, at n.44 (citing the Alaska Native Claims Settlement Act, 43 U.S.C. § 1601 (1971)).

⁵¹ Freund, *supra*, at 102-104.

⁵² See I.R.C. § 368(a)(1)(A) through (C).

⁵³ See *infra*.

dozen requirements for pooling.⁵⁴

Freund gives another by modifying the example to suppose that Buyer was, until recently, an 85%-owned subsidiary of another company. A point under negotiation is whether to pay in cash (Seller's preference) or stock (Buyer's preference). Buyer's lawyer argues that using cash means no pooling, which means post-closing earnings will be lower, so argues to lower the purchase price. May sound good to a novice. But the lawyer, also a part-time accountant, will observe that Buyer's having been a sub within the past two years of another company disqualifies pooling treatment on its own—so this Seller's lawyer can easily defeat the argument of Buyer's lawyer to lower the price for a cash deal.⁵⁵

But pooling is dead, so consider a deal to sell a corporate division.⁵⁶ A threshold legal issue is whether the division sale constitutes the sale of all or substantially all the assets of the corporation requiring a shareholder vote.⁵⁷ The standard approach to analyzing whether a transaction triggers statutes requiring shareholder votes for the sale of "all or substantially all" a

⁵⁴ Cunningham, *Introductory Accounting* (2d ed.), *supra*, at 231-234.

⁵⁵ Accounting Principles Board, Op. No. 16.

⁵⁶ The pooling examples remain particularly illuminating, however, for they rose in significance from 1975 to 2000, the precise time period when the teaching of accounting in law schools declined in significance. See *infra* section III.

⁵⁷ *E.g.*, Delaware General Corporation Law, § 271(a); Model Business Corporation Act, §§ 12.01-12.02.

corporation's assets considers quantitative and qualitative characteristics of the transaction.⁵⁸

Different judges have applied a bewildering array of metrics for the quantitative assessment. These range from the book, market or transaction value of the assets to the revenue, gross or net income, or cash flows generated by the assets.⁵⁹ Each of these concepts is a term of art. They can mean different things, within a range, so long as it is reasonable. Knowing this, as well as the boundaries, is essential for a lawyer to reach an informed opinion concerning whether shareholder approval is required—or at least and more likely to advise a client of the probability that a judge would decide on a preliminary injunction or summary judgment motion that it was.⁶⁰

⁵⁸ *E.g.*, *In re Avard*, 5 Misc.2d 817, 144 N.Y.S.2d 204 (N.Y. Sup. Ct. 1955) (construing predecessor to current New York statute); *U.S. Bank Nat'l Ass'n v. Angeion Corp.*, 615 N.W.2d 425 (Minn. App. 2000) (applying New York law), *review denied*, 2000 Minn. LEXIS 691 (Minn. 2000); *Gimbel v. Signal Companies, Inc.*, 316 A.2d 599 (Del. Ch. 1974), *aff'd per curiam*, 316 A.2d 619 (Del. 1974) (construing Delaware statute); *Oberly v. Kirby*, 592 A.2d 445 (Del. 1989) (holding that sale of securities amounting to 80% of assets did not trigger Delaware statute because entity's business consisted of buying and selling securities).

⁵⁹ *E.g.*, *In re General Motors Class H Shareholders Litig.*, 734 A.2d 611, at n.10 (Del. Ch. 1999) (cataloguing six separate Delaware cases and noting complexity of the analysis that reflects “a policy preference for doing equity in specific cases over the value of providing clear guidelines for transactional lawyers structuring transactions for the corporations they advise”).

⁶⁰ Tax knowledge that hinges on accounting concepts is also implicated in an asset acquisition for stock. A stock-for-assets acquisition qualifies as a tax-free reorganization

The question of whether a division sale constitutes all or substantially all a corporation's assets can call for refining the numbers even further, a refinement that also calls for close cooperation between lawyers and accountants in designing suitable representations and warranties. Major questions arise due to the difficulty of deriving reliable historical or projected operating results at the division level. The two broadest questions are the feasibility of the buyer's accounting post-closing and the sense of its purchase price.

Divisions are typically run as integrated operations within a corporation. Intra-company transactions may not be recorded in accordance with GAAP. They may be invisible. Funds flowing from headquarters to the division may have been assigned a cost (an interest rate) but how that was determined (not using market rates) and how the division is going to be charged when it is freestanding or part of the buyer are different matters. Moreover, headquarters would have provided a range of back office services, such as legal, accounting, and insurance, whose costs will not burden the division's books either.

Lawyers obviously are not the prime professionals to assess these matters. But they must understand them to assure that a due diligence team staffed with accountants gains access to required information and draft agreements reflecting adjustments required by these

under Section 368(a)(1)(C) of the Internal Revenue Code where at least 90% of the seller's net assets and 70% of its gross assets are included. Rev. Proc. 77-37, § 3.01. Assumption of liabilities does not disqualify tax-free treatment, though the seller must liquidate and distribute the stock to its shareholders. IRC 368(a)(2)(G).

An equally stunning range of qualitative characteristics has been emphasized or muted by various judges, running from whether a sale would radically transform or materially alter the purpose of the corporation to whether the assets sold are the sole or primary ones owned.

accounting realities. These representations are intended, in part, to elicit information from the seller about variances and ultimately to provide adjustments to the purchase price or representations that everyone is happy with (the seller can stand by and the buyer can look to if things go awry). Examples of such representations include:

That all services rendered to the division have been recorded in its accounts at full and fair value; that interest has been charged on all funds furnished to the division at competitive market rates; that all goods sold to or from the division have been accounted for as if they were transferred in arm's length transactions; that the division's income has not been overstated because land it leases from headquarters carries rent below that obtainable in an arm's length transaction.⁶¹

In many cases, making some or all these representations will not be easy or possible for the seller. Likewise, it may be difficult for a division seller to prepare audited or certified financial statements. In that case, it will be necessary for the seller to furnish *pro forma* financial statements. This involves starting with the existing financial records and then making adjustments for intra-company transactions otherwise unrecorded. Seller's management must then estimate these figures—the value of legal services for example and the market cost of borrowed funds. The buyer's auditor must examine the assumptions and estimates. A lawyer unaware of the flexibility and judgment involved will be less well-prepared to assess whether the process has proceeded satisfactorily or whether additional contractual protections are required.

⁶¹ Freund, at 457.

Suppose a buyer and seller agree in principle to an asset sale, but disagree on the value to be assigned to some intellectual property yet to be market tested. The seller places a high value on the assets while the buyer is more pessimistic. One solution (apart from leaving the assets out of the deal)⁶² is an earn-out provision under which the purchase price payable is contingent on actual performance and paid over time.⁶³ The lawyer most capable of negotiating and agreeing on the terms and specifics of an earn-out provision is one who understands accounting.

Apart from specifying legal standards to impose on the buyer that are relatively easy to negotiate and draft (even if difficult to define, such as managing the business as a prudent person would or using best efforts),⁶⁴ specification of how the accounting will be done is essential. Sellers will have no control after the deal closes over such matters, and so will prefer an agreement drafted with an orientation toward the top line (sales), to minimize the role the buyer's judgment can play in the process. Buyers, in control, will prefer a focus at or near

⁶² *E.g.*, Dale A. Oesterle, *The Law of Mergers and Acquisitions* (1999), 160-162.

⁶³ A classic classroom favorite from contract law using an earnout is *Bloor v. Falstaff Brewing Corp.*, 601 F.2d 609 (2d Cir. 1979); see Victor Goldberg, *Great Contracts Cases: In Search of Best Efforts—Reinterpreting Bloor v. Falstaff*, 44 St. Louis L.J. 1465 (2000). Goldberg points out that earnouts are not routinely used in acquisitions, though they are used regularly enough and when used pose difficult issues of drafting and interpretation. *Id.* (of 9,000+ deals in 1998, only 153 used earnouts, though many of these ended up in dispute, usually arbitration).

⁶⁴ *E.g.*, *Richmond v. Peters*, 22 Bank & Corp. Gov. L. Rep. 404 (6th Cir. 1999) (excerpted in Dale A. Oesterle, *The Law of Mergers and Acquisitions* (1999), 303).

the bottom line, enabling them to exercise judgment concerning a variety of matters over which GAAP gives discretion.

The accounting-savvy seller's lawyer will take care in the agreement to constrain buyer discretion over the top line. This calls for providing rules concerning when revenue is recognized. This lawyer may also seek to restrict the buyer's discretion over the bottom line. Ways to do so include specifying what expenses are associated with the intellectual property in question; how fixed charges associated with it will be depreciated; and how reinvestment in the kindred technology will be treated (expensed or capitalized, for example).

A lawyer asked to give an opinion concerning whether a company has the legal power to pay a distribution to its shareholders must know some accounting.⁶⁵ Such distributions are often made in connection with transactions involving a substantial role for business lawyers, ranging from spin-offs and split-ups to joint ventures and other cooperative enterprises.⁶⁶

Rules in most states forbid shareholder distributions that would render assets less than liabilities or produce equity insolvency (the inability to pay debts as they come due).⁶⁷ No one

⁶⁵ *E.g.*, *Consolidated Rock Products Co. v. DuBois*, 312 U.S. 510 (1941) (Douglas, J.).

⁶⁶ Shareholder distribution rules are a particularly good example of the overlap of the accounting and legal professions, for the topic is tested on the licensing exams of both professions. *See* Craig A. Peterson and Norman W. Hawker, *Does Corporate Law Matter? Legal Capital Restrictions on Stock Distributions*, 31 *Akron L. Rev.* 175 (1997). In an earlier era, this was seen as the essential overlap in law and accounting. *E.g.*, William P. Hackney, *Accounting Principles in Corporation Law*, 30 *L. & Contemp. Probs.* 791 (1965).

