Financial Moral Panic! Sarbanes-Oxley, Financier Folk Devils, and Off-Balance Sheet Arrangement

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Financial Moral Panic!
Sarbanes-Oxley, Financier Folk Devils, and Off-Balance-Sheet Arrangements

José Gabilondo*

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INTRODUCTION

The firm has come undone.¹ The break-up started as an idea in finance, where options pricing and transaction cost analysis traced the firm’s fault lines with theoretical implications about how the firm funds itself.² Then, traders went to work, turning these financial in-

¹ Instead of thinking of it as a solid entity, see the firm as a cipher and accounting rules as the symbol system that constitutes and decodes the cipher. Accounting theorists see the firm this way. See, e.g., Jim Donegan & Shyam Sunder, Contract Theoretic Analysis of Off-Balance Sheet Financing, J. ACCT. AUDITING & FIN., March 1989, at 203, 204 (“From the representational faithfulness perspective, the firm is seen as a collection of economic facts; accounting methods are evaluated by their ability to produce numbers and disclosures that approximate these facts as closely as possible.”) (citations omitted). The “facts” are value propositions about cash flows and contingencies. The law of financial reporting is the syntax and the grammar of this language and each financial report is a novel utterance. A good transactional lawyer is a finance semiotician too. See generally Lawrence A. Cunningham, Semiotics, Hermeneutics, and Cash: An Essay on the True and Fair View, 28 N.C. J. INT’L L. & COM. REG. 893, 894–95 (2003) (arguing that a hermeneutic approach to accounting would facilitate the convergence of national accounting standards).

² Two major insights that in particular helped to atomize the firm’s cash flows were options pricing and transaction cost economics. In 1973, a paper by Fischer Black and Myron Scholes transformed finance by demonstrating a mathematical approach to pricing options and corporate liabilities. Fischer Black & Myron S. Scholes, The Pricing of Options and Corporate Liabilities, 81 J. POL. ECON. 637 (1973). A new part of financial speech, options pricing let traders estimate the value of bundles of financial risk which had previously been held hostage to whole asset forms. In other words, the Black-Scholes model helped to demonstrate that an option is the smallest unit of financial contingency. See infra note 185 for an example of an options pricing analogy for the federal government’s risk with respect to federally-insured deposits. Maturing after options pricing, transaction cost economics provided an intellectual foundation for increased scrutiny of the “make-or-buy” problem as applied to funding. See Ronald Coase, The Nature of the Firm (1937), reprinted in THE NATURE OF THE FIRM: ORIGINS, EVOLUTION, AND DEVELOPMENT 18 (Oliver Williamson ed., 1990) (illuminating how a firm’s organizational structure reflects the decisions by a firm to economize on costs by sometimes internalizing factors of production and, at other times buying them in the open market); see also OLIVER WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 2–12 (1985) (putting the 1937 article in the context of the analytical approaches which developed in its wake). See infra notes 257–61, 275–78 and accompanying text for recommendations to reduce the transaction costs of gathering information about firms’ effective capital structure in order to promote greater investor understanding of firm funding. See generally Charles R.P. Pouncy, Contemporary Financial Innovation: Orthodoxy and Alternatives, 51 SMU L. Rev. 505, 551–54 (1998) (arguing that the Efficient Capital Markets Hypothesis, modern portfolio theory, the Modigliani-Miller theorem about optimal capital structure, and options pricing provided the rationale for wide use of new financial products).
sights into self-sustaining markets where firms could meet their needs for liquidity and capital with complex products. Here, securitization and other forms of disintermediation made funds more mobile and helped to "complete" the financial markets. Understandably, the Securities and Exchange Commission (SEC) and accounting regulators did not keep pace with these dynamic shifts. Before these shifts,

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5 When used to describe a firm, "liquidity" means the firm's ability to satisfy its payment obligations as they become due. See U.S. COMPTROLLER OF THE CURRENCY, LIQUIDITY: COMPTROLLER'S HANDBOOK 1 (2001), available at http://www.occ.treas.gov/handbook/liquidity.pdf. Prudent regulation of depository institutions has the most systematic approach to firm liquidity. See also generally JARI KALLBERG & KENNETH PARKINSON, CORPORATE LIQUIDITY: MANAGEMENT AND MEASUREMENT (1993). See Pouncy, supra note 2, at 527-34, 569-71 (showing how competition and interest in speculation led to intermediation in firm funding through swaps, derivatives, money market instruments, and securitization).

4 "Funding" refers to how the firm finances its activities. See LIQUIDITY: COMPTROLLER'S HANDBOOK, supra note 3, at 9-22 (summarizing liquidity sources and distinguishing between retail and wholesale funding sources). In general, funding relates to the liabilities and equity accounts on the right hand side of the balance sheet. An operational rather than legal concept, funding refers to how the firm stays afloat as an obligor. To appreciate what funding means to transactional lawyers, visit The Bond Market Association, Funding, http://www.bondmarkets.com/funding (last visited Feb. 18, 2006). "Disintermediation" means any substitution in the funding market by one liquidity or capital source for another. See LIQUIDITY: COMPTROLLER'S HANDBOOK, supra note 3, at 1-2 (explaining how the shift from retail to wholesale funding by banks has increased their overall liquidity risk). A la Coase, transaction cost efficiencies drive these substitutions. For example, the commercial paper market took off because high-quality borrowers could borrow more cheaply by issuing their own paper to investors rather than by getting a bank loan. See John P. Judd, Competition Between the Commercial Paper Market and Commercial Banks, ECON. REV. (1st Q. 1979), at 39. Similarly, transaction accounts with nonbank financial institutions have diverted customer deposits from banks, now scrambling for low-cost funding. (Deposits were the manna of bank funding because they were cheap.) See, e.g., Robert Litan, The Revolution in U.S. Finance: Past, Present, and Future, Remarks Before The American College, Bryn Mawr, Pennsylvania (Apr. 30, 1991) (explaining how receivables securitization transformed the flow of funds between financial intermediaries) (copy on file with author).

5 A complete market is one in which all commodities and claims can be traded. WILLIAM H. BEAVER, FINANCIAL REPORTING: AN ACCOUNTING REVOLUTION 38-39 (3d ed. 1998). See also Mario Draghi et al., Transparency, Risk Management and International Financial Fragility, at 1 (Harv. Bus. Sch. Working Paper No. 03-118, 2003) ("The role of swaps and other privately negotiated derivative instruments is to complete financial markets, thus increasing the ability of individuals, financial institutions, corporations and governments to manage risk.").

6 This is another example of the point that "[c]ontemporary financial innovation is a dance between the regulator and the regulated." Pouncy, supra note 2, at 546 (showing how heterodox economic theory reveals a wider range of public risks from derivatives and financial innovation generally than does orthodox economics). Pouncy notes how firms mitigate the costs of regulation through tactical innovation: Kane has characterized this process as the "regulatory dialectic." This process is a continual struggle between regulators and the regulated in which regulatory policy is confronted with financial innovation de-
readers of financial reports could look to the balance sheet as a rough proxy for a firm's net worth. But as firm managers turned increasingly to "off-balance-sheet" (OBS) arrangements like swaps and special purpose vehicles, the balance sheet lost its faithfulness as a public financial report. Investors outside of the charmed circle of the financially initiated were lost.

The gap between what public financial reports say about funding and how the cash actually moves in and out of firms became apparent with some highly publicized losses at Enron and other large firms, many of which involved cash flow games. A Greek chorus of indignant legislators, disgruntled investors, and evasive regulators blamed the losses on rogue managers and officers at these firms. These cads had broken the rules of the game, said the chorus. A special fury went to the auditors who had given the rogues cover under financial accounting. In this blame narrative, financiers became folk devils who threatened virtuous wealth accumulation by retail investors and signed to circumvent the policy. Regulatory policy is then adjusted to counteract the circumventive innovation, which, in turn, induces another innovative response. This process is also known as Goodhart's Law, which concludes that "basing a policy upon a recognized statistical relationship will bring about a policy-induced change in the relationship."

Id. (footnotes omitted) (citing Edward J. Kane, Microeconomic and Macroeconomic Origins of Financial Innovation, in FINANCIAL INNOVATION 5-6 (William L. Silber ed., 1975)); see also infra notes 262-75 and accompanying text for a critical evaluation of the agency's knowledge base.

7 See infra notes 107-14 and accompanying text to appreciate the scope of the balance sheet.

8 State law, the certificate of incorporation, or a bond covenant may let other corporate constituencies vote on fundamental questions of capital structure. See JERRY W. MARKHAM & THOMAS LEE HAZEN, CORPORATE FINANCE: CASES AND MATERIALS 156-220 (2004). It is, however, the firm's managers who run its day-to-day funding, including the use of off-balance-sheet arrangements.

9 In addition to Enron, recent prominent corporate scandals have included Dynegy (misrepresentation of cash flows on its statement of cash flows), Global Crossing (potential phantom transactions with no economic substance), Adelphia (three billion dollars in questionable loans), Tyco (charges of tax evasion and evidence tampering), WorldCom (significant accounting irregularities), Xerox Company (accounting irregularities), Arthur Andersen (obstruction of justice claim), KPMG (auditing malfeasance), ImClone (insider trading), and Merrill Lynch & Company (deceptive securities analysis). See generally Jerry W. Markham, Accountants Make Miserable Policemen: Rethinking the Federal Securities Laws, 28 N.C.J. INT'L L. & COM. REG. 725, 773-86 (2003) (reviewing asset write-downs, rising earnings restatements, and other accounting irregularities leading to market and Securities and Exchange Commission (SEC) interventions). For a bibliography of over one hundred legal, administrative, and congressional documents related just to Enron, the most notorious of these scandals, see Stephanie Burke, The Collapse of Enron: A Bibliography of Online Legal, Governmental and Legislative Resources, Apr. 15, 2002, http://www.llrx.com/features/enron.htm.
others. (Much of what was "lost" was unrealized value created by these rogues in the first place using the same accounting practices, but more about this later.) The pattern of losses across firms cast doubt on the financial reporting model overall, including the statement of cash flows, a financial report which had previously stood in relatively good repute.¹⁰

Financial moral panic! A moral panic starts with some bit of reality and then mushrooms into a movement for reform as sensationalist media reports fuel populist outrage over wrongdoing.¹¹ In a moral panic, "[s]tatements that would . . . mark the speaker as hyperbolic or paranoid suddenly acquire the status of incontestable fact, while skeptics are pitied for their callous denial."¹² In this nervous climate, Congress passed the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley or Act).¹³ Moral panic legislation blames social problems on bad people rather than bad structures and the Act bears these hallmarks by casting corporate officials and auditors as deviants. In this case, casting financiers as miscreants substituted for a more nuanced examination of whether the law of financial reporting adequately mapped firms’ true capital structure in light of the dynamic funding shifts of the past thirty years.¹⁴

To Congress’s credit, the Act roused the SEC from its slumber over accounting. Specifically, the Act directed the agency to require publicly-registered firms to say more about these curious “off-balance-sheet” items, which had previously escaped much substantive disclosure.¹⁵ Under the baleful glare of Congress, the SEC adopted a rule

¹⁰ The balance sheet is built on generally accepted accounting principles (GAAP), the basis for financial accounting. See Markham, supra note 9, at 765–68 (reviewing the development of generally accepted auditing standards (GAAS) and GAAP).

¹¹ See infra notes 32–53 and accompanying text for an explanation of moral panic and moral panic analysis.

¹² PHILIP JENKINS, MORAL PANIC: CHANGING CONCEPTS OF THE CHILD MOLESTER IN MODERN AMERICA 7 (1998) (analyzing the moral panics from 1890s–1990s about the sexual abuse of minors). To understand the analogy drawn in this Article, substitute "financier" for "child molester."


¹⁴ By the law of financial reporting I mean only federal securities laws, not state laws that impose financial reporting requirements.

¹⁵ Sarbanes-Oxley Act of 2002 § 401(a), 15 U.S.C. § 7261(c)(1) (Supp. II 2002), added § 13(j) to the Securities Exchange Act of 1934, which required the SEC to amend its rules to require each annual and quarterly financial report required to be filed with the SEC to disclose: all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons, that may have a ma-
that selectively increases the transparency of firms' effective capital structure by making them consider the financial impact of some types of OBS arrangements. When reporting to Congress on the rule's efficacy and the current structure of the OBS market, though, the SEC admitted that market transparency problems persist. Given the ongoing gap between publicly-reported funding and funding as the daily practice of survival by firms, do public financial reports say enough about how a firm finances itself? Not yet. Much of what led to Enron and the other losses continues. What is needed is a technical legal approach rather than the now-familiar "perp" walk on the nightly news.

Like marabunta, scholars have descended upon the Act's provisions about corporate governance, the audit process, and accounting generally. My own ant-like contribution to this debate is to frame the Act in terms of financial moral panic, to point out how this legislative terrestrial current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses. 15 U.S.C. § 78m(j) (Supp. II 2002).


See Office of the Chief Accountant, SEC, Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers 40 (2005), http://www.sec.gov/news/studies/soxoffbalancerpt.pdf [hereinafter SEC REPORT]. See also infra notes 225-34 and accompanying text about the SEC's conclusion that opacity persists with respect to the transparency of firms' OBS dealings.


Moreover, pre-Enron market failures are likely to continue if certain structural conditions in the market persist. First, disclosure related to derivatives positions is costly, and those costs are not reduced by the collapse of Enron; indeed, the cost of derivatives disclosure is greater if market participants are more concerned about such disclosures. Second, it is not necessarily easier for market participants to assess derivatives disclosure (or non-disclosure) post-Enron; they have similar technological capacity and access to information. Moreover, the gap between what managers know and what shareholders understand could persist if both issuers and investors become more sophisticated.

Id. (emphasis added) (footnotes omitted).

approach limited the Act’s efficacy in predictable ways, and to recommend changes to reduce, if possible, the risk of future financial moral panics. Indeed, as noted, post-Enron scholarship ought to restore a factual rather than moral approach to complex financial transactions.\(^20\)

With an argument used historically by the Left, Part I explains how financial moral panic was the zeitgeist for the Act.\(^21\) In a financial moral panic, false cause obscures a more complete understanding of cause-in-fact by blaming what are really routine market losses on individuals deemed to have acted in exceptionally opportunistic ways. The Act’s legislative history shows how financiers came to be viewed as folk devils and financial predators. Framed this way, their misconduct would distract investors and others from ambient economic anxieties about the ongoing market risk of unrealized gain in financial assets, an anxiety made more acute during a price bubble. Unfortunately, structural economic insecurity transcends individual misconduct. Indeed, this insecurity is intrinsic to our economic system.

Turning from cultural studies to financial reporting, Part II explains, again, why the balance sheet no longer reflects a firm’s financial position.\(^22\) The aim here is to provide a critical counterpoint to the prevailing view that financiers at Enron and other firms destroyed “real” shareholder value, often with bogus deals involving off-balance-sheet arrangements. Indeed, managers’ fiduciary duties to shareholders may have obliged these managers to use such arrangements (and, indeed, may continue to do so) for the sake of increasing re-

\(^{20}\) See Partnoy, supra note 18, at 1247 (arguing that regulatory responses to Enron based on the idea that fraud rather than financial complexity of derivatives led to Enron are misguided). Such scholarship has already been developed with respect to securitization, which suffered guilt-by-association to the extent that it was associated with Enron’s OBS practices. See Steven L. Schwarcz, Securitization Post-Enron, 25 CARDOZO L. REV. 1589, 1568–74 (2004) (clarifying the value of securitization); Steven L. Schwarcz, Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures, 70 U. CIN. L. REV. 1309, 1318 (2002) (“Ultimately, the greatest danger of the Enron debacle is our possible overreaction, and consequent over-regulation.”); see also William W. Bratton, Enron and the Dark Side of Shareholder Value, 76 TUL. L. REV. 1275, 1283 (2002) (“[T]he rogue characterization serves a double function—it deflects attention from the respectable community’s own business practices. This Article aspires to counterbalance with a picture of Enron’s collapse that deemphasizes the rogue to focus on the regular.”); Steven L. Schwarcz, Rethinking the Disclosure Paradigm in a World of Complexity, 2004 U. ILL. L. REV. 1, 18–19 (challenging the efficacy of mere disclosure of extremely complex financial instruments because disclosure will not produce a critical mass of investors who understand the transaction reasonably promptly).

\(^{21}\) See infra notes 54–104 and accompanying text.

\(^{22}\) See infra notes 122–34, 217–24 and accompanying text.
sidual return. To show how better cash flow reporting may have stemmed these losses, this Article discusses the statement of cash flows, a relative late-comer to the financial reporting model. This is part of a plea for reporting a firm's effective capital structure to improve the overall usefulness of public reports to financial reporting's diverse constituencies, i.e., investors, financial regulators, managers, auditors, and information intermediaries. More granular disclosure would benefit investors (even though it might increase firms' reported volatility) by reminding investors of the unavoidable uncertainty of future financial states of the world. Part III then discusses the SEC's OBS disclosure rule. In truth, despite its substantial limitations, the rule contributes to the evolution of financial reporting because the rule makes firms say more about their effective capital structure. But more is needed.

Part IV recommends some technical improvements to these technical problems. First, the SEC should require firms to disclose a transparency ratio on the balance sheet which suggests the magnitude of OBS items not otherwise disclosed. Revealing the fact of nondisclosure would seem to be a corollary of disclosure. Such a financial transparency ratio would reduce the information gap between firm insiders and outsiders without too much reporting "noise." Second, the SEC should require the reporting of more firm-

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23 Beaver notes that financial reporting balances the interests of five distinct constituencies: investors choosing between alternative investment portfolios, financial reporting regulators concerned about capital formation and resource allocation, firms' managers interested in increasing shareholder wealth and their own, auditors who need financial information to certify a firm's financial reports, and information intermediaries involved in searching out and processing "raw" financial data. See Beaver, supra note 5, at 150-56.

24 See infra notes 187-216 and accompanying text.

25 See infra notes 198-203 and accompanying text.

26 See infra notes 245-80 and accompanying text.

27 I use the word "firm" broadly to mean any business that consumes financial capital. So that includes corporations, partnerships, limited liability entities, business trusts, and other forms of business organization. Federal securities laws require any firm with $10 million or more in assets and five hundred or more owners of any class of equity securities to register with the SEC. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78ll (2000 & Supp. II 2002). Registrants include the country's largest corporations, thus including those listed on the exchange and over-the-counter securities markets. My comments about financial reporting obligations under federal securities law apply only to registrants, but the economic arguments in the Article apply to all firms.

28 There are three kinds of knowledge: what one knows, what one knows that one does not know, and what one does not know that he does not know. The distinction reflects the behavioral assumption that "human behavior is intendedly rational, but only limitedly so . . . ." Herbert A. Simon, Administrative Behavior: A Study of Decision-Making Processes in Administrative Organization xxiv (1961).
level information about cash flow to help market intermediaries further disaggregate the firm's cash flows into tradable units. The SEC could do this through the statement of cash flows. If adopted, these suggestions would increase transparency, enabling traders and other financial intermediaries to further complete funding markets. Also, the SEC should institutionalize market-wide surveillance of effective capital structure to increase the agency's in-house knowledge about funding trends. So informed, the SEC could better mitigate future financial moral panics by responding to fear with facts. Part V points out that there will always be an Enron and that, therefore, transactional law faculty should proselytize students (and seek curricular rents from deans) in order to increase the transactional and financial sophistication of law students, who could then better inject sobriety into future panics.

29 In considering cash flow, I join others who note the value of liquidity disclosures. See Matthew J. Barrett, The SEC and Accounting, in Part Through the Eyes of Pacioli, 80 NOTRE DAME L. REV. 837, 863-65 (2005) (praising the value of the liquidity risk disclosures required to be made by Item 303 of Regulation S-K); Cunningham, supra note 1, at 924-30 (arguing that increased accounting focus on the statement of cash flows would facilitate international convergence of accounting standards); Jack Friedman, Chapter 11 Financial Reporting Rules for Debtors: The Impact on Creditors, Shareholders, New Investors, and the Bar, 9 EMORY BANKR. DEV. J. 257, 266 (1992) (noting creditor interest in increased disclosure of cash flow information about debtors); Henry T. C. Hu, Faith and Magic: Investor Beliefs and Government Neutrality, 78 TEX. L. REV. 777, 854-60 (2000) (arguing that mutual funds should be subject to the same general liquidity disclosures currently required for publicly-registered companies); Stanley Siegel, The Coming Revolution in Accounting: The Emergence of Fair Value as the Fundamental Principle of GAAP, 42 WAYNE L. REV. 1839, 1850 (1996) (arguing that recent accounting pronouncements recognize the increasing relevance of cash flow calculations).

