

## DISCLOSURE AND JUDGMENT: “WE HAVE MET MADOFF AND HE IS OURS”

*Jeffrey M. Lipshaw*<sup>\*</sup>

I have had money managers and investment advisers counseling me since my wife and I, thirty years ago, first opened one of those innovative Cash Management Accounts at Merrill Lynch. The young fellow who was recommending certificates of deposit to protect our first \$20,000 (later our down payment on a house) is now a seasoned executive, and he has done a pretty good job along the way. We saved a few dollars over the course of a career, and another money manager did a nice job diversifying us away from the bursting of the Internet bubble earlier in this decade. Here is an example of the good advice. One of the hot stocks of that bubble was Qualcomm—it was what Peter Lynch called a “twenty-banger”; shares we bought at \$28 were trading for \$560. As the stock approached \$600 per share, and was coming to dominate our portfolio, the question was what to do. Pundits were saying, “buy”; this was easily going to be a \$1,000 stock. Shortly thereafter it did a four-for-one split, the bubble burst, and it never again approached the equivalent of \$600 per share. I was a pretty sophisticated fellow, but I loved that stock. What I had never heard of, however, was the idea of re-balancing the portfolio. If I was smart about anything, it was that when my advisor said we need to sell a good chunk of the Qualcomm to rebalance, I resisted for a little bit, and then said to myself, “Wait a minute, what am I paying him for, if not exactly this kind of judgment?” What was the difference between saying that about my advisor and someone else saying it about Bernie Madoff, other than dumb luck?

It turns out mine was good judgment, but that is not my point. My scholarly project is not nearly as much about the specifics of regulation, whether by the SEC or others, as about judgment and its irreducibility. I feel eminently unqualified to expound on the silver bullets that are the key to solving systemic problems, perhaps because my intuition is that there are either no silver bullets, or so many that the silver is not worth very much. This crisis is, like all disasters seen in retrospect, the confluence of a number of things at just the right time—an economic Bridge of San Luis Rey, as it

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<sup>\*</sup> Associate Professor, Suffolk University Law School. A.B., University of Michigan; J.D., Stanford University. This essay was the basis of my presentation at a symposium entitled “The Fallout from the Bailout,” held at the University of Dayton Law School on March 20, 2009. As to the title, consider it a tribute to Walt Kelly and Pogo (“we have met the enemy and he is us”), crossed with a reference to William Henry Harrison’s original message in the War of 1812 (“we have met the enemy and they are ours”). The question is: By what grace of God were many of us fortunate enough not to have relied on a Madoff or Stanford or somebody like them?

were.<sup>1</sup> Lots of money in the system, loose standards for credit ratings,<sup>2</sup> undue faith (or hubris) in the science of financial models,<sup>3</sup> and the usual psychology of bubbles took greed and fear out of the appropriate equilibrium. Now we are dealing with the fear side of the polarity.

Being pathologically fearful of pontificating about systemic solutions,<sup>4</sup> I am more interested in looking at the system from the inside out, or more precisely, at the point at which the objective data the system presents interfaces with individual minds that have to process the data. My thesis is that more information, more data, more disclosure of the kind traditionally mandated by the SEC is good, but at the end, somebody makes a judgment about what to infer from the data. The only real question is the number of proxies and heuristics that intervene between the decision-maker and the data. The consequence is that, unless we are prepared to make a fundamental move from disclosure-based regulation to merit regulation, we can tweak around the edges with improvements to the SEC's oversight, but nothing is going to substitute for human beings making sound judgments about the information that has been disclosed to them.

How do today's collateralized debt obligations fit within the securities regulation system? Following the Choi and Pritchard casebook,<sup>5</sup> I start my course on securities regulation with a series of hypotheticals that establish the parameters of markets for information, and then the kinds of regulation that might be appropriate. I observe that one may sell or buy a computer or a calculator or bicycle or book or candy bar without a whole lot of obvious regulation or interference from the government, and ask the question: Why are investment securities so special? We distinguish between three different kinds of regulation. Merit regulation actually regulates the

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<sup>1</sup> See generally THORNTON WILDER, *THE BRIDGE OF SAN LUIS REY* (1928).