⁶⁷ *E.g.*, Model Business Corporation Act, § 6.40.

can form a judgment about these matters without knowing basic accounting. Likewise, without such knowledge no one can assess whether certain adjustments to the accounts are lawful for the purpose of enabling the making of the distribution.⁶⁸

Loan agreements contain private arrangements to afford creditor protection like that offered by statutes restricting distributions to shareholders. They invariably are tighter than the statutes and are defined expressly in terms of financial ratios that depend on accounting information. A typical covenant requires a lender to maintain a minimum level of working capital, defined in turn as current assets less current liabilities (themselves further defined).

⁶⁸ *E.g.*, *Randall v. Bailey*, 23 N.Y.S.2d 173 (Sup. Ct. 1940), *aff'd*, 288 N.Y. 280 (1942) (classic case approving board's creating surplus from which dividends could be lawfully paid by revaluing real property assets on the balance sheet, along with the equity, a strategy not possible to imagine, understand, or assess, without knowing a little accounting); *see also* *Klang v. Smith's Food & Drug Centers, Inc.*, 702 A.2d 150 (Del. 1997) (similar more up-to-date case).

Remedies for breach of these financial covenants may include acceleration of the principal amount of the loan. Some agreements contain cross-default provisions under which the agreement is deemed breached upon the breach of another agreement. Lawyers negotiating and drafting these documents obviously must be competent to create legal definitions using accounting concepts, and sufficiently understand the variety of these definitions to ensure harmonization of triggers in various agreements.⁶⁹

Beyond knowledge of basic definitions, a business lawyer's familiarity with a few technical accounting rules is important. For example, if the remedy on default is acceleration of the principal, accounting rules require that the entire principal amount be treated as a current liability. That treatment can trigger defaults under other agreements that contain ratio tests requiring minimum working capital levels.

Accounting rules also provide, however, that a lender's waiver of default for at least one year from a balance sheet date enables the borrower to treat the defaulted obligation as a long-term liability. If so reducing the borrower's working capital would trigger a default on

⁶⁹ Indentures and credit agreements contain dozens of defined accounting terms used to specify the respective rights and duties of the borrower and lender. A typical indenture includes, for example, the following accounting terms: "Capital Lease Obligation," "EBIT," "EBITDA," "Fixed Charge Coverage Ratio," "Funded Debt," "Indebtedness," "Intangible Assets," "Interest Expense," "Net Income," "Net Tangible Assets," "Net Worth," "Pre-Tax Cash Flow," "Tangible Net Worth," and "Working Capital." Some of these may be modified by the word "Consolidated," and this term defined. *E.g.*, Model Simplified Indenture, 38 Bus. Law. 741 (1983). Case law takes these definitions seriously. See Michael, *supra* (excerpting a series of cases, including *Powell v. Burke*, 423 A.2d 97 (Conn. 1979)).

senior debt, it may be in the lender's best interest to waive the breach rather than accelerate. A lawyer who is also a part-time accountant can explain this to the lender and its other lawyers in a way that many cannot—sometimes preventing a financial cascade in no one's interest.⁷⁰ Many terms in loan agreements incorporate by reference the definition of generally accepted accounting principles. It is common for such loan agreements to include as a "rule of construction" a provision such as, "Unless the context requires otherwise, an accounting term not otherwise defined has the meaning assigned to it in accordance with generally accepted accounting principles in effect from time to time."⁷¹

Innocuous, fair and even-handed as an appeal to "generally accepted" principles sounds, this is not always in a client's best interest and only an accounting-savvy lawyer will know or understand why. GAAP is a set of conventions, rooted in historical cost accounting and conservative in its philosophy, that tends to understate the fair value of vast asset classes, including particularly intellectual property. A shareholder buyout agreement of a high-tech company with enormous intellectual property rights using unadorned GAAP to set the price would be disastrous for the selling shareholder.

The framework of the Federal securities laws relating to the disclosure of forward looking information is teeming with the law and accounting overlap. The Private Securities Litigation Reform Act of 1995 defines various categories of forward looking information, two

⁷⁰ K-Mart faced just such a situation in 1996. See K-Mart Gains Reprieve in Final Accord, But Retailer to Post Loss for Quarter, *Wall. St. J.* (March 4, 1996); K-Mart Corp., Report on Form 8-K (filed Jan. 19, 1996).

⁷¹ Model Simplified Indenture, *supra*.

of which pose substantial mixed questions of law and accounting (fact): predictions that must be disclosed if created and those that may voluntarily be disclosed. The cautious advice is to resist creating projections in these two categories, advice that must conform with legal standards and accounting principles.

Suppose two firms plan to merge. Rules require a joint proxy statement governing shareholder approval of the deal to include *pro forma* financial statements showing how the combined entity's financials would look if they had been combined previously. That suggests what is called for is historical information and to that extent there is no major problem (though the activity is by no means simple addition, but calls for harmonizing the accounting used by the combining firms that may have differed when they stood alone).

More critical is whether the resulting picture presents a reasonably accurate one or whether it is deficient or misleading in some way that requires adjustment. SEC regulations say that when this occurs the *pro forma* presentation must "give effect to the range of possible results."⁷² While lawyers may read this to require detailed presentation and footnote analysis of the range, the standard response of accountants is not to disclose such details but offer a broad and strict disclaimer emphasizing that *pro forma* presentation is a "mechanical exercise" bearing no relation to actual results or any measurement or aggregation of synergy or other gains to be generated from the combination. No lawyer can advise in this process without knowing what these sorts of terms are intended to convey, why accountants are concerned about them, or how to negotiate with the SEC if that becomes necessary to

⁷² SEC Reg. § 210.11-02(b)(8).

convince it to approve proxy materials prepared this way.⁷³

Similar conversations between lawyers and auditors arise concerning loss contingencies resulting from litigation risks. These are disclosed as a line item on the balance sheet with cross-references to footnotes. Lawyers and auditors must confer to prepare the appropriate disclosure. That discussion is more productive when each side understands that the other has different professional objectives and duties. The concern of lawyers is confidentiality, while that of auditors is disclosure; lawyers are advocates for their clients, while auditors are watchdogs for the public.⁷⁴ But understanding different professional roles is hardly enough.

The law and accounting professions use different vocabulary to discuss the subject of loss contingencies. Auditing rules provide that losses that are remote need not be disclosed at all, those that are possible call for such descriptive disclosure, and those that are probable (and can be estimated in amount) must be recorded on the books in those amounts. The two professions define these terms remote, possible, and probable differently. Lawyers negotiating with auditors over which risks and amounts must be disclosed or kept confidential will be far more successful armed with an understanding of these differences and will be able to find a middle ground that meets the professional duties of both sides.

A lawyer advising a client facing a shareholder proposal may benefit by knowing accounting. Grounds on which management may properly exclude such a proposal include

⁷³ See also Oesterle, *supra* (“any investor reading the *pro forma* for information must have a very sophisticated knowledge of accounting principles to make sense of the numbers and qualifications”).

⁷⁴ *United States v. Arthur Young & Co.*, 465 U.S. 805, 818 (1984).

where the subject matter relates to *de minimus* operations. The SEC measures the threshold in accounting terms, as less than 5 percent of the company's total assets, net earnings and gross sales.⁷⁵ Terms of accounting art again. While accountants will have to crunch the numbers to test the thresholds, it will be up to lawyers to argue the case, using accounting vocabulary.

One regulatory reform that is possible in Enron's light, particularly with the concomitant fall of its outside auditor Arthur Andersen, is to turn accounting principles into law. The US and UK are unusual because they allow accounting rules to be set by the accounting profession. In Continental Europe, accounting rules are codified by legislators as a matter of law. If this practice were adopted in the wake of Enron/Andersen, no longer would there be any question of a lawyer's duty to master the subject. They would be law, *de jure*. For some purposes in the US, accounting is law, as where accounting rules promulgated by the private sector are sanctioned and functionally adopted by the SEC. These appear in the vast accounting provisions of the federal securities laws and regulations, ranging from the numerical data required in the management's discussion and analysis (MD&A) sections to the more detailed specifications of Regulation S-X.⁷⁶

⁷⁵ Rule 14a-8 (5) (in addition, for management to exclude it, the proposal must not otherwise be significantly related to the company's business).

⁷⁶ See William J. Grant, Jr., Regulation S-X: A Primer for the Practitioner, in Kenneth J. Bialkin & William J. Grant, Jr., Securities Underwriting: A Practitioner's Guide (1985), 343.

While most securities lawyers are familiar with the disclosure requirements of Regulation S-K adopted by the SEC pursuant to the 1933 Act, many practitioners who engage in securities matters

But suppose Congress legislated that the origination and review authority for accounting principles was vested entirely in the SEC or other federal agency—a commonplace proposal in the late 1960s and early 1970s amid that era’s escalating level of accounting scandals.⁷⁷ All other pronouncements—of the FASB, the AICPA, and state accountancy bodies—would be demoted to the status of secondary authority, much as with the ABA, state bar associations, and law review commentary. A lawyer’s practical needs would be unchanged from the current state of affairs. Competent business lawyers know this and

are unfamiliar with the SEC’s financial statement disclosure requirements contained in Regulation S-X. In the context of a public offering of securities, such attorneys usually rely on the issuer’s accountants to ensure compliance with the SEC financial disclosure requirements. Although some reliance is generally appropriate, the varying degrees of expertise in SEC matters among accounting firms and the fact that issues of financial disclosure often involve mixed questions of law and accounting make it incumbent upon an attorney who represents either an issuer or an underwriter, at a minimum, to understand the fundamental financial disclosure requirements of Regulation S-X.

