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The Arbitrage Of Truth: Combating Dissembling Disclosure, Derivatives, And The Ethic Of Technical Compliance

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The Arbitrage of Truth: Combating Dissembling Disclosure, Derivatives, and the Ethic of Technical Compliance

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ABSTRACT

The financial world has been in uproar over news that Greece used sophisticated financial products and Lehman Brothers used accounting tricks to mask the extent of their financial obligations. One explanation for this behavior lies with what I call "the ethic of technical compliance." This ethic poses enormous regulatory challenges, forcing the rule maker to get the text of the law "just right" because adherents of this ethic are implicitly subscribers to a deconstructionist theory of interpretation according to which all we have is the text of the law. A Derridean stance provides a principled basis for bankers to ignore the apparent intent behind rules because chasing authorial intent is chasing

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a chimera. The essay argues that business ethics has become sentential and external rather than a function of an inner moral experience.

This essay then explores the conditions that allow Wall Street to arbitrage truth in this way. Ironically, part of the answer lies with a transformation of the notions of truth and falsity from their original Greek meanings (recounted by Heidegger). The Greek word for truth is alethea—sometimes translated as "unconcealedness." Truth is that which is unveiled. The Greek word for false is pseudo. However, pseudo does not simply mean "concealed" as the counter to "unveiling." It can mean an appearance that is dissembling. The nuance is lost in our current conception of the "false" because we ground falsity in misstatements and omissions. As illustration, contrast a name assumed by an imposter with a "pseudonym"—a false name used by an author. An imposter assumes a name falsely—a classic misstatement because the name does not refer to the person who uses it. In contrast, the pseudonym intentionally conceals the author without misstatement because it correctly refers to the author while simultaneously concealing his identity. This idea of simultaneous disclosure and concealment lies at the core of much financial engineering that our regulatory scheme has difficulty combatting.

Applied to Greece, labeling a financial obligation as a derivative allowed a transaction to proceed under a pseudonym; its purpose was concealment without misstatement. The difficult legislative challenge is to design systems of rules in which we can again, like the ancient Greeks, properly label such behavior as "false." The current debate over rules—versus standards—based systems of disclosure ignores this insight at its peril.

The essay concludes by suggesting that an antidote for the ethic of technical compliance is to rethink our approach to definition of the type of "financial obligation" that requires disclosure. This essay explains why it might be prudent to invert the definition of financial obligation not by reference to transaction structure but instead by reference to the source of the financial product—Wall Street itself—a strategy that strengthens a general standards-based approach to disclosure and takes away the ability to arbitrage truth.

I. INTRODUCTION

> The legal system—his voice was extremely loud—is corrupt. It has nothing to do with truth! So I ask him—I was trying to keep my voice as composed as I could—what is truth. He laughs at me. He stands right there and laughs at me! 'Who are you,' he says, 'Pontius Pilate?'
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> —LAWRENCE JOSEPH, LAWYERLAND 72 (1997)

Our financial system has descended into crisis. This crisis has its origins in the relationship between people and the texts of laws, regulations and contracts they write to govern their lives. In short, it is the thesis of this essay that the crisis followed directly from the well-known limitations of language itself, and the difficulties associated with interpretation. We must understand the problem before considering possible solutions.

While the financial press and other observers remain entranced by the intricacies of Enron's Raptor financings, and more recently, by Lehman Brothers' use of the Repo 105 gimmick, and the derivatives used by the Greek government, to name some of the more infamous deals, the fundamental problem may remain hidden by the overwhelming details of these poster children for the ills of the financial system. All of these complex transactions fundamentally resemble far simpler solutions to legal problems that have acquired the status of myth.

Let us begin by considering a few simple stories about the posture that people take towards legal language.

In Israel, there is a prohibition against raising pigs "on the land" given to the Jews by God. An enterprising farmer sees profit in running a pig farm. How can this be done given the prohibition of the law?

Answer: Construct a series of pens that are elevated three feet above the ground and raise the pigs on these platforms. The platforms keep the pigs "off the land," so compliance with the law is preserved. Both God and the secular authorities are reportedly happy with the arrangement.

In Louisiana a number of years ago, a company proposed to issue bonds to finance the construction of a casino. The company prepared to launch the offering the next morning when a junior associate at the law firm hired to represent the underwriters managing the bond offering came up with a distressing discovery—the parish in which the casino was to be built had an old law on the books that prohibited gambling. How can the offering proceed in a timely fashion without obtaining a delay producing amendment to this law?

Answer: Recognize that the casino operations do not constitute "gambling;" rather, the casino is in the business of "gaming." Boldly disclose in the offering memorandum that the financed activity does not violate the law because "gaming" is not "gambling." A simple addition to the offering memorandum inserted late at night at the financial printers allows the offering to proceed as planned the next morning. The associate is placed on the fast track to partnership for uncovering the law and finding a solution.

In the early 1990s, an underwriter proposed an offering of securi-

ties to a Brazilian company. The negotiations initially went poorly because the underwriter demanded a comprehensive covenant package to protect against default risk. The chief financial officer of the company expressed dismay, asserting that there was no history of default on obligations of this sort in Brazil. The bankers asked incredulously about the massive defaults in the 1970s in Brazil and other South American countries.

Answer: The financial officer shook his head, explaining that all those defaults involved "loans" and not "securities." The requested enhanced protections should not be necessary because the transaction involved securities and not loans. The offering proceeds with limited protections. The bankers use the "loan" versus "securities" explanation in their sales pitch to investors and the placement is a resounding success.

Each of these stories has a happy ending (with reservation for the pig farmer's confrontation with God at the pearly gates). The farmer makes a profit, the casino prospers without intervention from the parish, and the bond offering is repaid at maturity. In each case, the confrontation between conduct and law is solved by making a category judgment that the conduct falls outside, rather than inside, the regulated or otherwise undesirable characterization.[2]

However, in the recent financial crises, the transaction participants have made similar category judgments with less fortunate results. Greece entered the European Union when it did not have the financial strength to do so. Lehman presented itself to the market as more financially sound than circumstances warranted.[3]

II. THE CURRENT SITUATION AND A TENTATIVE EXPLANATION

The financial press is in uproar over news that Greece used sophisticated financial products to mask the extent of its financial obligations.[4] The revelation that Wall Street recently proposed continued use of financial engineering to prolong the charade—advice that Greece rejected—

2. The tales of the Israeli pig farmer and the associate participating in the offering for the Louisiana casino had acquired the status of legend, as tales told late at night at financial printers by more senior associates to their juniors. The author represented a participant in the Brazilian transaction recounted above and thus the tale has the status of a first-hand report. The story of the literal application of law to allow pig farming on the land given to the Jews by God also is recounted in SLAVOJ ZIZEK, THE FRAGILE ABSOLUTE: OR, WHY IS THE CHRISTIAN LEGACY WORTH FIGHTING FOR? 140–41 (2000) (contrasting the approach to rule compliance in the Jewish religion with that found in the Christian tradition).

3. *See* Report of Exam'r Anton R. Valukas, at 6, *In re* Lehman Bros. Holdings Inc., 439 B.R. 811 (Bankr. S.D.N.Y. 2010) (No. 08-13555), available at http://lehmanreport.jenner.com.

4. Louise Story et al., *Wall St. Helped to Mask Debt Fueling Europe's Crisis*, N.Y. TIMES, Feb. 14, 2010, at A1.

adds to the outrage.[5] Thereafter, the cries against Wall Street intensified with revelations that Lehman Brothers concealed up to $50 billion in debt by using repurchase transactions to raise capital—transactions which it reported as "sales" rather than short-term borrowings.[6] This technique allowed Lehman Brothers to present itself to the market as more financially sound than circumstances justified because it reported a lower leverage ratio.[7] Post-Enron, why should we expect bankers to propose schemes to clients that mask reality and, indeed, to use these techniques for their own business reporting—and why do they continue to get away with it? Did neither the bankers nor the regulators learn anything from the U.S. experience with Enron and similar scandals?

The answer lies with what, in my prior analysis of Enron, I have termed "the ethic of technical compliance."[8] This ethic assigns praise or blame to conduct solely by reference to technical compliance with rules.[9] Applying this ethic, there is nothing wrong with proposing a derivative transaction with similar financial consequences to debt—even with knowledge that this circumvents debt limits imposed for entry into the E.U. Similarly, there is nothing wrong with structuring capital-raising activities that technically constitute "sales" rather than short-term borrowings—even with knowledge that this paints a far more favorable financial portrait than short-term borrowings would reflect.

In the Greek transactions, the savvy bankers almost certainly obtained legal advice opining that the transactions technically complied with law. We know that Lehman Brothers obtained legal advice that its repurchase transactions constituted "sales" under United Kingdom law—bolstering its aggressive financial reporting position.[10] Legal advice provides cover for participants by making proof of a crime difficult, even if laws were broken, because conscious knowledge of lawbreaking is a common prerequisite for finding criminal liability.[11] Legal

5. In November of 2009, Gary D. Cohn, the president of Goldman Sachs, visited Athens to propose a transaction to defer Greece's health care debt far into the future. *See* Story, *supra* note 3.

6. *See* Valukas, *supra* note 3, at 6.

7. *Id.* at 7.

8. *See* William H. Widen, *Enron at the Margin*, 58 BUS. LAW. 961, 965 (2003) [hereinafter Widen, *Enron at the Margin*].

9. *Id.*

10. *See* Amir Efrati & Ashby Jones, *Legal Experts Say Lehman Criminal Case Would Be Difficult*, WALL ST. J., March 13, 2010, at B3.

11. To find criminal liability, the law typically imposes the requirement of a "guilty mind" or mens rea, in one form or another. In a securities law context, this requirement is typically referred to as a scienter requirement. The details of particular mental state requirements for a finding of liability are beyond the scope of this essay except to note that legal opinions and other evidence of technical compliance with law are designed to negate any notion that the "perpetrators" could have criminal liability because they did not realize they were doing anything that was against the

advice may defeat *scienter* even if the opinions expressed are aggressive or flat-out wrong because they provide evidence that the participants did not intentionally violate the law.[12]

To combat this approach to financial reporting and improve transparency of markets, first we must identify and understand the phenomenon of the ethic of technical compliance. Only then may we be in a position to propose solutions to counter this mode of behavior. This essay attempts to do both.

My point of departure for this inquiry is the observation that we are facing a crisis in accepted modes of interpretation for legal texts. We need to consider approaches to interpreting a broad range of legal texts—constitutions, statutes, common law cases and contracts—to understand the problem before considering solutions. The ethic of technical compliance shares a lineage with theories of interpretation as disparate as the textualism advocated by Justice Scalia and the deconstructionist methods of Jacques Derrida.

The problem posed by this ethic is decidedly not the problem of criminal behavior on Wall Street. Just as the poor will always be with us, so to too will criminals always be with us. My concern is not with Scott Sullivan, Bernie Madoff, Lew Freeman, or Scott Rothstein. These fraudsters clearly broke the law, and they knew they were doing so when they acted.[13] In their cases, regrettably, the text of the law and its associated sanctions failed to deter. This is a serious problem, but it is not my primary concern.[14]

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law. For a discussion of scienter requirements in securities cases, see Donald C. Langevoort, *Reflections on Scienter (and the Securities Fraud Case Against Martha Stewart that Never Happened)*, 10 LEWIS & CLARK L. REV. 1-17 (2006).

12. *See* Efrati & Jones, *supra* note 10.

