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## ACCOUNTING AND THE NEW CORPORATE LAW

JOEL SELIGMAN\*

I want to talk today about legal education. In particular I want to discuss certain ways in which the teaching of corporate law has become largely dated.

It is a conventional idea in corporate law today to teach that the state law applicable to insider trading was largely a failure and has been generally displaced by such federal securities law staples as Rule 10b-5, § 16, and Rule 14e-3.<sup>1</sup> Similarly, most corporate law texts recognize that certain of the most fundamental principles of corporate suffrage emanate from the federal proxy rules, not state corporate law.<sup>2</sup> The typical text, however, tends to become reticent when exploring the extent to which the federal securities laws have also begun to displace state corporate law fiduciary duty concepts.<sup>3</sup> This process of augmenting or displacing traditional state corporate law is most advanced in an area I want to discuss today, the duty of care. I call this process the new corporate law.

In corporate law, the duty of care is the basic negligence concept. In most corporate law casebooks, the concept is recognized as important, but the key lesson is that plaintiffs very rarely succeed in duty of care actions. The *ratio* typically goes something like this: Directors and officers, according to leading cases such as *Francis v. United Jersey Bank*,<sup>4</sup> must "discharge their duties in good faith and with that degree of diligence, care and skill which ordinarily prudent [persons] would exercise under similar circum-

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\* Professor, The University of Michigan Law School. I would like to express my gratitude to Al Conard, Ted J. Fiftlis, Eugene Imhoff, and Edward Labaton for their comments on this essay.

1. Compare 7 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3466-85 (1991) (state common law) with *id.* at 3485-545 and 8 *id.* at 3547-770 (federal insider trading law).

2. See 4 *id.* at 1916-2119.

3. See Joel Seligman, *The New Corporate Law*, 59 BROOK. L. REV. 1 (1993).

4. 432 A.2d 814 (N.J. 1981).

stances in like positions.”<sup>5</sup> When, say, a director fails to acquire a rudimentary understanding of the business of a corporation, *or* to keep informed of its activities, *or* to adequately monitor corporate affairs and policies, *and* this failure is the proximate cause of (or, at least a substantial factor contributing to) a loss, the director can be held liable for a failure to supervise a corporation. Typically this lesson is embellished by observing that directors normally may rely on the reports of officers, committees, and outsiders such as the certified public accountant,<sup>6</sup> and that, in many instances, a director can be held liable for a failure to supervise only when given notice that something may be amiss.<sup>7</sup> As a famous Delaware case put it, “there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.”<sup>8</sup>

Enter now the voracious exceptions. When directors actually do make a decision, that decision normally will be insulated from judicial review by the business judgment rule, which, in essence, applies as long as the directors were untainted by a conflict of interest and adequately informed.<sup>9</sup> In the leading corporate law jurisdiction for publicly traded corporations, Delaware, “the concept of gross negligence is . . . the proper standard for determining whether a business judgment reached by a board of directors was an informed one.”<sup>10</sup> Delaware goes further. A corporation can amend its certificate of incorporation to preclude totally the personal liability of any director to the corporation or its stockholders for monetary damages for breach of the duty of care.<sup>11</sup> And, even if a Delaware corporation does not go so far, most plaintiffs’ complaints raising duty of care issues will be dismissed under the current procedures for initiating a derivative action. This will occur either because less than a majority of a board are properly named as defendants and a demand to initiate a suit must be made of the board of directors, which can decline to proceed,<sup>12</sup> or because the complaint does allege that a majority or more of a board has been properly named as defendants, but the board appoints other directors to an independent litigation committee, which, after an investigation, recommends dismissal to the trial court.<sup>13</sup>

There are various permutations that can be played on these themes. Excessive corporate salaries or perquisites can be challenged under the waste doctrine, which will require their partial return to the extent that they can

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5. *Id.* at 820 (quoting N.J. STAT. ANN. § 14A:6-14 (West 1969)).

6. *See, e.g.*, DEL. CODE ANN., tit. 8, § 141(e) (Supp. 1992-93).

7. *See, e.g.*, *Bates v. Dresser*, 251 U.S. 524 (1920).

8. *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963).

9. *See, e.g.*, *Smith v. Van Gorkom*, 488 A.2d 858, 872-73 (Del. 1985).

10. *Id.* at 873. For circumstances that can lead to a holding that directors made an uninformed decision, see also *Grobow v. Perot*, 539 A.2d 180, 191 (Del. 1988).

11. DEL. CODE ANN., tit. 8, § 102(b)(7) (Supp. 1992-93).

12. *See, e.g.*, *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).

13. *See, e.g.*, *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

be likened to a gift of corporate property, even in the absence of a conflict of interest.<sup>14</sup> The waste doctrine can be characterized as an application of the duty of care. Similarly, the corporate law casebooks often will explore different state standards for the duty of care, the business judgment rule, and the demand on directors rules. Or the duty of care can be put in a sociological context with explorations of such topics as how many hours directors devote to their task; how the board's agenda is developed; what kind of staff the board has; and how directors are selected.<sup>15</sup> Rationalizations can be propounded for the sweeping business judgment defense in terms of the risktaking functions of the board or the ability of shareholders to diversify their investment portfolios.<sup>16</sup> More broadly, it can be urged that market forces generally constrain corporate negligence; violations of the duty of care that do occur are in essence just an "agency cost."<sup>17</sup>

But the basic lesson of this pedagogy is almost always the same: The duty of care is applicable to boards of directors and corporate officers, but it very rarely succeeds. There is a necessary, or almost necessary, inference that the wise student then draws: The duty of care is not very important.

I think both this basic lesson and the concomitant inference are wrong. Not because the casebooks and law teachers wrongly analyze the cases they study, but because they, in fact, are studying the wrong illustrations of the duty of care. We are in effect teaching a 19th century version of corporate law that has been overtaken by late 20th century developments.

In the real world, the language of corporate governance is accounting. Boards of directors are concerned with whether they were adequately informed before making a decision. But they express this concern in such terms as, "Do we have adequate internal controls?" "Was that process sufficiently audited?" To teach corporate law, as most of us do, while generally ignoring the significance of auditing and internal controls to business decisionmaking, runs the risk of systematically misunderstanding what we are studying. Let me illustrate this proposition by suggesting how a new corporate law of the duty of care might be taught. I particularly want to emphasize the significance of auditing and the role of the Securities and Exchange Commission.