⁷⁷ *E.g.*, Homer Kripke, *The SEC, The Accountants, Some Myths and Some Realities*, 45 *NYU L. Rev.* 1151, 1176-78 (accountants should play the leading but non-exclusive role in propounding accounting principles but establishing them as binding should be the province of an administrative agency such as the SEC for the “skills necessary are not only those of the accountant, but those of the lawyer, the economic statistician, the economist and the financial analyst”); Abraham J. Brilloff, *Accounting Practices and the Merger Movement*, 45 *Notre Dame L. Rev.* 604, 623-24 (1970) (proposing the creation of a specially constituted consortium charged with enacting applicable accounting rules); Arthur Andersen & Co., *Establishing Accounting Principles—A Crisis in Decision Making* 23 (1965) (proposing establishing an accounting court to take setting accounting rules out of the hands of practitioners).

therefore treat accounting principles as an important tool in their professional toolbox, even if by virtue of the manner and source of their present promulgation they are better understood as facts rather than law.

III. The Training of Business Lawyers

Law students are often surprised to learn that stock options need not burden an income statement. They often think that they obviously would. But accounting is not so obvious, and a little such understanding will go a long way. Reactions like these make a business lawyer and law professor interested in accounting wonder what role law schools play.

A decade ago, one study lamented the state of accounting teaching in law schools, echoed by a leading law professor in an article urging law schools to do more.⁷⁸ A few years later, another article on how accounting is and can be taught in law school—presented at a major conference by an author of a corporations casebook that incorporates accounting—suggests little improvement in the environment.⁷⁹

Harder evidence confirms the sense that the state of accounting teaching in law schools has been deteriorating. The number of full-time law teachers indicating that they teach accounting has fallen steadily since the mid-1970s, the peak of accounting pedagogy in law schools. At its high-point in 1975, 150 full-time law professors identified themselves as teachers of

⁷⁸ Fiflis, *supra*, at 968-970.

⁷⁹ Elliott J. Weiss, Teaching Accounting and Valuation in the Basic Corporation Law Course, 19 *Cardozo L. Rev.* 679 (1997).

accounting.⁸⁰ In 2001, 96 did so, a drop of 36% during a period when the number of law schools increased by 19% and the number of full-time law professors increased by 35%.⁸¹ The portion of that group indicating that they were teaching accounting during the year surveyed likewise has suffered a steady decline since the mid-1970s, dropping a full 50% in that period.⁸²

⁸⁰ American Association of Law Schools, *The AALS Directory of Law Teachers (1975)* (the “1975 Directory”).

⁸¹ American Association of Law Schools, *The AALS Directory of Law Teachers (2001-02)* (the “2001 Directory”). See Appendix A. As a point of comparison at the other extreme, the 2001 Directory lists as teachers of constitutional law 109 persons in New York City alone (135 for the metropolitan New York area) and 61 in the Boston area. The 1975 Directory listed 51 constitutional law teachers in New York City (75 for the metropolitan New York area) and 41 in the Boston area. Since 1975, therefore, the number of constitutional law teachers increased by 113% in New York City, 80% in metropolitan New York, and 49% in the Boston area (while, as the text indicates, the total national number of legal accounting professors fell by 36%).

⁸² *Id.* These data are not conclusive, of course, for the subject could be increasingly taught by adjuncts or others not listed in the AALS directory. It is doubtful the entire shift can be explained on these grounds. Even the portion it does explain is not exactly good news for those who believe accounting should be considered an important course for lawyers. The allocation of full-time faculty dedicated to a subject indicates institutional commitment, while delegation of the course to others does not. To the extent the teaching is done by accounting scholars, moreover, this could do more harm than good. *E.g.*, Weiss, *supra* (teaching accounting to lawyers in the way accounting professors teach it in business schools is the worst thing that could be done).

An additional indicator is the number of schools boasting a full-time law professor teaching accounting. The 1975 Directory identifies 111 schools as having at least one full-time

So beginning when leading business lawyers such as Jim Freund were emphasizing how important accounting is to their practice, the academy began to demote its significance in the law school curriculum.⁸³ Reasons for the decline include the rising intellectual influence of

faculty member covering accounting, while the 2001 Directory identifies 83 schools (note that the number of schools has increased during this period by 19%). The 1975 Directory identifies 8 schools as having 3 or more such faculty; the 2001 Directory identifies 2 (NYU and Cardozo, both at 3).

⁸³ Other 1970s era expressions of the centrality of accounting to a broad range of public policy matters include Abe Briloff's books of 1972 and 1976, *see supra*, and Congressional adoption of legislation mandating the maintenance of accounting books and records and compliance controls, *see infra* (discussing the Foreign Corrupt Practices Act). The spirit of the times is amplified in the following poignant commentary from a 1971 review of Filfilis and Kripke, *Accounting for Business Lawyers*, by Tulane University accounting professor Stephen Zeff:

While the accounting mission may have been transparent in a simpler day, it is today as complex and changing as modern society itself. If at one time, it was pardonable for legal practitioners to ignore accounting altogether, today it is not.

Zeff, *supra*, at 358. Briloff entitled a final chapter of his 1976 book *More Debits Than Credits* "We Are In Pari Delicto," criticizing the roles played by all parties in accounting scandals, including especially law firms involved directly with National Student Marketing (White & Case) and Robert Vesco (Wilkie, Farr & Gallagher). *More Debits Than Credits*, at 363-370 (noting that in these fiascos the "deals could not have been created" without lawyer involvement and documentation, which does not "come forth parthenogenetically" and that lawyers drafting these documents "must have recognized" what they were doing).

modern finance theory in business and law schools.⁸⁴ This theory's efficient capital market hypothesis discounts the relevance of accounting data in a world where financial analysts pierce the form of accounting reports to discover fundamental values wholly apart from accounting choices. Accounting books published after 1975 often include defensive-sounding statements about the role of accounting in a world of efficient markets.⁸⁵

At the same time that accounting was declining in significance, the course in Corporate Finance gained popularity.⁸⁶ That course is seen to offer a greater opportunity for including discussion of contemporary debates in corporate law conducted by corporate law professors yet using the vocabulary and tools of financial economics.⁸⁷ The community of law professors

⁸⁴ Lawrence A. Cunningham & Warren E. Buffett, *The Essays of Warren Buffett: Lessons for Corporate America* (1st rev. ed. 2001), 25.

⁸⁵ *E.g.*, Stanley Siegel and David A. Siegel, *Accounting and Financial Disclosure* (1983), 10-11, state that "Recent economic theory, in particular the 'efficient market hypothesis,' has occasionally lent itself to the suggestion that the financial statements of enterprises may no longer be relevant to investment decisions." Following this announcement are a series of replies, that financial statements remain important for (1) taxation, labor union negotiations, and internal corporate capital allocation; (2) businesses whose securities do not trade in organized markets; and (3) promoting market efficiency.

⁸⁶ The 2001 *Directory* lists nearly 400 faculty covering corporate finance, up from 300 compared to 1975. That represents a 33% increase since 1975 and a level of coverage in 2001 more than four times greater than the coverage of accounting.

⁸⁷ See William W. Bratton, Book Review: *Corporate Finance in the Law School Curriculum* (reviewing Robert W. Hamilton, *Corporation Finance; Cases and Materials*), 1985 *Duke L.J.* 237 (1985).

did not pursue original research in accounting to the same degree or on the same scale.⁸⁸ The subject and teaching of finance is seen as offering theoretical and empirical heft, while that of accounting is seen, wrongly, as insufficiently theoretical and excessively practical.⁸⁹

The decline in teaching resources allocated to accounting is matched by changes in the nature and number of accounting materials prepared for use in law school classrooms. When accounting was first taught in law schools in the late 1940s, leading scholars from the country's most prestigious law schools raced to publish prodigious casebooks on the subject, starting with a group of professors from Harvard, and followed in rapid succession by scholars from each of Yale, Cornell, and Columbia.⁹⁰ These works and revised editions, averaging 525

⁸⁸ The trends are now beginning to reverse, with doubt cast over the ECMH and a return to an understanding of the importance of accounting data. *E.g.*, Claire A. Hill, *Why Financial Appearances Might Matter: An Explanation for "Dirty Pooling" and Some other Types of Financial Cosmetics*, 22 *Del. J. Corp. L.* 141 (1997). The ingrained thinking is stickier among journalists, and therefore likely to take the public longer to catch on. A leading columnist for *The Wall Street Journal* argues, for example, that it doesn't matter whether one accounts for stock options or not, for the market will figure out their significance without regard to accounting. Holman W. Jenkins Jr., *Much Ado About Stock Options*, *Wall St. J.* (April 3, 2002):

"In the real world [sic], any information, as long as it's deemed relevant, will be processed into the mill for pricing securities. It doesn't matter whether the data is computed into the income statement or appears in a footnote or is shouted up and down Wall Street by a man in a tutu."

⁸⁹ See Fiffis, *supra*.

⁹⁰ See Appendix B. Bragging rights for this leadership are enduringly exercised. *E.g.*, Herwitz & Barrett, *supra*, at vi ("This book's roots date back to [Harvard] Professor Robert Amory, Jr.'s pioneering

pages in length, were succeeded by like-sized and impressive accounting casebooks prepared by the next generation of law professors in the 1970s.⁹¹

The next phase of books on accounting for lawyers was decidedly minimalist, however.