30 Accounting considers financial reporting from two distinct but related perspectives: financial reporting as an information tool in the service of market efficiency and financial reporting as a measurement device for a firm's financial characteristics. See BEAVER, supra note 5, at 76-77. An informational view evaluates the adequacy of financial reports in terms of their marginal informational value to decision-making about the firm. Id. A measurement view strives for fidelity between a firm's financial reports and its financial essence. Id. Although the recommendations made in Part IV have informational consequences, the thrust of this Article is to measure the firm as a financial item in a more comprehensive fashion.

31 This Article grew out of teaching the Dynegy case (mentioned supra note 9 and discussed infra notes 150-53 and accompanying text) in my corporate finance course at the College of Law. The case resonated with my conclusion from my time in Washington, D.C. during the Enron hearings that the law has not adequately thematized useful legal standards about how firms fund themselves. The two notable exceptions to this conclusion are the prudential regulation of banks and the net capital rule for broker-dealers (discussed infra notes 182-85, 263 and accompanying text), two examples of a federal interest in firm funding. I began writing this Article to identify OBS arrangements which would be presumptively material under the applicable disclosure standards. Deductive presumptions develop in common law after a
I. FINANCIAL MORAL PANIC: FINANCIERS AS PREDATORS

Congress passed the Act after a hue and cry went up about investor and employee losses caused by accounting irregularities at several national firms.\(^3\) Typical of moral panic legislation, the Act focused on bad actors rather than on bad structures.\(^3\) In particular, the thorny issue that the Act and the prior congressional hearings dodged was the extent of economic insecurity intrinsic to an economy such as ours, in which most people's wealth takes the form of unrealized gain in financial assets. As discussed in the following section, displacement of this sort is par for a moral panic. What was novel about this one was the symbiotic (and ambivalent) relationship between the moral discourse against the market and the critics' psychological and financial investment in the market itself. Let me start by explaining moral panic and moral panic analysis.

A. Moral Panic and Moral Panic Analysis

Moral panic theory claims that the media, moral entrepreneurs, government authorities, and special interest groups (including values communities) often react to a perceived threat to a fundamental social interest by invoking a deviant to blame for the perceived threat.\(^3\) Stanley Cohen, now a sociologist at the London School of Economics, introduced the moral panic concept to analyze nervous British reactions to public brawling between two youth groups in Britain: the period of gestation through inductive adjudication. I had wanted to shortcut that process, since presumptions can add legal certainty to compliance and can help judges faced with adjudicating the materiality of complex OBS items. My research, however, did not turn up enough aggregate data about effective capital structure to let me articulate a presumption about the materiality of OBS items. So, I offer the financial transparency ratio discussed herein, \textit{infra} notes 248–56 and accompanying text, as a basis for a future presumption about materiality. I leave the project of building presumptions to the future, my own as well as that of colleagues, critics, and allies.

\(^3\) See supra note 9 listing some of the more prominent examples of the losses attributed to accounting irregularities.
\(^3\) See infra notes 95–104 and accompanying text.
\(^3\) See STANLEY COHEN, FOLK DEVILS AND MORAL PANICS xxxi (3d ed. 2002). Cohen notes a concurrent use of the term by another researcher control (Jock Young), and assumes that both traced the idea of moral panic to Marshall McLuhan. \textit{Id.; see generally} MARSHALL McLuhan, UNDERSTANDING MEDIA: THE EXTENSIONS OF MAN (1964). Other British sociologists like Stuart Hall also popularized the idea, which formed part of the cultural studies movement. See infra note 68 and accompanying text for Hall's argument about the racialized construction of mugging. See generally Michael Tonry, \textit{Rethinking Unthinkable Punishment Policies in America}, 46 UCLA L. Rev. 1751, 1782–84 (1999) (reviewing the original clash between the Mods and the Rockers leading to early moral panic analysis).
Mods and the Rockers. He defined a moral panic as a situation in which a condition, episode, person or group of persons emerges to become defined as a threat to societal values and interests; its nature is presented in a stylized and stereotypical fashion by the mass media; the moral barricades are manned by editors, bishops, politicians and other right-thinking people; [and] socially accredited experts pronounce their diagnoses and solutions.

Reviewing the deployment of the concept over its busy thirty-year life, Cohen recently identified seven classic social situations which trigger a moral panic. What the triggers have in common is that they are perceived by the usual authorities (Church, state, the family or their diverse proxies) to threaten the social or moral order: young, working class violent males; school violence; recreational drug use; child abusers, Satanists, and pedophiles; popular dissemination of sexual and violent content; welfare cheats and single mothers; and refugees and asylum seekers. Though comprehensive, this is not an

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35 See COHEN, supra note 34, passim.
36 See id. at 1.
37 See id. at viii–xxi. Most of these situation predicates have generated legal scholarship applying moral panic analysis.
exhaustive list. Crime triggers much moral panic.\textsuperscript{43} Sexual and gender minorities are also favorite targets of moral panics.\textsuperscript{44}

In each of these cases, an incident or pattern catalyzes pre-existing social anxiety and an ad hoc issues movement is born. The media fans the flames through sensationalist and reductionist news stories.\textsuperscript{15} As Cohen notes, identifying a "folk devil" to blame takes the place of cooler consideration of multivariate causes which may have contributed to the original trigger.\textsuperscript{46} Usually, a hasty legal reform results from the panic. Driven as it is by irrationality, the reforms usually miss the point of the original problem and suffer from disproportionality.\textsuperscript{47}

A remedial move made by socially conscious critics, moral panic theory contests the "folk devil" construction of the problem and reframes it, instead emphasizing structural causes. Thus, moral panic theory reveals the unstated ideological interests at work in a particular framing of a problem by allowing us "to identify and conceptualize the lines of power in any society, the ways we are manipulated into taking some things too seriously and other things not seriously enough."\textsuperscript{48} In discussing the Mods and the Rockers, Cohen lists the two key aspects of a moral panic which moral panic theory targets, i.e., an ideological slant and false causation:

[T]he point [of moral panic analysis] was to expose social reaction not just as over-reaction in some quantitative sense, but first as tendentious (that is, slanted in a particular ideological direction) and second, as misplaced or displaced (that is, aimed—whether de-


\textsuperscript{45} See COHEN, supra note 34, at 1.

\textsuperscript{46} Id. at xxii.

\textsuperscript{47} Id. See also JENKINS, supra note 12.

\textsuperscript{48} See COHEN, supra note 34, at xxxv.
liberately or thoughtlessly—at a target which was not the 'real' problem). 49

While a moral panic fixates on individual deviants, moral panic analysis tries to refocus the policy debate on the web of institutions, ideological interests, and other drivers that work in concert to recast social anxieties into a discourse about bad people rather than bad conditions. 50 Moral panic theory must evolve in light of changes in media structure and in reaction to complementary theories of social construction and cultural studies, of which moral panic was an important harbinger. 51 By extending the analysis beyond the usual authorities and the usual suspects, 52 my aim is to expand the reach of moral panic arguments into financial legislation as well. 53

49 Id. at xxxi.
50 Id. at xxii:
   To point to the complexities of the relationship between social objects and their interpretations is not a 'criticism' but the whole point of studying deviance and social control. Some trivial and harmless forms of rule-breaking can indeed be 'blown out of all proportion.' And yes, some very serious, significant and horrible events—even genocide, political massacres, atrocities and massive suffering—can be denied, ignored or played down. Most putative problems lie between these two extremes—exactly where and why calls for a comparative sociology of moral panic that makes comparisons within one society and also between societies.

Although both the original model of moral panics and the reformulations which introduced notions of ideology and hegemony were exemplary interventions in their time, we argue that it is impossible to rely on the old models with their stages and cycles, univocal media, monolithic societal or hegemonic reactions. The proliferation and fragmentation of mass, niche and micro-media and the multiplicity of voices, which compete and contest the meaning of the issues subject to 'moral panic', suggest that both the original and revised models are outdated in so far as they could not possibly take account of the labyrinthine web of determining relations which now exist between social groups and the media, 'reality' and representation.

Id. Cohen notes that theories of social construction, media and cultural studies, and the idea of the "risk" society followed the sociology of moral panic analysis. See COHEN, supra note 34, at xxii–xxvi.
52 See supra notes 37–44 and accompanying text.
53 Security panic analysis is another extension of the moral panic concept. Security panic arguments explain repressive intrusions in civil liberties on perceived threats to national security, typically from noncitizens or other outsiders. See Adrian Vermeule, Libertarian Panics, 36 RUTGERS L.J. 871 (2005).
B. Financial Moral Panic: When Financiers Become “Folk Devils”

Financial moral panic is the expression in the explicitly economic sphere of the more general form of moral panic. The public discourse about the scandals discussed in this Article was framed in the familiar terms of a moral panic. In this panic narrative, rogue managers and auditors threatened public confidence in a vital public good—the capital market—risking the solvency of every investor’s financial future. A national *auto de fe* against financial heresy, the congressional hearings leading up to the Act opened on this tone.\(^{54}\) Consistent with popular accounts of accounting scandals, the legislative history of the Sarbanes-Oxley Act similarly reflects the reception of the blame narrative.\(^{55}\) Some witnesses did testify to the technical na-

\(^{54}\) In Inquisition history, the *auto de fe* was a public spectacle in which the Crown and Inquisition authorities convened in the town square to discipline those who had been convicted by Inquisition authorities for violating religious law. See *Jean Plaidy*, *The Spanish Inquisition* 147–59 (1967). In Spain, the *auto de fe* helped to consolidate a central national identity by imposing a uniform regulation across geographically and culturally disparate communities. *Id.* at 87–103.

\(^{55}\) Notice the invocation of sensationalist media accounts typical of a panic in the opening statement of the Committee Chair, Senator Sarbanes:


> . . . As *The Washington Post* put it, if one company “issued make-believe accounts, why should anyone believe that dozens of other companies aren’t practicing the same deception?”


Chairman Sarbanes’ focus on media triggers reflects the ongoing value of Cohen’s point about the role of the media in a moral panic:

> The student of moral enterprise cannot but pay particular attention to the role of the mass media in defining and shaping social problems. The media have long operated as agents of moral indignation in their own right: even if they are not self-consciously engaged in crusading or muck-raking, their very reporting of certain ‘facts’ can be sufficient to generate concern, anxiety, indignation or panic. When such feelings coincide with a perception that particular values need to be protected,
ture of the accounting problems which underlay Enron, but these voices were outnumbered by the gnashing of teeth over lapses in professional ethics. Imputing a simple intent to Congress's 535 independent members often seems farfetched, but not so with respect to the sentiment that the corporate officials and auditors in question had behaved wantonly.\footnote{As one legal commentator put it:}

The preconditions for new rule creation or social problem definition are present. \textit{See Cohen, supra} note 34, at 7.

\footnote{One witness explicitly warned that merely focusing on bad actors would not resolve the structural problems with financial reporting:}

You will hear or have heard many suggestions for improvement to our system of financial reporting and audits of those financial reports. Some will say that auditor independence rules need to be strengthened. That external auditors should not be allowed to do consulting work and other nonaudit work for their audit clients. That external audit firms should be rotated every 5 years or so. That oversight of auditors needs to be strengthened. That punishment of wayward auditors needs to be more certain and swift, and so on and on. In my opinion, those suggestions, even if legislated by Congress and signed by the President, will not fix the underlying problem.

The underlying problem is a technical accounting problem. The problem is rooted in our rules for financial reporting. Those financial reporting rules need deep and fundamental reform. Unless we change those rules, nothing will change. Today's crisis as portrayed by the surprise collapse of Enron is the same kind of crisis that arose in the 1970's when Penn Central surprisingly collapsed and in the 1980's when hundreds of savings and loan associations collapsed, which precipitated the S&L bailout by the Federal Government. There will be more of these crisis [sic] unless the underlying rules are changed.

\textit{Hearings, supra} note 55, at 189-90 (statement of Walter Schuetze, Chief Accountant, U.S. Securities and Exchange Commission, 1992-95). For example, some of what came out in the hearings was that Enron seemingly complied with accounting requirements. \textit{Id.} at 577 (prepared statement of Joel Seligman, Dean and Professor, Washington University School of Law) ("The off balance sheet transactions that Enron employed were made in accordance with generally accepted accounting standards.").

\footnote{As one legal commentator put it:}

Congress jumped into the Enron media circus by holding almost thirty Enron-related media hearings within three months of that company's bankruptcy. Those hearings in many ways resembled a McCarthy-era witch hunt against suspected communists. Enron executives were likened to the terrorists who struck America on September 11, 2001. . . . Great theater, but such histrionics had been little seen since Joseph McCarthy left the Senate.

Witnesses who did appear to testify were berated, badgered, mocked, and cut off if their answers were not what the congressional examiner wanted to hear. One member of Congress insisted on only yes or no answers to complicated, convoluted questions that assumed a guilty answer.

floor debate from the Act contains numerous aspersions about chief executive officers, chief financial officers, and accountants—the folk devils of this financial moral panic. (Lawyers played a key role in the media construction of this moral panic, confirming their complicity in feeding a moral panic which they were also in a position to critically evaluate.)

However, the actual social interest at stake in the scandals rarely appeared publicly during the Hearings. The structural interest which these scandals really threatened was a shared "consensus reality" about the nature of prosperity, financial value creation, and eco-

58 See 148 CONG. REC. S6734, S6750 (daily ed. July 15, 2002) (statement of Sen. Grassley) ("We ought to be correcting the situation so that people have confidence and so that crooks who are running our corporations and doing these things that are evidenced here. When I say 'crooks running our corporations,' I mean the ones who would do this sort of thing to their stockholders and to the country and to the economy—so that they cannot get away with that in the future."). Blaming these individuals for the losses also required explaining these losses in moral rather than market terms, a point that I make below. See infra notes 61–87 and accompanying text.

59 Given that law professors now form part of the chattering class that comments in the media about legal controversies, Erwin Chemerinsky's observations on the ethical duties of law professors in this role bear repeating:

Consider the first duty of a commentator to be competent. While lawyers may have a sense of how ordinary criminal investigations work and how ordinary trials are conducted, political proceedings are a hybrid of legal process and political determinations.

. . . .

There also appeared to be added pressures on commentators to speculate on cases occurring in the political, rather than legal, arena.

. . . .

It is more difficult in political commentary to compartmentalize one's opinion from legal description. Therefore, it is even more important that commentators in the political arena be aware of their biases and make full disclosure of them to the media and public.


60 In a moral panic, lawyers can function as the disease or the cure:

The legal system, in the conventional wisdom, should be immune to such hysteria, and indeed, should act as a rational and calming force. All too often, however, the creation of a moral panic depends on the complicity and active participation of the legal system. Legal actors—police, prosecutors, defense attorneys, expert witnesses, judges, juries—have in various ways, the power to affirmatively fuel the creation of institutionalized hysteria.

At present, our consensus reality about wealth rests on unrealized gain as an important store of value. To some extent, the New Deal laid the groundwork for the current "consensus reality" in which even lower-middle class workers rest their future on unrealized gain in financial assets. This view seems to have become the

Consensus reality explains the nature of perceived reality as the result of implicit or explicit agreement between social participants into a contract about what the state of the world is. See THOMAS S. KUHN, THE STRUCTURE OF SCIENTIFIC REVOLUTIONS 10-12 (1970) (noting how theoretical challenges to dominant paradigms are opposed by incumbent academics that stand to lose reputation by the reception of the new idea). The idea implies that the experience of reality is contingent and open to paradigm shifts.

For example, in a paper based on the Federal Reserve triennial survey of consumer finances, a researcher notes "a striking pattern of growth in family income and net worth between 1998 and 2001" by offsetting the unrealized appreciation in consumers' investment holdings against the large increase in liquidated debt of U.S. households. See Ana M. Aizcorbe et al., Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances, 89 FED. RES. BULL. 1, 1 (2003) ("The level of debt carried by families rose over the period, but the expansion in equities and the increased values of principal residences and other assets were sufficient to reduce debt as a proportion of family assets.").

The New Deal itself was no moral panic because the legislative remedies were proportional to the scope of the economic crisis. Another difference is that the New Deal deemphasized individual wrongdoing and emphasized structural reform, unlike Sarbanes-Oxley, which focused on increasing criminal penalties for certain white-collar offenses. In his history of the New Deal, Robert Leuchtenburg describes how the Depression put the nation on a crash course with class consciousness by bringing out some of the contradictions about market distribution:

The persistence of the depression raised questions not merely about business leadership but about capitalism itself. When so many knew want amidst so much plenty, something seemed to be fundamentally wrong with the way the system distributed goods. While the jobless wore threadbare clothing, farmers could not market thirteen million bales of cotton in 1932. While children trudged to school in shoes soled with cardboard, shoe factories in Lynn and Brockton, Massachusetts, had to close down six months of the year. While people went without food, crops rotted in the fields. Western ranchers, unable either to market their sheep or feed them, slit their throats and hurled their carcasses into canyons. In the plains states, breadlines marched under grain elevators heaped high with wheat.

WILLIAM E. LEUCHTENBURG, FRANKLIN D. ROOSEVELT AND THE NEW DEAL 1932-1940, at 22-23 (1963) (footnotes omitted) (analyzing Roosevelt's role in institutionalizing New Deal programs). Hunger and need planted the seeds of collective action: In February 1933, thousands of former members of barter groups seized the county-city building in Seattle. In the Blue Ridge, miners smashed company store windows and storekeepers were given the choice of handing out food or having it seized. Unemployed workers in Detroit invaded self-service groceries in groups, filled their baskets, and left without paying. Iowa leagues of the unemployed enlisted jobless gas and light workers to tap gas and electric lines. In Des Moines, workers boarded streetcars in groups of ten or twenty and told the cowed conductors to "charge the fares to the mayor." In Chicago, a
dominant way that investors conceptualize their wealth.\textsuperscript{64} Granted, the most notorious of these accounting scandals, Enron's bankruptcy, \textit{did} result in significant realized losses to shareholders, creditors, and employees.\textsuperscript{65} Much of the most sensationalist reporting, however, re-

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\textsuperscript{64} In the 1960s a split began developing between technical analysts who measured firm profitability with information other than net income and investors who focused on short-term earnings. \textit{See} BEAVER, \textit{supra} note 5, at 4 ("In the late 1960s the perspective shifted from economic income measurement to an 'informational' approach."). Investors, however, continued to look at earnings:

Initially, American investors were concerned primarily with the net worth, book value or physical assets of the firm. Investors then relied on income return, dividends and yield as a measure of the firm's worth. Following World War II, high taxes on ordinary income and tax rates which favored capital gains shifted investors [sic] attention from dividends to earnings. . . . During the 1960s, instant growth in earnings became the single most important indicator of a stock's worth in the eyes of the investment community.


\textsuperscript{65} A realized loss means the loss of an actual out-of-pocket outlay of cash or some other liquid resource. In contrast, stock appreciation is unrealized gain until the stock is reduced to cash through sale. "Losing" share appreciation is an unrealized loss. To put it in another way, your consumer debt is your lender's unrealized gain, although collateral may reduce your lender's market risk. \textit{See} LAWRENCE REVSINE \textit{ET AL.}, \textit{FINANCIAL REPORTING AND ANALYSIS} 48–50, 805 (1999).