13. There is no doubt that the crimes of Sullivan, Freeman, Madoff and Rothstein were intentional violations of the law with knowledge of wrongdoing. *See* Scott Reeves, *Lies, Damned Lies and Scott Sullivan*, FORBES, Feb. 17, 2005 ("I knew it was wrong," Sullivan said. "I knew it was against the law, but I thought we'd make it through."); Defendant Lewis B. Freeman's Sentencing Memorandum, United States v. Freeman, Case No. 10-CR-20095-PCH (S.D. Fla. June 21, 2010) ("I want to begin by reaffirming that I am guilty of engaging in a criminal conspiracy. During a period of over nine years, I knowingly and willfully misappropriated money from matters in which I was appointed as a fiduciary by federal and state courts."); Defendant's Sentencing Memorandum, United States v. Rothstein, Case No. 09-60331-CR-Cohn (S.D. Fla. June 4, 2010) ("Mr. Rothstein acknowledges that he not only stole other people's monies, he also used it to corrupt the political process and enhance his power for personal gain."); Plea Allocution of Bernard L. Madoff, United States v. Madoff, Doc. No. 09-CR-213(DC) (S.D.N.Y. March 12, 2009) (read in court) ("As I engaged in my fraud, I knew what I was doing was wrong, indeed criminal.").

14. Charles Ponzi structured perhaps the most famous case of outright intentional financial fraud—a structure in which funds received from recent investors were used to pay returns to prior investors. This created the appearance of investment return where none actually existed—assets simply did not backstop investments made. *See generally* MITCHELL ZUCKOFF, PONZI'S SCHEME: THE TRUE STORY OF A FINANCIAL LEGEND (2005); DONALD H. DUNN, PONZI: THE INCREDIBLE

Rather, my focus is on Jeffrey Skilling and Ken Lay of Enron, the Greek finance ministers and Goldman Sachs, and the executives of Lehman Brothers (and their accounting and legal advisors). In these later cases, the transactions at issue were structured technically to comply with law. If these "technical compliers" are criminals, they are criminals of a different and more troubling sort. Indeed, they may believe that they are not "bad men" because their conduct complied with the rules laid down.[15]

TRUE STORY OF THE KING OF FINANCIAL CONS (1975). Such an intentional scheme to defraud, while interesting in its own right, is not the concern or focus of this essay. Like the more recent scandal involving Bernard Madoff, Charles Ponzi knew the scheme was fraudulent and could not withstand scrutiny. Similarly, this essay does not focus on problems associated with excessive speculation. To be sure, fierce competitiveness and an appetite for risk taking may fuel the passion for speculation which many believe threatens our modern financial markets. *See generally* EDWARD CHANCELLOR, DEVIL TAKE THE HINDMOST: A HISTORY OF FINANCIAL SPECULATION (2000). This essay's concern with the concept of "truth" is related to financial speculation only insofar as accurate information is needed to backstop informed speculation or risk–taking to distinguish that activity from mere gambling. The problem with the current ethics that govern creation of transaction structure and associated canons of disclosure is precisely that it impedes informed risk taking. Lastly, this essay does not expect that ethics lessons or regulation will lessen Wall Street's ravenous pursuit of self-interest at the expense of its customers and clients, tales that have been told by many. *See generally* JIM SALIM WITH R. FOSTER WINANS, THE GREAT WALL STREET SWINDLE (2001). Rather, the hope is to show that the emperor has no clothes when Wall Street markets transaction structures as a technique to manage and suppress unwelcome disclosures which, if the unvarnished truth had been revealed, would have promoted informed speculation (at the least) or, more likely, prevented transactions from proceeding because, like the vampires of the horror genre, they could not withstand the sunshine.

15. In contrast to transactions known to be fraudulent or criminal, in Enron, the Lehman Brothers bankruptcy, and the Greek Debt crisis, the parties attempt to comply with technical legal requirements. The steps taken by Enron to make its transactions technically comply with law are detailed in Widen, *Enron at the Margin*, supra note 8. Enron's attempts to technically comply with law, and the shortcomings of this approach, are further detailed in a variety of places. *See* WILLIAM C. POWERS, JR. ET AL., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. 11 (2002) ("The transactions . . . that had the greatest impact on Enron's financial statements involved four SPEs known as the 'Raptors.'"), *available at* http://news.findlaw.com/hdocs/docs/enron/specinv020102rpt1.pdf. The Powers Report was commissioned to conduct an investigation of a variety of related party transactions and, in particular, the transactions that led to Enron's third-quarter 2001 earnings charge and restatement. *See generally* PERMANENT SUBCOMMITTEE ON INVESTIGATIONS OF THE COMMITTEE ON GOVERNMENTAL AFFAIRS, THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE, S. REP. NO. 107–10 (2002) (discussing the results of the Senate investigation into the Enron failure), *available at* http://news.findlaw.com/hdocs/docs/enron/senpsi70802rpt.pdf; *In re* Enron Corp., FIRST INTERIM REPORT OF NEAL BATSON, COURT-APPOINTED EXAMINER, No. 01-16034 (Bankr. S.D.N.Y. Sept. 21, 2002) (describing various Enron structured financial transactions), *available at* 2002 WL 31113331. The steps taken by Lehman Brothers to technically comply with accounting rules in its Repo 105 transactions, including obtaining a legal opinion from an English law firm, are detailed in Valukas, *supra* note 3. Commentators on the Greek debt crisis assume the transactions at issue were perfectly legal. *See, e.g.*, Story, *supra* note 4. Greece's use of swaps with Goldman Sachs and the basis for asserting technical compliance with reporting obligations, as well as the shortcomings of reporting, are described in a recent Eurostat report. *See* EUROPEAN COMMISSION, EUROSTAT, REPORT ON THE EDP METHODOLOGICAL VISITS TO GREECE IN 2010 (May 12, 2011).

The technical compliers pose a real challenge for the design of any future financial regulatory reform, as well as the interpretive posture taken by judges and regulators in administering the resulting system, because they and their ethic of technical compliance call into question the very possibility of creating an effective system of financial regulation.[16] I will argue that this ethic flourishes because conceptions of morality have followed our conceptions of scientific knowledge. Scientific knowledge has become an impersonal system of sentences in theories independent of a subject "knower."[17] When morality becomes sentential, it subordinates the role of the internal relationship between an actor and his conscience, measuring morality by conformity between an external act and a system of sentences.[18]

The ethic requires that the lawmaker must get the text of the law "just right" because the lawmaker cannot rely on any independent moral system to guide the actions of those subject to law.[19] Private and internal notions of morality no longer function as a backstop that informs the financial professional's stance towards the positive law.[20] Recognizing that business morality has become sentential is the first step towards thinking about a solution. We are in a "battle of words," and to win this battle, the legal system must wear its morality on its sleeve by expressly including its vision of morality in the text of its laws. If the public cannot win this battle (and it is not certain it can), then the war to save our financial system may be lost. I conclude this essay with concrete suggestions for how an element of public morality might be introduced into our legislation.

III. WALL STREET: THE TRUE BELIEVERS IN THE ETHIC OF TECHNICAL COMPLIANCE

Anecdotal evidence in the form of statements made by participants in the Greek debt crisis and the collapse of Lehman Brothers support the claim that much of Wall Street, as well as the applicable regulators, operate in accord with the ethic of technical compliance.

The participants in the current Greek drama seem to have accepted the ethic of technical compliance at face value—indeed, even the regulators. E.U. Chief Finance Minister Olli Rehn already has focused on compliance with rules, stating, "[i]t is clear that a profound investigation

16. *See,* David Reilly, *Closing Lehman's Loophole*, WALL ST. J., Mar. 13, 2010, at B16 ("Give Wall Street a rule and it will find a loophole.").

17. IAN HACKING, WHY DOES LANGUAGE MATTER TO PHILOSOPHY? 159 (1975).

18. *See id.* at 160–61.

19. *See* Widen, *Enron at the Margin*, *supra* note 8, at 999–1000.

20. *Id.*

must be done on this matter, . . . and I will ensure that we conduct the inquiry so we see whether all the rules were respected."[21] The Greek finance minister, George Papaconstantinou, has countered that "such swaps were legal when Greece used them."[22] Gerald Corrigan, a managing director of Goldman Sachs, stated that, after reviewing his firm's deals with Greece, "it is clear to me that there is nothing inappropriate and it was in conformity with existing rules and procedures" at that time.[23] Michael Meister, financial affairs spokesman for German Chancellor Angela Merkel's Christian Democrats, sums up the situation well saying, "Goldman Sachs broke the spirit of the Maastricht Treaty, though it is not certain it broke the law. . . . What is certain is that we must never leave this kind of thing lurking in the shadows again."[24] It appears the E.U. inquiry will take place in accord with the ethic of technical compliance.

Executives of Lehman Brothers have expressed similar sentiments, most revealing of which is the firing of a "whistleblower" who questioned whether the use of the now infamous Repo 105 transactions violated Lehman's own internal ethics rules.[25] At Lehman Brothers, technical compliance with accounting rules trumped internally-prepared ethical standards that suggested a different result. Some seem to believe that the use of accounting rules in an aggressive manner is no big deal.[26] Lehman's U.K. law firm that blessed the Repo 105 transaction as a "true sale" has rejoiced that the Bankruptcy Examiner's Report did not challenge the technical correctness of their legal opinion.[27]

The players in the Enron scandal made similar statements pointing to their technical compliance with law.[28]

It is clear to me that the ethic of technical compliance is alive and

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21. Stephen Castle, *Pressure Rises on Greece to Explain and Fix Crisis*, N.Y. TIMES, Feb. 17, 2010, at B3.

22. *Id.*

23. *See* Jessica Papini, *Goldman Executive: 'Nothing Inappropriate' in Greece Deal*, WALL ST. J., Feb. 23, 2010, http://online.wsj.com/article/SB10001424052748704454304575081541068116062.html.

24. Elisa Martinuzzi & Maria Petrakis, *EU Seeks Greek Swaps Disclosure After Ministry Probe*, BLOOMBERG, Feb. 15, 2010, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=A5MJFT2dMyIU.

25. *See* Michael Corkery, *Lehman Whistle-Blower's Fate: Fired*, WALL ST. J., Mar. 16, 2010, at C1.

26. *See* Max Abelson, *The Repo Men's New Lehman Shrug*, N.Y. OBSERVER, March 17, 2010, http://www.observer.com/2010/wall-street/repo-mens-newlehman-shrug.

27. *Lehman Brothers' Former Heads Criticised for Lapses*, BBC NEWS (Mar. 12, 2010), http://news.bbc.co.uk/2/hi/8563604.stm (quoting a spokesperson for the firm saying, "[t]he Examiner—who did not contact the firm during his investigations—does not criticise those opinions or say or suggest that they were wrong or improper. We have reviewed the opinions and are not aware of any facts or circumstances which would justify any criticism.").

28. *See* Widen, *Enron at the Margin*, supra note 8, at 964–65.

well on Wall Street and that the regulatory challenge is to understand this phenomenon and consider how best to counteract it.

IV. The Effects of Knowledge Becoming Sentential: Scientific and Moral

My proposal for understanding the ethic of technical compliance starts with noting a structural similarity between the evolution of our conception of scientific knowledge and Wall Street's conception of moral knowledge—a conception that seems to permeate the business world generally. We must focus closely on language usage because the technical compliers pay close attention to the language of laws, rules, and regulations.[29] Language clearly matters to law—the point is so obviously true that we may fail to consider the implications of this fact.