A leading textbook published in 1983 managed a slim 259 pages,⁹² with the next year featuring a “nutshell” series on the subject, and since 1983 numerous other books of such brevity have appeared, including one at a record low 138 pages.⁹³ While shorter content on its own does not mean the quality of the material is down, it does suggest that either student interest or institutional capacity is. Since 1980, only one new accounting casebook has been published (595 pages)⁹⁴ and though the old Harvard book was updated in full-length (1094 pages) even this pedigreed tome had to be trimmed and published simultaneously in a “concise” edition (670 pages).⁹⁵

casebook on accounting for law students in 1948.”); Jack B. Weinstein, A Tribute to Dean William C. Warren, 92 Colum. L. Rev. 1315, 1317 n. 5 (1992) (Warren’s 1950 “casebook on accounting inaugurated the teaching of accounting at Columbia and elsewhere in the nation.”).

⁹¹ Ted Fflis *et al.* (1971) (687 pp.); and James D. Cox (copyright date of 1980, written and published in the late 1970s) (807 pp.). Also David Herwitz, a younger member of the earlier Harvard group, published a new version of that team’s work in 1980.

⁹² Siegel & Siegel, *supra*.

⁹³ Cunningham (270; 299 pp.); Mundstock (350 pp.); Ames (138 pp.). See Appendix B.

⁹⁴ Michael, *supra*.

⁹⁵ Accounting gets a little treatment in the books for cognate courses. For the basic

The reduced commitment of legal academic resources to accounting pedagogy comes at an inopportune time when you consider the rising importance of corporate governance and corporate social responsibility during the same period of the 1980s and 1990s.⁹⁶ As

corporations course, the emphasis is on little. About a half dozen pages per 1000 is being dedicated to the topic. *E.g.*, Lewis D. Solomon *et al.*, *Corporations: Law and Policy* (4th ed. 2000) (Ch. 8, “An Introduction to Financial Accounting and Valuation,” Sec. A: “Financial Accounting Demystified” (16 pp. / 1358 pp); Melvin A. Eisenberg, *Corporations and Other Business Associations* (8th ed. 2000), 17 (ch. 1, sec. 4, “An Introduction to Financial Statements) (5 pp. / 960); David G. Epstein, Richard D. Freer, Michael J. Roberts, *Business Structures* (2000), 14-26 (12 pp. / 813 pp.) (trot through the basic financial statements).

For advanced courses such as corporate finance, the treatment gains a modicum of heft. *E.g.*, Dale A. Oesterle, *The Law of Mergers and Acquisitions* (2002) (Ch. 7, “Accounting and Tax Issues in M&A,” Sec. A “Accounting for M&A”) (24 pp./ 689 pp); John D. Ayer, *Guide to Finance for Lawyers* (2001) (Ch. 12, “The Least Accounting You Can Get Away With”); Victor Brudney & William W. Bratton, *Corporate Finance* (4th ed. 1993), App. A. (36 pp. / xxxx pp.); Robert W. Hamilton & Richard Booth, *Corporation Finance* (3d ed. 2001) (ch. 1, “Accounting and Valuation”) (59 pp. / 929 pp.); William J. Carney, *Cases and Materials on Mergers and Acquisitions* (2000) (xxx / xxxx pp.).

For securities regulation, the treatment is on accounting and auditor certifications and liability. *E.g.*, Larry D. Soderquist and Theresa A. Gabaldon, *Securities Regulation* (4th ed. 1999) (registration process and letters from auditors); David L. Ratner and Thomas Lee Hazen, *Securities Regulation* (5th ed. 1996) (auditor liability); Richard W. Jennings, Harold Marsh Jr. and John C. Coffee Jr., *Securities Regulation* (7th ed. 1992) (notably the oldest among these securities regulation books and the one with the most accounting-related content, though still devoted to the strictly legal rather than the law and accounting context).

⁹⁶ Forces driving this rise included hostile corporate raiders in the 1980s and the

Washington University School of Law Dean Joel Seligman argues, accounting is not merely the language of business, but the language of corporate governance.⁹⁷ Key concepts in corporate law such as the duty of care and business judgment rule should be viewed not in the simplistic terms of arid statements (reasonable prudence and presumption of its exercise) but how they shape what directors do and how constraints in addition to state law—particularly accounting rules, auditing standards, and SEC enforcement—thus define corporate governance.

A robust literature by contemporary accounting scholars investigates the relationship

predominance of the institutional investor in the 1990s. Highlights of this rise included the establishment of corporate governance programs at various schools. Columbia Law School's Center for Law and Economic Studies was founded in 1975, with a major project on corporate governance undertaken shortly thereafter. Cardozo Law School founded its Samuel and Ronnie Heyman Center on Corporate Governance in 1985, kicked off with a major symposium on the subject. Since the early 1990s, ALI-ABA has been hosting an annual conference on corporate governance.

In the past several years, numerous programs in corporate governance have sprouted, including the 1997 founding of NYU's Center for Law and Business and the establishment in 2000 of the George Washington University Law School's Institute for International Corporate Governance and Accountability; the University of Delaware's Center for Corporate Governance; and Tuck's Center for Corporate Governance. In 2002, Stanford inaugurated an LL.M. degree in Corporate Governance. [Yale founded an International Institute for Corporate Governance in 19[xx]. Also Kennesaw State University's Corporate Governance Center].

⁹⁷ Joel Seligman, *Accounting and the New Corporate Law*, 50 Wash. & Lee L. Rev. 943 (1993).

between accounting information and corporate governance.⁹⁸ Accounting data influence the mechanisms for dealing with corporate law's central problem, the separation of ownership from control.⁹⁹ Accounting information influences governance in every direction, including board conduct, shareholder rights, executive compensation, takeovers, proxy contests, debt contracts, and the audit function—every subject on the syllabus of a basic law school class on corporations.¹⁰⁰

Consider one of corporate law's central doctrines, the duty of care, taught by such classic cases as *Bates v. Dresser*.¹⁰¹ A bank's bookkeeper opened and used a personal account at the bank to write checks that would be charged to other customer's accounts. The accounting consequence was the bank faced greater liabilities to the bookkeeper and correspondingly lower liabilities to its other customers. He eventually was caught, of course, but a few simple internal controls the bank's board or management easily could have designed would have prevented the scheme (such as having the bank's cashier rather than its bookkeeper make the requisite entries or, Eureka, having an auditor double check them).¹⁰²

⁹⁸ *E.g.*, Robert M. Bushman & Abbie J. Smith, Financial Accounting Information and Corporate Governance (April 2001) (working paper reviewing and proposing additional research).

⁹⁹ Eugene F. Fama & Michael C. Jensen, Separation of Ownership and Control, 26 J.L. & Econ. (1983).

¹⁰⁰ Bushman & Smith, *supra*, at 2.

¹⁰¹ 251 U.S. 524 (1920) (Holmes).

¹⁰² At the time, these controls were beyond the needs of common experience, however, so no

Another early case now a staple of the corporations course is *Graham v. Allis Chalmers*.¹⁰³ The engine of *Graham* was a price-fixing scheme by employees in the company's power equipment division, an old-line operation that was capital intensive, highly competitive and selling standardized products. Shareholders sought to hold the board accountable for its failure to detect and deter the scheme, which cost the corporation millions. The board having been given no reason to suspect such foul play, the court rejected the shareholders' claim. The fact that this position is extreme is something only someone with a bit of accounting sense would know, given the commodity character of that business.¹⁰⁴

With internal controls now functionally required by federal securities laws,¹⁰⁵ *Bates* and *Graham* are both dated,¹⁰⁶ but the cases remain instructive on the scope of the duty of care

duty of care violation was found (today there is little question one would be, as the ensuing discussion explains).

¹⁰³ 188 A.2d 125 (Del. 1963).

¹⁰⁴ Weiss, *Teaching Accounting and Valuation*, *supra*, at 693-695.

¹⁰⁵ *E.g.*, Securities Exchange Act of 1934, § 13(b)(2). This is the wrongly-named Foreign Corrupt Practices Act of 1977, as amended 1988, 15 U.S.C. § 78m(b). These laws are part of the Securities Exchange Act, § 13(b)(2)(A), and give the SEC general authority to adopt implementing rules and regulations, e.g., 17 C.F.R. § 240.13b2-1 *et seq.*, and cover all SEC registrants and all their activities (not, as the act's title may wrongly suggest, those relating to foreign corrupt practices).

¹⁰⁶ *See In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996). The Enron debacle put the question of sufficient internal controls squarely on the table, though the

and the power of corporate law's companion central doctrine, the business judgment rule. They remain instructive as a practical matter as well, because they help to shape required and optimally-designed internal controls. The precise contours of the requisite controls vary by business, company size, and other factors including, most critically, the nature and extent of accounting complexities.

In fact, one internal control requirement set down by federal securities laws is to have controls that enable registrants to prepare financial statements in accordance with generally accepted accounting principles.¹⁰⁷ This requirement means that to specify the content of the most basic obligation in all of corporate law—the duty of care—one must have some accounting sense.¹⁰⁸ The consequences for a corporation and its directors for failing to master this are

Power's Committee Report suggested the internal controls were up to legal standards. See Power's Committee Report, *supra*. Others drew the lesson that this meant the legal standards governing internal controls—as well as much else in corporate law—are inadequate. *E.g.*, Bratton, *supra*. Either way, forming such an opinion is difficult without an understanding of accounting knowledge relating to the processes of measuring and aggregating data and related accounting aspects of internal controls.

¹⁰⁷ SEC Rule 13(b)(2)(B). See also SEC Staff Accounting Bulletin No. 99 (SEC Staff warning that immaterial but intention misstatements may constitute violation of the Foreign Corrupt Practices Act).