Who lost what in Enron? Enron's ten largest shareholders lost about $11 billion (Alliance Premier Growth, Fidelity Magellan, AIM Value, Putnam Investors, Morgan Stanley Dividend Growth, Janus Fund, Janus Twenty, Janus Mercury, Janus Growth and Income). MICHAEL COVEL, \textit{TREND FOLLOWING: HOW GREAT TRADERS MAKE MILLIONS IN UP OR DOWN MARKETS} 122 (2004). Several public retirement funds incurred realized losses. \textit{See}, \textit{e.g.}, University of California, Update on the UC's Enron Investments and Lawsuits, \texttt{http://www.universityofcalifornia.edu/news/enron/q\&a.html} (last visited Feb. 19, 2006) (announcing a realized loss of $115.5 million on shares purchased for $68.50 or $71.34 and sold for an average price of $5.33). Other large losses (indicated here in parentheses) included the Kansas Public Employees Retirement System (about $1 million), the City of Fort Worth Retirement Fund (nearly $1 million), the Teacher Retirement System of Texas (realized losses of $23.3 million; unrealized losses of $12.4 million), the Georgia Teachers Retirement System ($79 million), the New York City Pension Fund ($110 million), and the Ohio State Pension Fund ($114 million). \textit{See} Turtle Trader, Hall of Shame, \texttt{http://www.turdetrader.com/hall-of-shame.html} (last visited Feb. 19, 2006). For many of the large public retirement funds, the losses were relatively insignificant as compared with the overall fund size, indicated here in parentheses: Pennsylvania Public School Employees' Retirement System ($50 billion) lost $59 million, less than 0.25%; New York State Pension Fund ($112 billion) lost $58 million; Pennsylvania State Employees' Retirement System ($24.7 billion) lost $10.6 million; York County, Pennsylvania
lated to unrealized losses.\textsuperscript{66} As reported in the media, the alarm over these unrealized losses threatened the ongoing viability of the consensus reality built around unrealized gain. To recapitulate, protecting the consensus reality was the (unstated) social interest at stake in the media construction of the scandals, the Hearings, and the Act, i.e., the anxiety driver in Cohen's model about moral panic.\textsuperscript{67}

In a general moral panic, though, economic anxiety is displaced away from the market and onto social issues.\textsuperscript{68} My point in this Part

\begin{itemize}
    \item and City Employee Pension Funds ($182 million) lost $1.26 million; and the State of West Virginia ($5.4 billion) lost $1 million. \textit{Id.}
    \item Enron employees who had invested in Enron stock suffered significant losses of unrealized value, which became realized only when the employees sold their shares later. Enron blocked these employees who had chosen to invest their shares in Enron from selling these shares during an eleven-day period in the fall of 2001. See \textit{Hearings on the Enron Collapse and Its Implications for Worker Retirement Security, Part II Before the H. Comm. on Educ. and the Workforce, 107th Cong. 104 (2002)} (statement of Mikie Rath, Benefits Manager, Enron Corp.), \textit{available at} http://edworkforce.house.gov/hearings/107th/fc/fchearings.htm (follow "Serial No. 107-42 (PDF, 6.6M)" hyperlink). Enron's retirement plan gave its staff twenty investment options, including mutual funds, a Schwab account, and Enron stock. \textit{Id.} Enron matched contributions only to its Enron stock. \textit{Id.} Participants could trade the stock in their accounts daily, with the exception of the matching contributions of Enron stock, which could not be traded before the plan participant reached the age of fifty. \textit{Id.} In the first week of October, Enron mailed its employees a notice that, due to a change in the plan service provider, a trading suspension would be in effect for eleven trading days, from October 29 to November 13, 2001. \textit{Id.} On October 16, 2001, Enron announced a $618 million third-quarter loss, beginning a downward price spiral in its stock. Press Release, Enron Corp., \textit{Enron Reports Recurring Third Quarter Earnings of $0.43 Per Diluted Share; Reports Non-Recurring Charges of $1.01 Billion After-Tax; Reaffirms Recurring Earnings Estimates of $1.80 for 2001 and $2.15 for 2002; and Expands Financial Reporting (Oct. 16, 2001)}, \textit{available at} http://www.enron.com/corp/pressroom/releases/2001/ene/68-3QEarningsLtr.html. On October 10, Enron stock was selling for $35 a share. By October 26 it had fallen to $15 and by November 20 it had fallen to $7 per share. By the end of November, Enron stock was selling for fewer than fifty cents a share. The lockout occurred during this price drop. Blackout periods routinely occur when plans change service providers or when companies merge. Such periods are intended to ensure that account balances and participant information are transferred accurately. Blackout periods will vary in length depending on the condition of the records, the size of the plan, and number of investment options. While there are no specific ERISA rules governing blackout periods, plan fiduciaries are obliged to be prudent in designing and implementing blackout periods affecting plan investments.
    \item Clearly there is a tradeoff between increasing the allocative efficiency for firms (for example, by letting them off the hook in terms of their legal duties to their employees) and the distributional equity objective of increasing economic security for these same employees. That conundrum drives the panic.
    \item Stuart Hall noted the link between economic insecurity and moral panic. He showed how underlying economic anxiety was displaced into an anxiety about "muggings" by black, working class men. \textit{See generally STUART HALL ET AL., POLICING THE CRISIS: MUGGING, THE STATE, AND LAW AND ORDER (1978)} (using moral panic analysis
of the Article is to show that in a financial moral panic the economic anxiety stays in the economic sphere but plays out in a new form. Put another way, the logic of the financial moral panic must explain the losses caused by the scandals without undermining the basic optimism in capital markets overall. Since indifferent markets could not be blamed for these investment and employment losses, bad people would have to be. A parody of Calvinist predestination, causation in this instance explained financial losses in terms of personal morality, not market movements, as reflected in the moral critiques of accounting scandals issued at the time.69

In truth, a greater challenge to the current consensus reality about unrealized wealth comes from the prevalence of economic insecurity in U.S. households, not primarily from rogue financiers. Consider the sobering facts behind the real estate bubble. After a period of flat rates of homeownership, homeownership did increase from around 60% in the early 1990s to more than 65% by 2000.70 Home mortgage debt increased too.71 As the real estate price bubble increased home equity, households converted this (unrealized) home equity gain into liquidity by pledging their unrealized equity as collateral in refinancing and equity lines of credit.72 At the same time,

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69 This statement by a political action group that advocates for middle- and working-class families is an example of a moral theory of financial loss:

Corporate scandals have taken money directly out of the pockets of millions of Americans. The Institute for America’s Future has found that individual retirement accounts have lost over $175 billion. American Family Voices has determined that public pension funds across America have lost at least $6.4 billion. And over one million workers have lost their jobs as their looted companies tumbled into bankruptcy. . . . While all this went on, company insiders cashed in. . . .

No wonder that working families are saying that enough is enough: we can do better.

See American Family Voices, Corporate Recklessness Report, http://www.americanfamilyvoices.org/pdf/cost.pdf (on file with Author). The website says that the purpose of American Family Voices is to be “a strong voice for middle and low income families on economic, health care, and consumer issues.” Id.


70 Id.

71 For example, in 2003, homeowners liquidated $312 billion in equity through refinancing and equity lines of credit. See Federal Deposit Insurance Corporation, FDIC Outlook: In Focus This Quarter: The U.S. Consumer Sector, http://www.fdic.gov/bank/analytical/regional/ro20044q/na/2004winter_01.html (scroll to “House-
the subprime mortgage market grew from $35 billion in 1994 to $140 billion in 2001.\(^7\)

The net result of these trends in homeownership, refinancing, and equity draws is that during the last thirty years, U.S. homeowners' equity has actually dropped from 68.3% to 55%.\(^7\) Of course, financing consumption has become more expensive as the cost of living has increased, seen most dramatically in the 350% increase between 1977 and 1998 in health insurance rates.\(^7\) During this same period average household income went up just 17%.\(^7\) Not surprisingly, foreclosure rates on single-family homes have increased nine-fold since the 1950s and threefold since the 1980s.\(^7\) It would seem that economic insecurity is a staple of many U.S. households, despite the nominal bubble in asset prices.\(^7\)

\(^{73}\) Mortgage indebtedness is measured with a loan-to-value ratio that compares the amount of the loan with the value of the property. See generally FRANK FABOZZI & DESSA FABOZZI, THE HANDBOOK OF FIXED INCOME SECURITIES 485 (4th ed. 1995). The higher the ratio—i.e., the greater the amount of the loan to the property being financed—the greater the degree of the borrower's leverage. The median loan-to-value ratio for mortgage indebtedness rose from 15% in 1984 to over 35% in 2001. Li, supra note 70, at 32.


\(^{76}\) Id.


\(^{78}\) Financial innovation may significantly increase the fragility of firms. See Pouncy, supra note 2, at 566. One approach to reducing the economic insecurity imposed on others by this type of firm fragility is to build in limits to financial innovation to reduce the potential social costs of failure. Taking a different tack, my approach sees the regulation of financial risk-taking as a separate field from the human...
Against this background of ambient economic insecurity, the narrative about rogue officers who robbed workers of their life savings is poignant but no less misleading for being so. An explanation of these financial losses in terms of individual misconduct misses the point. After all, it was the same accounting and business practices here repudiated that had created much of the wealth and many of the jobs whose evaporation had triggered the financial moral panic in the first place. In fact, Enron, in particular, had become a poster firm for "best practices" in financial engineering, associated with the production of financial wealth. This poignant narrative about inves-

services regulation needed to provide a safety net for investors when firms come apart. The recommendations made in this Article do nothing to reduce the structural condition of economic insecurity. Rather, these recommendations suggest that financial reports ought to more fully express the natural volatility involved in capital investment instead of airbrushing risk out of financial reports. Sobering annual reports may better pierce investment euphoria than those currently allowed under financial reporting. Identifying the regulatory provisions—i.e., Social Security, education, unemployment insurance, housing benefits—to insulate vulnerable persons from the social costs of financial innovation is beyond the scope of this Article. However, for these recommendations to contribute more to vulnerable constituencies, provisioning for the social costs is essential.

No doubt, it produces cognitive dissonance to admit that one may owe her employment security to questionable accounting practices: Earnings management distorts the allocation of resources in the economy, especially in periods of high financial valuations. When hiring and investment decisions are observable [in the market], bad managers hire and invest too much in order to mimic good managers. When they are caught and forced to restate, their firms shrink quickly.

Simi Kedia & Thomas Philippon, The Economics of Fraudulent Accounting 25 (Nat'l Bureau of Econ. Research, Working Paper No. 11573, 2005), available at http://pages.stern.nyu.edu/~tphilipp/papers/sktp.pdf. See also Daniel Gross, The Crime: Slow Job Growth. A Suspect: Enron, N.Y. TIMES, Sept. 11, 2005, § 3, at 3 (suggesting that aggressive earnings management explained much of the job growth in recent years). In a similar vein, when students in my class complain about receiving a grade they feel is lower than deserved I am tempted to ask whether they also complain when receiving an examination grade they feel is higher than they deserve. So far I have resisted the temptation.

One commentator who put the Enron question into a market structure perspective noted that:

This story is not, however, simply about moral hazard, or a few bad agents, but rather about the general evolution of the practices used to define the rights to income derived from the productive assets of corporations . . . . As a leading innovator in its field, pressing into the gray areas of corporate practice to more aggressively engineer its financial structures, Enron provides a convenient case of best practice in modern industrial evolution. In light of its bankruptcy this may seem unusual, but it should be remembered that the practices which led to its collapse had previously been praised as visionary.

tor and worker losses also reflects a common misconception about the nature of unrealized appreciation in financial assets. Again, most of what Enron employees lost was unrealized value, which, for example, the federal income tax laws do not tax as income. Evoking tulip bulbs, Enron reminded us of the ephemeral nature of unrealized gain, striking a chord since such gain makes up much of our wealth. Would a retirement based on unrealized appreciation in corporate equities be rosy? Maybe not, given the nature of market risk. John Kenneth Galbraith argues that during a price bubble, a collective psychology built on denial of financial realities sets in with investors. The psychology leads to financial speculation and concomitant disaster. Financial moral panic is a defense mechanism of this mindset. More specifically, my point is that panics of this type deny the unavoidable underlying volatility of financial assets, of which capital market investment is simply the most popular example. Moreover, although framed in terms of class injury to Enron workers who lost unrealized value, the class discourse around the corporate scandals silenced other more fundamental phrasings of the economic insecurity in question. Queen for a day or investor for life—how salient is the difference for many?

81 The inability or unwillingness to distinguish between the loss of unrealized value and cash losses occurred throughout the hearings. See, e.g., HEARINGS, supra note 55, at 3–4 (statement of Sen. Richard C. Shelby) (“Unfortunately, Enron is only the tip of the iceberg. Some experts have estimated that investors lost over $200 billion over the last 6 years due to earnings restatements and to lost market capitalization following audit failures.”); Id. at 7 (statement of Sen. Debbie Stabenow) (“In fact, in Michigan, the Genesee County Employees Pension Fund lost $370,000 on Enron’s fall, and I know that there were hundreds of thousands of dollars that were lost in other pension funds, not to mention the employees who lost their life savings.”).

82 In the 17th century, Holland was seized with a speculative investment fever over tulips, leading to a major financial crisis there. See CHARLES KINDLEBERGER, MANIAS, PANICS, AND CRASHES: A HISTORY OF FINANCIAL CRISIS 109–11 (2000). The tulip has become the official flower of financial historians.

83 See JOHN KENNETH GALBRAITH, A SHORT HISTORY OF FINANCIAL EUPHORIA 1–17 (1993) (arguing that collective psychological mechanisms contribute to financial crises by, inter alia, discouraging criticism of financial speculation).

84 This psychology is the collective behavioral expression of the financial instability some scholars cite as a cause of financial innovation. See Pouncy, supra note 2, at 566–67 (analyzing Minsky’s financial instability thesis that cyclical fragility in the finance sector leads to financial innovation). Bounded rationality en masse like this should give us pause when wondering about privatizing Social Security.

85 Airbrushed financial statements help to lull investors into this mindset.

86 E.M. Forster evokes this silenced constituency when introducing Leonard Bast, the protagonist in Howard’s End, a class novel set in Edwardian England:

We are not concerned with the very poor. They are unthinkable and only to be approached by the statistician or the poet. This story
When deviants are singled out to bear the blame for structural problems this way, it is the Left which turns to moral panic analysis to contest the moral framing of the problem. While used by the sex Left, the penological Left, and the racial Left to address conventional deviancy, moral panic analysis has not been deployed by legal scholars to parse finance law. This is another expression of the tendency in contemporary legal scholarship to match particular critical meth-

deals with gentlefolk, or with those who are obliged to pretend that they are gentlefolk.

The boy, Leonard Bast, stood at the extreme verge of gentility. He was not in the abyss, but he could see it, and at times people whom he knew had dropped in, and counted no more. He knew that he was poor, and would admit it; he would have died sooner than confess any inferiority to the rich. This may be splendid of him. But he was inferior to most rich people, there is not the least doubt of it. He was not as courteous as the average rich man, nor as intelligent, nor as healthy, nor as lovable. His mind and his body had been alike underfed, because he was poor, and because he was modern they were always craving better food. Had he lived some centuries ago, in the brightly coloured civilizations of the past, he would have had a definite status, his rank and his income would have corresponded. But in his day the angel of Democracy had arisen, enshadowing the classes with leathern wings, and proclaiming, 'All men are equal—all men, that is to say, who possess umbrellas,' and so he was obliged to assert gentility, lest he slipped [sic] into the abyss where nothing counts, and the statements of Democracy are inaudible.


Queen for a Day was a popular 1950s "sob show" in which working-class women competed for having the most economically miserable life, as determined by an audience applause meter. The winning Cinderella would receive prizes and weep while being crowned and robed. As its producer noted, "Sure 'Queen' was vulgar and sleazy and filled with bathos and bad taste . . . . That was why it was so successful. It was exactly what the general public wanted . . . . And the TV audience cried their eyes out, morbidly delighted to find there were people worse off than they were, and so they got what they were after." MAXENE FABE, TV GAME SHOWS 120–30 (1979) (quoted in Shawn Hanley, Queen for a Day (Dec. 16, 1996) (unpublished manuscript, available at http://history.sandiego.edu/gen/projects/hanley/queen.html) (internal quotation marks omitted).

See COHEN, supra note 34, at xxxi:

It is obviously true that the uses of the concept to expose disproportionality and exaggeration have come from a left liberal consensus. This empirical project is concentrated on (if not reserved for) cases where the moral outrage appears driven by conservative or reactionary forces. For cultural liberals (today's 'cosmopolitans'), this was an opportunity to condemn moral entrepreneurs, to sneer at their small-mindedness, puritanism or intolerance; for political radicals, these were easy targets, the soft side of hegemony or elite interests.

Id.

See supra notes 38–44 (see cited legal scholarship applying moral panic analysis to the social control of conventional folk devils).
ods with substantive political projects, thereby freezing the movement of a critical style across ideological camps. Moral panic analysis has, however, no natural affinity with either the Left or the Right, given that mobs can form anywhere along the political spectrum. So, moral panic analysis may critique statutes which favor interests anywhere along the majoritarian spectrum. As in any panic, a financial moral panic is another opportunity to consider the social construction of deviancy, although the folk devils in question may not belong to the usual suspects. To the extent that it challenges popular legislation,

90 See Edward L. Rubin, The New Legal Process, the Synthesis of Discourse, and the Microanalysis of Institutions, 109 Harv. L. Rev. 1393, 1398-1403 (1996) (noting the historic divide between critical approaches such as law and economics and outsider jurisprudence). Rubin notes that there is no intrinsic antagonism between—in this case—law and economics and alterity jurisprudence:

An obvious explanation is the divergent political predilections that gave rise to each movement, but the correspondence between their political positions and their methodologies is not logically required. That is, economic analysis is not necessarily the exclusive instrument of the political right, nor deconstruction the instrument of the left; political debate could have been carried out within either methodological framework.

Id. at 1401-02. He looks to scholarship (as do I) as a place where academics can integrate methodologies without the bondage of history:

In fact, it is remarkable how disconnected the two movements are, given that they have developed in the same academic institutions, published in the same scholarly journals, and shared a common concern with law and legal institutions.

... Because any synthesis of these movements is likely to occur at the level of scholarly discourse, and not at the level of substantive political positions, real possibilities for synthesis emerge primarily in this methodological realm.

Id. at 1412. I tried doing so in Sending the Right Signals: Using Rent-Seeking Theory to Analyze the Cuban Central Bank, 27 Hous. J. Int’l L. 483, 484-525 (2005) (“Identifying the governance structure of rent-seeking deals between central banks and their constituencies shows how private creditor interests impact the workings of financial regulations. To that end, using opportunism to model institutional and individual action makes [critical] theory more relevant, especially that of liberals, progressives, and deconstructionists on the left (island [Cuba], diaspora, and elsewhere.”).

91 Pointing out the social construction of financial elites as deviants does not suggest that all folk devils suffer equally. We know that they do not. The sociology of law makes clear that governmental social control is regressive, falling most heavily on the most socially and economically marginalized. See Donald Black, The Behavior of Law 16-30 (1976) (expressing law as a series of postulates that describe the incidence of social control). Nor do I suggest that the financiers convicted during this round-up had not broken some law. Given the pattern of prosecutorial retreat into obstruction of justice charges when the evidentiary burdens of substantive offenses were too high, the legal violations, however, may not have been of financial law. Even financial witch hunts, though, must conform to procedural requirements. See Arthur Andersen LLP v. United States, 125 S. Ct. 2129 (2005) (unanimously reversing prosecution on obstruction of justice charge due to defective jury instructions).
effective moral panic analysis is coherently (and persuasively, I think) anti-democratic.

But where was the economic Left to object to the ideological framing of the corporate scandals? Students of constitutional law should be aware of the historic role of federal courts in silencing proponents of Left-based radical approaches to economic insecurity.92 The ongoing effect of this silencing is that the United States—unlike many other industrialized economies—lacks a robust economic Left from which to frame economic questions in more explicitly structural terms, an ironic market failure in the marketplace of ideas.93 Also, the otherwise left-leaning moral panic analysts may object less when it is financiers who fall prey to social stigma.94

In the absence of any meaningful opposition to the blame narrative, Congress acted accordingly. Since the evil calling for Congress’s attention was framed as mischief by officials and auditors, the Act ended up with a punitive rather than technical focus. The traditional focus of federal securities law is disclosure.95 However, only three of

92 Indeed, the American judicial campaign against the economic left has been singularly effective. See, e.g., Whitney v. California, 274 U.S. 357 (1927) (conviction for political organizing on behalf of the Communist Party); Abrams v. United States, 250 U.S. 616 (1919) (upholding conviction of anarchists); Debs v. United States, 249 U.S. 211 (1919) (convicting Eugene Debs for anti-war speech made after a strong 1916 run for President).