At the end of *Why Does Language Matter to Philosophy*,[30] Ian Hacking puts forth his theory that our concept of scientific knowledge has evolved from the time of Descartes to become essentially sentential. He believes that language matters to philosophy today for the same reason that "ideas" mattered to philosophers in the 17th and 18th centuries.[31] Then, ideas served as the interface between a knowing subject and what is known.[32] Now, sentences perform that same mediating role.[33] In sum, in our time scientific knowledge has become sentential.[34]

In the Cartesian spirit, a large part of the Western philosophical tradition conceived of knowledge as an internal relationship between a subject "knower" and an object of knowledge.[35] The objects of knowledge were communicated to knowing subjects through "ideas."[36] Acquiring knowledge was analogized to the faculty of vision—the "seeing" of the truth through perception of the idea.[37] For example, the goal of a mathematical proof was to internalize it by running the steps in the proof faster and faster before the mind until you could "see" the correctness of the proof in a single mental gaze.[38] A demonstration or proof was designed to be a "showing" to the inner eye, which, if sufficiently clear and distinct, ensured its truth and resulted in knowledge.[39] The concept of "idea" was thought to be so basic as to not need a definition

29. *See id.*
30. Hacking, *supra* note 17, at 159.
31. *Id.*
32. *Id.*
33. *Id.*
34. *Id.* at 157–63.
35. *Id.* at 159.
36. *Id.* at 159–60.
37. *Id.* at 159–61.
38. *Id.* at 161–62.
39. *Id.*

(or to be incapable of one).[40]

In contrast, most modern philosophers of science conceive of knowledge as being "theoretical."[41] By "theoretical," Hacking argues, they mean a system of sentences or statements, as expounded by C. G. Hempel, among others.[42] Currently, a mathematical demonstration is recognized as a sequence of sentences.[43] This concept is reflected in W. V. O. Quine's observation that the "lore of our fathers is a fabric of sentences."[44] Though Karl Popper disagrees with Hacking that knowledge has changed, he does believe in "objective knowledge" which resides in books, libraries and computer memories.[45] Knowledge occupies its own autonomous world, separate from knowing subjects, even though it is a product of human effort.[46] This allows for a theory of knowledge—an epistemology—without a knowing subject.[47]

Hacking's project is essentially analytic and descriptive. Having noticed an evolution in the concept of knowledge, in which the need for a knowing subject is subordinated, if not eliminated, he challenges the reader to consider the implications of this development, but without suggesting any concrete consequences that flow from this evolution. I consider an extension of his observation that scientific knowledge has become sentential, and ask: What evidence is there that moral knowledge has become sentential and what would be the consequences of such a development?

I believe the ethic of technical compliance provides an example of moral knowledge becoming sentential. While, at one time, we theorized that a central component of moral knowledge involved a relationship between an action and an actor (examining the internal mental state of the actor, just as knowledge required consideration of the internal mental state of the knower), in many sectors of social life, consideration of the mental state of the actor is subordinated or eliminated from consideration.

The ethic of technical compliance appears to make this very move because we find transaction participants defending their actions by reference to compliance with a text, while, at the same time, declining to accept any duty to consider the broader implications of their actions for

40. *Id.* at 158–59.
41. *Id.* at 160–61.
42. *Id.*
43. *Id.*
44. *Id.*
45. *Id.* at 184–86.
46. *Id.* at 186.
47. *Id.* at 186–87.

the financial system or society in general.[48] The participants appear to have no conscience and yet assert that they have done nothing wrong.[49] They would appear to sleep well at night, but for the pesky inquiries of regulators, prosecutors, and the press.

Just as a modern scientific theory is evaluated by a correspondence between the world and a system of sentences that set forth the theory, so the moral status of an action is evaluated by a correspondence between the outward act and the system of sentences that comprise the moral system. The morality of an action is not seen by the actor as involving an appeal to any inward guide such as conscience, just as scientific knowledge has become autonomous and no longer requires a knower—the inner conscience once required to understand moral knowledge correlates to the inner eye of reason formerly required to understand scientific knowledge—and neither are needed any longer.

Such a moral system presents an additional problem for juridical laws because the legal system, by including a *scienter* element for proof of many crimes, retains a requirement to look at the inward state of the actor as a prerequisite to finding liability.[50] Thus, even when an outward act fails to conform to the system of sentences (and, thus, is "wrong" in accord with the ethic), liability for the actor does not result because, by and large, the criminal justice system does not use a strict liability system for assigning fault.[51] So, society's legal system does not blame the actor, even though the pure form of the ethic would find criminal liability. The system does not even adequately deter behavior that contravenes the ethic.

Indeed, adherents of the ethic of technical compliance may, themselves, believe in a hybrid system in which praiseworthy (or, at least, acceptable) behavior is measured by technical compliance with rules, whereas blameworthy behavior is measured by a two-part test: (i) failure to comply with rules, coupled with (ii) knowledge of wrongdoing. Such a hybrid system fosters an aggressive stance toward the rules in which the subject has every incentive to engage in conduct that goes to the very edge of the law. In so doing, behavior can be expected to stray over the line from time to time. Indeed, the structure of the system breeds this result.

Though the ethic of technical compliance may treat morality as sentential, this essay next considers whether such an approach to interpretation of law is respectable.

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48. *See supra* notes 26–27 and accompanying text.

49. *See* Abelson, *supra* note 26.

50. MODEL PENAL CODE § 2.02 (General Requirements of Culpability).

51. *Id.*

V. IS THE ETHIC OF TECHNICAL COMPLIANCE A RESPECTABLE APPROACH TO LAW?

When press revelations expose examples of the ethic of technical compliance at work, a first reaction often condemns the financial engineering as the handiwork of corrupt people. To be sure, to understand one possible mindset that continues to propose schemes of this sort, you must return to Oliver Wendell Holmes. He famously observed that, if you truly want to understand law, you must understand it from the viewpoint of the "bad man" whose conduct is influenced solely by consideration of sanctions.[52] If technical compliance avoids liability, then the "bad man" will take action if profit is expected. The "bad man" either assumes an amoral position or, perhaps, an egoistic stance. Indeed, Holmes suggested that the law would be improved if it used a vocabulary that banned all words with an ethical or moral connotation in general usage because these words lead to confusion.[53] For Holmes, law and morality are separate spheres (or, at least, the legal advisor best understands the law if he assumes this stance).[54]

The ethic of technical compliance, however, does not compel this standpoint. An adherent of the ethic of technical compliance may fall into a third camp—that technically complying with rules in this way truly is moral—and not simply moral from the standpoint of ethical egoism.[55]

To motivate the idea that the rule-following behavior at the core of the ethic of technical compliance may constitute a legitimate ethical stance, consider a few examples far from the field of business. Sincere followers of some of the world's great religions take similar stances in their personal lives. This can be seen in the procedures followed by orthodox Jews in the observance of the Sabbath (for example, preprogrammed schedules to allow use of elevators in hospitals and apartment buildings on Saturday) and in the practices of devout Muslims to obtain financing in compliance with the strictures of Sharia law (for example, using leases and other financial devices to finance home purchases without technically making interest payments).

We must acknowledge that these instances of technical compliance with religious laws are sincerely believed by devout followers who are neither "bad men" nor ethical egoists. Their personal religious morality

52. *See* O. W. Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 459 (1897).

53. *See id.* at 459–62.

54. *See id.* at 459.

55. *See* LOUIS P. POJMAN & JAMES FIESER, ETHICS: DISCOVERING RIGHT AND WRONG 87 (7th ed., 2011) ("Ethical egoism is the moral view that everyone ought always to do those acts that will best serve his or her own best self interest.").

simply contains a component in which the ethical or the moral consists of precise and technical adherence to the rules laid down by their faith.

What is troubling about the financial situation is simply this. I suspect many external observers would say it was morally wrong for the bankers to have worked with Greece to circumvent the E.U. debt limitations.[56] All parties knew well that these limits existed to protect the E.U. from just the sort of financial crisis that has occurred, but also knew that clever financial engineering could circumvent the limits. Circumventing the E.U.'s limits is exactly what the parties set out to do with apparent disregard for consequences other than their own potential liability for technical law-breaking.[57] We must, however, accept the possibility that no overriding ethical principles guided their actions precisely because they equate the ethical with technical legal compliance. It would be more convenient, in some sense, to simply dismiss their behavior as the acts of bad men or selfish egoists.

When no independent system of beliefs guides action independent of legal considerations focused on technical compliance, the regulatory challenge becomes acute because one suspects the problem is widespread—not limited to just the bad or the selfish. The lawmakers cannot expect that laws will be interpreted using any principle of charity[58] that looks beyond the words of legislation to the underlying intent behind the rules. If a large segment of the population refuses to apply a principle of charity in interpreting the rules because they honestly believe they are doing nothing wrong (without simply being selfish), then they place

56. Indeed, negative publicity surrounding the transactions with Greece and other matters has prompted Goldman Sachs to note "adverse publicity" as a risk factor in its most recent annual report filed with the SEC. *See* The Goldman Sachs Group, Inc., Form 10-K for the fiscal year ended December 31, 2009, Commission File Number: 001-14965 at 34–35, available at http://www.sec.gov/Archives/edgar/data/886982/000095012310018464/y81914e10vk.htm#113 (filed Feb. 26, 2010). Prior to reports of Goldman Sachs' involvement in the Greek financial crisis, the firm had been compared to a "great vampire squid wrapped around the face of humanity" based on its involvement in other financial crises. Matt Taibbi, *The Great American Bubble Machine*, ROLLING STONE (April 5, 2010, 3:58 PM), http://www.rollingstone.com/politics/news/the-great american-bubble-machine-20100405.

57. *See* Papini, *supra* note 23 (noting that a deal set up by Goldman "helped mask the true level of Greece's indebtedness until recently," but quoting a Goldman director saying, "it was in conformity with existing rules and procedures").

58. The concept of using a principle of charity in interpretation, often attributed to the philosopher, W. V. O. Quine, in his analysis of radical translation, appears to have been coined by N. L. Wilson. *See* N. L. Wilson, *Substances without Substrata*, 12 REV. METAPHYSICS 521 (1958). This principle states that a translator should adopt a translation that maximizes the number to true utterances on the charitable view that the speaker of an unknown language attempts to speak the truth. I use the idea of a principle of charity here in a broader sense of assuming that a rule-maker had a purpose of fostering transparency when he adopts a system of disclosure. *See generally* HACKING, *supra* note 17, at 148.

enormous pressure on the rule-maker to get the text of the law "just right"—and this is very hard to do.

Both deconstructionist and textualist theories argue, from a principled position, that the text of the law is all that should be considered in interpretation. Accordingly, the essay turns to an examination of those theories.

VI. DERRIDA'S DECONSTRUCTION

The ethic of technical compliance requires that the text be "just right" because, whether they know it or not, the adherents of this ethic are implicitly following aspects of Jacques Derrida's theory of deconstructionist interpretation.[59] According to this view, all we have is the *text* of the law, without resort to the intentions of the authors to guide us.[60] This theory of interpretation applies to any text, including a law or regulation, because the text of the law is merely a system of signs disconnected from a speaker.[61] When language appears in text, as opposed to direct discourse, it becomes a separate object in itself.[62] This stance towards a text provides a principled basis for bankers to ignore the apparent intent behind E.U. regulation that limits debt because recourse to authorial intent is an inappropriate posture to take when confronted with any text. This is so even if the bankers suspect a legislative intent behind a regulation. Chasing authorial intent is chasing a chimera. (To be sure, as reflected in Goldman Sachs's public pronouncements for example, the bankers do not admit to being deconstructionists, instead claiming that they will adhere to both the letter and the spirit of laws.)[63]

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59. *See generally*, JACQUES DERRIDA & JOHN D. CAPUTO, DECONSTRUCTION IN A NUTSHELL: A CONVERSATION WITH JACQUES DERRIDA (John D. Caputo ed., 1997).

60. *Id.* at 130 ("By the 'law' . . . Derrida means the positive structures that make up judicial systems of one sort or another, that in virtue of which actions are said to be legal, legitimate, or properly authorized.").