¹⁰⁸ Numerous professional bodies, mostly drawn from the accounting and auditing professions, have expended substantial effort since 1975 refining the concept and development of internal controls. These include, in particular, the National Commission on Fraudulent Financial Reporting (the "Treadway Commission"), jointly sponsored by the AICPA, the American Accounting Association, the Financial Executives Institute, the Institute of Internal

staggering civil and criminal penalties.¹⁰⁹ Understanding the most basic features of corporate governance, therefore, depends on some grasp of accounting.¹¹⁰

Students taught that they must advise directors as to the scope of their duty of care must have some sense of what that means in concrete rather than abstract terms. A board typically seeks advice from lawyers while making decisions, unlike doctors, say, who work in the operating room without their lawyers present. When the duty of care calls for a director to possess a rudimentary understanding of a business and basic accounting principles, the lawyer must know what that rudimentary understanding is in a way that a medical malpractice lawyer need not know first-hand the relevant standards of care that surgeons owe their

Auditors, and the National Associate of Accountants (these organizations are in turn collectively called the Committee of Sponsoring Organizations (“COSO”) of the Treadway Commission and operate their own project on internal controls). Members of the legal profession, particularly those in the ABA Business Law Section’s Committee on Law and Accounting, play important roles in monitoring the proposals of these organizations. *E.g.*, “Management” Reports on Internal Control: A Legal Perspective, 49 Bus. Law. 889 (1994).

¹⁰⁹ Foreign Corrupt Practices Act of 1977, as amended 1988, 15 U.S.C. § 78m(b)(4), (5) (1994) (criminal liability for persons who knowingly circumvent or fail to implement systems of internal controls or knowingly falsify books and records) (as noted above, this statute applies to all business transactions, foreign and domestic).

¹¹⁰ Other cases contained in numerous Corporations casebooks that require some accounting sense to appreciate include *Joy v. North*, 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983) and *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). Fiftlis, *supra*.

patients.

The classic case *Francis v. United Jersey Bank* makes the point about what directors must know.¹¹¹ A court found a board member liable for breach of her duty of care, owing to her failure to read financial statements that would have tipped her off to embezzlement at the company. *Francis* acknowledges that while board members don't have to be accountants, they must have a sufficient understanding of the subject to read financial statements and to spot questions they raise. A law student can't be expected to understand the nature of the advice required to be given to a director—that the director have a rudimentary understanding of accounting—without knowing what the advice calls for—a rudimentary understanding of accounting.

At an even more particular level of case law study requiring accounting sense, consider *Ash v. McCall*.¹¹² Shareholders alleged breach of the duty of care and waste against the buyer's board in an acquisition of a company plagued by accounting irregularities that produced enormous overpayment in the purchase price—the McKesson-HBOC deal. The accounting related to revenue recognition rules, chiefly the booking of sales as final that were in fact contingent, and made contingent through side letters offering return privileges not part of the company's ordinary sales practices. Some evidence showed more aggressive accounting practices, such as backdating sales contracts.

Plaintiffs argued that numerous red flags would have alerted a reasonably prudent

¹¹¹ 432 A.2d 814 (N.J. 1981).

¹¹² 2000 WL 1370341 (Del. Ch. 2000).

buyer to the irregularities. These consisted entirely of published reports questioning the target's accounts receivable. Though the judge could have displayed a bit more accounting virtuosity by explaining the content of these reports, even getting a class discussion this far into the dispute requires a little background on revenue recognition as well as internal controls. It also requires a detour into the nature and extent of accounting and financial due diligence conducted in connection with a merger transaction and how easy or difficult it is to discover such shenanigans.¹¹³

Another broad topic covered in the basic corporations that cannot be understood without the ABCs of accounting under one's belt concerns dividend policy, and particularly the restrictions on shareholder distributions. We already covered the broad subject when considering the professional activities of a business lawyer, so now let's consider a particular case often studied in the basic corporations course, *Kamin v. American Express*.¹¹⁴ Amex held stock in another company with a tax basis of \$30 million and a current market price of \$4 million and its board decided to withdraw from the investment. It considered two alternatives to do so.

Plan A was to distribute the stock as a dividend to stockholders. That would result in a reduction of the asset side of the balance sheet of the carrying value of the stock and a reduction to the owners' equity portion of the balance sheet in like amount (retained earnings). The holders would get \$4 million. Plan B was to sell the stock, take a hit to income of \$26

¹¹³ The court dismissed the complaint's theories of waste and breach of the duty of care.

¹¹⁴ 383 N.Y.S.2d 807 (Sup. Ct. 1976), *aff'd*, 387 N.Y.S.2d 993 (App. Div. 1976).

million for GAAP and income tax purposes and thus reduce net income by an order of about \$8 million. The company would then distribute the \$4 million proceeds it would have distributed under plan A, plus the \$8 million tax savings as a distribution to shareholders.

The board opted for Plan A though Plan B looks more economically rational. It did so because it judged that the market pays more attention to income than to asset levels and wanted to avoid having the market punish its stock price—an understanding students without an accounting sense cannot possibly achieve. Ditto for understanding why the court deferred to the board's judgment in dismissing the plaintiff's claim.

Testing the reasonableness of corporate charitable contributions against the doctrine of waste often calls for some accounting sense. Two staples of the corporations course make the point, *Theodora Holding Corp. v. Henderson*¹¹⁵ and *Kahn v. Sullivan*.¹¹⁶ In *Theodora*, the court puts into perspective a gift of more than \$528,000 worth of stock by using a few tax and accounting steps. At the corporation's tax rate of 75%, the cost to the donation's corporation was really only \$132,000 and lower yet after special rules applicable to holding companies are given effect. Divesting itself of this stock also enabled the corporation to eliminate a large portion (\$130,000) of its reserves for unrealized capital gains on its balance sheet, boosting net worth. These moves would dumbfound a law student with no accounting basics.

The *Kahn v. Sullivan* opinion keeps the tax and accounting issues more in the background. On the

¹¹⁵ 257 A.2d 398 (Del. Ch. 1969).

¹¹⁶ 594 A.2d 48 (Del. 1991).

basic duty of care and duty of loyalty claims, however, much turns on the board's retention of law and accounting firms as a means for discharging those duties by becoming fully informed about the financial aspects of a corporate charitable contribution. (It may be that just such practices are what enabled Enron's directors to claim they discharged their fiduciary duties.)

Accounting becomes more important in the law school curriculum in more advanced business-related courses, such as securities regulation, corporate finance, and mergers & acquisitions.¹¹⁷ To give just one example of a case that could arise in these courses, as well as in the basic corporations course, consider the meaning of materiality under the federal securities laws. This conceptual centerpiece of our disclosure system frequently calls for understanding basic accounting principles. Take the Supreme Court's opinion in *Virginia Bankshares, Inc. v. Sandberg*, a standard corporate and securities law case.¹¹⁸

At stake was whether disclosure stating that the board's opinion that \$42 was a "fair" or "high" price for shares was actionable. In evaluating whether that price was either fair or high, the Court makes the following critical observation:

"Whereas the proxy statement described the \$42 price as offering a premium above both book value and market price, the evidence indicated that a calculation of the book figure based on the appreciated value of the Bank's real estate holdings eliminated any such premium."

Students reading this passage for the first time may be expected to grasp that there is

¹¹⁷ See *supra* (footnote summarizing accounting matters in books for advanced courses).

¹¹⁸ 501 U.S. 1083 (1991).

a difference between "book value" and "appreciated value." But a teacher can hardly leave it at that. Doesn't it need to be pointed out that book value is an accounting concept constrained by historical cost accounting conventions, and subject to depreciation cost allocation exercises; that this figure has certain uses for accounting purposes, but is not a reliable indicator of present market or exchange values, for which various adjustments must be made?

Sounds simple, even trivial, but the student with no notion of accounting will be stumped.¹¹⁹

Training lawyers, and especially business lawyers, for practice is a major responsibility the legal academy bears. Lawyers have a professional responsibility to help promote the integrity and competence of the bar, a duty most essential in law schools and thus imposed upon law professors.¹²⁰ If 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. It is probably too soon to sound an alarm that the teaching of accounting has been irresponsibly neglected in law schools, but the Enron debacle is the perfect opportunity for the legal academy to make sure that time never comes by reversing current trends. Meanwhile, lawyers already in practice should heed the professional responsibility

¹¹⁹ See Lawrence A. Cunningham (ed.), *Conversations from the Buffett Symposium*, 19 *Cardozo L. Rev.* (1997) (comments of Prof. Kitch putting in a kind word for teaching of the trivial).

¹²⁰ The hortatory Ethical Considerations accompanying canonical competency requirements applicable to lawyers include a mandate to aid in the improvement of all phases of legal education. Model Code of Professional Responsibility, Canon 1, Ethical Consideration 1-2.

warnings as well.

IV. The Fiduciary Duties of Business Lawyers

Lawyers owe clients a series of duties in discharging professional responsibilities. One is competence. This section addresses whether a business lawyer's duty of competence includes some level of accounting knowledge. The preceding discussion of what business lawyers do and what law students must know to grasp corporate law may suggest that they do.

The professional literature concerning legal ethics offers a more equivocal answer. An analysis of that literature informed by the context of a business law practice suggests that whatever the duty's precise technical content, a business lawyer's professional ethics should command them to master accounting basics.