The SEC has authority to regulate accounting standard-setting and, probably, auditing.<sup>18</sup> The distinction between accounting and auditing was

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14. See, e.g., *Rogers v. Hill*, 289 U.S. 582, 591-92 (1933); cf. *Michelson v. Duncan*, 407 A.2d 211, 217-220 (Del. 1979).

15. See, e.g., Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477 (1984).

16. See, e.g., *Joy v. North*, 692 F.2d 880 (2d Cir. 1982).

17. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

18. This authority derives from § 19(a) of the 1933 Act and § 13(b) of the 1934 Act, which empowers the Commission to prescribe "the methods to be followed in the preparation of accounts . . ."; from its explicit power to require certification of financial statements, see, e.g., Sch. A, Items 25, 26, 1933 Act; § 12(b)(1)(J), 1934 Act; and from the fraud provisions of the 1933 Act, especially §§ 11 & 17, and the 1934 Act, see §§ 18(a) & 10(b). For authority under the Inv. Co. Act, see § 30(e); under the Public Utility Holding Co. Act, see § 14.

described by an *ad hoc* Commission on Auditors' Responsibilities in these terms:

In the broadest sense, the discipline of accounting includes auditing. However, accounting can be described as measuring and reporting the effects of economic activities of individual entities. Auditing, on the other hand, involves an independent examination to determine the propriety of accounting processes, measurements, and communication. Stated simply, the accountant prepares financial information; the auditor checks it.<sup>19</sup>

The Commission first became seriously concerned with auditing after its 1940 investigation of McKesson & Robbins.<sup>20</sup> In that case an annual audit by a reputable firm of accountants did not prevent the senior officers of the company from siphoning away several millions in cash, primarily by overstating its inventory and accounts receivable by approximately \$20 million and reporting large profits from a wholly fictitious crude drug business.<sup>21</sup>

Beginning in the 1970s with such cases as the criminal conviction of the auditors involved in the Equity Funding fraud<sup>22</sup> and with the Commission's questionable payment or overseas bribery enforcement actions,<sup>23</sup> attention again was focused on the problem of "audit failures" or "cooked books."

Besides continuing with enforcement actions against auditors, the Commission mounted a two pronged response during the 1970s to the problem of audit failures. In 1977 the Commission approved a rule change in the listing requirements of the New York Stock Exchange (NYSE) to require each domestic company with common stock listed on that exchange, "as a condition of initial and continued listing of its securities . . . to establish not later than June 30, 1978, and maintain thereafter an audit committee comprised solely of directors independent of management and free from any relationship that, in the opinion of the board of directors, would interfere with the exercise of independent judgment as a committee member."<sup>24</sup> This was a salutary, if modest, reform. On March 11, 1976, when SEC Chairman Roderick Hills had requested that the NYSE make this amendment to its listing requirements, he estimated that almost ninety

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19. COMMISSION ON AUDITORS' RESPONSIBILITIES, REPORT, CONCLUSIONS AND RECOMMENDATIONS xii (1978).

20. SEC, REPORT ON INVESTIGATION, MCKESSON & ROBBINS, INC. (1940).

21. For further discussion of the McKesson & Robbins and other leading audit failures, see generally 2 LOSS & SELIGMAN, *supra* note 1, at 715-25.

22. United States v. Weiner, 578 F.2d 757 (9th Cir. 1978); Seidman & Seidman, Acct. Ser. Rel. 196, 10 SEC Dock. 327 (1976) (noting at 334: "By the time the massive fraud was disclosed, Equity had in excess of \$120 million (net of deferred taxes) in fictitious or fraudulently inflated assets on its books").

23. See 2 LOSS & SELIGMAN, *supra* note 1, at 660-61.

24. Sec. Ex. Act Rel. 13,346, 11 SEC Dock. 1945 (1977).

percent of the nation's largest corporations already had established audit committees.<sup>25</sup> A 1980 SEC survey of 1,200 business corporations whose securities were publicly traded found that the typical audit committee met 2.7 times per year and limited its functions to approval of the selection of the firm's outside auditor and review of audit plans and results.<sup>26</sup>

More significantly, at approximately the same time, the Commission persuaded Congress to enact the Foreign Corrupt Practices Act. That Act added § 13(b)(2) to the Securities Exchange Act, which requires each reporting corporation to "make and keep books, records, and accounts, which in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer" and to "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that . . . transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles. . . ."<sup>27</sup> A primary purpose of § 13(b)(2) was to prevent corporate officers or directors from making materially false or misleading statements or omitting to state material facts "to an accountant in connection with (1) any audit or examination of the financial statements of the issuer . . . or (2) the preparation or filing of any document or report required to be filed with the Commission . . . ."<sup>28</sup>

Section 13(b)(2) has been invoked by the SEC in enforcement proceedings challenging such audit failures as: "(1) inventory problems, (2) problems

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25. Addresses of Roderick Hills, June 21, 1976 and June 30, 1976, summarized in JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* 547 (1982).

26. STAFF OF SENATE COMM. ON BANKING, HOUS. & CORPORATE GOVERNANCE, 96th Cong., 2d Sess., SEC STAFF REPORT ON CORPORATE ACCOUNTABILITY: A RE-EXAMINATION OF RULES RELATING TO SHAREHOLDER COMMUNICATIONS, SHAREHOLDER PARTICIPATION IN THE CORPORATE ELECTORAL PROCESS AND CORPORATE GOVERNANCE GENERALLY, 496-506, 608 (Comm. Print 1980).

27. 15 U.S.C. 78m(b)(2) (1977). For citations concerning this Act, see 2 LOSS & SELIGMAN, *supra* note 1, at 696 n.223.

Proposed SEC rules that would have required all annual reports filed with the Commission or mailed under the proxy rules to include a management statement on internal accounting control, reported on by an independent accountant, encountered substantial opposition and were withdrawn, the Commission later noting private sector initiatives in the area. Sec. Ex. Act Rel. 34-15,772, 17 SEC Dock. 421 (1979), Acct. Ser. Rel. 278, 20 SEC Dock. 310 (1980); Acct. Ser. Rel. 305, 24 SEC Dock. 746 (1982). The Commission, however, did use its new authority to adopt Rules 13b2-1 and 13b2-2, which prohibit the falsification of corporate records or accounts as well as a director's or officer's making materially false, misleading, or incomplete statements to an accountant in connection with an audit or examination or in connection with the preparation or filing of required reports. Sec. Ex. Act Rel. 15,570, 16 SEC Dock. 1143, 1147-48 (1979).