61. *See id.*

62. *See id.*

63. *See* Goldman Sachs Group, Inc., *Goldman Sachs 2001 Annual Report, Business Principles No. 2*, http://www2.goldmansachs.com/our_firm/investor_relations/financial_reports/annual_reports/2001/html/prnciples/principle_2.html ("We are dedicated to complying fully with the letter and spirit of the laws, rules and ethical principles that govern us."). Perhaps, in the case of the Greek transactions, Goldman Sachs found it hard to reconcile its dedication to complying with the spirit of the laws with three other of its principles—Principle No. 1, which states that its clients' interests always come first, Goldman Sachs Group, Inc., *Goldman Sachs 2001 Annual Report, Business Principles No. 1*, http://www2.goldmansachs.com/our_firm/investor_relations/financial_reports/annual_reports/2001/html/principles/principle_1.html; Principle No. 3, which says, "[o]ur goal is to provide superior returns to our shareholders," Goldman Sachs Group, Inc., *Goldman Sachs 2001 Annual Report, Business Principles No. 3*, http://www2.goldmansachs.com/our_firm/investor_relations/financial_reports/annual_reports/2001/html/principles/principle_3.html; and Principle No. 5, which says "[w]e stress creativity and imagination in everything we do," Goldman Sachs Group, Inc., *Goldman Sachs 2001 Annual Report, Business Principles No. 5,*

By claiming that Wall Street shares Derrida's deconstructionist stance towards texts, I do not mean to suggest that the two share a common ethic. For Wall Street and the ethic of technical compliance, moral conduct consists in following the precise words of a text—there is no other moral order. Derrida and other deconstructionists do not adopt the same posture towards justice.[64] For Wall Street, morality has become sentential—there is nothing more. For Derrida, justice is decidedly non-sentential and lies beyond the text of any positive law:

> A judge, if he wants to be just, cannot content himself with applying the law. He has to reinvent the law each time. If he wants to be responsible, to make a decision, he has not simply to apply the law, as a coded program, to a given case, but to reinvent in a singular situation a new just relationship; that means that justice cannot be reduced to a calculation of sanctions, punishments, or rewards. That may be right or in agreement with the law, but that is not justice. Justice, if it has to do with the other, with the infinite distance of the other, is always unequal to the other, is always incalculable. You cannot calculate justice.[65]

Derrida should not be misunderstood to say that anything goes with the interpretation of texts:

> This does not mean that we should not calculate. We have to calculate as rigorously as possible. But there is a point or limit beyond which calculation must fail, and we must recognize that.[66]

From this perspective there is a relationship between law and justice: law without justice is a "monster," and justice without law is a "wimp."[67] Justice provides the motivation to change the positive law by improving it—even though justice may be an impossible limit that we can never expect to reach.

Interestingly, this idea that justice stands beyond positive law was hinted at long ago when English courts were divided between "law" and "equity."[68] When a claim could not be pursued at common law—pre-

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http://www2.goldmansachs.com/our_firm/investor_relations/financial_reports/annual_reports/2001/html/principles/principle_5.html.

64. *See* DERRIDA & CAPUTO, *supra* note 59, at 17 ("I cannot know that I am just. I can know that I am right. I can see that I act in agreement with norms, with the law. . . . But that does not mean that I am just.").

65. DERRIDA & CAPUTO, *supra* note 59, at 17.

66. *Id.* at 19.

67. *Id.* at 136 ("For justice and law are not supposed to be opposites but to interweave: laws ought to be just, otherwise they are monsters; and justice requires the force of law, otherwise it is a wimp."). The idea that law can be a monster in this sense traces to Drucilla Cornell. *See* DRUCILLA CORNELL, THE PHILOSOPHY OF THE LIMIT 167 (1992).

68. I do not mean to suggest by this remark that interpretation and application of the law should be the same for interpreting a constitution, a statute, or a common law rule. Different considerations apply in the different spheres.

cisely because the "text" of the doctrine as reflected in case law did not provide a remedy—a plaintiff could pursue a claim in a court of equity, which existed precisely to allow appeals to justice not grounded in common law. Structurally, most U.S. courts today sit as courts of both law and equity thus incorporating the general idea that the court may, indeed, appeal to general principles of justice. Equity itself, however, has developed its own system of rules that, in many respects, has become as formal as the rules of law. Equity has evolved into a parallel system of positive textual law—it has become sentential just like the common law whose limitations it was designed to remedy.[69] Thus, in modern times, an appeal to equitable principles is properly seen as an appeal to another text and not the mysterious justice that lies beyond the text of law.

While a deconstructionist approach to law recognizes the existence of a principle of justice beyond the text, the doctrine of textualism advanced by Justice Scalia does not endorse a policy of going beyond the text to find justice. The essay now turns to that doctrine.

VII. SCALIA'S TEXTUALISM

Distrust of the search for authorial intent does not confine itself to deconstructionists. Justice Scalia of the United States Supreme Court expresses disapproval of reference to legislative intent as a method for interpretation of statutes; Oliver Wendell Holmes expressed doubt about reference to intent in interpreting statutes; and the Allies required that German courts eschew reference to legislative intent and the spirit of the law as part of reforming the German legal system after World War II.[70]

The ethic of technical compliance resembles a respected "textualist" theory of statutory interpretation. The textualist approach to statutory interpretation is a formal approach that limits the interpretive process to an examination of the ordinary meaning of the words used in

69. For a discussion of law and equity, see Stephen N. Subrin, *How Equity Conquered the Common Law: The Federal Rules of Civil Procedure in Historical Perspective*, 135 U. PA. L. REV. 909, 914–21 (1987).

70. *See* ANTONIN SCALIA, A MATTER OF INTERPRETATION: FEDERAL COURTS AND THE LAW 16–18 (Amy Gutmann ed., 1997). *Compare* Zedner v. United States, 547 U.S. 489, 511 (2006) (Scalia, J., concurring) ("[T]he use of legislative history is illegitimate and ill advised in the interpretation of any statute . . . .") *with* Oliver Wendell Holmes, *The Theory of Legal Interpretation*, 12 HARV. L. REV. 417, 417–18, 419 (1899) ("[W]e ask, not what this man meant, but what those words would mean in the mouth of a normal speaker of English, using them in the circumstances in which they were used. . . . We do not inquire what the legislature meant; we ask only what the statute means."). In Nazi Germany, judges rejected formalistic textualism, arguing that statutes should be interpreted in light of the intent of the lawmakers and not narrowly confined to the text of the statute—a practice the Allies changed as part of the reform of the German legal system. *See* Cass R. Sunstein, *Must Formalism Be Defended Empirically?*, 66 U. CHI. L. REV. 636, 636–37 (1999).

the statute.[71] Appeals to extrinsic sources such as, (i) the intent of the legislature, (ii) identification of the problem the statute was intended to remedy (i.e. the "purpose" for the statute), or (iii) general principles of justice and fairness, are off-limits. Though these three reasons to reject extrinsic sources as a basis for interpretation overlap, they each have a slightly different focus.

There are specific structural reasons to reject the intent of the legislature as relevant to statutory interpretation—reasons that do not support the rejection of the search for authorial intent in the case of a single author as urged by the deconstructionists for literary works. First, ascribing intent to an artificial entity, such as a legislative body or a corporation, is problematic because we typically think of intent as a property of individuals. Artificial entities do not have mental states even though individual persons who form part of the artificial entity do have mental states. Second, in the lawmaking process, it is common for individual legislators to make statements about the intent of the law. These statements often get published as part of a legislative history for the law. Yet, these statements may be the view of but a single person. They were not voted on and approved by the rule-making body as a whole. Reference to legislative history of this sort may be criticized as undemocratic:

> [T]extualist judges have contended, with much apparent impact, that courts should not treat [committee reports or sponsors' statements] as authoritative evidence of statutory meaning. These textualists have predicated their resistance to such use of legislative history on two important premises . . . . First, textualist judges argue that a 535-member legislature has no "genuine" collective intent with respect to matters left ambiguous by the statute itself. Even if Congress did have a collective intent, they add, courts act improperly when they equate the views of a committee or sponsor with the intent of the entire Congress and the President. Second, textualists contend that giving decisive weight to legislative history assigns dispositive effect to texts that never cleared the constitutionally mandated process of bicameralism and presentment.[72]

Even scholars who disagree with Justice Scalia's textualism, such as Harvard Law Professor Laurence Tribe, agree with him that use of legislative history is problematic for these very reasons.[73]

Purposive or teleological interpretation of statutes is, perhaps, the

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71. SCALIA, *supra* note 70, at 24 ("Words do have a limited range of meaning, and no interpretation that goes beyond that range is permissible.").

72. John F. Manning, *Textualism as a Nondelegation Doctrine*, 97 COLUM. L. REV. 673, 674–75 (1997).

73. *See* SCALIA, *supra* note 70, at 65.

dominant theory of statutory interpretation today.[74] While an adherent of purposive interpretation would certainly consider legislative history as an important source of information to determine the purpose behind a statute, it is not the only source.[75] The interpreter might refer to the general structure of the law and the state of society at the time the law was passed to uncover what its purpose must have been.[76] In this mode, the interpreter adopts the posture of an ideal legislator or a reasonable legislator (rather than simply attempting to discern what actual legislators intended).[77] Justice Stephen Breyer advocates for a strong form of purposive interpretation in his book, *Active Liberty: Interpreting a Democratic Constitution*.[78] This approach can be criticized on grounds similar to the criticism of the search for actual legislative intent: it "overlooks the strongest argument against the purposive approach: that it tends to override legislative compromises."[79] The approach also may be criticized because it tends to convert judges into legislators: "[i]f judges are asked to say what 'reasonable' legislators would like to do, they are all too likely to say what they themselves would like to do."[80]

The criticism of making appeals to concepts of justice and fairness is more complex. To be sure, appeals to justice and fairness to interpret statutes might be faulted on grounds similar to the objection to purposive interpretation: they simply give the judge the power to insert personal preferences into the law. Though an appeal to justice would not offend a deconstructionist such as Derrida, it worries textualists such as Justice Scalia because of the apparent unfettered discretion it bestows on judges.[81] Derrida welcomes appeals to justice, recognizing this as integral to a decision that is not mechanical.[82] Justice Scalia looks for a

74. *See* SCALIA, *supra* note 70, at 16 ("You will find it frequently said . . . that the judge's objective in interpreting a statute is to give effect to 'the intent of the legislature.' This principle . . . goes back at least as far as Blackstone.").

75. *See* STEPHEN BREYER, ACTIVE LIBERTY: INTERPRETING A DEMOCRATIC CONSTITUTION 82 (2008) ("[Judges] use [ ] purpose (along with the language, structure, and history) to determine the proper interpretation").

76. *See id.*

77. *See id.* at 83–84.

78. *Id.*

79. Richard Posner, *Justice Breyer Throws Down the Gauntlet*, 115 YALE L.J. 1699, 1710 (2006).

80. Cass R. Sunstein, *Justice Breyer's Democratic Pragmatism*, 115 YALE L.J. 1719, 1733–34 (2006).

81. *See* DERRIDA & CAPUTO, *supra* note 59, at 136; SCALIA, *supra* note 70, at 18 ("When [a judge is] told to decide, not on the basis of what the legislature said, but on the basis of what it *meant* . . . that will surely bring [the judge] to the conclusion that the law means what [he] think[s] it *ought* to mean.").

82. *See* DERRIDA & CAPUTO, *supra* note 59, at 136 ("[J]ustice and the law are not supposed to be opposites but to interweave . . . .").

more bounded exercise, if not a strictly mechanical one.[83] Indeed, for a textualist, justice and fairness may consist precisely in not going outside the text adopted by a democratic process—recognizing that the role of the courts is limited.[84]

The textualist believes that there is a correct approach to interpretation of legal texts. That approach eschews a search for legislative intent and more general purposes, instead focusing on a search for "original intent."[85] Original intent is confined to the intent of the words in the text—whether it be a constitution, a statute, or a regulation—as those words were understood in the relevant community of language speakers at the time of promulgation of the text.[86] This approach is intended to involve an objective search for meaning.[87] The search is objective because language is a public phenomenon, and we may investigate how the language of the text was used at the time relevant to the interpretation. The textualist must allow, however, that the search for original intent involves elements of indeterminacy.[88]

First, to the extent that the inquiry is historical in nature, difficulties always attend attempts to look into the past, and the more time that has elapsed, the more difficult the search. Second, indeterminacy flows from attempts to define the relevant community of language speakers to be considered. Language use changes over time. Evidence for language use at any point in time—say 1791—may require consideration of historical materials that both pre-date and post-date the time of promulgation of the text. How temporally far afield may examination of historical materials range?