Lawyers are fiduciaries for their clients.¹²¹ The principal justification for this designation is that clients seek from their lawyers the exercise of "professional judgment."¹²² That in turn

¹²¹ I develop a trust-based theory of the attorney-client relationship in a series of articles I wrote with Lester Brickman concerning various attorney fee structures. Lester Brickman and Lawrence A. Cunningham, *Game Theory and Nonrefundable Retainers: A Response to Professors Croson and Mnookin*, 2 *Harvard Negotiation Law Review* 69 (1997); Lester Brickman and Lawrence A. Cunningham, *Nonrefundable Retainers: A Response to Critics of the Absolute Ban*, 64 *Cincinnati Law Review* 11 (1995); Lester Brickman and Lawrence A. Cunningham, *Nonrefundable Retainers Revisited*, 72 *North Carolina Law Review* 1 (1993); Lester Brickman and Lawrence A. Cunningham, *Nonrefundable Retainers: Impermissible Under Fiduciary, Statutory and Contract Law*, 57 *Fordham Law Review* 149 (1988).

¹²² *E.g.*, Daniel R. Coquillette, *Professionalism: The Deep Theory*, 72 *N.C. L. Rev.* 1271 (1994).

requires the client to repose trust and confidence in the lawyer. In exercising professional judgment, the lawyer must advance the client's interests as the client would define them if fully informed. A wellspring of duties flow from the fiduciary obligation, including undivided loyalty¹²³ and avoiding conflicts of interest,¹²⁴ preserving client confidences and secrets,¹²⁵ representing a client zealously,¹²⁶ safeguarding client property,¹²⁷ and—of greatest importance here—the duties of competence, diligence,¹²⁸ and candor.¹²⁹

Lawyers think of competency in terms of "general technical proficiency."¹³⁰ Competency means ability, in fact, to accomplish objectives with the capacity of an ordinarily able professional in such circumstances. This ordinarily concerns legal knowledge, skill and preparation, in light of the legal and factual context of a representation.¹³¹ Knowledge relates to identifying, assessing and

¹²³ Model Rules, Rule 1.7 comment 1.

¹²⁴ Model Code, Canon 5; Model Rules, Rules 1.7, 1.8, 1.9, 1.10.

¹²⁵ Model Code, Canon 4; Model Rules, Rule 1.6.

¹²⁶ Model Code, Canon 7; Model Rules, Rules 1.2, 1.3.

¹²⁷ Model Code, DR 9-102, 2-110(A)(2), 2-110(A)(3); Model Rules, Rule 1.15.

¹²⁸ Model Code, DR 6-101(A)(3).

¹²⁹ Model Rules, Rule 8.4(c) (candor); Model Code, 21, DR 1-102(A)(4), 7-101(A)(3) (candor); Model Rules, Rules 1.2-1.4 (candor).

¹³⁰ Wolfram, at 186.

¹³¹ Model Rules, Rule 1.1 (competent legal skill, knowledge and preparation); Model Code,

dealing with legal problems; skill to advising, negotiating, and planning a course of action; and preparation is the thinking through on both lines of professional activity.

The professional literature and ethics codes speak of *legal* competence. On its face, therefore, competency in distinctly non-legal areas of accounting would not be required. Yet the intersection of law and accounting is clear, as the practice and classroom examples given suggest. So questions of mixed law and fact arise because of that intersection. The facts or factual context of a business law representation include financial realities and the manner of their accounting reporting. Competence encompasses an understanding of that relationship and an analysis of the degree to which differences exist that affect legal relations.

Reinforcing this common-sense view are prudential factors that stem from two kindred duties, the duty of diligence¹³² and the duty of candor.¹³³ The duty of diligence may compel business lawyers, as a matter of legal ethics, to gain a little accounting competency. Advising a corporate client concerning the disposition of 60% of its “net book assets” may require brushing up on the meaning of the terms assets, sales and earnings. Failing that, the duty of candor probably compels lawyers to inform clients of limited capabilities.

As an outer limit, finally, and apparently an issue implicated by Enron, lawyers must

Canon 6, DR 6-101(A)(1)-(A)(2) (competence).

¹³² Model Code, DR 6-101(A)(3) (diligence).

¹³³ Model Rules, Rule 8.4(c) (candor); Model Code, 21, DR 1-102(A)(4), 7-101(A)(3) (candor); Model Rules, Rules 1.2-1.4 (candor);

advise clients so that they avoid any violation of the law¹³⁴ and may not “counsel or assist a client in conduct that is criminal or fraudulent.”¹³⁵ Lawyers cannot further a client’s criminal or fraudulent purpose nor continue representation that is known to assist the client in the design. These mandates call for active rather than passive attention to client actions and purposes.¹³⁶ They encompass the capacity to address non-legal matters, in the business law setting including ways accounting facts may indicate when fraud or criminality is afoot.¹³⁷ Cynicism is obviously not required, but healthy professional skepticism and curiosity is.

One distinguishing feature of business lawyering is the frequent presence of an organizational client, such as a corporation or partnership. Lawyers’ duties in such representations can run in numerous directions, depending on who is identified as the client.¹³⁸ Candidates are the entity itself, plus its board of directors, individual directors,

¹³⁴ Model Rules, Rule 1.6 (Comment); Rule 1.2 (Comment, adding “knowingly” as a qualification).

¹³⁵ *Id.*, Rule 1.6.

¹³⁶ *Cf.* ABA Canon 32 (“The Lawyer’s Duty in the Last Analysis: a lawyer “advances the honor of his profession and the best interests of his client when he renders service or gives advice tending to impress upon the client and his undertaking exact compliance with the strictest principles of moral law.”).

¹³⁷ *Cf.* Restatement of the Law Governing Lawyers § 151(3) (“In counseling a client, a lawyer may address non-legal aspects of a proposed course of conduct, including moral, reputational, economic, social, political and business aspects.”).

¹³⁸ Model Rules, Rule 1.13 (reflecting this entity theory of the corporation); compare Model

committees, individual executives, and all other juridical agents. A business lawyer urged to act on a manager's behalf when the corporate client's interest would be harmed must not act. Knowing that the managerial and corporate interest diverge in these ways may depend critically upon some accounting dexterity.

If a business lawyer's duty of competence encompasses matters of accounting, however, this by no means requires direct or prior knowledge of accounting. That is only one way to discharge the duty. Lawyers may also discharge the duty of competence by learning on the spot. Lawyers can also meet their duty of competence by leaning on other lawyers with the requisite expertise.¹³⁹ So the duty of competence can be discharged by knowing, learning, or affiliating. In the case of affiliation, moreover, relying upon trained accountants would ordinarily meet the requirements of the duty.

Even if the duty of competence can be met by associating with accountants possessing the core competency, there remains a substantial professional and practical necessity for business lawyers to have a working knowledge of relevant accounting standards. This view of the duty of competence means only that failure of business lawyers to understand accounting issues involved in transactions they are structuring and advising upon do not, as a technical matter, breach their professional responsibility or constitute malpractice.

But this is not saying much. In practice, after all, enforcement of competency standards by

Code, DR 4-101, 5-101, DR 5-105 (eschewing the entity theory of the corporation in favor of rules relating to confidentiality and loyalty).

¹³⁹ Charles W. Wolfram, *Modern Legal Ethics* (1986), 185-192.

professional discipline is rare, limited to the "blatant bungler."¹⁴⁰ Legal malpractice claims can be defeated even for failure to master legal principles taught in basic first-year law classes, such as the rule against perpetuities.¹⁴¹ Failure to master accounting matters, even in the intersection of law and accounting, is less likely to result in successful malpractice claims. For these, a good defense would be the hardy "mere error in judgment" doctrine, strong so long as a lawyer can show good faith.¹⁴²

But should this excuse business lawyers from the effort? All lawyers know that just because something is legal doesn't mean it is right. In the area of legal ethics, just because a duty can be technically discharged in a painless way, doesn't mean client interests are served. This is particularly the case when rival lawyers are masters of the competency. Clients without such lawyers are twice disadvantaged.

Rather than examining the technical content of the duty of competence and doing the bare minimum to meet it, the more ethical and prudential question is how best to meet client needs in the realistic context of business law practice.¹⁴³ The answer is akin to the knowledge

¹⁴⁰ Charles W. Wolfram, *Modern Legal Ethics* (1986), 190; Stephen Gillers, *Regulation of Lawyers* (4th ed. 1995), 654 (citing Susan Martyn, *Lawyer Competence and Lawyer Discipline: Beyond the Bar?*, 69 *Geo. L. J.* 705 (1981)).

¹⁴¹ *Lucas v. Hamm*, 364 P.2d 685 (Cal. 1961).

¹⁴² Wolfram, *supra*, 213-214.

¹⁴³ *Cf. In re Cooperman*, 83 N.Y.2d 465, 469 (1994) (Bellacosa, J.) ("The conduct of attorneys is not measured by how close to the edge of thin ice they skate. The measure of an attorney's conduct is not how much clarity can be squeezed out of the strict letter of the law, but how much honor can be poured into the generous spirit of lawyer-client relationships.").

lawyers in other fields must command though no formal legal or ethical demand is imposed on the lawyer: environmental lawyers knowing a little geology; medical malpractice lawyers knowing a little medicine; constitutional lawyers knowing some political theory; agents who are lawyers knowing something about publishing, music, or sports; and criminal defense lawyers having some street smarts.

Business lawyers may also be required to have a core competency in such related fields as antitrust,¹⁴⁴ environmental law, intellectual property, regulatory, tax, even zoning. To the extent these arise less frequently than accounting issues, however, it is far easier for business lawyers to discharge the duty of competence through affiliation rather than using direct knowledge. For example, suppose an M&A lawyer represents a buyer of a manufacturing facility with numerous underground storage tanks. As part of his due diligence in assessing risks of assuming environmental liabilities he may retain a geologist to conduct ground water tests and rely on that expert to discharge the duty of competence.