93 Today one can speak of the economic Left in the United States only apocryphally because, in terms of institutionalized economic views, our system has only a party of the center, a party of the right, and elements of the far right. To invoke “the left,” therefore, without explicit qualification is to move the political spectrum rightward. See Matt Bai, The Framing Wars, N.Y. TIMES MAG., July 17, 2005, at 38 (profiling Professor George Lakoff, who studies how framing of political issues affects the efficacy of political advocacy). For a prominent counterexample that attempts to institutionalize a Left perspective in the legal academy, see generally LEFT LEGALISM/LEFT CRITIQUE (Wendy Brown & Janet Halley eds., 2002).

94 Brown and Halley note that a willingness to consider radical uncertainty is an essential part of critique. Applying financial moral analysis to discourses purporting to address distributional problems is part of a richer critique of economic life:

    For part of what it means to dissect the discursive practices that organize our lives is to embark on an inquiry whose outcome is unknown, and the process of which will be radically disorienting at times. . . . Indeed, one of our worries about legalism pertains to its impulse to call the question too peremptorily. . . . It was through the process of subjecting political and philosophical idealism to critique that Marx found his way to dialectical materialism and political economy, but a careful reading of this early work makes clear that Marx did not know in advance where his critiques would take him . . . .

LEFT LEGALISM/LEFT CRITIQUE, supra note 93, at 27.

95 See THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 740 (4th ed. 2002) (stating that “federal securities law’s exclusive focus is on full disclosure”).
Sarbanes-Oxley’s sixty-six substantive provisions address disclosure. Instead, criminalizing corporate and managerial activity is the overriding purpose of the Act; three titles are dedicated to fraud and criminal penalties. Targeting folk devils, the Act increased the liability of the chief financial officer (CFO) by requiring the CFO to attest to the accuracy of periodic reports under pain of criminal prosecution. Moreover, by setting up the Public Company Accounting Oversight Board, the Act puts auditors squarely in the sights of the SEC, now empowered to increase its criminal and disciplinary ac-

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96 In addition to the rule discussed here, Sarbanes-Oxley amended the previous requirement that certain individuals with controlling interests in a registrant disclose change in control transactions involving the firm. See 15 U.S.C. § 78(p) (2000 & Supp. II 2002). Also, the law charged the SEC with rulemaking to ensure that registrants disclose whether audit committees include anyone who is a financial expert. See id. § 7265 (Supp. II 2002). The law does provide for additional review of registrant disclosures by SEC staff, but the section does not impose a new disclosure requirement. See id. § 7266 (Supp. II 2002).


98 For example, the Act requires the CFO to attest to the accuracy of the firm’s financial reports. 15 U.S.C. § 7241 (a) (2)-(3) (Supp. II 2002). It requires that:

(2) based on the officer’s knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading; . . .

(3) based on such officer’s knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report . . .

Id. Failure to comply with the attestation requirement exposes a chief financial officer to imprisonment for up to 20 years and fines of up to $5 million. 18 U.S.C. § 1350 (Supp. II 2002). The new requirements extend the chief financial officer's previous duty to ensure the accuracy of financial reports. See Joseph F. Morrissey, Catching the Culprits: Is Sarbanes-Oxley Enough?, 2003 COLUM. BUS. L. REV. 801, 841-44 (pointing out that chief financial officers and chief executive officers already had to attest to the accuracy of financial reports under securities law requirements that predated Sarbanes-Oxley); Marie Leone, Command and Controllers: Sarbanes-Oxley May Bring New Risks to the CFO’s Office, But It’s Raising the Profile of the Once-Faceless Company Controller, CFO.COM, July 14, 2003, http://www.cfo.com/article.cfm/3009814/c_3036076?origin=archive (considering alternative reporting structures in the firm to comply with the CFO’s new statutory liabilities).
tion over a profession that had previously been largely self-regulated. Again, this emphasis on individual criminality reflects the influence of moral panic in the legislative process. Consistent with the national mood, financiers convicted in related prosecutions have received heavy sentences, in particular the contumaciously intransigent ones who refused to plea bargain. Other prosecutions and civil actions brought against corporate officials have also tried to expand the concept of financial loss beyond the previous legal definition. Constructing the problem in question in terms of corporate


rogues has also dovetailed with the SEC's self-concept as an enforcement agency, rather than as a knowledge center about capital market structure.\textsuperscript{102}

Granted, public floggings do deter misconduct, but they are not likely to solve the technical problems about financial reporting.\textsuperscript{103} These problems continue.\textsuperscript{104} Part IV offers technical recommendations for these problems which would contribute to financial transparency for lay investors.\textsuperscript{105} But, first, I must address some of the

Securities law does recognize a civil action for unrealized loss, but only if the disclosure of the misrepresentation caused the loss. 15 U.S.C. § 77l(b) (2000 & Supp. II 2002) (allowing an action for loss measured as "the depreciation in value of the . . . security" resulting from a misrepresentation).

\textsuperscript{102} Consider the emphasis on enforcement from the SEC's website discussion on institutional mission: "Crucial to the SEC's effectiveness . . . is its enforcement authority. Each year the SEC brings hundreds of civil enforcement actions against individuals and companies for violations of the securities laws." U.S. Securities and Exchange Commission, How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, http://www.sec.gov/about/whatwedo.shtml (last visited March 2, 2006). Later I urge the SEC to reconsider its self-concept more in terms of regulatory intelligence about capital market structure. See infra notes 262–80 and accompanying text, suggesting the formation of a capital structure surveillance unit at the SEC to supplement and inform enlightened enforcement of the securities laws.

\textsuperscript{103} The Public Company Accounting Oversight Board is supposed to fix the system and force accountants to be policeman in their audits. Does anyone seriously believe that this board will be able to monitor the auditing of thousands of public companies to assure that accountants are acting as policemen, rather than accountants? Of course it cannot, but investors are still being deceived into believing that it will. The Enron debacle and the telecom and dotcom implosions, as well as continuing scandals, by now should have removed any doubts as to the hollowness of the assurance that full disclosure protects investors. That was an impossible dream, and Sarbanes-Oxley only adds more smoke to this vision.

Markham, supra note 9, at 799.

\textsuperscript{104} See William H. Beaver, What Have We Learned from the Recent Corporate Scandals That We Did Not Already Know?, 8 STAN. J.L. BUS. & FIN. 155, 163 (2002) (analyzing corporate scandals in the context of capital markets research on financial reporting discretion). Professor Beaver notes how the emotional climate of the corporate scandal has impeded a more technical approach to the issues:

At this stage, there has been a great deal of rhetoric and outrage but relatively little analysis. There has been pressure for rapid responses in the absence of fully understanding the causes of the problems and how they are linked to structural defects in the financial reporting-corporate governance environment. Without these links, it is possible that, in spite of an increase in legislation and regulation, the same problems will reappear.

\textit{Id.} at 168. See also Partnoy, supra note 18, at 1264 for a concurrence.

\textsuperscript{105} See infra notes 245–80 and accompanying text.
technical dynamics behind the hazy moral construction outlined in the previous Part.

II. FROM MORALIZING TO FINANCIAL TRUTH: CORRECTING THE MYOPIA OF THE BALANCE SHEET

Many of the losses which triggered the financial moral panic involved the failure to disclose significant OBS liabilities and the related failure to book loan income as such, rather than as operating cash flow. In other words, neither the balance sheets of these firms nor their statements of cash flows adequately reflected the firms' true capital structure. Understanding why this gap developed requires appreciating the appeal of OBS arrangements to managers, who gravitate to the OBS sector for both fiduciary and self-serving reasons. Using examples of the cash flow games played by Enron and Dynegy, below I explain why a disclosure standard based on effective capital structure would result in more transparency about a firm's risk.

A. The Discrete Charm of Off-Balance-Sheet Arrangements

The balance sheet is supposed to be a point-in-time snapshot of a firm's net worth and capital structure, i.e., the mixture of the debt and equity instruments that finance the firm. Net worth is calculated by netting the reporting firm's claims to value against the claims of others on the firm. The balance sheet "recognizes" these claims by estimating their total value and aggregating like claims into analytically unified categories of asset claims, liability claims, and equity claims. Shown on the left side of the balance sheet, "Assets" are the firm's claims on others. These claims are listed by declining liquidity. Shown at the top of the right side of the balance sheet, "Liabili-
ties" are third parties' credit claims on the firm. They are listed by maturity and relative priority. The difference between "Assets" and "Liabilities" is called "Shareholder's Equity" and appears under the "Liabilities" section in the right-hand column. The owners' account, shareholder's equity is the residue that would be left for the firm's owners in a hypothetical liquidation after satisfaction of creditors' claims. By convention, the "Assets" equals the sum of the "Liabilities" and "Equity" accounts. The firm's balance sheet also includes the assets and liabilities of any other entity controlled by the firm. Most registrants use the annual 10K form filed with the SEC as their balance sheet.

Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. Liability entries should also tell a reader something about a firm's funding style. Does the firm issue long- or short-term debt? Will its payment obligations mature over time or all at once? The answers to these questions help a reader appreciate the funding philosophy of the firm.

"Equity... is the residual interest in the assets of an entity that remains after deducting its liabilities." Id. The real value of asset and liability claims is unclear because neither is marked-to-market to reflect liquidation value. Most firms value assets at historic cost rather than replacement cost. Firms book liabilities at par, i.e., nominal, value rather than reflecting what creditors would accept to settle the claim (which would be a mark-to-market approach to liabilities). So the value of Shareholders' Equity is intrinsically variable.

In truth, though, the varieties of accounting methods used by the balance sheet make it hard to estimate a firm's actual liquidation value without more detail about assets and liabilities.

The accounting and reporting model under Generally Accepted Accounting Principles is actually a mixed-attribute model. Although most transactions and balances are measured on the basis of historical cost, which is the amount of cash or its equivalent originally paid to acquire an asset, certain assets and liabilities are reported at current values either in the financial statements or related notes. For example, certain investments in debt and equity securities are currently reported at fair value, receivables are reported at net realizable value, and inventories are reported at the lower of cost or market value.


This is called the fundamental accounting equation. PAUL D. KIMMEL ET AL., FINANCIAL ACCOUNTING 12 (1998).

Part of the OBS sector had started with an early accounting pronouncement that clarified when a firm had to consolidate legally separate entities on its balance sheet. AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, ACCOUNTING RESEARCH BULLETIN
The numbers on the balance sheet matter dearly. If they hint at illiquidity or capital shortfalls, the firm may have to pay more for credit, face the white-hot glare of regulators, or trigger adverse contractual rights of demanding counterparties. For example, some credit covenants let a creditor sue if the borrowing firm’s (balance sheet) debt to equity ratio drops below a contractually-set point. To mitigate these business risks, the careful manager optimizes the presentation of information on the balance sheet. For example, firms may reclassify debt from short-term to long-term in order to improve their liquidity ratios. Shifting numerical values only in the assets column (left-hand side), only in the liabilities column (right-hand side), or only between the liability and the equity accounts (both on the right-hand side) does not change the overall size of the balance sheet. To modify the size of the visible balance sheet, managers must move off the balance sheet, using reporting discretion which is customary in accrual accounting. For example, the classification of operating leases is subject to significant discretion. The generalized

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NO. 51: CONSOLIDATED FINANCIAL STATEMENTS (1959) (requiring consolidation of a legally separate entity when the reporting firm had a controlling financial interest, including majority voting interest). Consolidation eliminates the risk of surprise from an OBS item because the reporting firm absorbs the OBS entity for reporting purposes. The issues presented in this discussion arise with respect to unconsolidated entities.


116 See Jeffrey Gramlich et al., Balance Sheet Management: The Case of Short-Term Obligations Reclassified as Long-Term Debt, 39 J. ACCT. RES. 283 (2001) (documenting significant debt reclassifications of 220 firms to smooth out balance sheet liquidity and leverage measures).

117 None of these moves disturbs the basic stability of the fundamental accounting equation that “Assets” equals the sum of “Liabilities” plus “Equity.”

118 A prominent accounting theorist notes: The term used in the research literature is earnings management, rather than some pejorative phrase, such as earnings manipulation. . . . Discretion in financial reporting can be used to signal or convey additional information management has that is not publicly available. Hence, it may be benign rather than sinister . . . earnings management does not necessarily imply a violation of Generally Accepted Accounting Principles (GAAP). There is a range of discretion within the boundaries of judgment that is permitted, in fact required, under GAAP-based accrual accounting. See BEAVER, supra note 5, at 163.

119 Booked off-the-balance sheet, the lease shows up in neither the asset or liability column. But recognizing the item on the balance sheet increases book assets by the value of the item and book liabilities by debt in respect of the lease. Constructive capitalization better reflects a firm's effective capital structure. See Eugene A. Imhoff et al., Operating Leases: Impact of Constructive Capitalization, ACCOUNTING HORIZONS,
practice of funding with OBS items leads finance practitioners to distinguish between a firm's "book leverage" and its "financial leverage." Some arrangements are hard to classify as on- or off-balance-sheet.

Managers may seek shelter from balance sheet disclosure both for fiduciary and opportunistic reasons. Conducting a transaction

Mar. 1991, at 51 (showing effects on net income and balance sheet of constructively capitalizing unrecorded operating leases). The Securities and Exchange Commission estimates that U.S. corporate issuers may owe as much as $1.25 trillion in non-cancelable OBS operating leases. See SEC REPORT, supra note 17, at 4.

A fundamental aspect of capital structure, leverage is the ratio of debt financing to equity financing; in other words the extent to which owners use creditors' resources to increase the firm's operating base and the owners' residual upside gain. Financial accounting calculates "book" leverage with generally accepted accounting principles. A more economic observer measures the firm's effective leverage (also called financial leverage) on the basis of actual financial power. Obviously, book and financial leverage diverge. Finance classes teach students about financial leverage. See RAY H. GARRISON ET AL., MANAGERIAL ACCOUNTING 796-97 (11th ed. 2006).

The treatment of leases is a good example of how items with potential OBS implications were treated. The problem with a lease is that it may be a true lease or, instead, a disguised property interest that belongs on the balance sheet. Between 1939 and 1959, the main source of accounting rules was the AICPA's Committee on Accounting Procedure, which produced Accounting Research Bulletins (ARB). The AICPA first addressed lease accounting in 1949. See AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, ACCOUNTING RESEARCH BULLETIN NO. 38 (1949) [hereinafter ARB No. 38] (superseded by AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, ACCOUNTING RESEARCH BULLETIN NO. 43: RESTATEMENT AND REVISION OF ACCOUNTING RESEARCH BULLETINS (1953)). ARB No. 38 laid down only a loosely defined standard about the problem. Later lease accounting pronouncements refined these principles to increase the accuracy of financial reporting with respect to leases. Identifying when a lease had to be reflected on the balance sheet, i.e., capitalized, or could be located off the balance sheet remained a contentious issue for the next forty years. See FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 13: ACCOUNTING FOR LEASES (1976) (clarifying when leases must be capitalized on the balance sheet); FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 23: INCEPTIONS OF THE LEASE (1978) (noting when capitalization must be done at the beginning of a lease); FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 91: ACCOUNTING FOR NONREFUNDABLE FEES AND COSTS ASSOCIATED WITH ORIGINATING OR ACQUIRING LOANS AND INITIAL DIRECT COSTS OF LEASES (1986) (identifying which costs need not be reflected on the balance sheet); and FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 98: ACCOUNTING FOR LEASES (1988). The issue is still not definitively resolved.

It is no accident that these items are invisible. Consider this comment on the OBS items targeted by the new disclosure rule:

The [OBS entities] that this interpretation covers are currently invisible, by design. There is no simple or reliable way for analysts or investors to judge which companies are most likely to be affected. Clues might be found in the management's discussion and analysis, but not enough to enable financial statement users to reliably estimate how the interpretation will affect companies' financial statements. This new interpretation might cause very few changes in corporate balance sheets,
off the balance sheet gives managers more flexibility by reducing the discipline of oversight from creditors or owners who would be able to monitor publicly-reported financial details. Common fiduciary motivations include managing the firm's book leverage, credit rating, or risk profile for the sake of protecting the trading value of the firm's shares. For example, an OBS deal may boost the firm's book income without worsening the firm's book leverage. A firm may deduct the OBS debt interest from some special purpose entities on its federal taxes without having to report the underlying liability on its balance sheet. Firms also use OBS partnerships to optimize the tax value of their research and development expenditures. Segregating a business project off-balance-sheet insulates the firm from the risk of because companies that would have to consolidate their SPEs under the requirements of this interpretation might already be taking steps to shut down or sell their interests prior to the effective date. This scenario would avoid the embarrassment for the sponsors of presenting what they never professed to own. The other alternative is that Interpretation 46(R) might cause significant adverse adjustments to companies' balance sheets and create technical defaults in loan covenants. Jalal Soroosh & Jack T. Ciesielski, Accounting for Special Purpose Entities Revised: FASB Interpretation 46(R), CPA J., July 2004, at 30, 37, available at http://www.nysscpa.org/cpajournal/2004/704/essentials/p30.htm. In this sense, using OBS activities increases the value of a manager's "switching options" to reallocate resources between investment. Cf. George Triantis, Financial Slack Policy and the Laws of Secured Transactions, 29 J. LEGAL STUD. 35, 39, (2005) ("As a general proposition, managers are much more prone to take actions that increase their welfare (for example, perquisite consumption or empire building) or the welfare of their shareholders (for example, share repurchases or high-risk investments) if they have cash at their disposal."). The disclosure recommendations made in Part IV may reduce the value of these options by providing more detail about cash flow to external constituencies of the firm. See Part IV.A. See generally William Beaver, Perspectives on Recent Capital Market Research, 77 ACC. REV. 453, 466-68 (2002) (concluding that it is difficult to isolate the primary motive for discretionary behavior by managers over reporting earnings because managers have multiple motives for such conduct). Cf. Anthony J. Luppino, Stopping the Enron End-Runs and Other Trick Plays: The Book-Tax Accounting Conformity Defense, 2003 COLUM. BUS. L. REV. 35 (arguing that accounting practices should be conformed to tax standards to avoid characterizing transactions differently for tax and financial accounting purposes). See generally Fred D. Campobasso, Off-Balance-Sheet Financing Can Generate Capital for Strategic Development, HEALTHCARE FIN. MGMT., June 2000, available at http://www.findarticles.com/p/articles/mi_m3257/is_6_54/ai_62929196 (noting return and liquidity advantages to using synthetic leases, sale-and-leaseback, and joint venture arrangements to finance real estate operations). See David Mangelfrida & E. Ray Beeman, Recent IRS Securitization Ruling Signals Analytical Shift in Distinguishing Between Sales and Financings, INVESTMENT LAW., Oct. 1998, at 5 (explaining ability to characterize the lease as sale or financing). See generally Douglas Shackelford & Terry Shevlin, Empirical Tax Research in Accounting, 31 J. ACC. & ECON. 321 (2001); Terry Shevlin, Taxes and Off-Balance-Sheet Financing: Research and Development Limited Partnerships, 62 ACC. REV. 480 (1987).
loss from the investment. Stealth funding through OBS arrangements may avoid covenants limiting investment in new business opportunities in bank loan documents, bondholder indenture agreements, or a firm's certificate of incorporation. Such deals may, however, violate explicit contractual duties of good faith and fair dealing.

Apart from fiduciary brinksmanship for the sake of shareholders, managers may also use an OBS arrangement for their own opportunistic ends, which may be antithetical to the interests of their principals, i.e., shareholders. When executive compensation is pegged to balance sheet ratios such as return on assets, return on equity, and debt-to-equity, a manager would likely prefer, all else being equal, an OBS deal which increases his compensation by improving one of these ratios.