In 1988 Congress adopted the Foreign Corrupt Practices Act Amendments, which added §§ 13(b)(4)-(7). See H.R. CONF. REP. No. 576, 100th Cong., 2d Sess. 916-917, *reprinted* in 1988 U.S.C.C.A.N. 1762, 1949-50. These Sections, among other things, limit criminal liability to persons who *knowingly* violate § 13(b)(2); and define the terms *reasonable assurances* and *reasonable detail* to mean "such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs."

28. 17 C.F.R. § 240.13b2-2 (1992).

with separation of duties and the lack of documentation of transactions, and (3) problems with the books, records, and accounting procedures of the company."<sup>29</sup>

As the first litigated section 13(b)(2) decision explained:

It is clear that section 13(b)(2) and the rules promulgated thereunder are rules of general application which were enacted to (1) assure that an issuer's books and records accurately and fairly reflect its transactions and the disposition of assets, (2) protect the integrity of the independent audit of issuer financial statements that are required under the Exchange Act, and (3) promote the reliability and completeness of financial information that issuers are required to file with the Commission or disseminate to investors pursuant to the Exchange Act.<sup>30</sup>

29. SEC v. World-Wide Coin Inv., Ltd., 567 F. Supp. 724, 738 (N.D. Ga. 1983). For illustrative SEC proceedings, see *Tonka Corp.*, Accounting & Auditing Enforcement Release (AAER) 73, 34 SEC Dock. 118 (1985); *Burroughs Corp.*, AAER 50, 32 SEC Dock. 935 (1985); *Citizens Trust Co.*, AAER 84, 34 SEC Dock. 1272 (1986); *De Laurentiis Entertainment Group, Inc.*, AAER 144, 38 SEC Dock. 1343 (1987); *Clayton A. Sweeney*, Sec. Ex. Act Rel. 24,888, 39 SEC Dock. 160 (1987). See also *Michael R. Maury*, AAER 93, 35 SEC Dock. 435 (1986) (company controller who was highest ranking accounting employee, though not a decision-maker, had a duty to the company and its stockholders not to assist, or even acquiesce in, false financial statements); *Steven L. Komm*, AAER 175, 40 SEC Dock. 4 (1988) (chief financial officer violated Rule 13b-2 when he falsified books, records, and accounts concerning disposition of automated teller machines).

Even before enactment of § 13(b)(2), the Commission emphasized in enforcement actions the need for a registrant to maintain an adequate system of internal controls. See, e.g., *Drayer-Hanson, Inc.*, Acct. Ser. Rel. 64 (1948) ("the auditors should have made a more thorough examination of the registrant's system of internal control and . . . should have determined that they were being operated effectively"); *S. D. Leidesdorf & Co.*, Acct. Ser. Rel. 209, 11 SEC Dock. 1724, 1735 (1977) ("Independent auditors should carefully test and evaluate the internal control systems of an audit client before placing any reliance upon those controls"). See also *Stanley I. Goldberg*, AAER 13, 28 SEC Dock. 1086 (1983); *Murphy, Hauser, O'Connor & Quinn*, AAER 18, 29 SEC Dock. 489 (1983); *Frederick S. Todman & Co.*, AAER 36, 31 SEC Dock. 259 (1984); *Robert S. Harrison*, AAER 74, 34 SEC Dock. 141 (1985); *Stewart Parness*, AAER 108, 36 SEC Dock. 286 (1986).

No private cause of action is available under § 13(b). See, e.g., *McLean v. International Harvester Co.*, 817 F.2d 1214 (5th Cir. 1987); *Lamb v. Phillip Morris, Inc.*, 915 F.2d 1024 (6th Cir. 1990), cert. denied, 498 U.S. 1036, 111 S. Ct. 961.

30. SEC v. World-Wide Coin Inv., Ltd., 567 F. Supp. 724, 747. This case further elaborated at 750-51:

"Internal accounting controls" must be distinguished from the accounting system typically found in a company. Accounting systems process transactions and recognize, calculate, classify, post, summarize, and report transactions. Internal controls safeguard assets and assure the reliability of financial records, one of their main jobs being to prevent and detect errors and irregularities that arise in the accounting systems of the company. Internal accounting controls are basic indicators of the reliability of the financial statements and the accounting system and records from which financial statements are prepared.

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Although not specifically delineated in the Act itself, the following directives can

SEC auditing proceedings are essentially failures to exercise due care. Let me offer an illustration. In 1992 the Commission brought a Rule 2(e) proceeding against two certified public accountants, John R. Schoemer and Michael P. Denkensohn, for alleged misconduct in their audit of the December 31, 1983, consolidated financial statements of Marsh & McLennan Companies, Inc. (MMC).<sup>31</sup> The Commission's summary of the proceeding reads like a paraphrase of the typical corporate law casebook's duty of care:

The Commission concludes that Respondents did not examine MMC's 1983 consolidated financial statements in accordance with GAAS [Generally Accepted Auditing Standards] in that they (1) failed to obtain sufficient competent evidential matter to afford a reasonable basis for the opinion on those financial statements; and (2) failed to exercise due professional care in performing the audit.

Standard of Field Work No. 3 of GAAS states: "Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit." The Commission finds that the evidence obtained by Respondents during the course of the 1983 audit of MMC's consolidated financial statements was insufficient to afford a reasonable basis for their opinion that MMC's method of recording the existence, completeness and value of certain of its investments was proper. As discussed below, the Commission finds that Respondents did not obtain competent evidence concerning the nature and extent of the investment activities of MMC's investment unit, the Investment Management Group ("IMG"), when various other audit steps likely would have produced the necessary information.

General Standard No. 3 of GAAS states: "Due professional care is to be exercised in the performance of the audit and the preparation

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be inferred from the internal controls provisions: (1) Every company should have reliable personnel, which may require that some be bonded, and all should be supervised. (2) Account functions should be segregated and procedures designed to prevent errors or irregularities. The major functions of recordkeeping, custodianship, authorization, and operation should be performed by different people to avoid the temptation for abuse of these incompatible functions. (3) Reasonable assurances should be maintained that transactions are executed as authorized. (4) Transactions should be properly recorded in the firm's accounting records to facilitate control, which would also require standardized procedures for making accounting entries. Exceptional entries should be investigated regularly. (5) Access to assets of the company should be limited to authorized personnel. (6) At reasonable intervals, there should be a comparison of the accounting records with the actual inventory of assets, which would usually involve the physical taking of inventory, the counting of cash, and the reconciliation of accounting records with the actual physical assets. Frequency of these comparisons will usually depend on the cost of the process and upon the materiality of the assets involved.