¹⁴⁴ M&A lawyers in particular must shoulder a duty of competence with respect to knowledge of economics when evaluating the potential antitrust implications of proposed transactions and how to address them. The relevant variables for determining whether the Clayton Act, Sherman Act, or the FTC Act pose threats to competition, free trade or fair competition, respectively, hinge upon defining markets, measuring concentration, calculating market shares using the Herfindahl-Hirschman Index, and estimating efficiency gains. *E.g.*, Department of Justice and Federal Trade Commission, 1992 Horizontal Merger Guidelines, 57 Fed. Reg. 41552-01 (1992) (adopted Sept. 10, 1992). The lawyer-economist and law/economics mix in these settings is conceptually, functionally, and ethically analogous to the lawyer-accounting and law/accounting mix addressed in this article generally.

Certainly he can do the same thing as to the financial statements furnished about the facility—hire an accountant (or have the client hire an accountant). However, one difference in thinking about this context is that the M&A lawyer will face the accounting questions in every deal he advises on.¹⁴⁵ Environmental and other matters do not routinely arise. Also, buyers and sellers invariably have or retain accountants to work on just about every deal. Relying on accountants hired by the client or the other side is not the same as hiring a geologist to investigate an environmental risk.

Putting a final dose of common sense into this discussion, take a final simple example of competency not involving accounting. Suppose a lease agreement containing a provision prohibiting assignment without a landlord's consent. Wise lawyers contacting a landlord seeking such a consent will not tip their hand about how important that consent is to the deal. They instead will as much as ethically possible allow the landlord to believe that the lease can simply be left out of the deal. Indeed, lawyers may even indicate that absent the consent the deal can be structured in a manner not requiring it, as switching from an asset acquisition structure to a stock deal.¹⁴⁶

Ask two questions about this fact pattern. First, would a lawyer's giving away the goose

¹⁴⁵ The same is true of tax. Large and medium size law firms have responded to tax pervasiveness by building up entire tax departments, while smaller and solo operations routinely retain tax law experts for support. The future of law firms may be to include some accounting expertise on similar terms, wholly apart from questions concerning the debate over multi-disciplinary practice.

¹⁴⁶ *E.g., Branmar Theatre Co. v. Branmar, Inc.*, 264 A.2d 526 (Del. Ch. 1970).

be professional malpractice or a violation of principles of professional responsibility? It would certainly come close. Second, how different is this from the example given earlier of a lawyer who knows he needs the consent of a 15% shareholder for a merger that would otherwise not be given the desired accounting treatment?

V. The Competency of Business Lawyers

A familiar pass-the-buck *pas de deus* in deal meetings and conference calls occurs when the accountant says, after an impasse, “that’s a legal problem” at the same time the lawyer says “that’s an accounting problem.” The truth is what’s not said, the dog that didn’t bark: both are right. Both should be more willing to venture into the other’s territory—and the good news is Enron may accelerate what was already emerging as a trend in that direction.¹⁴⁷

The collapse of Enron arises from related party transactions that were improperly accounted for and inadequately disclosed. There you starkly see the accounting and law link. When a transaction is made, there is an accounting consequence and in turn or simultaneously a disclosure consequence. They are

¹⁴⁷ On the law side, see Fiflis, *supra*; Weiss, *supra*; Cunningham, *supra*; Seligman, *supra*; and note *supra* (regarding teaching accounting in law schools). On the business school side, see George J. Siedel, Six Forces and the Legal Environment of Business: The Relative Value of Business Law Among Business School Core Courses, 37 Am. Bus. L. J. 717 (2000); Robert A. Prentice, The Case for Educating Legally-Aware Accountants, 38 Am. Bus. L. J. 597 (2001). Accounting textbooks invariably include some legal material. *E.g.*, Donald E. Kieso, Jerry J. Weygandt, and Terry D. Warfield, *Intermediate Accounting* (10th ed. 2001); Robert F. Meigs and Walter B. Meigs, *Accounting: The Basis for Business Decisions* (10th ed. 2000).

related. The captain of the accounting team may be a different person from the captain of the disclosure team, but the two go hand in hand, they must harmonize, the one must know what the other is doing and understand why.

Consider, however, a very different professional outlook and culture offered by the senior partner at one of Enron's main outside law firms, Vinson & Elkins.¹⁴⁸ In response to criticism of his law firm's role in the debacle, he is quoted in an interview by *The New York Times* as saying: "There is a misunderstanding of what outside counsel's role is. . . . We would have no role in determining whether, or what, accounting treatment was appropriate for a client."¹⁴⁹

If this statement is true, it suggests a wedge between the professional cultures of lawyers and accountants that is dangerous. If true, it may help to explain, in part, the accounting transgressions that occurred at Enron. This is not to argue that had Vinson & Elkins's deal lawyers working on Enron matters understood accounting would have been able to hold credible discussions about relevant rules to prevent the accounting shenanigans or (much less) Enron's collapse. The cautionary tale is more modest, yet still quite meaningful. Lawyers with such capabilities will be in a position to do so and, at least some of the time, that capability will pay off.

Nor is this to argue that Vinson & Elkins breached any such duty in its representation of

¹⁴⁸ John Schwartz, Troubling Questions Ahead for Enron's Law Firm, *The New York Times* (March 12, 2002).

¹⁴⁹ *Id.*

Enron. As a technical matter, the duty of competence may not call for a law firm's involvement in discussing appropriate accounting treatment. But the statement attributed to the senior partner still defies reality. The interplay between accounting questions and the overall deal environment is such that the accounting issues cannot be ignored. They are often a central part of a deal and negotiations. It would be astonishing if business lawyers at Vinson & Elkins did not seek to understand, discuss, and negotiate the accounting treatment of transactions in the ordinary course of events. The quoted statement sounds more like *post hoc* advocacy.

The degree of accounting knowledge required or appropriate will vary with a business lawyer's professional role. The role and responsibility of inside general counsel concerning internal controls is likely to be far greater than that of outside counsel. The role of outside counsel is likely to be far greater than inside general counsel in structuring major transactions. Yet a different role is played by lawyers representing adverse parties, as underwriters, lenders, other investors or buyers/sellers on the other side of a business combination.¹⁵⁰

As already noted, lawyers representing the organization have different responsibilities than those representing individual officers, directors, shareholders or other constituents.¹⁵¹ In

¹⁵⁰ Lawyers at Kirkland & Ellis are quoted as making this point amid the Enron debacle. Kirkland represented some of the partnerships at the heart of Enron's collapse. Declining to comment on specifics of the firm's representation, a partner is reported as noting that the controversy concerned Enron's accounting issues while Kirkland & Ellis represented the partnerships, not Enron. Ellen Joan Pollock and Kathryn Kranhold, Law Firm Kirkland & Ellis Draws Notice From Investigators Into Enron Partnerships, *Wall St. J.* (April 2, 2002).

¹⁵¹ *See supra.*

each case, the lawyer involved in corporate representation must identify the client—whether the corporate entity or some other, such as the board, a director, and so on.¹⁵²

Requisite accounting knowledge among lawyers may also vary with the stage of a business transaction calling for representation. In the early stages of a deal—and further into them for smaller operations—greater facility is likely to be required because the lawyer may be the only professional involved in the early planning phases. There is often no accountant yet on the participant's list.

Equally, however, accounting is as specialized a field as law, so that a business lawyer experienced in acquisitions or public offerings, say, may have a better feel for accounting problems and issues in doing those deals than an accountant experienced in tax matters or liquidations. When the expert accountant is present, moreover, the lawyer must be able to speak his language—to reach a deal that achieves the many competing objectives of any complicated transaction—corporate governance, tax, accounting, securities, regulatory, antitrust and so on.

A business lawyer's competency as a part-time accountant does not entail that a lawyer become a CPA or even hold an undergraduate degree in accounting, nor to read everything available about accounting. Rather, it means a basic familiarity with the landscape—the basic financial statements and their relationships to each other, the major categories of accounts

¹⁵² *Id.* (compare Model Rules and Model Code). This is particularly the case in situations seen in Enron, where a manager's and the corporation's interests may diverge, as where closing a deal will yield the manager a bonus but the deal is no longer in the corporation's best interests.

that appear in these statements, the sources of accounting authority in the professional literature, and the range of discretion and judgment accounting rules allow and require (and the temptations this creates for massaging the numbers)—pretty much what is provided in a traditional law school course introducing law students to accounting.¹⁵³

Beyond such a handle on the basics, lawyers should make it a professional habit to stay abreast of the top handful of hot topics of debate within the accounting profession and also understand the accounting aspects of transactions they are involved with—true sales rules, leasing rules, derivatives rules for example.¹⁵⁴ This calls for a commitment to develop an evolving base of professional experience—the opposite of the attitude reflected in the

¹⁵³ Like strides can accrue from perusing a simple introductory book written for the lay person, including the following. Benjamin Graham, *The Interpretation of Financial Statements* (1937) (some technical material is obviously dated but the thrust of the analysis by the father of fundamental analysis remains apt); Steven A. Finkler, *Finance & Accounting for Nonfinancial Managers* (1992) (more up-to-date); Leonard A. Bernstein & John J. Wild, *Analysis of Financial Statements* (5th ed. 2000) (more advanced and in-depth but still accessible).