Undisclosed OBS arrangements bear on conflicts between a firm's competing claimants, including the stockholder-bondholder conflict over the firm's exposure to financial risk. OBS cash flow

128 \textit{Cf. In re Explorer Pipeline Co.}, 781 A.2d 705 (Del. Ch. 2001) (holding that corporation's decision to enter into an OBS operating lease was not subject to a super-majority provision found in the corporation's certificate of incorporation); \textit{see also} Samir El-Gazzar et al., \textit{The Use of Off-Balance Sheet Financing to Circumvent Financial Covenant Restrictions}, 4 J. ACC. AUDITING FIN. 217 (1989) (analyzing forty-three addenda to leases which contained debt covenants to examine how firms use OBS arrangements to modify covenant-based restrictions).

For example, a court has been unwilling to expand the concept of good faith with respect to balance sheet debt. See Metro. Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1507-08 (S.D.N.Y. 1989) (rejecting plaintiff's request to imply a covenant of good faith and fair dealing into a bond indenture which did not impose debt limits on the defendant-issuer). The use of OBS debt, however, may warrant wider consideration for a creditor, although careful bond counsel would draft covenants taking into account the existence of OBS items.

150 Bondholders enjoy legal priority over stockholders to only a liquidated amount, i.e., the principal and interest on the bonds in question. See \textit{Malitz}, supra note 115, at 3–4 (explaining the conflict of interest between creditors and owners of a corporation). Stockholders recover only after satisfaction of these liquidated claims, but they keep whatever is left over, i.e., the residual upside. These adverse rights lead to a class conflict in the corporation over risk and investment: stockholders may prefer a low probability, high investment return because they collect the residue; contra, bondholders may prefer a high probability, low investment return because they get paid first and gain nothing from risk in excess of what is required for a return of their capital. When OBS liabilities increase the residual upside, these liabilities let the firm leverage the bondholders' money free of the contractual protections for which the bondholders bargained. This is the private firm version of the financing moral hazard in banks. See \textit{infra} note 185. Conversely, OBS assets may inure to the benefit of the bondholder to the extent that the OBS asset may be used to fund the bondholder's fixed claim on firm assets.
may also increase existing agency costs for shareholders.\textsuperscript{151} Management accounting will carefully monitor these arrangements to the extent that they are material to the decisions faced by a firm's managers.\textsuperscript{152} Some firm outsiders such as institutional creditors may also bargain for this type of information.\textsuperscript{153} Financial databases, an important public source of firm-level information, however, usually lack much information about OBS items.\textsuperscript{154}

To illustrate the motivations that lead corporate officials to use OBS arrangements, the next section discusses cash flow games used by two companies implicated in the accounting controversies that led to the Act, Enron and Dynegy.

\textbf{B. Cash Flow Games}

The purpose of this particular Enron strategy was for Enron to receive liquidity from a bank without increasing the firm's financial

\textsuperscript{151} Cash flow from an OBS item intensifies the agency problem over free cash flow because it is harder for corporate stakeholders to monitor activities sourced off-the-balance sheet. The new OBS disclosure rule could reduce the agency costs for the shareholder if the disclosure helps to monitor the agent's opportunism by revealing the nature of the free cash flow more accurately. Cf. George G. Triantis, \textit{Organizations as Internal Capital Markets: The Legal Boundaries of Firms, Collateral, and Trusts in Commercial and Charitable Enterprises}, 117 \textit{Harv. L. Rev.} 1102 (2004) (modeling a firm as an internal capital pool in which legal restrictions on liquidity restrict managerial discretion, including the freedom to consume perquisites). So, apart from the opportunity cost of liquidity, i.e., foregone investment return, restraining managers' opportunism is a governance reason why shareholders might prefer to limit a firm's liquidity. For an empirical analysis of how free cash flow impacts managerial decision-making, see John Paul Broussard et al., \textit{CEO Incentives, Cash Flow, and Investment}, \textit{Fin. Mgmt.}, July 1, 2004, at 51 (analyzing different incentives for chief executive officers to encourage them to invest excess cash flow for the benefit of shareholders).

\textsuperscript{152} To the extent that OBS items may impact the firm, its management accounting will track the risk. See \textit{Garrison et al.}, supra note 120, at 9:

\begin{quote}
Financial accounting is mandatory; that is, it must be done. Various outside parties such as the Securities and Exchange Commission (SEC) and the tax authorities require periodic financial statements. Managerial accounting, on the other hand, is not mandatory. A company is completely free to do as much or as little as it wishes. No regulatory bodies or other outside agencies specify what is to be done, or, for that matter, whether anything is to be done at all. Since managerial accounting is completely optional, the important question is always, "Is the information useful?" rather than, "Is the information required?"
\end{quote}

\textit{Id.} If the information is useful to the firm's managers, ought it not be revealed to investors and other market intermediaries?


\textsuperscript{154} See Imhoff et al., \textit{supra} note 119, at 63 (finding that financial databases of Dun and Bradstreet, Value Line, and Compact Disclosure did not reflect the value of legally binding OBS operating lease commitments in firms' financial information).
ratios by having to report a liability on the Enron balance sheet.\(^{135}\) At this time, Enron needed to maintain its credit standing to avoid a negative funding spiral.\(^{136}\) If its credit rating were to drop, some energy trading counterparties would stop dealing with the firm, depriving it of operating cash flow.\(^{137}\) Worse still, if Enron's credit dropped below investment grade, trading counterparties would demand more collateral (taxing liquidity further), the interest cost of some variable rate debt would increase, some payment obligations would become accelerated, and Enron would be locked out of the commercial paper market, hence worsening the firm's illiquidity spiral.\(^{138}\)

Finessing these funding demands with its financial reporting duties, Enron arranged a series of "prepays" which gave the firm more than $8 billion in financing over six years.\(^{139}\) Given their true economic nature as loans, Enron ought to have reported the prepays as bank loans on its balance sheet that generated financing cash flow—

\(^{135}\) Many of Enron's solvency problems dealt with how the firm financed its transformation from an energy company to a derivatives trading platform in which—towards the end—ninety percent of firm revenues came from trading in increasingly esoteric financial derivatives like bandwidth and pollution-emission credits. See Ronald Fink, Beyond Enron: The Fate of Andrew Fastow and Company Casts a Harsh Light on Off-Balance-Sheet Financing, CFO, Feb. 2002, available at http://www.findarticles.com/p/articles/mi_m3870/is_2_l8/ai_83045541.

\(^{136}\) As has been noted: Enron was acutely aware of the importance of its credit ratings. In its 1999 annual report, Enron management stated that the company's "continued investment grade status is critical to the success of its wholesale business as well as its ability to maintain adequate liquidity." . . . An investment grade rating was needed not only to keep down credit costs but also because various trigger provisions for support of [off-balance sheet entities] would be activated in the event of a ratings downgrade.

See MARKHAM, supra note 57, at 100.


\(^{138}\) Id. at A-5.

rather than operational cash flow—on the statement of cash flows.\textsuperscript{140} Had Enron reported the prepays this way, credit ratios which determined the firm’s ongoing credit access would have deteriorated. Indeed, the debt-to-equity ratio would have risen from about 69\% to about 96\%, and the debt-to-total-capital ratio would have increased from about 40\% to 49\%.\textsuperscript{141}

The mechanics of the transaction are a bit more complicated.\textsuperscript{142} Again, Enron wanted to borrow money without reporting a loan on its balance sheet. So Enron structured the deal as a pair of commodities trades. The would-be lender—in this case, the bank—wanted to make a loan but did not want to speculate in commodities. Ordinarily Enron would reflect a loan from a bank on the firm’s balance sheet as a liability and report the cash inflow on the firm’s statement of cash flows as a financing cash flow. But another of Enron’s preferences about this transaction was to keep the firm’s debt-to-equity ratio as low as possible (lenders will charge more to lend to a firm with a high debt-to-equity ratio). Of course, an accounting question arises as to whether these arrangements are a trade or a loan, which would entail adverse balance sheet consequences.\textsuperscript{143}

In order to avoid classifying the transaction as a loan, Enron inserted a sham counterparty between Enron and the bank.\textsuperscript{144} In this way, Enron converted the loan from the bank into two sales contracts. In the deal, the bank would “buy” a fixed amount of commodities from the sham counterparty. Next, Enron would “sell” that same amount of commodities to the sham counterparty. So far these were two commodity contracts with only incidental credit risk (although the net effect of the deal was that Enron had sold commodities to the bank).

In order to keep the bank from bearing the commodity price risk in the sales, Enron also entered into a swap with the bank.\textsuperscript{145} In the swap, the bank would exchange the market value of the com-

\textsuperscript{140} Id. at 14.
\textsuperscript{141} Id. at 17. See also Accounting Treatment of Prepays, supra note 137, at A-4.
\textsuperscript{143} A loan compensates the lender for credit risk and the commodity value of money. A trade compensates the trader for price risk in the commodity. Settlement does expose a trader to the counterparty’s credit risk incidentally, but it is the (up-side) commodity price risk and not the counterparty credit risk which induces the risk-taking.
\textsuperscript{144} See Role of the Financial Institutions, supra note 139, at 14-15.
\textsuperscript{145} Id.
commodities for the price agreed to in the original sale to the counterparty.\textsuperscript{146} If the price of the commodities had decreased (by the time the bank went to sell the commodities) the swap made the bank whole at the original prices.\textsuperscript{147} If the price of the commodities had increased (by the time that the bank went to sell the commodities) the swap terms required the bank to transfer that upside to Enron, which would give the bank only the original fixed prices.\textsuperscript{148} Using the OBS swap, thus gave the bank the credit risk which it wanted without exposing the bank to commodity price risk.\textsuperscript{149} Why would the bank enter into this deal? The bank wanted and received the loan interest and fees from what was really an effective loan.

Another energy company (and Enron trading counterparty), Dynegy, also used creative accounting to turn financing into operational cash flow, at least as a financial reporting matter. In 2001, securities analysts compared Dynegy’s accrual-based earnings with its operating cash flow and concluded that the operating cash flow did not seem to sustain the share price of Dynegy stock.\textsuperscript{150} The company needed more operating cash flow to support the trading price of its stock.\textsuperscript{151} To reassure (and mislead) its critics, Dynegy generated phantom operational cash flow using OBS arrangements that were later deemed loans as a matter of law.\textsuperscript{152} As with the Enron prepay, the disclosure of loan rather than operating cash flow (i.e., effective capital structure) would have depressed Dynegy’s share price, reduced the firm’s credit access, and triggered a negative funding spiral like the one described above for Enron. As part of the SEC’s order to institute cease-and-desist proceedings, Dynegy agreed to restate its 2001 financial statements to more accurately reflect the firm’s effective capital structure.\textsuperscript{153}

\textsuperscript{146} Id.
\textsuperscript{147} See id.
\textsuperscript{148} See id.
\textsuperscript{149} See id. at 15.
\textsuperscript{152} James Olis, the financier who designed the arrangement, now faces a twenty-four-year sentence. See Nichols, supra note 100.
\textsuperscript{153} See Miltich, supra note 150, at 986.
C. The Materiality of Effective Capital Structure

Given the gap, then, between the foreseeable misleading financial reports prepared by managers and the realities of the cash flow games which these reports seek to address, what should financial reporting law do? Mapping a firm's effective capital structure is the counter-move to the earnings management practices made possible by the accounting discretion. So, financial reporting law should encourage more comprehensive measurement of a firm's effective capital structure. This would mean reflecting more of a firm's volatility in messier financial reports. Like the shadows in Plato's allegory about the cave, public financial reports can only convey a highly selective approximation of a firm's financial reality, but increased reported volatility would be more accurate.

The existing literature on effective capital structure focuses on mapping effective debt, although understanding effective equity belongs to effective structure analysis too. All effective debt analysis involves reconstructing the whole from the part. For example, much like proving the existence of a black hole by observing its gravitational pull on matter, effective debt can be backed out by comparing income tax returns (which claim business interest deductions

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154 A suggestion made during the SEC's administrative rule-making about OBS items epitomizes what effective capital structure is:
The Management Discussion and Analysis should provide a pro forma capital structure showing the full effects of all off balance sheet financing entities. The common stock equity of the company should be recast to show the pro forma level of common equity that exists once the debt related aspects of the special purpose entity are factored in. . . .

. . . The Management Discussion and Analysis should also show the potential effects that imputed debt service from the special purpose entity may have on the covenants in the various financing agreements for the company. . . . [T]he full effects should be shown.


155 Apart from any limitations in the reports themselves, public disclosures are only as complete as their underlying markets: "Given that many of the assets and claims reported on the financial statements are represented by imperfect or incomplete markets, . . . the 'ideal' that financial statements are attempting to represent is not clear conceptually." BEAVER, supra note 5, at 4. For an explanation of Plato’s allegory about bounded rationality, see S. Marc Cohen, The Allegory of the Cave, http://faculty.washington.edu/smcohen/320/cave.htm (last updated July 8, 2002).

156 The federal government's position as a stand-by source of equity capital to bail out insured depositors of failed banks is an example of effective equity.

157 The forensic accounting exercises which Congressional subcommittees engaged in when reconstructing Enron's effective balance sheet are an example of effective debt analysis. See supra note 141 and accompanying text.
from both "book" and effective liabilities) and the balance sheet (which includes only "book" debt). Undisclosed debt exists to the extent that the tax interest deductions suggest debt greater than the book debt. Debt rating agencies approximate effective capital structure when considering the impact of OBS items on a credit rating. Capitalizing OBS leases into the equity account rather than as a liability may better reflect the all-in cost of OBS items. Investors, though, lack the time and resources needed to infer true capital structure.

Comprehensively measuring cash flow is a key aspect of effective capital structure. A firm manages its day-to-day liquidity on the basis of financial cash flow. Though valuable, financial cash flow is hard to square with the balance sheet and the income statement, which use different accounting methods to present financial information.

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159 Id.

160 These OBS factors include: operating leases, pension obligations, debt of joint ventures and unconsolidated subsidiaries, guarantees, receivables that have been factored or sold with recourse, potential legal judgments or settlements of lawsuits, and other contingent liabilities, including environmental cleanup liabilities. STANDARD AND POOR'S, CREDIT POLICY UPDATE: FACTORING OFF-BALANCE SHEET FINANCING INTO THE RATINGS PROCESS 1-2 (April 15, 2002) (on file with author) (reviewing Standard and Poor's rating criteria for off-balance sheet items) (available to registered Standard and Poor's users at http://www.standardandpoors.com). As per the Efficient Capital Markets Hypothesis (ECMH), it is specialized intermediaries that first analyze raw financial data and then internalize it by buying or selling securities in the open market or preparing market intelligence for use by other investors. The market internalizes the information as trading prices begin to internalize the information. Debt rating agencies serve this function for OBS items by treating operating lease expenses as a permanent part of a firm's effective capital structure.

161 See Steve C. Lim, Steven C. Mann & Vassil T. Mihov, Market Evaluation of Off Balance Sheet Financing: You Can Run but You Can't Hide 2 (Dec. 1, 2003), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=474784 (comparing the impact of OBS operating lease financing on a firm's debt cost for 6800 U.S. issuers). The study examined whether credit ratings reflected this aspect of the firms' effective capital structure. Id. The authors compared two valuation approaches to the OBS items: treating the OBS item as a current liability or as permanent part of the company's capital. Id. They concluded that the perpetuity approach resulted in a higher actual cost, which better reflected the true cost of the leases. Id.

162 Cash is fungible. From a cash management perspective, then, it makes no difference whether a cash inflow or outflow arises on or off the balance sheet.

163 The main reporting formats are: the balance sheet, the income statement, the statement of changes in equity, and the statement of cash flows. See generally
Examples like the cash flow games played by Enron illustrate the gap between tracking financial cash flow and reported cash flow. Instead of financial cash flow, the statement of cash flows reflects accounting cash flow, the best publicly available proxy for a firm's financial cash flow. Tracking accounting cash flow has many virtues, as shown by the SEC's wide use of this technique to explain the OBS sector to Congress, the use of cash flow to measure firm profitability, the varied measures can provide only an impressionistic rendering of the dynamically shifting financial values that make up a firm. In this sense, cash flow intrudes into the neat formalisms of forward projection and financial reporting.

Accounting cash flow refers to a public representation of a firm's financial cash flow that conforms to generally accepted accounting principles. Ongoing debates about the advantages of a cash-flow tax rather than an income tax refer to accounting cash flow.

In its statutorily required (15 U.S.C. § 7261) report, the SEC stressed the reporting value of cash flow: "What presents difficulties for investors, as well as the market as a whole, is a lack of information about potential positive and negative cash flows." The Report also used cash flow scenario analysis throughout. See id. at 59 (using cash flow scenario analysis to estimate the value firm's obligations under employee defined-benefit plans); id. at 65 (estimating the value of cash flows from capital leases); id. at 67 (using cash flow scenario analysis to estimate the value of contingent obligations); id. at 89 (using cash flow to measure the impact of purchase and sale obligations of filers).

Some qualify the value of cash flow information over accrual earnings by pointing out that cash flow data is more relevant for firms experiencing rapid growth or de-
use of cash flow analysis by credit agencies,\textsuperscript{167} and the pedagogical value of cash analogies.\textsuperscript{168} Of course, uncertainty limits the ability to project future cash flow.\textsuperscript{169} The statement of cash flows nets cash inflows and cash outflows for a time period between two balance sheets.\textsuperscript{170} The statement does not reflect accrual losses or gains.\textsuperscript{171}

cline, but that accrual earnings say more about a firm during a steady period of the firm's life. See Divesh Shankar Sharma & Errol Iselin, The Decision Usefulness of Reported Cash Flow and Accrual Information in a Behavioral Field Experiment, 33 ACCT. & BUS. RES. (U.K.) 123 (2003) (noting that information about a firm's cash flows may be useful only for a firm facing solvency problems).

\textsuperscript{167} Reflecting the value of cash flow analysis, credit rating agencies note the importance of cash flow in their rating decisions. See Hearings on the Current Role and Functions of Credit Rating Agencies in the Operation of the Securities Markets Before the Securities and Exchange Commission 113 (Nov. 15, 2002) (testimony of Leo C. O'Neill, President, Standard & Poor's), available at http://www.sec.gov/news/extra/credrate/credrate111502.txt ("The information that we get, in most cases, is corporations, projections, call it what you will, their view of their future cash requirements, how their capital spending is going to go, what their cash flow is going to be to support that . . . .").

\textsuperscript{168} Analogizing to cash also helps to explain some income tax concepts. Students seem to find it easier to understand cash consideration than other forms of property. When explaining the tax implications of a transaction with noncash consideration, I encourage students to restate the consideration on both sides as cash and to analyze the issue restated that way. The tax effects of the notional cash exchange will generally mirror the tax effects of the actual noncash transactions. For example, to simplify the analysis in the case, restate as cash the consideration in Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184 (Ct. Cl. 1954), which addresses income recognition and basis for taxable exchanges.

\textsuperscript{169} As Beaver notes:

A common approach to valuation of complex claims under uncertainty is to take a valuation model derived from certainty, such as the discounted cash flow model, and to replace each variable in that formula with the expected value of that variable to reflect the uncertainty . . . . In a multiperiod setting, characterizing the present value or price of a complex claim in terms of discounting expected cash flow [under uncertainty] at expected rates of return is not possible in general.

See BEAVER, supra note 5, at 60–61; id. at 49 (noting the Financial Accounting Standards Board’s preference for accrual earnings over cash flow).


\textsuperscript{171} Accrual accounting records resource inflows and outflows based not on actual cash flows, but instead on the basis of whether a firm’s legally-enforceable rights (or obligations with respect to outflows) have vested. See DYCKMAN ET AL., supra note 108, at 33–34. A firm’s statement of income identifies what the firm’s net profit or loss position was during a specific period, typically one year’s economic activity. The income statement provides a bridge between a firm’s balance sheet at the beginning of the period in question and the balance sheet at the end of the reporting period. A typical income statement reflects various different measures of income, typically accrual income plus other adjustments. Some measures try to reconcile accrual earn-
Rather, it reflects only accounting cash outflows and inflows.\textsuperscript{172} The statement lets a reader compare accrual-based earnings or balance sheet values with accounting cash flow, sourced on- or off-balance-sheet. Any single financial indicator has its limits and this is also true for measures that track cash flow.\textsuperscript{173} Publicly revealing more about financial cash flow would lead to the appearance of volatility for firms.\textsuperscript{174} Part IV recommends changes to make the statement of cash flows with cash flow by adding back to accrual earnings accounting adjustments that do not reflect actual funds outlays. For example, accounting goodwill is a wasting asset for which a firm "accounts" by allocating a portion of the deemed waste in goodwill in each accounting period, i.e., amortization of goodwill. So, since accrual earnings reflect the amortization of goodwill, all else being equal, they will be lower than actual cash earnings for the same period. One approach to reconcile book earnings to cash flow is to add back the amount of amortized goodwill to the accrual amount.