31. John R. Schoemer, C.P.A., AAER 365, 51 SEC Dock. 158 (1992).



of the report." The Commission finds that Respondents did not conduct their audit with due professional care in that, having made the decision to perform substantive testing of the company's investment portfolio accounts within the IMG, they failed to follow established audit procedures to test that (a) securities recorded in the investment portfolio accounts existed at the balance sheet date; (b) all securities that should have been recorded were in fact recorded in the investment portfolio accounts; (c) securities were properly valued in accordance with GAAP; and (d) all liabilities related to the securities were recorded in the financial statements.<sup>32</sup>

For students to study even one illustration of this type of proceeding would potentially open their eyes to the pivotal roles that the outside auditor and the board's audit committee play in corporate governance. The study of such a proceeding could include also a brief introduction to the reading of financial statements. The idea would be to help students understand what an investor or a member of the board would read in a balance sheet or income statement, not how to prepare these types of financial statements. Similarly, the study of such a case could introduce students to a clearer sense of bookkeeping, internal accounting controls, and auditing.

What distinguishes Commission audit failure proceedings from state corporate law duty of care activities is not merely that they focus on financial auditing, but also the variety of remedies the SEC can employ and the frequency with which the agency brings actions. At the current time the Commission, in essence, can invoke five different types of remedies:

(1) Judicial injunctions under, among other provisions, § 21(d)(1) of the Securities Exchange Act;<sup>33</sup>

(2) Disciplinary actions against accountants under Rule 2(e) of the Commission's Rules of Practice;<sup>34</sup>

(3) Disciplinary proceedings against the corporate registrant under § 15(c)(4) of the Securities Exchange Act;<sup>35</sup>

(4) Administrative cease and desist proceedings against either the accountant or the registrant;<sup>36</sup> or

(5) References to the Justice Department for criminal prosecution.<sup>37</sup>

Even brief exposure to this range of remedies should highlight that too much of our study of corporate law is based on the fallacy that the primary

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32. *Id.* at 159-60.

33. See 15 U.S.C. § 78u(d) (1988). Regarding Commission injunctive proceedings, see generally 10 LOSS & SELIGMAN, *supra* note 1, ch. 12.A (forthcoming 1993).

34. 17 C.F.R. § 201.2e (1992). Regarding Rule 2(e) proceedings, see generally 10 LOSS & SELIGMAN, *supra* note 1, ch. 13.A(3) (forthcoming 1993).

35. 15 U.S.C. § 78o(c)(4) (1988); see 4 LOSS & SELIGMAN, *supra* note 1, at 1898-902.

36. See 10 LOSS & SELIGMAN, *supra* note 1, ch. 13.D(2) (forthcoming 1993).

37. See 10 LOSS & SELIGMAN, *supra* note 1, ch. 12.B (forthcoming 1993). Leading criminal accounting fraud cases include *United States v. Natelli*, 527 F.2d 311 (2d Cir. 1975), *cert. denied*, 425 U.S. 934 (1976); *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970); *United States v. Benjamin*, 328 F.2d 854 (2d Cir.), *cert. denied*, Howard v. United States, 377 U.S. 953 (1964); *United States v. White*, 124 F.2d 181 (2d Cir. 1941).

remedial purpose of most corporate law related litigation is shareholder compensation. It is one primary purpose. The other primary purpose is deterrence. This point becomes almost banal when it is recognized how many more lawsuits are litigated against the corporation itself for misrepresentations and omissions grounded in senior agents' negligence than against the agents themselves.

The frequency with which securities law judicial and accounting remedies can be brought dwarfs state corporate law duty of care proceedings. Since 1970, for example, there have been over 120 Rule 2(e) proceedings brought against accountants;<sup>38</sup> of the sixty § 15(c)(4) proceedings brought between

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38. In *Touche Ross & Co. v. SEC*, 609 F.2d 570, 582 (2d Cir. 1979), the Second Circuit upheld Rule 2(e) as applied to accountants as "a necessary adjunct to the Commission's power to protect the integrity of its administrative procedures and the public in general."