Beyond the temporal problems that attend a search for original intent, the scope of the relevant community of language speakers may present additional problems. In one sense, when a law applies throughout the United States—such as the U.S. Constitution or a federal statute—we might say that the question of the relevant community of language speakers is easily answered. The community should be the citizens of the United States.

Several objections might be raised to this simple reply. First, is it

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83. *See* SCALIA, *supra* note 70, at 25 (praising the oft-derided "formalistic" nature of textualism).

84. *See id.* at 23 ("To be a textualist . . . [o]ne need only hold the belief that judges have no authority to pursue those broader purposes or write those new laws.").

85. *See id.* at 38 (discussing the use of writings by constitutional framers to understand how the Constitution was originally understood).

86. *See id.* at 38 ("What I look for in the Constitution is precisely what I look for in a statute: the original meaning of the text . . . .").

87. *Id.*

88. *See id.* at 38 (discussing the use of outside texts to determine the original meaning of the constitutional framers).

not unrealistic to assume a monolithic use of language across the United States at any particular point in time? Second, and perhaps more importantly, even if such a monolithic usage might be constructed, should that usage apply in the context of specialized legislation? For example, should financial regulation be administered against the backdrop of a monolithic national usage of financial terms or, instead, should administration take place using a community of language speakers made up of accountants, bankers and lawyers? The question of the appropriate community of language speakers is even more acute when one considers that juries will operate on the periphery of administration of specialized financial legislation, and these juries will almost certainly not include financial professionals.

Despite these problems with implementing textualism, at least we can understand the approach. We must recognize, however, that a textualist does not consider only a single text during the interpretive exercise. Though a textualist might, at first blush, make a claim to confining every inquiry to the text of a particular law, the foregoing discussion makes clear that this assertion is inaccurate because the textualist does in fact consult other "texts" to arrive at an interpretation. To see that this is so, we might make a fruitful comparison to principles of contract interpretation.

The parol evidence rule forms a cornerstone of black letter contract law. Under this rule, a court's inquiry into the interpretation of an integrated contract must be confined to the four corners of the document (absent some ambiguity in the contractual language).[89] This rule operates to exclude consideration of prior and contemporaneous written and oral agreements because they are extrinsic to the contract document itself.[90] Much like a statute in the view of the textualist, an integrated contract is one that expresses the complete, exclusive and final expression of the parties' agreement.[91] Nevertheless, statutory modifications of this common law contract doctrine counteract the unreality of this approach to contracts as texts.

For example, under the Uniform Commercial Code ("UCC"), in contracts for a sale of goods, the party to a contract always is free to appeal to usage of trade, course of dealing and course of performance to explain the meaning of an integrated contract.[92] While this excludes evidence of prior or contemporaneous agreements that are extrinsic to the contract in question—other forms of extrinsic evidence that might

89. U.C.C. § 2-202 (2011).
90. *Id.*
91. *Id.*
92. U.C.C. § 2-202(a) (2011).

inform judgments about usage are permitted.[93] The interpretive norm merely excludes extrinsic evidence of competing contracts. Other evidence for the usage of the contract terms within the relevant community of language users is permitted.

The UCC reflects a hierarchy of potential communities of language users relevant to contract interpretation. This hierarchy reflects the sort of challenge facing the textualist when he attempts to define the relevant "market" of language users to interpret a law. The UCC defines the relevant market for contract interpretation, in general, as the trade in which the contract participants are operating.[94] If the parties themselves, however, have a prior course of dealing that evidences a particular usage, then the relevant community of language users shrinks to the usage adopted by the two contracting parties by giving priority to language usage by the parties over usage in the trade.[95] The relevant community of language users further shrinks along temporal lines if the contract is a long-term contract and there is a course of performance under the very contract in question to which the court might refer.[96] In this case, the usage reflected in the course of performance of the particular contract takes priority over prior use between the parties in previous contracts or the language use prevalent in the trade in general.[97] The UCC approach to contract interpretation reflects the reality that language usage often is context-sensitive and that a relevant community of language users first must be established as a prerequisite to proper interpretation.

Just as the judge interpreting a contract may ignore prior and contemporaneous "texts" as an illegitimate source for interpreting an integrated contract, so the textualist will ignore legislative history as an illegitimate text to consult in interpreting a law. The prior or contemporaneous agreements are illegitimate because they are too close in form to the integrated contract and threaten its legitimacy; so too the legislative history is too close in form to the law under review because it threatens to replace it.

The prior and contemporaneous agreements usurp the authority and sanctity of the integrated contract, and destroy its utility, because the very purpose of using an integrated contract is to reduce the contract to a single and complete document. Allowing consideration of prior and contemporaneous agreements undermines this very purpose. Similarly, the reference to legislative history usurps the authority and sanctity of the

93. *Id.*
94. *See* U.C.C. § 1-303 (2011).
95. U.C.C. § 1-303(e) (2011).
96. *Id.*
97. *Id.*

written law both because it is not adopted in a process that gives the law democratic legitimacy and because there are good reasons to believe that the legislative history may have been created in ways that attempt to undermine the legislative process (for the history is not approved by vote in the relevant legislative bodies and individual legislators may insert self-serving language into the history).

Prior and contemporaneous agreements and legislative histories are the wrong sorts of texts to consult because they directly challenge the function of the primary text under consideration. When the judge considers, usage of trade, course of dealing, or course of performance to interpret a contract, however, he is considering texts of another sort—trade manuals, prior contracts, and testimony. Similarly, when the textualist considers historical materials to interpret a law as part of discerning its original meaning, he almost certainly will consult texts such as books, letters, and press reports.

In each case, a direct reference to dictionary definitions (which one sometimes encounters in court decisions) involves an express reference to a text—the dictionary quoted. Further, the reference to "usage" in a community of language users involves an implicit reference to a more ubiquitous and ephemeral text of sorts—the unwritten rules of pragmatics, semantics, and syntax that operate in the background of language use. Thus, it is wrong to say that the textualist only consults a single text when interpreting a law. Rather, textualism attempts to exclude consideration of certain types of texts when interpreting the law just as a judge excludes certain types of texts when interpreting a contract. They both more accurately might be called "selective textual exclusionists."

The indefiniteness associated with the search for original meaning reveals how spaces of ambiguity exist, which can be used to create loopholes that avoid regulation. Identification of the importance of usage in a community of language users, however, provides another clue to how Wall Street might justify the creation of novel financial transactions that circumvent disclosure rules.

VIII. Creation of Meaning through Use: Genus Words, Species Words and Derivative Contracts

One way to understand the operation of the ethic of technical compliance is to view it as a battle of linguistic usage between genus words and species words, particularly when a new financial product is invented and assigned a new name. This battle over usage took place when, in the early 1980s, Wall Street unveiled the "interest rate swap" to replace the

"back-to-back loan."[98] The interest rate swap contract ushered a new financial animal into the transaction zoo known as the "derivative contract," or "swap" for short. I witnessed this process at the start of my legal career on Wall Street. A simple example illustrates this battle.

Assume that the term "contract" describes a universe of discourse. In this universe, the terms "debt," "gambling," and "insurance" operate as genus words that denote different kinds of contracts. Species of debt contracts include "loans," "mortgages," and "bonds." Species of gambling contracts include wagers on "horse races," "blackjack," and "roulette." Species of insurance contracts include "car insurance," "health insurance," and "life insurance." In the regulatory world of contracts, classification as a "debt contract" requires that the contract be disclosed in financial statements, classification as a "gambling contract" means that the contract is illegal (except in carefully delimited circumstances), and classification as an "insurance contract" means that only designated legal entities (i.e., insurance companies) may offer insurance contracts to the public. In stylized form, this describes the state of the world in the early 1980s before Wall Street invented the "derivative contract."

The creation of this new financial product presented the regulatory system with a choice: Should swaps be treated as a species of one of the three established genus classifications, or should the swap instead be seen as a new genus of contract? The ramifications of the classification choice are significant. If the swap were treated as a new species of an existing genus, then it would fit into an existing regulatory framework that requires disclosure, is illegal, or may be offered only by designated companies. If, on the other hand, the swap were treated as a new genus, it would fall outside all existing schemes of regulation. Usage of the terms "derivative contract" and "swap," after an uncertain start, evolved into a separate genus category. However, this evolution of usage was actively managed by interested parties.

In particular, Wall Street worked hard to ensure that the term "swap" gained acceptance as a genus word and not a species word when it entered the universe of discourse as a new form of contract. Acceptance of "swap" as a genus word was the course preferred by business because it avoided the burden of existing regulation in the three forms of debt, gambling, and insurance. The battle for acceptance of a word as a genus word and not a species word is a complex process undertaken at many levels. The creation of the industry group, the International Swaps and Derivatives Association (ISDA), certainly contributed to the idea

98. *See* Frank Partnoy, *Financial Derivatives and the Cost of Regulatory Arbitrage*, 22 J. CORP. L. 211, 218–20 (1997).

that swaps were a new genus.[99]

The development of standard terms, conditions, and contracts for swaps further contributed to the idea that swap contracts were different because they were documented on their own special forms developed by ISDA.[100] The original swaps were plain vanilla interest rate swaps in which Party A exchanged a fixed rate of interest computed with reference to a notional principal amount with Party B for a floating rate of interest, typically LIBOR (the London Interbank Offered Rate), computed on the same notional amount.[101] As participants became more comfortable with this new transaction form, they began documenting ever more complex swaps using ISDA forms. The market realized that the streamlined document forms might be used to exchange almost anything financial (not just interest rates). This insight led to, among other things, the credit default swaps one sees today.

In the early days of swaps, the derivatives industry focused intensively on the concern over gambling contracts, obtaining legal opinions in various jurisdictions confirming that swaps were not a form of gambling contract. As the market grew, the participants kept telling themselves that swaps were a new genus, and they behaved as if swaps were not a species of regulated contract. This growing usage via practice gave an aura of safety in numbers. If the regulators did not agree with market usage treating swaps as a new genus, then everybody in the industry would have violated the regulations. Not content to rest with the developing common usage given to the term "swap," the industry also sought regulatory clarification to confirm this usage.

One example of strengthening this "genus" usage through legislation is The Commodity Futures Modernization Act of 2000 signed by President Clinton.[102] It prohibits states from regulating credit default swaps as insurance.[103] Another example, also signed by President Clinton, is the Financial Services Modernization Act of 1999,[104] which explicitly exempts security-based swap agreements (a derivative financial product based on another security's value or performance which includes credit default swaps) from regulation by the SEC.[105] It does this by amending the Securities Act of 1933, Section 2A, and the Securities

99. *See id.* at 219 n.43 ("In 1984, a group of swaps dealers formed the International Swap Dealers Association, now called the International Swaps and Derivatives Association (ISDA), and ISDA has produced standardized swap documentation since then.").

100. *See id.*

101. *See id.* at 219.

102. *See* 7 U.S.C. § 1 (2006).

103. *Id.* § 2.

104. 15 U.S.C. §§ 6801–6809 (2006).

105. *Id.* § 6802(e)(1)(C).

Exchange Act of 1934, Section 3A, to make clear that these swaps are excluded from the definition of "security" so as to escape regulation.[106] Legislative efforts are not exclusively one way. Recently, a New York State assemblyman announced legislation that would regulate credit default swaps as insurance.[107] However, this effort to confirm new financial terms as species words, rather than genus words, appears to be the exception.