¹⁵⁴ For lawyers in certain practice areas, such as bankruptcy, the level of requisite accounting knowledge is arguably higher than for that of a business lawyer engaged in ordinary transactional work. *E.g.*, American Institute of Certified Public Accountants, Inc. (AICPA), *Statement of Position No. 90-7, Financial Reporting by Entities in Reorganization Under the Bankruptcy Code* (calling for fresh start accounting principles to be applied in preparing disclosure statements analyzing reorganization value of debtors under proposed plans); Susan Jensen-Conklin, *Financial Reporting By Chapter 11 Debtors: An Introduction To Statement Of Position 90-7*, 66 *Am. Bankr. L.J.* 1 (1992).

conference-call buck passing.¹⁵⁵

It is not generally necessary to research issues in the accounting literature, but to read the leading release or position. Nor is it necessary, as it is with reading legal materials, to master all the accounting jargon—it is sufficient to get to the heart of the document. Business lawyers should get on the mailing list of leading accounting firms that periodically prepare and distribute newsletters on current topics of interest.

When a lawyer's practice leads to repeat representation in the same type of deal—M&A or underwriting or high-tech venture capital—prudence calls for learning the special accounting issues that arise in those kinds of deals. The business lawyer should become familiar with the interpretations of principles produced by the FASB and AICPA on the relevant subjects. For lawyers routinely drafting transactional documents involving accounting concepts, there are a number of reliable practice aids that should be consulted.¹⁵⁶

Tips for business lawyers on how to develop simple core competencies in basic accounting thus overlap with tips for staying abreast of relevant court precedents,

¹⁵⁵ How to inculcate such professional values—and whether it is even possible to do so—has been a constant concern and debate in legal education. Wolfram, *supra*, at 193-94. In the case of promoting a professional culture among business lawyers to see accounting basics as part of their bailiwick, the solution is far simpler and beyond debate: the accounting course. Cf. Wolfram, at 197 (citing clinical programs as tools to provide skills training otherwise absent from the traditional law school curriculum).

¹⁵⁶ Among the best is Terry Loyd, *Financial Language in Legal Documents*, PLI Accounting for Lawyers (1994), 261-322.

administrative rule making, legislation, market contexts, and other matter relevant to the effective representation of clients. The list could include more general advice such as attending bar meetings and lectures concerning law and accounting, attending panels where business lawyers or SEC representatives discuss accounting, subscribing to professional literature addressing the subject and so on.

For firms, it would include teaching accounting basics and instruction concerning how they arise in the firm's practice. These topics would be part of the firm's in-house training programs, something many firms already do because it is common sense. When particular issues percolate in a firm's practice areas, special attention should be given to them in training seminars. Hot accounting topics of recent years had the tendency to arise in connection with certain practice areas.¹⁵⁷

In M&A, for example, the big bath maneuverer was prevalent. A sort of financial facelift, this strategem lumps major events adversely affecting income to current periods to facilitate improved financial appearances in succeeding periods. It is particularly common in, but by no means limited to, costs related to acquisitions, divestitures, reorganizations, and other extraordinary organic business changes. These transactions call for numerous accounting judgments as to both timing and classification. Managers often

¹⁵⁷ Stretching back through the past decade, major changes in accounting principles business lawyers must be aware of include the rules governing the accounting for retiree benefits, financial derivatives, business combinations, intangible assets, and stock options. Cunningham, *Introductory Accounting*, ch. 6.

expense as much of the potential costs of the transaction at the time it is consummated as possible.¹⁵⁸ They can go overboard.

In debt financing, there is the off-balance sheet tricks at the heart of Enron.¹⁵⁹ This describes a category of practices, some of which are legitimate, to engage in transactions that produce desirable benefits without undesirable reporting burdens. Events or transactions not required by GAAP to appear on a balance sheet are among the obvious for both their appeal and their legitimacy. Investments can be structured to be accounted for using the equity rather than the consolidation method, deals can be structured to obtain desired lease accounting treatment and, until recently neither derivative financial instruments nor commitments to cover retiree benefits needed to be recorded on a balance sheet—and stock options remain off-book altogether.¹⁶⁰ Knowing the rules and having the credibility to object effectively to violating them is a quintessential business lawyer skill.

Notably (but not limited to) the IPO and secondary equity markets are the proliferation of *pro forma* presentations of accounting data. Alongside the GAAP figures, particularly for earnings per share, are reported different figures calculated by ignoring a variety of expenses. Examples of such ignored expenses are: sales commissions, marketing and personnel costs, and disbursements to start a new

¹⁵⁸ It's also tempting to give current earnings such a "big bath" in one year to create a brighter looking future when the year is so dismal that investors have already written it off.

¹⁵⁹ See William J. Bratton, *Enron and the Dark Side of Shareholder Value*, Tulane L. Rev. (forthcoming 2002).

¹⁶⁰ Cunningham, *Introductory Accounting*, Ch. 6.

subsidiary.¹⁶¹ The typical argument for excluding these is that they are unusual one-time events, the standard required under GAAP to exclude items. These are controversial methods of presenting financial information. Staying on top of such widely publicized debates by tracking SEC releases is part of what most competent lawyers do with respect to staying on top of laws and regulations relevant to their practice. In these deals and in ordinary periodic reporting, the materiality principle requires reporting of items that are material and allows non-reporting of items that are not. Materiality is not an absolute concept but rather entails judgments. A standard legal formulation for public corporations under federal securities laws is whether there is a reasonable likelihood that an item would be important to an investor in making an investment decision about a security.¹⁶² The accounting rule asks whether it would influence a reasonable person's judgment.

Auditors in the past tended to use a simpler rule of thumb: that amounts not exceeding 5% of income were not material and those exceeding 10% were material. The SEC has rejected this simple numerical rule of thumb in favor of a broader "facts and circumstances" test.¹⁶³ Even so, the legal and accounting standards can produce different answers and a lawyer must know both to assure taking the more conservative position to assure compliance with both. Lawyers staying attuned to debate on the question of

¹⁶¹ Lynn E. Turner, "Accounting Irregularities II: What's an Audit Committee To Do?" (Speech, Atlanta, Georgia February 21, 2001) (available at www.sec.gov).

¹⁶² *TSC Indus. v. Northway, Inc.*, 426 U.S. 438 (1976) (context of proxy rules, 14a-9); *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988) (context of general disclosure, 10b-5).

¹⁶³ SEC Staff Accounting Bulletin (1999).

materiality in the legal literature will invariably gravitate towards the accounting literature as well.

Some accounting rules or topics that command the business lawyer's understanding arose directly in the Enron setting. These include rules relating to true sales, off-balance-sheet financing, purchase accounting, related party transactions, and ultimately, the meaning and implication of the concept of auditor independence. Lawyers are at the forefront of thought, analysis and design of corporate governance controls intended to prevent crafty operators from exploiting the cracks. These include enhanced oversight of auditors (current proposals being made regularly); enhancing the power, capability, and role of board audit committees; and promoting the effectiveness of third parties such as research analysts and rating agencies. The ultimate way of becoming an accounting-savvy business lawyer is to be part of this prophylactic side of law and accounting.

Conclusion

An old M&A story features a client who tells his lawyer that he has just made a deal to buy another business and agreed with his counterpart at the seller that he would only ask for one representation or warranty in the agreement and asks his lawyer which one he'd take. The only sensible answer is the financial statements. Yes, we like to have reps concerning environmental, pensions, tax, regulatory compliance, contractual compliance and so on, but the financials are, as they say, where the money is. It is the basis for assessing performance and value and, to a large (though imperfect) extent, reflects these other things.¹⁶⁴

Beyond the narrow deal-making payoff and ability to understand corporate governance that comes from business lawyers possessing accounting knowledge, consider the public

¹⁶⁴ Freund, at 254.

value. Whether accounting is the language of business or of corporate governance, it is a central force in the allocation of capital and hence the distribution of wealth.¹⁶⁵ Likewise, when abused, it has the function of misallocating capital and redistributing wealth to the fraudsters, as in the catastrophes ranging from Penn Central, to junk bonds, to Sunbeam, Cendant and Enron. The investing public puts enormous trust in corporate lawyers, whose work usually is unchecked by the adversary system and similar constraints and instead must be taken on faith.¹⁶⁶

The incidence of accounting machinations increased in the past several decades. Formal restatements of financial data reached an annual average of about 150 by the late 1990s, three times greater than the decade as a whole. Though this level remains low in the overall scheme of things (fewer than 1% of public companies), the trend is unacceptable and the number of innocent people hurt in the process is significant. In this midst, an entire industry called forensic accounting has emerged. Consisting of both lawyers and accountants, these sleuths seek to understand the causes of accounting scandals once they are uncovered. Their work should help formulate not only remedies in the cases they see—whether epic debacles or periodic scandals—but also to formulate strategies to prevent their recurrence and thus to reverse the alarming increase in financial reporting frauds.

¹⁶⁵ Fiftis gives the examples of the tax system's realization and amortization concepts as affecting the questions of distribution and allocation, respectively, Fiftis, *supra* at 970, but equally safe is the point left unadorned in this text.

¹⁶⁶ *In re Fields*, 45 S.E.C. 262, 266 n.20 (1973).

To cheer up those lawyers now fretting about a need to learn the dreary details of accounting, a few kind words are in order. It may not show the glamor and political appeal of sexy courses such as constitutional law or corporate finance, but it has deep theory, rich policy, and inordinate capaciousness. It is called hip, after Enron,¹⁶⁷ and is lavished with media attention, even if that attention is overdrawn just as the media attention lathered on shark attacks in the summer of 2001.¹⁶⁸

Appendix A: Accounting Pedagogy in Law Schools

¹⁶⁷ E.g., Cassell Bryan-Low, “A Sullied Profession Discovers It’s Hip To Be Calculating,” *Wall St. J.*, March 26, 2002.

¹⁶⁸ See Cunningham, *Outsmarting*. The number of worldwide shark attacks in 2001 was the second lowest in a decade, while during the summer more than 1500 stories dealt with shark attacks, a sum greater than the stories from the previous five summers combined.