The greater than 120 Rule 2(e) proceedings since 1970 include *Martin L. Sanchez*, Acct. Ser. Rel. 127 (1972); *Barry L. Kessler*, Acct. Ser. Rel. 129 (1972); *Robert Trivison*, Acct. Ser. Rel. 131 (1972); *Robert Lynn Burroughs*, Acct. Ser. Rel. 143, 1 SEC Dock. No. 8 at 26 (1973); *Laventhol Krekstein Horwath & Horwath*, Acct. Ser. Rel. 144, 1 SEC Dock. No. 17 at 11 (1973); *Touche Ross & Co.*, Acct. Ser. Rel. 153, 3 SEC Dock. 594 (1974), 153A, 17 SEC Dock. 1107 (1979); *Arthur Andersen & Co.*, Acct. Ser. Rel. 157, 4 SEC Dock. 547 (1974); *Adolph F. Spear*, Acct. Ser. Rel. 158, 4 SEC Dock. 591 (1974); *Loux, Gose & Co.*, Acct. Ser. Rel. 160, 5 SEC Dock. 89 (1974); *Westheimer, Fine, Berger & Co.*, Acct. Ser. Rel. 167, 5 SEC Dock. 799 (1974); *Benjamin Botwinick & Co.*, Acct. Ser. Rel. 168, 6 SEC Dock. 97 (1975); *Tubber T. Okuda*, Acct. Ser. Rel. 170, 6 SEC Dock. 188 (1975); *Peat, Marwick, Mitchell & Co.*, Acct. Ser. Rel. 173, 7 SEC Dock. 301 (1975), 173A, 12 SEC Dock. 361 (1977); *Harris, Kerr, Forster & Co.*, Acct. Ser. Rel. 174, 7 SEC Dock. 293 (1975); *Jerry A. McFarland*, Acct. Ser. Rel. 161, 5 SEC Dock. 61 (1974); *Hertz, Herson & Co.*, 45 SEC Dock. 889 (1975); *Thomas R. Mathews*, Acct. Ser. Rel. 179A, 8 SEC Dock. 588 (1975); *Bill D. Steele*, 8 SEC Dock. 732 (1975); *Rudolph, Palitz & Co.*, Acct. Ser. Rel. 191, 9 SEC Dock. 363 (1976); *Seidman & Seidman*, Acct. Ser. Rel. 196, 10 SEC Dock. 327 (1976), 196A, 11 SEC Dock. 1116 (1976); *S. D. Leidesdorf & Co.*, Acct. Ser. Rel. 209, 11 SEC Dock. 1724 (1977); *Reich, Weiner & Co.*, Acct. Ser. Rel. 210, 11 SEC Dock. 1919 (1977); *Eugene Testa*, Acct. Ser. Rel. 212, 12 SEC Dock. 67 & 276 (1977); *Laventhol & Horwath*, Acct. Ser. Rel. 227, 13 SEC Dock. 120 (1977); *Paul N. Conner*, Acct. Ser. Rel. 239, 13 SEC Dock. 1397 (1978); *Haskins & Sells*, Acct. Ser. Rel. 241, 14 SEC Dock. 148 (1978); *Ernst & Ernst*, Acct. Ser. Rel. 248, 14 SEC Dock. 1276, 1301 (1978); *Gerald J. Flannely*, Acct. Ser. Rel. 255, 15 SEC Dock. 1155 (1978); *Martin E. Davis*, Acct. Ser. Rel. 267, 17 SEC Dock. 1226 (1979); *Darrel L. Nielsen*, Acct. Ser. Rel. 275, 19 SEC Dock. 158 (1980); *Saul Glazer*, Acct. Ser. Rel. 282, 21 SEC Dock. 66 (1980); *Lester Witte & Co.*, Acct. Ser. Rel. 285, 21 SEC Dock. 1256 (1981); *Kenneth Leventhal & Co.*, Acct. Ser. Rel. 288, 22 SEC Dock. 262 (1981); *Arthur Andersen & Co.*, Acct. Ser. Rel. 292, 22 SEC Dock. 1346 (1981); *Louis Pokat*, AAER 2, 25 SEC Dock. 1176 (1982); *George L. Simmon*, AAER 12, 28 SEC Dock. 629 (1983); *Stanley I. Goldberg*, AAER 13, 28 SEC Dock. 1086 (1983); *Touche Ross & Co.*, AAER 16, 29 SEC Dock. 152 (1983); *Murphy, Hauser, O'Connor & Quinn*, AAER 18, 29 SEC Dock. 489 (1983); *James H. Feldhake*, AAER 27, 30 SEC Dock. 197 (1984); *Willie L. Mayo*, AAER 29, 30 SEC Dock. 462 (1984); *Stephen O. Wade*, AAER 32, 30 SEC Dock. 972 (1984); *Frederick S. Todman & Co.*, AAER 36, 31 SEC Dock. 259 (1984); *Smith & Stephens Accountancy Corp.*, AAER 39, 31 SEC Dock. 381 (1984); *Coopers & Lybrand*, AAER 45, 31 SEC Dock. 1000 (1984); *Russell G. Davy*, AAER 53, 32 SEC Dock. 1267 (1985); *Edward S. Markman, C.P.A.*, AAER 67, 33 SEC Dock. 886 (1985); *David G. Rogers*, AAER 69, 33 SEC Dock. 1090 (1985); *Weinaug & Co.*, AAER 71, 33 SEC Dock. 1227 (1985); *Schoenfeld & Mendelsohn*, AAER 76, 34 SEC Dock. 149 (1985); *Seidman & Seidman*, AAER 78, 34 SEC Dock. 304 (1985); *John*