One should not underestimate the insidious role that campaign finance (and the absence of meaningful reform) plays in the species versus genus battle over usage. Complex rules-based regulation is a fertile ground for needed "clarifications" in usage through legislation. The financial services industry and their lobbyists work hard to achieve these regulatory enhancements to usage of terms. The success of this activity depends on access to our senators and congressmen. This access is enhanced through campaign contributions. The recent Supreme Court decision on campaign finance, which confirms the treatment of corporations as "persons," will do nothing to help this situation.[108] To an extent, the legislative bodies that decry the ethic of technical compliance find themselves in a performative inconsistency when they facilitated the very development of usages that place financial transactions outside the scope of regulation.

I do not mean to suggest that the classification exercise is simply a page out of *Alice in Wonderland*.[109] Derivative contracts do, indeed, bear characteristics that resemble debt, gambling, and insurance contracts, but there are differences, at least in many cases. An alternate approach would have been to treat swaps as subject to all three regimes of regulation. Perhaps, however, borrowing a page from classifications in biology, our tendency is to make classifications exclusive rather than overlapping (e.g., a whale is either a fish or a mammal, but it is not both).

The process by which specific words acquire, through use, a meaning that facilitates the avoidance of regulation is not the only problem.

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106. Perhaps it should come as no surprise that a President who famously deconstructed the word "is" would be receptive to legislation clarifying the meaning of financial terms in this way. "It depends on what the meaning of the word 'is' is. If the—if he—if 'is' means is and never has been, that is not—that is one thing. If it means there is none, that was a completely true statement. . . Now, if someone had asked me on that day, are you having any kind of sexual relations with Ms. Lewinsky, that is, asked me a question in the present tense, I would have said no. And it would have been completely true." THE STARR REPORT, H.R. DOC. No. 105–310, at n.1128. (1998).

107. *See* Matthew Leising, *NY Assemblyman's Bill Would Regulate Credit Swaps as Insurance*, BLOOMBERG NEWS WIRE, March 25, 2010.

108. Citizens United v. Fed. Election Comm'n, 130 S. Ct. 876 (2010).

109. ALICE'S ADVENTURES IN WONDERLAND, LEWIS CARROLL (1865).

We need also consider whether our use of more general terms like "true" and "false" contributes to the successful design of structures that circumvent financial regulation. Just such an evolution in our usage of "true" and "false" also may have taken place.[110]

IX. The Contrast Between Modern and Ancient Conceptions of Truth

What general conditions allow Wall Street to arbitrage truth? Ironically, the answer may lie in the transformation of the notion of *truth* from its original Greek meaning in classical times, described by Heidegger in his lectures on Parmenides.[111] The Greek word for truth is *alethea*—sometimes translated as "unconcealedness."[112] Truth is that which is unveiled. The Greek word for false is *pseudo*.[113] However, in usage, *pseudo* does not always simply mean "concealed" as the counter to "unveiling." It can mean an appearance that is dissembling. The nuance is lost in our current conception of the "false" as the counterword for "truth" because we ground falsity in misstatements and omissions. The distinction is illustrated by the difference between a name assumed by an imposter and a name used by an author as a "psuedonym"—a false name. An imposter assumes a name falsely; this is a classic misstatement because the name used does not apply to the person who uses it. In contrast, the pseudonym intentionally conceals the author without being a misstatement because it correctly refers to the author while simultaneously concealing his identity. It is a concealment assumed by an author that fosters appearance by allowing a work to be published.

Applied to Greece, labeling a financial obligation as a derivative allowed a transaction to proceed under a pseudonym. Unlike the misstatement perpetrated by an imposter, the appellation "derivative" does apply to the transactions structured by Wall Street because Greece entered into derivatives trades. Yet, classification as a derivative concealed the true extent of Greece's overall financial commitments. Like the pseudonym, this was the very purpose of using a derivative—concealment without misplaced reference amounting to a misstatement.

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110. The law relating to the treatment of swap and derivatives contracts is, in its details, more complex than the outline given above, though these details are unnecessary for the argument of this essay. For an example of some of these complexities, see Stephen J. Lubben, *Derivatives and Bankruptcy: The Flawed Case for Special Treatment*, 12 U. Pa. J. Bus. L. 61 (2009). The account given above is based upon the author's personal involvement with the origins and development of the derivatives market in the 1980s.

111. *See* Martin Heidegger, Parmenides 17–58 (Andre Schuwer & Richard Rojcewicz trans., 1992).

112. *Id.*

113. *Id.*

The ethic of technical compliance thrives in a world where truth and falsity are conceived as binary because it tolerates a zone of dissembling appearance in which truth may be arbitraged. The difficult regulatory challenge is to design a regime in which we can again, like the ancient Greeks, properly label such behavior as "false."

The foregoing discussion has shown that the ethic of technical compliance may have a respected pedigree. But beyond these theoretical stances toward a text, and observations about how our usage of terms may facilitate operation of the ethic, why might someone believe that an aggressive stance toward the law is moral?

X. SYSTEMS AND BY-PRODUCTS

The idea that technical compliance might constitute a moral stance may strike some as an odd and counterintuitive account of our moral experience. For those who have a Kantian view of morality, it is an essential component that morality involves an internal conflict between a desire and a duty. The moral actor functions as a private legislature in which he constructs rules of reason for himself in the form of a categorical imperative, which describes a duty. The moral actor follows the call of duty developed via construction of the categorical imperative in accordance with reason. The categorical imperative is structured in the form of an injunction that might be universalized to apply to all actors. Unless the action required by the duty might rationally be recommended as a course of action for all actors, it is in the wrong form. This view of morality would seem to rule out dissembling behavior that allows a financial actor to take advantage of another.[114]

We ascribe praise or blame to an action in accord with whether the act is taken in accord with the duty. Praise or blame is appropriate because the actor is free to take either course—the moral actor is not constrained by nature to follow desire in the sense that an animal without reason follows desire. The moral actor has a choice because both desire (operating in the physical world of cause and effect) and reason (through an exercise of free will) may influence behavior. We praise the actor who follows reason. This account of morality harmonizes our scientific intuition that the world is ordered by the mechanical and external rules of cause and effect with our moral intuition that we have free will that may function as an internal cause of action outside physical laws.[115]

One answer to the Kantian account of our moral experience lies in the structure of systems that produce beneficial by-products.[116] Three

114. For an explanation of Kantian morality see POJMAN & FIESER, *supra* note 55, at 123–40.
115. *Id.*
116. This phenomenon is widely discussed in philosophical literature, notably by Jon Elster.

examples illustrate the point. First, in a capitalist system it is an article of faith that the good of society (we might say "truth" in a market) is fostered by the pursuit of self-interest by buyers and sellers. Individual buyers and sellers do not aim at producing wealth for society—they aim at producing wealth for themselves. Yet, the by-product of this pursuit is an efficient market in which all members of society benefit. Second, we expect that our adversarial judicial system of plaintiffs and defendants is well-suited to producing a form of juridical truth. The plaintiffs and defendants aggressively pursue their own self-interest within the confines of specified procedures, and the "truth" emerges (we might say "truth" in the courtroom). Third, in the political realm we expect that the competition of ideas fostered by a robust right to free speech will produce a government conducive to human flourishing—a form of political truth (we might say "truth" in politics). Only in the third case can it fairly be said that the individuals operating in the system truly believe that they are, in any sense, advocating for the public good or truth in the particular area of society involved. In cases one and two, the participants would have to admit they are not individually pursuing truth but that truth emerges from a process in which the aims of the participants are quite different. These thoughts are captured most famously by Adam Smith:

> It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own self-interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages.
>
> He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. . . . [H]e intends only his own gain, and he is in this, and in many other cases, led by an invisible hand to promote an end which was no part of his intention. . . . By pursuing his own interest he frequently promotes that of society more effectually than when he really intends to promote it.[117]

In a society that places faith in structures in which the aim of individual actors diverges from the desired by-product, it is understandable for individuals to assume that this structure operates widely in social life. The problem, however, is that in systems of disclosure and market regulation, it is hard to identify the social utility that emerges as a by-

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JON ELSTER, SOUR GRAPES: STUDIES IN THE SUBVERSION OF RATIONALITY 43 (1985). A good synopsis appears in Slavoj Zizek, *Why is Kant Worth Fighting For?*, *Foreword* to ALENKA ZUPANÈIÈ, ETHICS OF THE REAL, at ix–xi. (2000). *See also* ROBERT NOZICK, SOCRATIC PUZZLES 191–97 (1997).

117. ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 22 (1776).

product from individual practices that restrict disclosure or skirt market restrictions via application of the ethic of technical compliance. At least, at first blush, any reasons that might be given seem thin—what rationale might one give for limiting information in a system of disclosure? The only justification that suggests itself to me is some notion that providing too much disclosure creates a form of information overload—the disclosing party must self-edit by including only relevant information in order to make the information useable by the market.

A by-product stance toward moral behavior neatly reconciles pathological tendencies with the moral act because it eliminates the conflict between desire and a rule opposed to desire. An internal conflict results within an actor when a desire (such as creating private wealth) conflicts with a moral rule adopted by an actor (such as a prohibition against taking advantage of loopholes in the positive law out of a perceived duty to community). In a system that produces beneficial by-products, the actor makes the moral choice precisely by following his desire because following the desire is the mechanism through which benefit to the community is created. An executive at Goldman Sachs can assert that his firm is "doing God's work" because he has faith in the ability of the pursuit of self-interest to produce social welfare as a by-product. In a sense, this situation produces an excess of enjoyment for the technical complier—he gets the satisfaction of pursuing his desire, and gets the further satisfaction of knowing that he is helping society while doing so.

There are, however, well-known theoretical objections to the idea that an aggressive stance towards disclosure rules will create social value in the form of by-products. Indeed, economic theory suggests the opposite.[118]

John von Neuman's work on game theory and its applications to multiperson games in economic settings provide theoretical support for Adam Smith's insight about invisible-hand explanations.[119] However, they also expose its limitations. Kenneth Arrow and Gerald Debreu showed that in non-zero sum games an equilibrium can develop in which no player may increase his profit by changing strategy (analogous to a weak Pareto optimum).[120] In a rigorous mathematical model, the invisible hand produces a stable economic equilibrium acceptable to all players.

The problem with this result is that it applies under general condi-

118. In this discussion of economic theory, I follow LÁSZLÓ MÉRÖ, MORAL CALCULATIONS: GAME THEORY, LOGIC, AND HUMAN FRAILTY 135–49 (David Kramer ed., Anna C. Gösi Greguss trans., 1998).

119. *Id.* at 141–42.

120. *Id.*

tions that occur in a perfect market—conditions that do not obtain in any real economy. One assumption of a perfect market is complete or perfect information. Government intervention in the form of regulation aims to nudge our imperfect economy towards the ideal of the perfect market, and this is the very reason for rules that mandate disclosure. Actions by the technical compliers that limit disclosure destroy the very conditions thought necessary to produce the beneficial by-product.

To be sure, there are reasons to believe that the perfect market is an impossible and incoherent fantasy, and that all attempts to achieve an approximation of that ideal to improve social welfare are doomed to fail.[121] For present purposes, however, we may put these objections aside. The important point is that we have made political decisions on the generally accepted faith that government may adopt regulations that achieve these beneficial results.[122] The technical compliers forget this fact when their competitive drive leads them to structure transactions that conceal capital raising activities. The truly reflective technical complier should thus steer clear of dissembling disclosure and take no comfort that he will produce beneficial by-products through sharp practice when it comes to disclosure and market transparency.

To understand Wall Street, one must understand that a large percentage of the profits come from exploiting information asymmetries. Indeed, arbitrage activities rely on an imperfect market for information. Not all information asymmetries are sinister. While current SEC rules prohibit use of inside information to trade securities[123] (a "bad" information asymmetry), market research and analysis to identify promising investments is seen as a reward for engaging in the expensive task of information gathering (a "good" information asymmetry). In the case of private investment opportunities, an investment bank may seek out information that is not available to the public and use this information to its advantage (and the advantage of its clients). In the case of public companies, U.S. regulations operate on the assumption that all basic material information has been filed with the SEC and is publicly available. In this case, the private information derives from analysis of public

121. *See* William H. Widen, *Spectres of Law and Economics*, 102 MICH. L. REV. 1423 (2004) (book review).