\textsuperscript{172} An accrual loss would occur when the ultimate value of an asset or receivable turns out to be less than its book value. See generally DYCKMAN ET AL., supra note 108, at 40–41. Assume that a firm books an account receivable on the asset side of its balance sheet for $100. If the firm collects only $80 on the account, the deficit gives rise to an accrued loss reflected only on the income statement. The statement of cash flows would reflect an operating inflow of $80. Conversely, if a firm collects $120 in exchange for investment securities booked on the asset side of the balance sheet for $100, the firm books a gain in the income statement of $20. The amount reflected as an investment cash flow is $120.

\textsuperscript{173} Accrual accounting makes possible the economic matching of the expenses and revenues from a project. See BEAVER, supra note 5, at 2 ("Reporting cash receipts and cash disbursements will not properly match, and some form of accrual accounting is called for."). See also Cunningham, supra note 1, at 928 (noting limitations of cash flow reporting).

\textsuperscript{174} Agreeing with this view, an accounting study group considering the future balance sheet urged more cash flow-based analysis and disclosure, despite the resulting appearance of volatility:

The balance sheet of the future will be a more flexible instrument, able to adapt to a wide variety of industries and circumstances...  

... [I]t would permit the display of different kinds of numbers—either in a range, or presented as alternatives. This approach could be used to portray cash transactions for which audit assurance is highest, the historical cost allocations of prior cash transactions, [and] market values from actual arms'-length transactions....

... [W]e recognize that financial reports prepared in this fashion would appear to be considerably more volatile, complex and subjective than the financial reports we are accustomed to scrutinizing today....

... [I]t is the illusion of exactitude that carries with it the false perception that financial reports are relatively stable and easily comparable.... [W]e believe the current emphasis on reducing volatility, complexity, and subjectivity and on seeking a greater degree of comparability needs tempering. The world, the economy, and the business environment are in a constant state of flux and any financial reporting system that tries to distill all the data contained in increasingly complex financial statements into one verifiable, static number such as GAAP EPS [earnings per share] flies in the face of reality.
flows more useful as a public financial report by reflecting volatility, which is currently airbrushed out of the statement.

The statement of cash flows was the last major financial report to become widely used by firms. Ever reactive on accounting matters, the SEC began to mandate the disclosure of cash flow information by firms for the first time after an agency study recommended the mandatory disclosure of accounting cash flow. During this same period

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175 At the time of the New Deal, firms did not use the statement of cash flows widely, although accounting teachers had thought of a statement of the sources and uses of funds, and some firms were already voluntarily disclosing liquidity information. See Karl Käfer & V.K. Zimmerman, Notes on the Evolution of the Statement of Sources and Applications of Funds, 1 INT'L. J. ACCT. EDUC. & RES. 89-121 (1965) (tracing statement from emergence in the early 1900s through the early 1960s in UK and USA; the book contains an anthology of essays tracing the development of public financial reporting). Large railroad concerns were the first to include these statements in their financial statements. Id. A turn-of-the-century financial columnist, Thomas Warner Mitchell, was probably the first to publish systematic analyses of the sources and uses of funds by companies in the United States. See CORPORATE FINANCIAL REPORTING AND ANALYSIS IN THE EARLY 1900S 191-215 (Richard P. Brelf ed., 1986) (analyzing liquidity changes by the International Paper Company, the Tennessee Coal, Iron, and Railroad Company, and the Chicago and Alton Railroad Company). See also Cunningham, supra note 1, at 216-20 (discussing the development of the cash flow statement in the United Kingdom and Germany). Voluntary disclosures of cash flow information seems to be a pattern elsewhere too. See Christian Leuz, The Development of Voluntary Cash Flow Statements in Germany and the Influence of International Reporting Standards, 52 SCHMALENBACH BUS. REV. 182 (2000) (showing how German firms voluntarily reported cash flow information before any legal requirement to do so). U.S. Accounting authorities started requiring a statement of cash flows in 1971. For a comprehensive survey of cash flow products—especially in the United Kingdom—see T.A. Lee, TOWARDS A THEORY AND PRACTICE OF CASH FLOW ACCOUNTING (1986) (reviews history of cash flow accounting, accounting for goodwill and enterprise income, and the use of cash flow accounting to track firm profitability).

176 In 1971, the Accounting Principles Board of the American Institute of Certified Public Accountants issued Opinion 19, recommending the inclusion of a “Statement of Changes in Financial Position” in a firm’s financial statements. AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, ACCOUNTING PRINCIPLES BOARD OPINION NO. 19: REPORTING CHANGES IN FINANCIAL POSITION (1972). The main objective of Opinion No. 19 was to “summarize the financing and investing activities of the entity, including the extent to which the enterprise has generated funds from operations during the period.” Id. at ¶ 4 (quoted in J.W. Giese & T.P. Klammer, Achieving the Objectives of APB Opinion No. 19, J. ACCOUNTANCY, Mar. 1974, at 54-55). Research conducted after the adoption of Accounting Principles Board Opinion No. 19 found substantial noncompliance with the requirements. See Giese & Klammer, supra, at 54, 57 (concluding from a financial reporting study of fifty Fortune 500 firms that one-half of the firms did not properly label the sources and uses of funds). German firms also failed to comply with cash flow reporting requirements after it became a duty to make the disclosures. See Günther Gebhardt & Aaron Heilmann, Compliance with
cash flow became a popular way of valuing the firm. In 1985, the Financial Accounting Standards Board (FASB) began to adopt cash flow valuation for selected situations, starting with the treatment of pensions. Only in 1987 did FASB require the disclosure of accounting cash flow in a firm's financial reports. Beginning in that year, firms had to report cash flow classified according to whether it was related to operating, investing, or financing activity, a classification to which I return in my recommendations.

German and International Accounting Standards in Germany: Evidence From Cash Flow Statements, in THE ECONOMICS AND POLITICS OF ACCOUNTING 218 (Leuz et al. eds., 2004) (documenting that a majority of firms failed to report operating, investing, and financing cash flows as required by IAS7, the cash flow standard of the International Accounting Standards Board, and GAS2, the German accounting standard on cash flow). One reason for the belated recognition of cash is the accounting profession's historic preference for measures based on accrual earnings over cash flow indicators as a measure of firm value. See FIN. ACCOUNTING STANDARDS Bd., STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS No. 1: OBJECTIVES OF FINANCIAL REPORTING BY BUSINESS ENTERPRISES ¶ 44 (1978), available at http://www.fasb.org/pdf/con1.pdf. "Information about enterprise earnings and its components measured by accrual accounting generally provides a better indication of enterprise performance than does information about current cash receipts and payments." Id. This subordination of cash flow to accrual measures has hindered the comprehensive financial reporting of a firm's balance sheet and OBS sectors.

For an example of how law has incorporated cash flow analysis, consider how judges in Delaware dissenter's appraisal proceedings rely on cash flow discounting. See generally Joseph Evan Calio, New Appraisals of Old Problems: Reflections on the Delaware Appraisal Proceeding, 32 AM. Bus. L.J. 1 (1994) (documenting the increase in use of cash flow discounting by judges since a 1983 case authorized the use of any generally accepted financial valuation technique).

See Siegel, supra note 29, at 1851 (noting the adoption of cash flow valuation by the Financial Accounting Standards Board for pensions in 1985 and employee benefit plans in 1990). The Financial Accounting Standards Board (FASB) has been wryly commissioned the "SEC's SPE (Special Purpose Entity)" because of its funding value. See George Mundstock, The Trouble with FASB, 28 N.C. J. INT'L L. & COM. REG. 813, 834 (2003). "The SEC liked, and likes, having an off-budget source of financing for activities that it otherwise would be required to fund. FASB is the SEC's SPE (Special Purpose Entity)." Id.

Operating cash flow reflects net cash flow from a firm's core business, sales in the context of a merchandising concern, interest rate differentials and fee income in the context of a depository institution, capital return in the context of a registered broker-dealer, and the net return on underwriting in the context of an insurance company. See generally EUGENE BRIGHAM & MICHAEL EHHRARDET, FINANCIAL MANAGEMENT THEORY AND PRACTICE 40-41 (10th ed. 2002). Operating cash flow tells a reader of a firm's financial statements how much liquidity arose or was consumed by the firm's core business. Id. In this sense, operating cash flow may be the best indicator of trends in a firm's going concern value. Operating cash flow may be calculated with either the direct or indirect method, which presents operating activities in different ways but leads to the same net cash flow from operations. See DYCKMAN ET AL., supra note 108, at 1189. The indirect method derives the same net operating cash flow amount by adjusting net income for items whose operating cash flow and income effects are unequal. If the company chooses to report operations cash flow
Of firms, only banks come close to disclosing their effective capital structure because they must report their OBS positions to their banking supervisors. In these reports, the bank calculates its effective capital structure by converting OBS items into their balance sheet equivalents. Many of these items are credit exposures to borrowers, so conversion means that the bank adds these notional asset values to its balance sheet, which must still balance even as adjusted. Because prudential regulation imposes composition requirements on bank capital, e.g., Tier 1 and Tier 2 capital requirements, bank regulators say that the bank faces a “capital charge” on the formally OBS item. Banking supervisors demand that banks reveal their effective capital structure under the direct method, the firm must also include a supplemental schedule showing the reconciliation of earnings and net operating cash flows, i.e., a schedule of the indirect method. 

Investment cash flow reflects both the cash flow from a firm’s position-taking in investment markets—just like any other investor in the capital market—as well as the net cash effects of investing in (or liquidating) assets that support the firm’s core business. Dyckman, supra note 108, at 1191–92. So, for example, investment cash flow reflects the net return on a firm’s securities portfolio. Investment cash flow also reflects allocations of cash to buy physical plant, depreciable equipment, franchises, and other capital assets whose income is included in operating cash flow.

Financing cash flow reflects the firm’s cash position as a borrower and lender in the capital market. Id. at 1192.


A gap report that does not include off-balance-sheet interest rate positions does not fully measure a bank’s interest rate risk profile. All material positions in off-balance-sheet instruments whose value can be affected by interest rates should be captured in a gap report. Such instruments include interest rate contracts, such as swaps, futures, and forwards; option contracts, such as caps, floors, and options on futures; and firm forward commitments to buy or sell loans, securities, or other financial instruments.


The fundamental accounting equation still holds for this notional balance sheet.

Extra prudent through asymmetry, prudential regulation does not generally give regulatory capital credit, i.e., count an item as equity capital, for OBS commitments from a third party to contribute risk capital to a depository institution. Instead, banking regulators tend to give capital credit only for “a dollar on the barrel.”
capital structure in regulatory reports because of the spillover risks from bank failure and because federally-insured banking exposes the federal government to liquidity risk. Private firms do not directly expose the federal government to such risk and, hence, are not subject to the same degree of transparency.

III. SLOUCHING TOWARDS TRANSPARENCY IN SARBANES-OXLEY

Faced with the transactional complexities discussed in Part II, above, Congress turned away from a more detailed look at financial reporting requirements and, instead, penalized individuals. Sarbanes-Oxley did, however, add some transparency about effective capital structure, namely a direction to the SEC to require firms to better disclose OBS arrangements. After noting the SEC's reluctance to engage seriously with accounting, this Part analyzes the new OBS rule, which is a step in the right direction. It contributes to financial literacy by legally classifying some types of OBS arrangements. Nevertheless, the SEC—and I—conclude that more is needed.

A. Retreating to Accounting in Law

No statute explicitly charges the SEC with developing accounting standards. The New Deal's Securities Act and the Exchange Act gave the SEC authority over accounting standards. These authori-
ties specifically extend to the form and use of the balance sheet. Instead of using this authority directly, the SEC has let private standard setters make accounting pronouncements, often at the cost of sound accounting principles. This hands-off policy delayed ade-

that situation was not a moral panic—financial or otherwise—because the scope of the New Deal’s state-building was proportional to a generalized and serious economic crisis. For a good general discussion of the early history of the SEC’s use of accounting, see The SEC and Accounting: The First 50 Years (Robert H. Manheim & Mayes E. Leech eds., 1984) (Not surprisingly, given my thesis, the twelve essays make virtually no mention of the off-balance sheet sector or cash flow disclosures and their utility as regulatory indicators.).

The Securities Act provides:
Among other things, the Commission shall have authority, for the purposes of this title . . . , to prescribe the form or forms in which required information shall be set forth, the items or details to be shown in the balance sheet and earning statement, and the methods to be followed in the preparation of accounts, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and nonrecurring income, in the differentiation of investment and operating income, and in the preparation, where the Commission deems it necessary or desirable, of consolidated balance sheets or income accounts of any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.

15 U.S.C. § 77s (2000 & Supp. II 2002) (emphasis added). The SEC’s authority under the Exchange Act is essentially identical except that the provision also grants authority to deconsolidate the balance sheet of a registrant: “The Commission may prescribe . . . the methods to be followed . . . in the preparation . . . of separate and/or consolidated balance sheets or income accounts of any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer . . . .” Id. § 78m(b)(1) (emphasis added).

See Mundstock, supra note 178, at 817 (“Accounting, like commercial law, developed before courts and legislatures became involved in business affairs. While commercial law became an object for the state, accounting principles thus far have not.” (footnotes omitted)). The endowment effect is one of the reasons for the trend cited by Professor Mundstock:

Another factor that has contributed to the SEC’s ongoing abdication of responsibility over accounting principles is worth noting: People have a natural tendency to belittle expertise that they do not possess. The SEC has been composed primarily of lawyers. Lawyers do not want to be bothered by accounting, which they view as merely “technical.” Hence, the SEC has been willing to leave accounting to the accountants.

Id. at 827. Professor Mundstock notes the importance of institutional self-interest in standard setting:

To summarize the history of private standard-setting in America: the players [including accountants] acted in their own self-interest . . . . Independence really has meant isolation and irrelevance. The central feature of the resulting accounting standards is the flexibility notion: accounts need not be right, merely acceptable. . . . When faced with controversy, particularly critiques from business interests, the private standard setter has either reorganized or capitulated. The SEC’s insti-
quate regulation of OBS arrangements, which vexed fundamental accounting assumptions. In fact, the FASB did not address how firms ought to treat securitized assets—one type of OBS item—until 1996. Although the early and continued focus of legislative attention after Enron was on financier misconduct, former SEC Commissioner Richard Breeden introduced the idea of requiring disclosure of firms' OBS arrangements into the public record on the very first day of the Hearings. Some firms had voluntarily reported some of their OBS arrangements after Enron's problems had come to light, but by then it was clear that more was needed in terms of regulation.

Id. at 839. See Donegan & Sunder, supra note 1, at 210:

Under our current system of financial reporting, articulation between stocks on the balance sheet and flows on the statements of income and changes in cash flow is both incomplete and imperfect; the unavoidable lapses in articulation [i.e., mistakes and lack of correspondence between items on the balance sheet and flow statements] are critical to understanding the OBSF [off-balance-sheet financing] problem.

. . . How to construct correspondent variables, and under what conditions it is appropriate to abandon the task of articulation, are questions that lie at the heart of the major problems in standardizing accounting practice including OBSF.

Id. at 208. For example, market movements may change an OBS asset to a liability, and then back again. Consider a swap. When in-the-money, it is an asset to the swapholder. When out-of-the-money, it becomes a liability to the same counterparty. See, e.g., U.S. COMPTROLLER OF THE CURRENCY, AN EXAMINER'S GUIDE TO INVESTMENT PRODUCTS AND PRACTICES 90 (1992) (advising bank examiner to determine whether a bank's swap position increases or reduces risk).


193 See Fink, supra note 135 (describing how El Paso Corp. consolidated an OBS subsidiary, how Electronic Data Systems began to voluntarily report its OBS debt in its quarterly financial statements, and how PeopleSoft was considering book consolidation of a research and development subsidiary).
Adopting Breeden's suggestion, Congress directed the SEC to address the OBS sector by studying it and amending its rules to increase the public disclosure of OBS arrangements. After rulemaking, the SEC amended its forms and rules to require managers to discuss OBS information in the management's discussion and analysis of the annual report. Under the new requirement, registrants must also file a Form 8-K whenever they assume a direct financial obligation related to an OBS item.

The OBS rule does not require recognition of OBS items on the balance sheet, the income statement, or the statement of cash flows in the sense of financially complete measurement and disclosure of the item. Instead, the rule merely requires the firm to discuss the fact of OBS items in sufficient detail. As reflected in the Conference Report, which introduced H.R. 3763 (later enacted into law as the Act), Congress specifically expected the SEC to expand the disclosure requirements for registrants' OBS arrangements, but it is not clear whether the current rule has done so. For example, the OBS rule requires firms to disclose OBS items only if they are "reasonably likely" to impact the firm, a disclosure standard which gives reporting firms

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195 See supra note 15 for the language of the new statutory reporting requirement.
196 See SEC Final Rule, supra note 16. These are changes to Regulations S-B and S-K, which contain many of the SEC's financial disclosure requirements for registrants. See 17 C.F.R. § 228.303(c) (2005) (part of Regulation S-B); id. § 229.303(a)(4) (2005) (part of Regulation S-K). A similar requirement was imposed on the Exchange Act financial disclosures for foreign private issuers. Id. § 249.220(f) (2005) (foreign private issuers use Form 20-F to file an annual report with the SEC); id. § 249.240(f) (2005) (qualified Canadian issuers use Form 40-F).


198 For example, the information required by Item 301 to be included on the balance sheet, the statement of income, and the statement of cash flows are subject to this standard of disclosure. 17 C.F.R. § 229.301 (2005). This information is "recognized" in the accounting sense that the impact of the information is reflected in the firm's reported financial position. In contrast, disclosure of the mere existence of an item without further elaboration of its significance provides less information to readers of financial reports and leaves it to the discretion of corporate officials to decide the materiality.

199 The Act:

requires the Commission to revise its regulations under the securities laws to expand the disclosure requirements for the financial reports and registration statements of public companies, so that they provide adequate and appropriate disclosure of certain of an issuer's off-balance sheet transactions.

broad leeway.230 Originally, the SEC had proposed a disclosure threshold lower (i.e., one that would lead to more disclosure) than the standard generally used for material events, but the final rule abandoned this approach, substituting a “reasonably likely” for a “more than remote” standard.231 The “reasonably likely” threshold of probability for disclosure defeats some of the purpose of the rule by letting firms off the hook in terms of disclosing their effective capital structure.232 As well noted, the SEC’s adoption of a relatively weak disclosure standard reflects successful rent-seeking by issuers, finance firms, and accounting firms whose separate liquidity, business, and liability-reduction interests converged in this rulemaking project.233


232 See Partnoy, supra note 18, at 1278 (arguing that even under the subsequent OBS reporting requirements Enron managers need not have disclosed much of their OBS activity if they concluded that the financial downside of this activity was more remote than “reasonably likely”):

Disclosure of “reasonably likely” contingencies would not likely have prevented the problems associated with Enron. Indeed, Enron arguably was in compliance with the newly-enacted SEC regulations. In assessing the firm’s financial contingencies at the end of 2000, management would not have considered a scenario in which Enron’s stock price would decline by more than half to be “reasonably likely.” Accordingly, management would not have needed to disclose details about Enron’s derivatives contracts with the SPEs. Nor would it have been “reasonably likely” that the volatility of commodity prices in 2000 would continue.