1975 and June 1985, forty-six were said to have concerned accounting and

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E. Harrington, AAER 81, 34 SEC Dock. 859 (1985); Frantz, Warrick, Strack & Assocs., P.C., AAER 86, 35 SEC Dock. 42 (1986); Arthur Rogovin, AAER 87, 35 SEC Dock. 147 (1986); Robert E. Nilssen, AAER 111, 36 SEC Dock. 605 (1986); Albert Jacobs, CPA, AAER 114, 36 SEC Dock. 768 (1986); Huber, Erickson and Butler, AAER 115, 36 SEC Dock. 952 (1986); Marvin D. Haney, AAER 126, 37 SEC Dock. 663 (1987); Stephen Kutz, AAER 127, 37 SEC Dock. 669 (1987); KMG Main Hurdman, AAER 129, 37 SEC Dock. 1304 (1987); Myron K. Berryman, CPA, AAER 150, 39 SEC Dock. 89 (1987); Richard S. Gilman, AAER 159, 39 SEC Dock. 315 (1987); C. O'Neil Rasmussen, CPA, AAER 161, 39 SEC Dock. 335 (1987); Stephen Grossman, AAER 172, 39 SEC Dock. 833 (1987); Steven L. Komm, AAER 175, 40 SEC Dock. 4 (1988); Norman Abrams, C.P.A., AAER 179, 40 SEC Dock. 325 (1988); Bill R. Thomas, AAER 192, 41 SEC Dock. 70 (1988); John M. Schulzetenberg, C.P.A., AAER 200, 41 SEC Dock. 1285 (1988); Keith Bjelajac, CPA, AAER 201, 41 SEC Dock. 1221 (1988); John L. Van Horn, AAER 209, 42 SEC Dock. 182 (1988); Edmond A. Morrison, III, AAER 216, 42 SEC Dock. 1289 (1989); Larry A. Dixon, AAER 219, 43 SEC Dock. 713 (1989); Richard P. Franke, C.P.A., AAER 220, 43 SEC Dock. 858 (1989); Lynne K. Mercer, CPA, AAER 222, 43 SEC Dock. 1045 (1989); Sheldon M. Blazar, AAER 226, 43 SEC Dock. 1445 (1989); Marvin D. Haney, C.P.A., AAER 237, 44 SEC Dock. 49 (1989); Stephen P. Clark, C.P.A., AAER 239, 44 SEC Dock. 473 (1989); Jack M. Portney, C.P.A., AAER 242, 44 SEC Dock. 582 (1989); Frederick D. Woodside C.P.A., AAER 244, 44 SEC Dock. 691 (1989); Noemi L. Rodriguez Santos, AAER 246, 44 SEC Dock. 770 (1989); Combellick, Reynolds & Russell Inc., AAER 324, 49 SEC Dock. 1422 (1991); Stephen L. Hochberg, C.P.A., AAER 251, 45 SEC Dock. 350 (1990); Georgia McCarley, AAER 267, 46 SEC Dock. 1240 (1990); Bruce T. Andersen, CPA, AAER 268, 46 SEC Dock. 1603 (1990); William G. Gaede, Jr., CPA, AAER 274, 47 SEC Dock. 231 (1990); Charles C. Lehman, Jr., AAER 275, 47 SEC Dock. 283 (1990); Ernst & Whinney, 47 SEC Dock. 93 (Admin. Proc. 1990); Bruce F. Kalem, CPA, AAER 294, 48 SEC Dock. 759 (1991); Merle E. Bright, C.P.A., AAER 295, 48 SEC Dock. 762 (1991); Raymond Bacek, AAER 296, 48 SEC Dock. 1180 (1991); Michael R. Ford, CPA, AAER 302, 49 SEC Dock. 166 (1991); Samuel George Greenspan, CPA, AAER 312, 49 SEC Dock. 980 (1991); Edward Anchel, C.P.A., AAER 314, 49 SEC Dock. 988 (1991); Rodney Sparks, C.P.A., AAER 315, 49 SEC Dock. 1156 (1991); Terrance M. Wahl, AAER 321, 49 SEC Dock. 1400 (1991); Walter F. Buce, CPA, AAER 337, 50 SEC Dock. 93 (1991); Frederick S. Todman & Co., AAER 339, 50 SEC Dock. 144 (1991); Andrew L. Epstein, CPA, AAER 340, 50 SEC Dock. 143 (1991); Steven C. Wolfe, Sr., CPA, AAER 344, 50 SEC Dock. 554 (1991); Kenneth A. Huff, CPA, AAER 353, 50 SEC Dock. 1182 (1992); William P. Lorea, CPA, AAER 354, 50 SEC Dock. 1184 (1992); Amre, Inc., AAER 356, 50 SEC Dock. 1474 (1992); D. Spencer Nilson, CPA, AAER 364, 51 SEC Dock. 154 (1992); John R. Schoemer, C.P.A., AAER 365, 51 SEC Dock. 158 (1992); Artie S. Hope, C.P.A., AAER 368, 51 SEC Dock. 307 (1992); James Dougan, AAER 380, 51 SEC Dock. 606 (1992); Michael Briggs, C.P.A., AAER 381, 51 SEC Dock. 607 (1992); Andrew L. Epstein, C.P.A., AAER 384, 51 SEC Dock. 757 (1992); Artie S. Hope, C.P.A., AAER 386, 51 SEC Dock. 835 (1992); Jerry Bernstein, C.P.A., AAER 391, 51 SEC Dock. 1223 (1992); Leroy P. Studer, CPA, AAER 398, 51 SEC Dock. 1516 (1992); Robert A. Domingues, CPA, AAER 400, 51 SEC Dock. 2400 (1992); Mark Sauter, AAER 401, 52 SEC Dock. 818 (1992); Judy Wischer, AAER 402, 52 SEC Dock. 819 (1992); Denis Lustig, C.P.A., AAER 404, 52 SEC Dock. 887 (1992); Wayne F. Sloop, CPA, AAER 406, 52 SEC Dock. 898 (1992); Andrew Ligget, AAER 408, 52 SEC Dock. 1003 (1992); David J. Checkosky, AAER 412, 52 SEC Dock. 1122 (1992); Harold Fischman, AAER 413, 52 SEC Dock. 1212 (1992); Mark Baker, AAER 414, 52 SEC Dock. 1280 (1992); Larry G. Baker, CPA, AAER 415, 52 SEC Dock. 1443 (1992); Thomas Page Taylor, CPA, AAER 420, 52 SEC Dock. 1667 (1992); Milton M. Trujillo, AAER 423, 52 SEC Dock. 1716 (1992); James C. Andrus, C.P.A., AAER 424, 52 SEC Dock. 1718 (1992); and David M. Lamoreaux, CPA, AAER 429, 52 SEC Dock. 1908 (1992).

financial disclosures.<sup>39</sup> Similar totals have already begun to develop for accounting violations of the Commission's cease and desist powers which were only adopted in 1990.<sup>40</sup>

None of this is accidental. As the SEC's Director of Corporate Finance explained in 1992: "The Division has more than doubled its accounting staff. There are more than one hundred accountants in the Division, and accounting issues are a primary focus of the Division's review effort. . . . Simply put, if you have accounting issues, do not wait for the staff to find them, because they will."<sup>41</sup>

In contrast Professor Joseph Bishop observed in 1968 about the state corporate law duty of care:

The search for cases in which directors of industrial corporations have been held liable . . . for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack. Few are the cases in which the stockholders do not allege conflict of interest, still fewer those among them which achieve even such partial success as denial of the defendants' motion to dismiss the complaint.<sup>42</sup>

Twenty-five years later Bishop's words still ring true. Bishop identified only four cases where directors of industrial corporations had been held potentially liable for negligence uncomplicated by self-dealing. The 1992 American Law Institute Principles of Corporate Governance Proposed Final Draft cited only three cases as examples of "negligent liability."<sup>43</sup>

In recent years private plaintiffs in several individual months have filed at least that many duty of care cases, but under the federal securities laws. For a failure to disclose a duty of care violation can be fraud, a point, for example, implied by the Delaware Supreme Court decision, *Smith v. Van Gorkom*.<sup>44</sup>

Most of these private federal securities fraud cases are based on misrepresentations or omissions in a corporation's financial statements. For example, in recent years, a substantial number of lawsuits have alleged that

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39. William R. McLucas & Laurie Romanowich, *SEC Enforcement Proceedings Under Section 15(c)(4) of the Securities Exchange Act of 1934*, 41 BUS. LAW. 145, 152 (1985).

40. See, e.g., Fleet/Norstar Fin. Group, Inc., AAER 309, 49 SEC Dock. 821 (1991) (also internal accounting controls); Excel Bancorp, Inc., AAER 316, 49 SEC Dock. 1173 (1991) (same); Richard D. Lemmerman, AAER 320, 49 SEC Dock. 1334 (1991); Amre, Inc., AAER 356, 50 SEC Dock. 1474 (1992) (also internal accounting controls); Caterpillar Inc., AAER 363, 51 SEC Dock. 147 (1992) (Item 303 of Reg. S-K); Abington Bancorp, Inc., AAER 370, 51 SEC Dock. 476 (1992) (also internal accounting controls).

41. Linda C. Quinn, *The View from Corporation Finance*, in 23RD ANNUAL INSTITUTE ON SECURITIES REGULATION 3, 7 (Harvey L. Pitt et al. eds., 1992).

42. Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968).