122. The economists Samuelson and Nordhaus support the idea that government may take steps to improve the market in socially beneficial ways. MÉRŐ, *supra* note 118, at 142 ("When the checks and balances of Darwinian perfect competition are absent, when economic activity spills over outside of markets, when incomes are distributed in politically unacceptable ways, when people's demands do not reflect their needs—when any of these conditions arises, then the economy is not led by an invisible hand to an optimum position. Further, when a breakdown occurs, the carefully designed and restrained intervention of government may improve economic performance on this imperfect and interdependent globe.").

123. *See* 17 C.F.R. § 240.10b5-1 (2006).

information—in theory, anyone could do the analysis; the investment bank is rewarded for doing the analysis faster and better than the competition and selling the work product in the form of research reports to its clients (compensation coming in the form of brokerage commissions and trading for its own account).[124]

Beyond a penchant for secrecy with respect to information about companies, Wall Street is not a big fan of transparent pricing for its own services.[125] These facts suggest that, while we might hope through education to develop a class of enlightened technical compliers who do not game the disclosure system, we must allow that the very fact of competition will incentivize bankers to market products that conceal financial transactions. Indeed, short-sighted greed may trump the sort of long-term greedy self-interest that would seek to preserve and improve the market. If we take this somewhat cynical (though, I would suggest, practical) view, we must think carefully about how to play the game of technical compliance by drafting laws that counteract its pernicious impact. This leads directly to the debate over a technical rules approach as contrasted with a general principles approach to drafting.

XI. RULES VERSUS PRINCIPLES

A practical answer to an ethic that refuses to look beyond the text of the law is to insert the desired content into the text. This insertion can take one of two forms. The first approach—which could be called the "rules approach"—would draft increasingly comprehensive and complex legislation in an attempt to cover all relevant situations within the text of the law. However, the problem with attempting to be comprehensive with the use of detail is well-known and relates to the problem of contracting. It is often said that all contracts are "incomplete" in that they cannot cover all contingencies. This leaves open spaces in any negotiated agreement that must be completed by the gap-fillers of the law—often left to the discretion of a judge. Further, the more detail included in the contract, the higher the transaction costs of negotiation, drafting, interpretation, and monitoring the agreement. The same might be said of legislation. Is it possible for a rule-maker to anticipate all the contingencies and creative structures that Wall Street and the financial engineers might create?

At the other end of the spectrum—the second so-called "standards" or "principles approach"—the rule-maker drafts legislation in general terms. This approach requires the person confronted with the law to

124. *See* Andrew Ross Sorkin, *Big Clients Keep Their Head Start*, N.Y. TIMES, March 23, 2010, at B1.

125. *See id.*

engage in some form of evaluation to decide whether particular conduct is prohibited. This may result in the person looking for the "intent" behind the general language or to some other system of beliefs to discern the scope of the legislation.

This approach to drafting legislation may be criticized on at least two grounds: it gives wide discretion to regulators and judges to interpret the law, and it may fail to signal adequately the scope of the law to those subject to it. One perceived requirement of law is that it be public and knowable so that people may conform their conduct to it. Clarity of scope allows the law to teach the public what conduct is required. This function is hampered by vague and general laws.

In the principles versus rules debate over the correct approach to drafting legislation, Executive Order 12988, signed by President Clinton, provides a good place to start. This Order contains a helpful roadmap for legislators by outlining a number of areas that good legislation should explicitly address in order to reduce the burden of litigation in the federal courts. It makes little sense to draft legislation that does not address matters such as the applicability of a statute of limitations, the existence of a private right of action, the types of remedies that may be sought, and whether attorney's fees might be awarded to the prevailing party.[126]

Most of the Order addresses concerns such as these which might broadly be characterized as procedural in nature. These are matters for which clear and detailed rules (as opposed to general principles) make sense. As a signature example, courts should not be burdened with deciding whether a statute implies a private right of action when attentive drafting could answer the question definitively.

The Order, however, appears to side with the rules approach, rather than the principles approach, when it addresses the standard for proscribed conduct by contrasting a "clear legal standard" with "a general

126. Exec. Order No. 12,988, 61 Fed. Reg. 4729 (Feb. 5, 1996), *reprinted in* 28 U.S.C. § 519 (2006). The Order directs agencies to make every reasonable effort to ensure that proposed legislation, "as appropriate . . . specifies in clear language"—(A) whether causes of action arising under the law are subject to statutes of limitations; (B) the preemptive effect; (C) the effect on existing Federal law; (D) a clear legal standard for affected conduct; (E) whether arbitration and other forms of dispute resolution are appropriate; (F) whether the provisions of the law are severable if one or more is held unconstitutional; (G) the retroactive effect, if any; (H) the applicable burdens of proof; (I) whether private parties are granted a right to sue, and, if so, what relief is available and whether attorney's fees are available; (J) whether state courts have jurisdiction and "under what conditions an action would be removable to Federal court;" (K) whether administrative remedies must be pursued prior to initiating court actions; (L) standards governing personal jurisdiction; (M) definitions of key statutory terms; (N) applicability to the Federal Government; (O) applicability to states, territories, the District of Columbia, and the Commonwealths of Puerto Rico and the Northern Mariana Islands; and (P) what remedies are available, "such as money damages, civil penalties, injunctive relief, and attorney's fees." *Id.*

standard."[127]

> The agency's proposed legislation and regulations shall provide a clear legal standard for affected conduct rather than a general standard, and shall promote simplification and burden reduction.[128]

Nevertheless, a vague or general law that creates a "grey area" may have a beneficial effect on behavior even if it fails its precise signaling or educational function because it may engender a cautionary stance towards the law and compliance. Justice Brandeis famously noted the role that ambiguity may play in systems of rules:

> I have been asked many times in regard to particular practices or agreements as to whether they were legal or illegal . . . . One gentlemen said to me, '[w]e do not know where we can go.' To which I replied, 'I think your lawyers or anyone else can tell you where a fairly safe course lies. If you are walking along a precipice no human being can tell you how near you can go to that precipice without falling over, because you may stumble on a loose stone, you may slip and go over; but anybody can tell you where you can walk perfectly safe within convenient distance of that precipice.' The difficulty which men have felt . . . has been rather that they have wanted to go the limit rather than that they have wanted to go safely.[129]

Though Justice Brandeis correctly identifies the problem, he does not expand upon the likely source of this risky behavior. In a capitalist system the competitive structure of the market incentivizes men to "go to the limit" because a failure to do so places them at a disadvantage with respect to their peers. A certain pathology (in a Kantian sense) compels this result. Absent the possibility of meaningful sanctions to enter into this calculus of pathology, we should expect no other outcome unless business morality contains an ethical component beyond a utilitarian calculus of desire. The present state of the financial markets does not seem to justify such an optimistic stance towards the attitude of business. The Clinton edict to eschew general standards for proscribed conduct may in fact encourage, rather than discourage, risky behavior with respect to legal compliance.

A few conditions lead to conduct that crosses the line—counteracting the "grey area" effect identified by Justice Brandeis. First, regulators will only uncover a fraction of prohibited conduct. Second, in most cases the penalty for violation of the law will simply result in disgorgement of the benefit received as a result of the violation. Third, the viola-

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127. *See id.* § 3(a)(3).

128. *Id.*

129. *Control of Corporations, Persons, and Firms Engaged in Interstate Commerce: Hearing on S. Res. 98 Before the S. Comm. On Interstate Commerce* 62d Cong. 1161 (1911) (statement of Louis D. Brandeis).

tion will not result in jail time for individuals who perpetrated the scheme because of scienter requirements for imposition of criminal liability. Detailed rules make it easier to invoke technical compliance as part of an attempt to defeat scienter. This is a recipe for under-deterrence.

Simply following a principles approach does not appear to be a panacea either. A close look at case law dealing with accounting rules suggests that, under existing law, accountants should already follow a principles-based, rather than a technical rules-based, approach when it comes to preparation of financial statements.[130] This creates some concern that merely drafting principles will prove insufficient to counter the problem if the use of principles is not intelligently implemented. Lehman Brothers' use of the Repo 105 transaction illustrates this problem.

XII. LEHMAN BROTHERS, REPO 105 TRANSACTIONS AND PRINCIPLES

Strict adherence to bright-line rules seems to have influenced Lehman Brothers' use of the Repo 105 transactions. Lehman Brothers took the position that the use of these transactions was not technically illegal.[131] Nevertheless, the transactions masked the reality of the firm's financial position by allowing Lehman to report a lower leverage ratio. The Repo 105 transactions are an accounting treatment that allowed Lehman Brothers to temporarily remove billions of dollars from its balance sheet by using repurchase agreements.[132]

A repurchase agreement is a short-term financing transaction in which a borrower "sells" collateral to a lender and promises to repurchase it later.[133] Financial statements normally report repurchase agreements as liabilities of the borrower. The Repo 105 transaction allows the borrow to characterize its financing as a sale if the assets transferred have a value of 105% or more of the financing amount.[134] This transaction structure allowed Lehman Brothers to reduce its balance sheet by

130. *See generally*, United States v. Simon, 425 F.2d 796, 807–09 (2d Cir. 1969) (examining the acts of the accountants who did not financially benefit from fraud but nevertheless committed fraud); *see also* Ronald M. Mano et al., *Principles-Based Accounting: It's Not New, It's Not the Rules, It's the Law*, The CPA J. (Feb. 2006), http://www.nysscpa.org/cpajournal/2006/206/essentials/p60.htm.

131. *See* Efrati & Jones, *supra* note 10.

132. *See* Valukas, *supra* note 3, at 6 ("Lehman . . . had been using an accounting device . . . to manage its balance sheet—by temporarily removing approximately $50 billion of assets . . . .").

133. *See* Michael J. Fleming & Kenneth D. Garbade, *The Repurchase Agreement Refined: GCF Repo*, CURRENT ISSUES IN ECONOMICS AND FINANCE (June 2003), http://www.newyorkfed.org/research/current_issues/ci9-6.pdf ("A repurchase agreement is a sale of securities coupled with an agreement to repurchase the same securities at a higher price on a later date.").

134. *See* Valukas, *supra* note 3, at 6 ("[B]ecause the assets were 105% or more of the cash received, accounting rules permitted the transactions to be treated as sales. . . .").

eliminating assets while using the proceeds to repay short-term debt.[135] Lehman Brothers closed the transactions just prior to the end of a financial reporting period and reversed the transaction after the close of the reporting period by repurchasing the assets.[136] Lehman Brothers availed itself of a loophole in the Financial Accounting Standards Board's Statement ("FAS") 140, passed in September 2000, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," which contained the 105% threshold for sale treatment (rather than debt treatment).[137] FAS 140 updated FAS 125, passed in 1996, which attempted to codify accounting for repurchase agreements.[138]

In addition to thoughtful drafting of general rules that prohibit conduct, consideration must be given to specifying monetary damages that exceed the profit obtained from the illegal conduct—such as the treble damages imposed for certain antitrust violations—to counteract the under-detection problem.[139] Second, consideration must be given to eliminating a scienter requirement for violations of financial regulation. I have previously argued that in the special case of margin regulations Congress has already taken this step.[140] If there is any area of law in which the participants might be expected to have extensive legal advice concerning the scope of regulation, it would be in the financial services industry, making it an appropriate area to stand by the maxim that ignorance of the law is no defense. With these steps in place, intelligently drafted general rules might have a chance of introducing some muscle behind Justice Cardozo's observation about the potential benefits of ambiguity which general rules might provide.

To see what kinds of general rules that proscribe conduct might get Wall Street's attention, one need look no farther than recent case law.