233 Id. To the extent that a company’s true financial leverage exceeds its book leverage, a company’s funding costs would increase. So issuers interested in retaining freedom to manage the balance sheet tactically defend managerial discretion over OBS disclosures. Investment banks that collect transaction costs, i.e., fees, to plan and implement complex OBS deals would defend their business line. The OBS rule bears on the liability of accountants by setting out the scope of required disclosures, so accountants have a mixed interest in the rule. A standard which unambiguously establishes disclosure requirements immunizes accounting firms from pressure by issuers interested in particular reporting treatments that may be inconsistent with the standard. On the other hand, accountants have different levels of risk-aversion too, and those with an appetite for more risk might prefer a rule with leeway to go out on a limb in terms of whether and how OBS items are booked or disclosed. Most of the comments from accounting firms noted the need for clarity. One of the advantages for legal and financial scholarship of federal rulemaking under the Administrative Procedure Act is that the comment process leaves a written record of rentseeking by affected constituencies. These comments make it possible to document—and sometimes infer—the motives of affected constituencies.
Notwithstanding the widespread criticisms of accounting rules and auditors during the financial moral panic, the new rule turns directly to existing accounting standards and incorporates them by reference. Specifically, the rule defines an OBS arrangement as one of four items: a guarantee obligation captured by the definition in FASB Interpretation No. 45; a retained or contingent interest in assets transferred to an unconsolidated entity; an obligation referenced to the registrant’s stock which is excluded from FASB Statement of Financial Accounting Standards No. 133; or an obligation in a variable interest entity as defined by FASB Interpretation No. 46 (FIN 46). In particular, by internalizing FIN 46, the OBS rule does draw some relatively bright lines about the interests subject to consolidation. However, the standard leaves open important legal

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206 Id. at § 229.303(a)(4)(ii)(B).

207 Id. at § 229.303(a)(4)(ii)(C).

208 Id. at § 229.303(a)(4)(ii)(D).

209 For example, FIN 46 increases the minimum amount of third-party equity required in a special purpose entity to keep the entity off the sponsoring firm’s books to ten percent from the previous floor of three percent. FIN 46, supra note 204, ¶ E-23. Before this interpretation, a firm could avoid consolidating any SPE if at least three percent of the equity was owned by separate investors. SPEs that had an effective external equity of less than three percent contributed to Enron’s downward liquidity spiral. FIN 46 also creates some safe harbors for entities and arrangements that need not be consolidated. FIN 46 excludes the following legal forms from consolidation on a reporting firm’s balance sheet: qualifying special purpose entities as defined by STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 140, supra note 192, certain pension plans, not-for-profit entities, certain entities with interests in variable
questions because the Interpretation's criteria go to the heart of the meaning of an equity interest in a firm.\textsuperscript{210} As a result, the legal use of this accounting standard also internalizes interpretive ambiguity, as noted by the SEC.\textsuperscript{211}

These regulatory definitions of OBS arrangements, however, follow the pattern of the financial contracts involved in Enron. Essentially, it was these types of obligations which led to Enron's liquidity problems,\textsuperscript{212} raising the question of whether the rule leaves financial reporting ready to fight the last war but not the next one.\textsuperscript{213} More-

interest entities created before December 31, 2003, entities meeting the definition of a "business" under the standard, and certain other entities. FIN 46, supra note 204, ¶ 4.\textsuperscript{210} The interpretation requires a firm to consolidate any firm that is a variable interest entity, which includes any entity in which the equity investor lacks one or more of the following three incidents: 1) the direct or indirect ability to make decisions that effect the success of the firm; 2) the obligation to absorb the entity's expected losses; or 3) the right to receive the entity's residual gains. FIN 46, supra note 204, ¶ 14. As firms further unbundle risk, the question arises about the extent to which the firm retains any residual risk or whether that residual risk has been farmed out to other investors using OBS arrangements. For this reason, by turning FIN 46 into positive law, the OBS rule sets the stage for judicial adjudications to determine equity as an accounting matter. Those will be interesting cases to observe.\textsuperscript{211}

In its report to Congress, the SEC noted the ambiguity about this accounting standard as used in the OBS rule. \textit{See} SEC REPORT, supra note 17, at 92 ("Although Interpretation No. 46(R) constitutes an improvement over the previously existing consolidation guidance, a number of interpretive questions remain. Many users of Interpretation No. 46R [sic] find it theoretically and practically challenging to apply."). This is the converse situation to the FASB's de facto role as disclosure monitor:

In principle, the jurisdiction of the FASB was said to be the setting of financial accounting standards, whereas the jurisdiction of the SEC was said to be disclosure. Yet the distinction has never been well-defined, and, as a practical matter, the distinction is not operational. The standards of the FASB typically also include disclosure requirements.\textsuperscript{212}

Beaver notes as much:

Certainly, the accounting for Special Purpose Entities (SPEs) that was at the heart of the problems with Enron's financial reporting is being revisited and rightly so. However, a revision in this accounting standard represents a specific fix for a problem involved in a specialized
over, given the disclosure threshold adopted by the SEC, Enron might not have even had to disclose these particular OBS arrangements. Nor would these new requirements have required disclosure of the cash flow games that led to the highly publicized prosecution of officials at Adelphia Communications. In other words, what is required to be disclosed is only a subset of the OBS arrangements described previously.

Despite their under-inclusiveness, the attempt to codify the meaning of OBS arrangements in the federal securities regime is a good first step. This is no mean feat, because the OBS sector is where the wild things are. A brief summary of the major OBS arrangements is in order here. Many OBS arrangements are voluntary, i.e.,

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type of transaction and does not in itself address broader issues. For example, obtaining the effects of off-balance sheet financing via derivative transactions is a much more pervasive and difficult problem to address.

Beaver, supra note 104, at 164 (emphasis added).

214 Professor Partnoy concurs:

Disclosure of “reasonably likely” contingencies would not likely have prevented the problems associated with Enron. Indeed, Enron arguably was in compliance with the newly-enacted SEC regulations. In assessing the firm’s financial contingencies at the end of 2000, management would not have considered a scenario in which Enron’s stock price would decline by more than half to be “reasonably likely.”

Partnoy, supra note 18, at 1278.

215 See Triantis, supra note 131, at 12.

216 See infra notes 217–24 and accompanying text for a partial taxonomy of OBS arrangements.

217 Like the joke about the five blind men and the elephant, what is considered off-balance-sheet depends on whom you ask:

Once upon a time, there were five blind men who had the opportunity to experience an elephant for the first time. The first approached the elephant and, upon encountering one of its sturdy legs, stated, “Ah, an elephant is like a tree.” The second, after exploring the trunk, said, “No, an elephant is like a strong hose.” The third, grasping the tail, said, “Fool! An elephant is like a rope!” The fourth, playing with an ear, stated, “No, more like a fan.” And the fifth, leaning against the animal’s side, said, “An elephant is like a wall.” The five then began to argue loudly about who had the more accurate perception of the elephant.

The elephant, tiring of all this abuse, suddenly reared up and stomped on all of the men. He continued to trample them until they were nothing but bloody lumps of flesh. Walking away, the elephant said, “It just goes to show that you can’t depend on first impressions. When I first saw them I didn’t think they’d be any fun at all.”

contractual, arrangements. Banks have long made contingent credit commitments to borrowers that may not be reflected on the balance sheet, e.g., a depository institution's letters of credit, financial guarantees, and other loan commitments. Firms use affiliated trusts, limited liability partnerships, and limited liability companies to avoid recognizing financial activity on the balance sheet. Firms active in real estate may keep leases and synthetic leases off the balance sheet to reduce the reported firm size and its effective leverage. Sometimes a contract substitutes for a special purpose vehicle; for example, “take-or-pay” and “throughput” contracts require periodic payments for goods or services without regard to whether the buyer takes delivery or actually uses the services. Another OBS entity, the special purpose entity (SPE), is a separate legal person designed to serve a single purpose, for example, to hold assets or liquefy receivables. Other OBS liabilities include forward and futures contracts

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218 The broadest construction of the phrase would capture executory contracts, employment agreements, licenses, royalty contracts, pension commitments, and guarantees to customers under contracts. See SEC Final Rule, supra note 16. The SEC narrowed the reach of the rule by limiting OBS items to those determined as such under certain accounting statements. Id. But this produces regulatory renvoi: the legal scope of these pronouncements has yet to be determined. See supra notes 209–11 and accompanying text.

219 See Chris J. Bartrop & Diana McNaughton, 2 Banking Institutions In Developing Markets: Interpreting Financial Statements 13 (World Bank 1992) (classifying banks' OBS exposures, including credit substitutes and contingent liabilities). Assets and asset expectancies may be OBS too. The same contingent credit commitments of the depository institutions described above become assets of the lender once the borrower has drawn down on the credit line. As a credit intermediary, the function of a bank is to trade in products which reflect the holding preferences of other market participants with respect to the term and liquidity characteristics of assets and liabilities. One example of such a product is the bank’s commitment to extend credit to a (contingent) borrower in the event that this borrower fails to make payment on another contractual obligation. If the contingency ripens and the borrower draws down on the credit line, this credit exposure of the bank shows up as an asset on its balance sheet. In this sense, asset expectancies may also be OBS.


221 The best of both worlds, a synthetic lease lets the lessor depreciate the asset as though she owned it without recognizing the debt that true ownership would have entailed. See John Murray, Off-Balance-Sheet Financing: Synthetic Real Estate, 24 Mich. Real Prop. Rev. 5 (1997).

222 See generally Soroosh & Ciesielski, supra note 122.

223 SPEs are perhaps the OBS arrangement which has generated the most public and regulatory interest as of late due to Enron. Enron made wide use of special purpose entities (SPEs). It would transfer assets to the SPE, immediately recognize a financial accounting gain on the transfer as though sold at arm's-length, defer the recognition of any losses on the transferred assets, and reduce its book leverage by
lawsuits and other kinds of liabilities in the form of derivatives, e.g., credit derivatives. Even this partial taxonomy suggests the breadth of the OBS sector.

B. Persistent Opacity in the Off-Balance-Sheet Sector

The Act also required the SEC to report on the efficacy of its rulemaking to increase the transparency of OBS arrangements.\(^{225}\) Separately, the Act also directed the SEC to report on the existing market structure of OBS arrangements.\(^{226}\) (In a sense, the market structure report was intended to serve as a demonstration of the efficacy of the new reporting requirements.) The SEC filed a single report to Congress addressing both issues.\(^{227}\) Despite noting modest improvements in transparency, the report concluded that inadequate disclosure of OBS arrangements persisted.\(^{228}\) For example, the SEC concluded that financial transparency problems exist with regard to the reporting of firms' investments in other entities,\(^{229}\) of contingent shifting debt in respect to the assets off of the firm balance sheet. This worked well until the value of Enron stock fell, triggering contractual commitments that taxed the firm's liquidity. \(^{224}\)

A forward contract is a present contractual duty to perform at some future date. See Interest Rate Risk: Comptroller's Handbook, supra note 182, at 96–98. A futures contract is a forward contract that trades on a federally registered commodities exchange market. Id. at 93–95. A credit derivative is a contract that obligates a counterparty to indemnify a lender in the event of a credit loss on a loan to a third party borrower. See generally OCC Bulletin, U.S. Comptroller of the Currency, OCC 96-43: Credit Derivatives (Aug. 12, 1996).


\(^{226}\) See SEC REPORT, supra note 17, at 91–98.

\(^{227}\) The difficulty that I had locating anecdotal and aggregate information about the OBS sector for this Article leads me to join the following SEC conclusion about the ongoing underinclusiveness of adequate financial information about the OBS sector:

Nevertheless, it appears that issuers may not have identified all of the off-balance sheet arrangements that are required to be discussed in the OBS section of MD&A. Further, the Staff believes—based in part on the difficulties faced in gathering the data necessary for the Study and Report—that the quality of the issuer disclosures provided in the off-balance sheet section of MD&A can and should be improved.

Id. at 98.

\(^{228}\) The Staff notes that, due to the varying placement of the disclosures and the different levels of disclosures required [for investments], it may sometimes be difficult for investors to fully comprehend the extent of an issuer's involvement with equity method investments and to compare such involvements across issuers. As a result, the Staff acknowledges that the values reported . . . may be understated.

Id. at 40.
obligations and guarantees,\textsuperscript{230} of derivatives,\textsuperscript{231} and with respect to firms' OBS arrangements generally.\textsuperscript{232} These conclusions may understate the scope of the problem because the sample that provided the filings for the study does not represent the universe of most active users of OBS arrangements.\textsuperscript{253} The ongoing opacity of the OBS sector may also be due to the SEC's decision not to require firms to disclose comprehensive information about the unconsolidated entities with which a firm had OBS transactions.\textsuperscript{234} Because more is needed in the

\textsuperscript{230} "The Staff noted during its analysis of the filings that disclosures about contingent obligations vary widely in terms of format and location in the filing. As a result, the data for contingent obligations was difficult to collect in a consistent manner across issuers." \textit{Id.} at 69.

\textsuperscript{231} Despite the disclosures required by the accounting standards and the Commission's rules, there is still often a perceived lack of transparency as to an issuer's market risk exposures, use of derivatives and the potential impact of those derivatives. . . .

\textsuperscript{232} . . . [A]s a result of conducting the Study of filings by issuers, the Staff notes that it is often difficult to determine the total dollar amounts that are on the balance sheet related to derivatives. This difficulty stems from the fact that derivatives may be presented as separate line items on the balance sheet, or alternatively, included as a component of some broader category (e.g., other assets).

\textit{Id.} at 80--81.

\textsuperscript{233} "In many cases, it is obvious whether the commitment in question is, indeed, on the issuer's balance sheet (e.g., debt). However, in some cases, the Staff notes that whether the item is on or off the balance sheet remains unclear." \textit{Id.} at 90.

\textsuperscript{234} See SEC REPORT, supra note 17, at 27--29. The study sample was based on the 100 issuers with the largest capitalization and 100 randomly selected issuers. \textit{Id.} The sample selection methodology used by the SEC did not target the actual users of OBS arrangements. The pattern is that firms with greater financial risk tend to use OBS arrangements more than firms with less leverage. The managerial reasons for optimizing the balance sheet discussed earlier explain why this is so. Had the SEC been sensitive to effective capital structure, the sample might have been targeted more carefully to identify the firms with the greatest tendency to use OBS arrangements, i.e., highly indebted firms interested in reducing the appearance of leverage. Consequently, a sampling methodology that better targeted active users of OBS arrangements would probably have revealed an even greater degree of opacity in financial reporting.

\textsuperscript{234} The SEC's proposed rule had required disclosure of assets and liabilities of unconsolidated entities with which a firm had OBS arrangements. SEC Proposed Rule, supra note 204. In the Final Rule, however, the SEC receded from this requirement:

We have eliminated one aspect of the proposed disclosure requirements after considering the public commentary. The amendments do not require a registrant to disclose the nature and amount of the total assets and total obligations of an unconsolidated entity that conducts off-balance sheet activities on behalf of the registrant. Commenters indicated that it might be impracticable to obtain, monitor or evaluate information about unconsolidated entities that are unaffiliated with the registrant.

See SEC Final Rule, supra note 16.
way of material financial disclosures, Part IV of this Article recommends disclosures to further implement the disclosure objectives of the Act.

It is too early to comprehensively map the ultimate impact of the OBS rule, but changes have already occurred. While disclosing information about these arrangements may reduce the cost of capital for some securities issuers,\footnote{Cf. Douglas Diamond & Robert Verrecchia, Disclosure, Liquidity, and the Cost of Capital, 46 J. Fin. 1325, 1328-32 (1991) (making a mathematical argument that for large firms disclosure of financial information may add value by reducing the potential information asymmetry with investors, who might otherwise refrain from holding the securities of those firms).} \footnote{See, e.g., Andrew Osterland, Reining In SPEs: New Rules for Special-Purpose Entities May Result in Bigger Corporate Balance Sheets, CFO.COM, May 1, 2002, http://www.cfo.com/printable/article.cfm/3004484?f=options (describing credit downgrade and fifty percent price drop of share price of Adelphia Communications Corp. after it disclosed OBS debt in previously unconsolidated special-purpose entities).} capital costs have, in fact, increased for some firms after their disclosure of the existence of OBS arrangements.\footnote{The SEC noted that some companies had already done so: In anticipation of the implementation of Interpretation No. 46 and Interpretation No. 46(R), a number of entities restructured arrangements with potential VIEs [variable interest entities] such that they would not require consolidation. Disclosures of such restructurings were noted in the [SEC report] sample companies. The Staff also is aware anecdotally that many arrangements with potential VIEs were restructured such that the entity either would not be considered a VIE or such that no party would be required to consolidate the VIE. 

See SEC REPORT, supra note 17, at 92.} \footnote{This is another example of the "dance between the regulator and the regulated." Pouncy, supra note 2, at 546. Compliance by restructuring transactions or entities is common with respect to accounting standards. For example, FASB passed \textsl{STATEMENT OF FINANCIAL ACCOUNTING STANDARDS} No. 13 [hereinafter SFAS No. 13], supra note 121, to increase the reporting of OBS operating leases. SFAS No. 13 required firms to include a lease on the balance sheet if the lease possesses any of the following four attributes: the lease transfers ownership of the leased asset to the lessee; the lease lets the lessee purchase the leased asset for a below-market price; the lease is not cancelable for 75% or more of the lease’s economic life; or the present value of the minimum lease payments on the lease are at least 90% of the leased asset’s value. \textit{Id.} Evidence suggests that firms restructured the terms of their capital leases to avoid triggering SFAS No. 13’s capitalization requirements. See Eugene A. Imhoff, Jr. & Jacob K. Thomas, Economic Consequences of Accounting Standards: The Lease Disclosure Rule Change, 10 J. Acct. & Econ. 277 (1988) (showing how firms modified capital leases to avoid the new disclosure requirement).} If the past is prologue, firms will certainly minimize the compliance costs of the new rule by restructuring their transactions to avoid disclosures which adversely impact their capital and liquidity activities, leading to a fresh round of financial legerdemain and regulatory reprisal.\footnote{Overall, firms will likely reduce their OBS activities, especially to avoid the stigma of reporting previously undisclosed li-}
abilities. Some firms are considering the joint venture as an alternative to other OBS arrangements. Without the cost-savings formerly available through OBS arrangements, firms may pass on increased credit costs to their customers.

This new regulatory change and the ensuing OBS market structure shift may also impact the internal management structure of the firm. For example, consider the emergence of the CFO function as a reaction to the increased tactical significance of a firm’s funding activities. Today, the CFO provides strategic decision support for other managers rather than merely overseeing what were formerly the more ministerial functions of the treasurer and comptroller.

As noted by accounting researchers:

This new interpretation might cause very few changes in corporate balance sheets, because companies that would have to consolidate their SPEs under the requirements of this interpretation might already be taking steps to shut down or sell their interests prior to the effective date. This scenario would avoid the embarrassment for the sponsors of presenting what they never professed to own. The other alternative is that Interpretation 46(R) might cause significant adverse adjustments to companies’ balance sheets and create technical defaults in loan covenants.


Some banks act as conduit sponsors on behalf of clients. By requiring the sponsor banks to consolidate some previously OBS debt onto the balance sheet, banks face regulatory capital charges. The incidence of this cost does not stay with the bank, however. As one bank manager commented, “If we cannot maintain [these loans] off balance sheet, at a minimum our clients’ costs will go up . . . Worst case, we cut their line.” Brett Nelson, A Blue Summer For Off-Balance-Sheet Lenders?, FORBES.com, Apr. 11, 2003, http://www.forbes.com/2003/04/11/cz_bn_0411banks.html (quoting Bradley Schwartz, managing director of asset-backed conduits at J.P. Morgan Chase, which administers $17 billion in conduits).

Patterns of leverage influence how a firm organizes its financial management. For example, firms with high leverage appoint a Chief Risk Officer to manage risk enterprise-wide. See André P. Liebenberg & Robert E. Hoyt, The Determinants of Enterprise Risk Management: Evidence from the Appointment of Chief Risk Officers, 6 Risk MGMT. & INS. REV. 37, 45 (2003).