43. Cf. AMERICAN L. INST., *Principles of Corporate Governance: Analysis and Recommendations* 210 (Proposed Final Draft Mar. 31, 1992).

44. 488 A.2d 858, 890-92 (Del. 1985).

corporations made projections or forward looking statements of such matters as future earnings "without a reasonable basis."<sup>45</sup> While corporate law casebooks sometimes do refer to the relevant Commission safe harbor rules for projections,<sup>46</sup> the dominant lesson, to quote a leading case, has been:

As a matter of public policy, the SEC and the courts generally have not required the inclusion of appraised asset valuations, projections, and other "soft" information in proxy materials or tender offers. [Citations omitted.] The reasons underpinning the SEC's longstanding policy against disclosure of soft information stem from its concern about the reliability of appraisals, its fear that investors might give greater credence to the appraisals or projections than would be warranted, and the impracticability of the SEC's examining such appraisals on a case by case basis to determine whether they are sufficiently reliable to merit disclosure.<sup>47</sup>

Typically missing from discussion of earnings projections and other soft information has been the recognition that most corporations are managed by comparing actual performance to annual or more frequent internal operational budgets or business plans. These budgets or plans are projections of future revenues and expenses. When a corporation's performance is significantly short of a budget or plan, this usually is a signal or "red flag" that senior officers or the board have to investigate why.

Nor is it accurate to view private litigation concerning projections as limited to earnings predictions. A number of recent cases have also involved such cognate areas as bank loan loss reserves,<sup>48</sup> pending legal proceedings,<sup>49</sup>

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45. See 17 C.F.R. § 230.175 (1992). For discussion of the SEC's policy on projections, including citations to the literature and leading cases, see 2 LOSS & SELIGMAN, *supra* note 1, at 622-36 (1989 & 1992 Supp.).

46. 17 C.F.R. § 230.175 (1992) (1933 Act); 17 C.F.R. § 240.3b-6 (1992) (1934 Act) adopted by Sec. Act Rel. 33-6084, 17 SEC Dock. 1048 (1979).

47. *Flynn v. Bass Bros. Enters., Inc.*, 744 F.2d 978, 985 (3d Cir. 1984). *Flynn*, however, did identify some circumstances when the disclosures of soft information would be required. *Id.* at 988. See also *Sinay v. Lamson & Sessions Co.*, 948 F.2d 1037 (6th Cir. 1991); *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509 (7th Cir. 1989); *Isquith v. Middle S. Utils., Inc.*, 847 F.2d 186 (5th Cir.), *cert. denied*, 488 U.S. 926 (1988).

48. See, e.g., *Shapiro v. UJB Fin. Corp.*, 964 F.2d 272 (3d Cir. 1992); *First Chicago Corp.*, AAER 134, 38 SEC Dock. 677 (1987).

49. See, e.g., *Levine v. NL Indus., Inc.*, 926 F.2d 199, 203-04 (2d Cir. 1991) (Regulation S-K Item 101(c)(1)(xii) requires disclosure of both the cost of complying with environmental regulations and potential costs for failing to comply); *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 516-18 (7th Cir. 1989) (unclean power plant approval proceeding); *cf.* *United States Steel Corp.*, Sec. Ex. Act Rel. 34-16,223, 18 SEC Dock. 497 (1979) (corporation was found between 1973 and 1977 to have failed to disclose the material effects that compliance with environmental laws would have on capital expenditures and earnings and failed to disclose a series of pending or contemplated environmental administrative proceedings when it stated in its filings, "U.S. Steel had pledged to confront and resolve its environmental problems as effectively and efficiently as technology, time and money permit"). See generally 2 LOSS & SELIGMAN, *supra* note 1, at 649-62 (1989 & 1992 Supp.).

or trends or uncertainties concerning liquidity, capital resources, and income that the SEC requires corporate registrants to disclose in the Management Discussion and Analysis Item of Regulation S-K.<sup>50</sup>

Finally, it is worth emphasizing that the equivalent of a duty of care suit can also arise under the federal securities laws for such "plain vanilla" accounting misconduct as inventory fraud,<sup>51</sup> improper income recognition,<sup>52</sup> or improper accounting for goodwill.<sup>53</sup>

Now the objection can be posed to my proposal to integrate aspects of financial auditing and internal controls into the study of corporate law that this is unnecessary. We do, after all, have separate courses in topics such as accounting for lawyers. The leading accounting casebooks typically do address auditing and internal controls in their materials,<sup>54</sup> albeit from the point-of-view of use of reports of these processes, not how auditing or internal controls, in fact, are done. Nonetheless, much of the substance of accounting courses for lawyers studies such related but distinct topics as the selection of generally accepted accounting principles and the fundamentals of bookkeeping.

And the leading corporate law casebooks *do* address accounting issues, such as accounting aspects of corporate combinations,<sup>55</sup> the role of accounting in the payment of lawful dividends,<sup>56</sup> or various introductions to the balance sheet and the income statement.<sup>57</sup> When I suggest integrating a study of certain aspects of financial auditing and internal controls into the study of the duty of care, I am proposing materials no more sophisticated or numerical than the accounting materials already typically studied in the leading casebooks. I am not proposing the study of how an audit is conducted, but a more limited inquiry into the role of accounting information in corporate governance.

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50. 17 C.F.R. § 229.303 (Item 303) (1992); *see, e.g.*, Caterpillar Inc., AAER 363, 51 SEC Dock. 147 (1992); for discussion and citations to literature and leading cases, *see generally* 2 LOSS & SÉLIGMAN, *supra* note 1, at 66-72 (1989 & 1992 Supp.).

51. *See, e.g.*, Adams v. Standard Knitting Mills, Inc., 623 F.2d 422, 432-435 (6th Cir.), *cert. denied*, Adams v. Peat Marwick, Mitchell & Co., 449 U.S. 1067 (1980); *cf.* Burroughs Corp., AAER 50, 32 SEC Dock. 935 (1985).

52. *See, e.g.*, United States v. Stirling, 571 F.2d 708 (2d Cir. 1978).

53. *See, e.g.*, Republic Technology Fund, Inc. v. Lionel Corp., 483 F.2d 540 (2d Cir. 1973).

54. *See, e.g.*, TED J. FIFLIS, ACCOUNTING ISSUES FOR LAWYERS (4th ed. 1991).

55. *See, e.g.*, WILLIAM L. CARY & MELVIN A. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 1120-25 (6th ed. 1988); ALFRED F. CONARD ET AL., ENTERPRISE ORGANIZATION 1059-61 (4th ed. 1987).