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135. *Id.*

136. *See* Valukas, *supra* note 3, at 7 ("Lehman used Repo 105 for no articulated business purpose except 'to reduce balance sheet at the quarter-end.'").

137. Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 140*, at 4 (Sept. 2000).

138. *Id.*

139. See Lucian Arye Bebchuk & Louis Kaplow, *Optimal Sanctions When the Probability of Apprehension Varies Among Individuals* (Nat'l Bureau of Econ. Res., Working Paper No. 4078, 1992) for a general discussion of the problem of under deterrence and its attendant complexities. *See generally*, Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968); Richard A. Posner, *An Economic Theory of the Criminal Law*, 85 COLUM. L. REV. 1193 (1985).

140. *See* Widen, *Enron at the Margin*, *supra* note 8, at 970 n.46. My observation has been misunderstood as applying to securities laws more generally.

XIII. EXAMPLES OF LAWS AND RULES THAT FIGHT BACK

A recent decision illustrates how parties attempt to treat a swap as a genus that exempts them from regulation.[141] It also showed how a judge's application of a general provision sent shock waves of the desired sort into the derivatives market.[142] Another ongoing case, also involving derivatives, shows the extent to which defendants will make technical arguments to limit language that would clearly seem to have been designed with a broad reach to cover the transaction at issue.[143]

XIV. COUNTERACTING THE ETHIC OF TECHNICAL COMPLIANCE—A MODEL RESPONSE TO THE GREEK DEBT CRISIS

To counter the systemic incentives to "go to the limit," a simple standards or principles strategy may prove ineffective. We must, therefore, consider steps to make such an approach robust. For maximum effect, a robust standards approach should not limit itself simply to using general terms. In some legal settings, a set of rules includes express principles of interpretation that direct focus beyond the words expressing the rules. One example appears in the UCC, which adopts a hierarchy of principles that directs reference to usage of trade, course of dealing, and course of performance to interpret terms in fully integrated agreements.[144] The effect is to admit extrinsic evidence to interpret contracts, confirming that interpretation will never be limited to an examination of the mere four corners of a document. Another example appears in the United Nations Convention on Contracts for the International Sale of Goods ("CISG"), which similarly refers to trade usage and dealings between the parties, but also refers to promotion of global uniformity in interpretation—implicitly directing courts in one jurisdiction to look to decisions in other jurisdictions for guidance.[145] One also finds an attempt to include legislative intent into the text of law in Australia. Amendments to the Acts Interpretation Act 1901 provide that statements made in the Second Reading speech by Ministers introducing an Act may be used in the interpretation of that act.[146]

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141. CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP, 562 F. Supp. 2d 511 (S.D.N.Y. 2008), *aff'd in part, vacated in part,* 2011 WL 2750913292 (2d Cir. July 18, 2011).

142. *Id.* at 517.

143. SEC v. Rorech, 673 F. Supp. 2d 217, 225–26 (S.D.N.Y. 2009) (rejecting a motion to dismiss for failure to state a claim).

144. *See* U.C.C. § 1-303 (2011).

145. United Nations Convention on Contracts for the International Sale of Goods, *opened for signature* Apr. 11, 1980, S. Treaty Doc. No. 98-9 (1983), 1489 U.N.T.S. 3 (entered into force Jan. 1, 1988). Article 7 of the CISG requires that it be interpreted with the goal of international uniformity. *Id.*

146. *See Acts Interpretation Act 1901* (Cth.) s. 15AB. In the English tradition, proper practice did not allow courts to look at legislative pronouncements for the interpretation of acts of

In the context of the Greek debt crisis, how might regulators have used a robust standards approach? First, instead of mandating disclosure of "debt" and using other category words that may have an ossified meaning, the rules might have used a term with broader reach—for example, by requiring disclosure of "financial obligations"—the classic "standards" approach. Second, the rules might have included a principle of interpretation in the rules themselves that make reference to the functional equivalent of debt by requiring that the law be construed to promote disclosure. For example,

> These rules shall be liberally interpreted to promote disclosure of all financial obligations of the Member States (including its instrumentalities and agencies) with the purpose of providing a complete and accurate picture of the financial capacity of the Member States to honor financial commitments of any kind. Accordingly, the term "financial obligation" shall include, without limitation, an obligation denominated as a debt, a loan, a mortgage, a security, a sale, a sale-leaseback, a lease, a derivative, a securitization, a pre-export financing or other anticipation of revenue, or otherwise, and whether or not liquidated or unliquidated, certain or contingent, recourse or non-recourse, or structured directly by a Member State, one of its instrumentalities or agencies or through a special purpose or other financing vehicle.

For practical purposes, such a definition should be coupled with a procedure, similar to the no-action letter process used by the SEC, pursuant to which a would-be transaction participant might describe a transaction to the regulator and obtain advice as to whether or not a particular transaction would be covered by the above definition. If these no-action letters were published, they would, over time, form a supplemental text to which reference could be made to interpret the text of the rules.

Third, a robust standards approach could also benefit from a rethinking of the very concept of financial obligation by not attempting to rely solely on category words such as "debt" or "financial obligation" to delimit the category of transactions that require disclosure. Words such as these attempt to describe a resulting structure, leaving open the possibility that an alternate structure will emerge for which the existing category words are inadequate. This is exactly what happened when, in the early 1980s, Wall Street developed the "derivatives" transaction—a previously unknown legal form. Instead, the robust standards approach

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Parliament—in contrast to acceptable practice in the United States, Australia, and New Zealand. When practice began to change in English courts, this caused concern. *See* Scott C. Styles, *The Rule of Parliament: Statutory Interpretation After* Pepper v. Hart, 14 OXFORD J. LEGAL STUD. 151, 157 (1994).

might include a supplemental disclosure requirement that focuses on the origin of financial innovation and problematic structures. For example,

> Any capital raising transaction, if consummated, in which a Member State or any of its instrumentalities or agencies has consulted, engaged or hired, directly or indirectly, a commercial banker, an investment banker, a financial advisor, an underwriter, a placement agent, a consultant, or similar financial professional shall be presumed to result in the creation of a financial obligation which requires disclosure pursuant to these rules. The foregoing shall apply even if the financial professional purports to act as a principal and not as an agent or advisor.

The motivation for such a novel re-definition of financial obligation might be traced to Hume's reflections on causation.[147] Whenever a transaction is criticized as being the product of financial engineering created in the spirit of the ethic of technical compliance—from Enron to Greek debt—Wall Street seems lurking in the background. Wall Street appears first, followed by a scandal involving a fancy structure that enabled a non-disclosure by stipulating that all creations emanating from this source constitute "financial obligations" that require disclosure, a system of rules would migrate away from a focus on the intricacies of structure itself and instead focus on the apparent "cause" of these structures. (We need not assume that there is some hidden necessary connection; we need only note that the two are conjoined in our experience.) After all, Wall Street is in the business of raising capital in various ways and getting paid for it. These capital-raising activities all have the hallmark of generating funding for the client and require payment or repayment because Wall Street is not running a charity.

My supplemental definition of "financial obligation" does not limit itself to transactions in which the financial professional receives a fee, but simply requires that the financial professional have been consulted on the structure. To be sure, in most cases, the financial professional will have charged a fee. However, we do not want to encourage a practice in which financial professionals design complex structures "for free" and then receive compensation indirectly, either by charging a higher rate to facilitate garden-variety debt transactions or by purchasing assets at a discount. (To further enhance the definition, one might consider whether the concept of financial professional should be expanded expressly to cover accountants and lawyers lest the locus of financial engineering simply migrate.) Indeed, if the E.U. regulators want to elicit disclosure of prior exotic transactions used by other countries, I would recommend

147. *See generally* Donald Davidson, *Causal Relations*, 64 J. Phil. 691–92 (1967) (noting that cause and effect does not reflect a perceived necessary connection but simply the regular occurrence of the effect following the occurrence of the cause).

that they request a list of all transactions in which countries raised capital and engaged financial professionals. Such a definition might further be strengthened by requiring disclosure of any financing structure in which a third party received compensation in excess of a threshold amount. Follow the money, and you will find the transactions.[148]

XV. CONCLUSIONS

What is the theoretical status of my practical suggestions for combatting the ethic of technical compliance? Significantly, the strategy seems to involve the regulator in a mere war of words in which deconstruction of laws by business interests is countered by simply suggesting a better choice of words.

This explains the desire to improve regulatory schemes by, for example, revising the text of rules using the robust standards approach outlined above—particularly the use of general terms and the inclusion of principles of interpretation in the text of the rule or regulation. It also explains, to an extent, my third recommendation to rethink a definition of "financial obligation" to focus on origins rather than structure. However, this third recommendation has a broader purpose.

The Heideggerian insight that our modern conception of truth allows for a dissembling appearance to count as truth (or, at least, not falsehood) suggests an antidote for the ethic of technical compliance. In essence, the approach gives up on any attempt to provide a complete algorithm for separating those financing structures that should be disclosed from those financing structures that need not be disclosed. Recognizing that the financial professionals are engaged in the generic business of raising capital and that these almost certainly create repayment obligations of some sort (or deplete assets in the form of sale transactions), the rule simply designates for disclosure all structures which emanate from financial professionals—abandoning a classification scheme for transactions. To be sure, this involves a linguistic move of sorts because one must now define the scope of the term "financial professional" in order to fully understand the scope of the term "financial obligation." I submit, however, that this task is a far easier one than

148. There is an extensive literature considering the problem of corporate compliance and how to design efficient systems and rules that promote compliance with law. *See, e.g.* Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U.L.Q. 487 (2003) (discussing shortcomings of internal compliance programs, with citations to the literature). The position advocated for in this essay recommends drafting techniques that make it harder to game the system of legal rules. To be sure, this may push actors from the technical compliance camp to the intentional violation camp. It is assumed, however, that this is a step some actors may be unwilling to take. That is to say, an action will not be taken if it is more difficult to argue that the action technically complies with law.

attempting to catalog an ever expanding menagerie of financial products.[149] Indeed, if we give up on classifying the animals in the zoo, it may focus financial innovation in directions that do not "create" value for clients by manufacturing dissembling disclosure. The definition, if successful, removes profit from the arbitrage of truth.

I have suggested that we can understand the ethic of technical compliance by observing that moral knowledge has become sentential in the spheres in which the ethic operates. A consequence of this development is that business ethics will remain pathological—without resort to moral principles beyond the correspondence between outward acts and a text of rules and regulations. The competition inherent in our economic system ensures that the businessmen will approach the limits—walking dangerously close to the edge of the cliff in Justice Brandeis' metaphor[150]—to avoid placing themselves at disadvantage. This situation is unlikely to ever foster disclosure of the sort thought proper by regulators and the public. The solution to this problem requires elimination of the space in which truth may be arbitraged by eliminating the potentially hopeless task of classification of financial transactions into the disclosable and the private. In closing, I note that various interpretivist theories of law, explored by Ronald Dworkin and others, use a coherence, rather than a correspondence, model of truth to examine and critique legal practices.[151] Examining the ethic of technical compliance in light of coherence models of truth might be a worthwhile exercise, but such a project is beyond the scope of this essay.

149. One practical way to close the definitional loop might be to create a list of permitted financial professionals. Member States would commit to using only financial professionals included on the list. Capital-raising transactions with those on the list would require disclosure. Financial transactions with those not on the list would be void transactions (and not simply voidable transactions). To foster competition, admission to the list could be a simple matter of voluntary registration. Criminal sanctions might apply both to government officials and financial professionals who promote and execute transactions with unlisted firms.

150. *See supra* note 129 and accompanying text.

151. *See, e.g.* Ken Kress, *Why No Judge Should Be a Dworkinian Coherentist*, 77 TEX. L. REV. 1375 (1999) (examining the core role that coherence theories of truth play in the theories of Ronald Dworkin).