Typically an accountant, the comptroller acts with actual authority, has some general knowledge of the firm’s overall financial position, and reports to an officer. Generally a corporate treasurer maintains custody of accounts, manages relationships with creditors, services debt, and coordinates investment. See James D. Willson et al., CONTROLLERSHIP: THE WORK OF THE MANAGERIAL ACCOUNTANT 19–20 (6th ed. 1999) (discussing relationship between treasurer, controller, and chief financial officer). The comptroller forecasts the raising and utilization of liquidity, reconciles bank account balances, and manages internal control systems with respect to receipts and disbursements. Id. at 604–11 A small firm may not separate the treasurer and
Unlike the comptroller, a CFO may have significant apparent authority to bind the firm in complex financing transactions. Poised as a convenient folk devil, when a scandal occurs, the CFO is often the first officer to be blamed, fired, and, at times, prosecuted for violations of federal securities laws. The Act’s attestation requirements contribute to this tendency by increasing both the CFO’s significance and liability.\footnote{See supra note 98 for attestation requirements.}

Despite the congressional mandate, additional funding, the agency’s extensive research on the issue, and intense public pressure, the SEC could not definitively estimate the size of the OBS sector. If the SEC could not get this information, how could an investor make an informed investment decision about these firms? The purpose of the financial transparency ratio suggested in Part IV is to relate potentially material, undisclosed management accounting data about OBS arrangements to the balance sheet for the benefit of the wider investing public.\footnote{See supra notes 248-56 and accompanying text (for a ratio that would tell investors about the magnitude of management accounting data that is not disclosed in financial accounting reports).}

IV. CONFORMING FINANCIAL REPORTING LAW TO FUNDING VÉRITÉ

Given the ongoing opacities in the OBS market discussed above, more is needed. I recommend that the SEC take two regulatory actions to satisfy its duties under the Act to increase financial disclo-
First, the SEC should make registrants include a financial transparency ratio on their balance sheet that lets readers know the magnitude of what is not otherwise being disclosed about OBS items. This transparency ratio would act as an interface between the managerial accounting information (available only to firm insiders) and the financial accounting information required to be released by federal securities law as such. The transparency ratio would alert investors to risks the current information asymmetry makes difficult to evaluate. Second, the SEC should exercise its statutory authorities over accounting to make the statement of cash flows more useful as a public financial report by introducing some categories, including a distinction between operating cash flow and other types. Finally, a bureaucratic reform is in order too. The SEC should make policy research about trends in effective capital structure a routine part of its job, rather than a dramatic interruption of the agency’s perceived core functions. That way, the SEC could proactively deal with future funding shifts and their financial reporting implications and, thereby, stem future financial moral panics with facts instead of speculation.

Being more aggressively self-informed about funding practices would reduce the SEC’s risk of reputational slight through congressional prodding after celebrated disasters.

A. Reducing the Public Information Gap with a Financial Transparency Ratio

Being able to determine the inclusiveness of a firm’s reported financial position is presumptively material. Firms must now disclose any OBS arrangements material to a firm’s liquidity or capital resources. To link the GAAP balance sheet to a firm’s effective

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245 These recommendations further the SEC’s policy initiatives set out in its study of OBS arrangements. See SEC REPORT, supra note 17, at 98–105. In particular, disclosures of a balance sheet to OBS ratio and funding dynamics that are presumptively material (i.e., the two specific recommendations in this Part of the Article) would further consistency of financial disclosures, one of the four major initiatives discussed in this section of the Report.

246 Although the substance of the information would not be internalized into the decision-making process of a market participant, the investors would be aware of the fact of the information.

247 Making recommendations that are capable of being implemented is part of the institutional microanalytic approach in law. “[T]he microanalysis of existing institutions is more practical, at least in the short run, and more amenable to the specifically legal approach of framing recommendations to existing policymakers.” Rubin, supra note 90, at 1431 (arguing that institutional microanalysis can synthesize the historically separate critical disciplines such as alterity jurisprudence and law and economics).

248 See SEC Final Rule, supra note 16.
capital structure, the SEC should require registrants to put a financial transparency ratio on the balance sheet. The ratio would add marginal value with respect to undisclosed items or to the materiality of a firm’s OBS portfolio in the aggregate. Inspired by the leverage ratios used in financial analysis, a transparency ratio would reflect the proportion of, on the one hand, information required to be disclosed under current disclosure standards to, on the other hand, undisclosed information about contingencies known to the firm through its managerial accounting but not required to be revealed under current regulatory reporting thresholds. In so doing, the ratio would lessen information gaps between well-informed firm insiders, moderately-informed institutional investors, and uninformed public shareholders by signaling how much management accounting data escapes disclosure in public reports prepared using financial accounting rules. This proposal avoids the risk of excess disclosure for complex transactions which has been persuasively noted.

Such a ratio promotes transparency without risking disclosure logorrhea of irrelevant data or requiring firms to disclose sensitive information about specific financial claims. To the extent that the ra-

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249 See supra note 10.

250 In other words, the ratio would reflect the dollar volume of OBS arrangements, which taken singly would not rise to the level of materiality that currently triggers disclosure under the OBS rule. A firm may have several OBS positions, no single one of which materially impacts the firm’s liquidity or capital. Yet when added together the sum of OBS positions becomes material. The ratio would reveal the potential scope of such a risk.

251 Finance ratios use financial statement data to understand and predict firm performance. See William Beaver, Financial Ratios as Predictors of Failure, in EMPIRICAL RESEARCH IN ACCOUNTING: SELECTED STUDIES, 1966, at 71–111 (Sidney Davidson ed., 1967). See also KALLBERG & PARKINSON, supra note 3, at 23–31 (summarizing types of financial ratios used to evaluate a firm’s liquidity). Financial leverage measures the amount of debt to equity in a firm’s capital structure. Operating leverage attempts to assess the degree to which a firm’s operating costs are fixed. Meaningfully estimating operating leverage is difficult. Id. at 75. A firm may calculate its leverage ratios for internal use differently from leverage ratios intended for public dissemination.

252 See supra notes 130–34 and accompanying text (regarding information asymmetries).

253 See Steven L. Schwarcz, Rethinking the Disclosure Paradigm in a World of Complexity, 2004 U. ILL. L. REV. 1, 18–19 (2004) (challenging the sufficiency of disclosure of complex deals because the disclosure will not yield enough investors who understand the transaction in time to impact market prices). He calls these “disclosure-impaired transactions.” Id. at 30.

254 The SEC justified its adoption of the “reasonably likely” threshold for disclosure in part on the fear that a lower standard would generate too much information: “We believe that the ‘reasonably likely’ threshold best promotes the utility of the disclosure requirement by reducing the possibility that investors will be overwhelmed by voluminous disclosure of insignificant and possibly unnecessary speculative informa-
tio draws attention to undisclosed information, this proposal might reduce trading liquidity in a firm's securities. At its simplest, the ratio would compare the size of the reported balance sheet to a pro forma balance sheet—based on confidential management accounting information—that reflected a financial rather than accounting definition of leverage. In other words, the numerator of the ratio would be the GAAP balance sheet and the denominator would be an effective balance sheet. To calculate such a ratio would require auditors to systematically review confidential management accounting data and to put it in the context of publicly available information. A ratio of 1:1 would signal perfect transparency. The lower the ratio, e.g., 1:2, the less the amount of financial transparency in the firm's public financial reports. A low financial transparency ratio might signal dubious financial reporting motives. (For example, a firm may want to hide a higher leverage ratio or a concentration of debt contracts coming due for renegotiation.) By reminding the reader of financial statements of the limits of the balance sheet, the ratio would provide fair notice that an investor may need to poke around in a firm's financial reports. Changes in the ratio would also alert a reader as to whether a firm was changing its fundamental strategy with respect to the transparency of its funding practices.

B. Using Cash Flow Reporting to Further Disaggregate the Firm

Adding some reporting granularity to the statement of cash flows would help investors and other market intermediaries to evaluate a firm's funding position by reducing the transaction costs of monitoring the firm's cash flows. Doing this would further the SEC's stated...
policy of encouraging disclosure of material information about funding. 258

The statement of cash flows distinguishes between investment, operational, and financing cash flows. 259 However, the statement currently blurs two streams of investment cash flow that would have more informational value if unbundled: (1) that from investment in assets related to a firm's core functions; and (2) that due to investments in other than operational assets. By separating operational investment cash flow from market investment cash flow the classification would let the reader distinguish between investment required by the firm's core activities and that from the firm's activities as a speculative investor in the market. Such a distinction would help an investor to appreciate whether cash flow is attributable to business decisions about operations or to speculative investment decisions.

Since the statement of cash flows reflects the impact of much OBS activity, 260 comparing the volume of cash flow overall to a firm's risk capital in the form of a ratio would reflect the effective ability of a firm to leverage risk capital into liquidity. Abnormally high cash flow leverage ratios—or unusual trends in a firm's cash flow leverage ratio—could signal risk from OBS activities. 261

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258 In response to a petition from several accounting firms, the SEC had—before the OBS rulemaking—issued a statement calling for improvement of the quality of disclosure of OBS arrangements and clarifying the scope of registrants' then-duties under Regulation S-K, Item 303. Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations, Release Nos. 33-8056, 34-45321 (Jan. 22, 2002), available at http://www.sec.gov/rules/other/33-8056.htm. This guidance emphasized the cause and effect relationship between OBS activity and a firm's solvency and liquidity:

> [R]egistrants should consider describing the sources of short-term funding and the circumstances that are reasonably likely to affect those sources of liquidity.

> If the registrant's liquidity is dependent on the use of off-balance sheet financing arrangements, such as securitization of receivables or obtaining access to assets through special purpose entities, the registrant should consider disclosure of the factors that are reasonably likely to affect its ability to continue using those off-balance sheet financing arrangements.

*Id.* (footnotes omitted).


260 *See supra* note 170–71, 179–81 and accompanying text.

261 So, for example, Enron's cash flow games described in Part II.B might have been reflected through such ratio analysis.
C. Exploiting the SEC's Comparative Advantage to Conduct Capital Structure Market Surveillance

The financial moral panic revealed technical gaps in the SEC's capital structure knowledge, an agency whose institutional structure emphasizes disclosure and enforcement.262 This enforcement emphasis means that the contours of current law determine the agency's effective knowledge base.263 A more institutionally pervasive focus on capital market structure would complement the SEC's current approaches.264 The General Accounting Office recently noted these limits:

Both SEC and industry officials agree that the current level of human capital and budgetary resources has strained SEC's capacity to address current and evolving market issues. Industry officials generally hold SEC staff in high regard and said that SEC does a good job overall. However, industry officials also said that they would like to see SEC devote more effort to evolving and ongoing areas . . . .265

Although the agency has conducted special industry studies to cover self-diagnosed technical gaps, it failed to do so in time to deal with the crises in the OBS sector.266 Accordingly, the Act directs the

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262 For example, the focus of the Division of Enforcement—a historically and increasingly prominent function at the SEC—requires market knowledge only as needed to supplement legal claims in an enforcement action. In contrast, the few units that interact with firms regularly know the most about market structure.

263 Some exceptions are worth noting. The Office of Risk Management (Division of Market Regulation) monitors compliance by registered broker-dealers with the liquidity requirements of the net capital rule for broker-dealers. This Office has rich firm-level knowledge that could usefully be synthesized into a better understanding of broker-dealer market structure. See generally Michael P. Jamroz, The Net Capital Rule, 47 Bus. Law. 863 (1992) (describing in significant detail how the net capital rule ensures the liquidity of broker-dealers). When I worked in the Office of Compliance Inspections and Examinations (OCIE), I was enriched by regular and comprehensive contact with broker-dealers, securities exchanges, clearing and depository entities, and other financial intermediaries. See generally John H. Walsh, Right the First Time: Regulation, Quality, and Preventive Compliance in the Securities Industry, 1997 Colum. Bus. L. Rev. 165, 177–78 (1997) (describing OCIE's statutory authorities and programs).

264 Respectful of the agency staff's commitment to capital markets, I make these recommendations in the spirit of preserving the agency's reputation as a jewel of the New Deal.

265 General Accounting Office, SEC Operations: Increased Workload Creates Challenges, GAO-02-302, at 24 (2002) (finding that securities market structure changes had dramatically increased the volume and complexity of the SEC's workload and recommending increased capacity for the agency). See also Hearings, supra note 55, at 620.

266 See, e.g., SEC & EXCH. COMM'N, THE OCTOBER 1987 MARKET BREAK (1988) (analyzing the causes of market volatility that led to a thirty percent loss in the value of...
SEC to increase its technical expertise not just with respect to OBS arrangements but also securities violators and violations, \textsuperscript{267} enforcement actions, \textsuperscript{268} and credit rating agencies, \textsuperscript{269} suggesting the need for the SEC to retool its market structure knowledge generally. \textsuperscript{270} The Act’s directions to the General Accounting Office to conduct capital market studies more typically in the SEC’s bailiwick raise questions of whether the SEC has already lost some reputational capital with Congress. \textsuperscript{271}

Congress has enabled the agency to update its institutional mission by increasing its appropriation and reducing the transaction costs of hiring technical experts. First, Congress gave the SEC pay parity with depository institution regulators, who have long been able to pay staff more than the salaries on the General Service scheduler. \textsuperscript{272}


\textsuperscript{268} Id. § 704.

\textsuperscript{269} Id. § 702.

\textsuperscript{270} Congress’s direction to the SEC to conduct these studies suggests a critique of how the agency has handled the make-buy problem as applied to certain knowledge about capital market structure. The make-buy problem takes a different form in the context of a federal agency. Statutes determine the agency’s freedom to determine what goes on and what stays out, i.e., its institutional structure.

\textsuperscript{271} Sarbanes-Oxley requires the Comptroller General to study the impact of requiring mandatory rotation of registered accounting firms (Sarbanes-Oxley Act of 2002 § 207), the impact of the consolidation of accounting firms on public audit quality (Sarbanes-Oxley Act of 2002 § 701) and the relationship of investment banks and their advisors earnings management by private firms (Sarbanes-Oxley Act of 2002 § 705). Tasking the GAO with studies that fit squarely within the SEC’s jurisdiction may reflect a desire not to burden the SEC with more studies. But one wonders whether Congress doubted whether the SEC had enough internal knowledge, capital and willingness to address these questions, which bear importantly on market structure, or whether the GAO studies reflect a desire to have independent analysis with which to critically evaluate the performance of the SEC.

\textsuperscript{272} Previously, Congress had exempted the Federal Reserve Board, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and the National Credit Union Administration from statutory ceilings on staff compensations. Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. No. 101-73, §§ 805, 1105, 1202, 1203, 1206, 103 Stat. 183 (codified as amended in scattered sections of 12 & 15 U.S.C.). In response to vigorous SEC advocacy, Congress extended the same pay parity privileges
More recently, Congress increased the SEC's flexibility in hiring accountants, economists, and securities analysts. Increased resources without a more comprehensive market structure approach to capital structure surveillance will not, however, solve the regulatory reporting problems highlighted by these scandals. Therefore, to deal with this problem the SEC should establish a research and analysis unit (or reconfigure existing institutional resources) to exploit the SEC's existing knowledge base and to add to it by closely following trends in effective capital structure. This the SEC can do with the approval of a majority of commissioners before Congress acts remedially again. Such a unit could best exploit the agency's informational advantage about how firms finance themselves. The SEC's §401(c) report is to the SEC. Investor and Capital Markets Fee Relief Act, Pub. L. No. 107-123, §§8, 115 Stat. 2390 (2002).

Accountant, Compliance, and Enforcement Staffing Act of 2003, Pub. L. No. 108-44, 117 Stat. 842. The law allows the SEC to appoint these staff to the excepted service rather than the competitive service, which restricts employer discretion to redeploy or discharge staff more than the excepted service.

A small number of economists in the Office of Economic Analysis participate in a wide variety of regulatory, surveillance, and enforcement functions. This office needs more financial economists specifically trained in monitoring trends in firms' effective capital structure.

Drawing again on bank regulation, I urge the SEC to disrupt the Weberian logic of its current departmental structure and to consider the usefulness of an inter-divisional approach to capital structure surveillance. The Capital Steering Committee (Capital Steering) of the Comptroller of the Currency (Comptroller) is an example of an inter-divisional process that targets OBS items. Like any complex government bureaucracy, the Comptroller is functionally divided into a legal division, banking supervision divisions, a special unit that looks at regulatory capital policy, international divisions, and risk management divisions. Recognizing that OBS funding crosses these organizational units, the Comptroller has a standing inter-divisional process in Capital Steering to bring together legal, risk, and supervisory perspectives when ruling on national banks' funding practices. Capital Steering meets regularly to review proposals for funding products submitted by national banks. In the meeting, capital policy staff explain the funding products—many of which are OBS items—in order to educate staff from other divisions.

By institutionalizing information sharing about the frontiers of national banks' OBS activities, Capital Steering keeps the Comptroller's knowledge base about funding current.

Institutional theory about innovation in government bureaucracy, however, indicates that the suggestion to form a capital structure analysis unit will not be adopted. See generally OLIVER WILLIAMSON, THE MECHANISMS OF GOVERNANCE 219-49 (1996) (identifying structural institutional forces that restrict innovative change).

For example, in 2000, the SEC received nearly 100,000 separate filings by issuers describing securities products and transactions, a cornucopia of data about financial market structure. See GENERAL ACCOUNTING OFFICE, supra note 265 (finding that securities market structure changes had dramatically increased the volume and complexity of the SEC's workload and recommending increased capacity for the agency). The Division of Corporate Finance has the most complete knowledge base about financing trends because the unit reviews prospectuses about new securities. A Webe-
an example of the kind of aggregate market structure analysis that should be a routine matter for the agency.

At present, decisions about materiality are left to individual public companies, subject to adjudication to determine whether with the benefit of hindsight a registrant properly evaluated the materiality of a particular financial fact. Given the recurring funding situations faced by firms, though, some financing practices are presumptively material, as a matter of effective capital structure. However, judges, lawyers, and investors do not have the benefit of market-wide data when interpreting materiality. Armed with such market-wide knowledge, the SEC could provide more interpretive advice in the context of market structure as a whole. Information intermediaries like investment advisors and business newspapers would disseminate this information to a wider investing public. Better capital structure surveillance would also help the SEC to exercise its oversight duties over the new Public Company Accounting Oversight Board created by the Act.

arian bureaucracy, the Division divides prospectus review by industry such that few staff know more than one industry well.

A presumption encourages uniformity in an area that few investors and other market participants understand, lets registrants rebut this presumption in circumstances in which the financing trend does not materially impact a firm’s liquidity or capital, and preserves judicial discretion to determine when a rebuttal of the presumption is justified. This approach is also consistent with the tacit recognition in financial reporting law that certain events are deemed to be so material to a firm that a public issuer must file a Form 8-K as required by 17 C.F.R. § 240.13a-11 (2005).

V. THERE WILL ALWAYS BE AN ENRON (PROLEGOMENON)

We live in an economy organized around market risk, in which unrealized gain in financial assets will continue to be the chief store of wealth. Preserving the dignity of investors requires clearer disclosure about the market risk of unrealized gain, sobering though such disclosure may be. Not that any of this will prevent future financial disasters. So long as there are firms trying to economize on funding efficiencies (for both fiduciary and opportunistic motives), traders willing to help, and investors looking for a financial return, there will always be an Enron.²⁸¹

Given this structural implication of the rules of the game, it would behoove the legal profession to produce lawyers who are more financially fluent. Hindsight tells the repeat players in law school—law professors and deans—that some students may have a calling for transactional finance. These students are generally underserved by the current curriculum at many law schools.²⁸² Forced to take a random walk through the first year of law school, they typically begin upper-level courses without the basic analytical methods in finance, accounting, and game theory. Increasingly, these methods inform the performance expectations for an effective transactional lawyer, especially one who will be advising a chief financial officer, poised as the office is to bear liability and calumnies, especially after recent history's devilish depiction of this corporate official. For these students, fewer brambles and more financial analytic methods are needed. In closing, I call on my transactional law colleagues to foster more integration of analytical financial methods into a basic legal education. Such an approach might produce more transactional lawyers capable of spotting and stemming future financial moral panics.

²⁸¹ That conclusion is implied in the idea of the “regulatory dialectic.” See Pouncy, supra note 2, at 546.
²⁸² One exception is the positive trend in legal education towards increased training for law students in transactional law in the development of analytical methods courses. See, e.g., HOWELL E. JACKSON ET AL., ANALYTICAL METHODS FOR LAWYERS (1989) (assembles game theory, accounting, finance, statistics, and other transactional methodologies for use in a first-year or upper-level law school course). An elective first-year methods class at Harvard Law School uses this book, a fitting penance from the institution that helped to fossilize the Langdellian approach in the first place.