56. *See, e.g.*, CARY & EISENBERG, *supra* note 55, at 1296-98, 1300-51; CONARD ET AL., *supra* note 55, at 982-1024; ROBERT L. HAMILTON, CASES AND MATERIALS ON CORPORATIONS 411-20 (4th ed. 1990); LEWIS D. SOLOMON ET AL., CORPORATIONS: LAW AND POLICY 197-237 (2d ed. 1988); JESSE H. CHOPER ET AL., CASES AND MATERIALS ON CORPORATIONS 951-90 (3d ed. 1989).

57. *See* CHOPER ET AL., *supra* note 56, at 907-09; HAMILTON, *supra* note 56, at 71-77; SOLOMON ET AL., *supra* note 56, at 72-105.

What I envision ultimately is a new corporate law that focuses less on the status of corporate decisionmakers and more on the information on which they base their decisions. This type of corporate law would directly address the roles of the board's audit committee and the outside auditor, as well as internal accounting controls. This new corporate law similarly would address how business proposals are presented to a board for approval and how boards and senior managers use periodic internal budgets and earnings forecasts to manage their firms.

This type of inquiry would help students better understand the way in which corporations are actually managed. I began with the proposition that the language of corporate governance is accounting. No one who has attended a corporate board meeting and almost no one who has litigated a corporate law or federal securities fraud case doubts this.

In 1983 then SEC Commissioner James C. Treadway highlighted this point when he delivered an address addressing cases of "cooked books" to the American Society of Corporate Secretaries on April 13, 1983. He said, among other things:

... I believe the *single most significant factor* to emerge from these cases is the organizational structure of the companies involved. I refer to a decentralized corporate structure, with autonomous divisional management. Such a structure is intended to encourage responsibility, productivity, and therefore profits—all entirely laudable objectives. But the unfortunate corollary has been a lack of accountability. The situation has been exacerbated when headquarters has unilaterally set profit goals for a division or, without expressly stating goals, applied steady pressure for increased profits. Either way, the pressure has created an atmosphere in which falsification of books and records at middle and lower-levels became possible, even predictable. This pressure-filled atmosphere has caused middle and lower level managers and entire divisions to adopt the attitude that the outright falsification of books and records on a regular, on-going, pervasive basis is an entirely appropriate way to achieve profit objectives, as long as the falsifications get by the independent auditors, who are viewed as fair game to be deceived.<sup>58</sup>

But the primary reason for integrating the study of auditing into corporate law would be to better illustrate the significance of the traditional corporate law fiduciary duties themselves. Supreme Court decisions such as *Santa Fe Indus., Inc. v. Green*,<sup>59</sup> which in 1977 aborted a Rule 10b-5 challenge to a going-private transaction, because that Rule did not reach "a breach of fiduciary duty by majority stockholders, without any deception, misrepresentation, or nondisclosure,"<sup>60</sup> have artificially lulled many of us

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58. Reprinted in FIFLIS, *supra* note 54, at 623-24.

59. 430 U.S. 462 (1977).

60. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1977).

in corporate law teaching into viewing fraud as something fundamentally different than fiduciary duty violations. This is an error corporate law practitioners do not tend to make. When a business corporation misstates either the text or numbers in its financial statements, in the absence of a conflict of interest, this is typically viewed as fraud based on a form of negligence. In some instances there will be a pleading requirement that the plaintiff assert that at least severe recklessness was involved.<sup>61</sup> But as the SEC's safe harbor rule for projections with its reference to "reasonable basis" well illustrates, recklessness is not invariably a prerequisite for a securities fraud claim.<sup>62</sup> A private action can be successfully litigated against an accountant involved in the preparation of a registration statement under section 11 of the Securities Act of 1933 when the accountant is unable to carry a "due diligence" (or, duty of care) defense.<sup>63</sup> Similarly, when the SEC brings actions against accountants under sections 17(a)(2)-(3) of the same Act,<sup>64</sup> or Rule 2(e),<sup>65</sup> the Commission only has to prove the equivalent to negligence, rather than scienter. To be sure actions against accountants under Rule 14a-9<sup>66</sup> and aiding and abetting claims against accountants under Rule 10b-5<sup>67</sup> require at least reckless misconduct. But the difference between negligence, gross negligence, and recklessness is one of degree. The underlying auditing and internal controls processes remain the same.

Over fifty years ago then SEC Commissioner Jerome Frank warned that "there can be such a thing as excessive emphasis on the importance of the accountant's task."<sup>68</sup> He elaborated in a memorable passage:

Every man is likely to overemphasize and treat as fundamental those aspects of life which are his peculiar daily concern. To most dentists, you and I are, basically, but teeth surrounded by bodies. To most undertakers we are incipient corpses; to most actors, parts of a potential audience; to most policemen, possible criminals; to most taxi drivers, fares. "The Ethiopians," wrote Xenophon, "say that their gods are snub-nosed and black-skinned, and the Thracians that theirs are blue-eyed and red-haired. If only oxen and horses had hands and wanted to draw with their hands or to make the works of art that men make, then horses would draw the figures of gods like horses and oxen like oxen, and would make their bodies on models of their own." Spinoza suggested that if triangles

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61. See 8 LOSS & SELIGMAN, *supra* note 1, at 3653-77.

62. 7 *id.* at 3419-20 nn.45-47.

63. See, e.g., *Escott v. BarChris Constr. Co.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

64. See *Aaron v. SEC*, 446 U.S. 680 (1980).

65. David J. Checkosky, AAER 412, 52 SEC Dock. 1122, 1132-33 (1992).

66. *Adams v. Standard Knitting Mills, Inc.*, 623 F.2d 422 (6th Cir.), *cert. denied*, *Adams v. Peat, Marwick, Mitchell & Co.*, 449 U.S. 1067 (1980).

67. See 9 LOSS & SELIGMAN, *supra* note 1, at 4479-88, esp. 4487-88 n.66.

68. Jerome N. Frank, *Accounting for Investors, The Fundamental Importance of Corporate Earning Power*, 68 J. ACCT. 295, 300 (1939).



had a god it would be a triangle. We make life in the image of our own activities.<sup>69</sup>

I have no doubt that financial auditing and internal controls too could be excessively emphasized in the teaching of corporate law. But I depart today with the modest plea: Let's at least integrate sufficient aspects of auditing and internal controls into corporate law so that we can actually understand the fiduciary duties that we do teach our students.

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69. *Id.* at 295-96.