<sup>2</sup> See Jeffrey Manns, *Rating Risk After the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability*, 87 N.C. L. REV. 1011, 1044 (2009).

<sup>3</sup> Joe Nocera, *Risk Mismanagement*, N.Y. TIMES MAG., Jan. 4, 2009, at 25; see also NASSIM NICHOLAS TALEB, *FOOLED BY RANDOMNESS* (2d ed., Random House 2005) (2004).

<sup>4</sup> For the views of someone far more competent than I to expound upon the systemic issues, see Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L. J. 193 (2008). Professor Schwarcz defines systemic risk as

the risk that (i) an economic shock such as market or institutional failure triggers (through a panic or otherwise) either (X) the failure of a chain of markets or institutions or (Y) a chain of significant losses to financial institutions, (ii) resulting in increases in the cost of capital or decreases in its availability, often evidenced by substantial financial-market price volatility.

*Id.* at 204. Note that he is equally skeptical of disclosure for the control of systemic risk because the nature of systemic risk is that market participants, operating in their own interests do not perceive it; moreover, "investors and counterparties already demand, and usually receive, disclosure to the extent it helps them assess the merits of their investments, qua investments." *Id.* at 218. Not surprisingly, then, he does not see much of a role for securities regulation on the systemic side of things. *Id.* at 212. My focus here is on the more traditional role of securities regulation in eliminating information asymmetries.

<sup>5</sup> See STEPHEN J. CHOI & A.C. PRITCHARD, *SECURITIES REGULATION: CASES AND ANALYSIS* 22-31 (2d ed. 2008).

substance of the product. It would bar the use of trans fats in Big Macs or Whoppers. Disclosure regulation would not dictate whether the trans fats could or could not be used, but it will make sure that you know when you buy the burger just how much trans fat you are going to be consuming, and perhaps even some information about the risks and dangers of trans fat. Consumer education is a little like disclosure regulation, but the idea is not to do anything to the product or even disclose about specific products, but educate people about trans fats so they themselves demand the information and make their own decisions.

From the enactment of the two primary securities acts in the New Deal,<sup>6</sup> the primary focus of securities regulation about the securities themselves has been disclosure. There is also a great deal of regulation of the broker-dealer industry in the 1934 Act, but the primary goal of the regulation is transparency of the broker-dealer's role vis-à-vis the broker's role as agent or principal in the transactions. The competence of the broker or investment adviser is still regulated by state law. Moreover, the format of the disclosure in the regulatory system depends on whom the information is about, to whom the information is being given, and the extent to which the transactions are public or, in other words, broad distributions. We can say generally at one end of the spectrum, a broad distribution of a new company's securities to the general public will require the full panoply of disclosure, and rigorous control of the process by which that disclosure in the form of a prospectus gets into the hands of the purchaser. At the other end of the spectrum, there is a relatively laissez-faire approach to narrowly focused offerings of well-known seasoned issuers (as they are called) to sophisticated purchasers.

The drafters of the 1933 and 1934 Acts were not thinking about complex collateralized debt obligations and their associated derivatives and hedges, but let us focus for a moment on what those securities do, and why disclosure regulation is still an appropriate method.<sup>7</sup> There are two pieces to the puzzle, and in my experience, no industries are as simple in concept, but as complex in execution, as the ones for (a) securitizing pools of collateralized financial instruments, and (b) instruments used as “credit enhancements” or hedges which are derivative allocations of financial and casualty risk on those pools.

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<sup>6</sup> See Securities Act of 1933, 15 U.S.C. § 77 (2006) (“the 1933 Act”); Securities Exchange Act of 1934, 15 U.S.C. § 78a-78kk (2006) (“the 1934 Act”).

<sup>7</sup> See generally Asset-Backed Securities, 70 Fed. Reg. 1,506, 1,508 (Jan. 7, 2005) (noting that “asset-backed securities and ABS issuers differ from corporate securities and operating companies. In offering ABS, there is generally no business or management to describe. Instead, information about the transaction structure and the characteristics and quality of the asset pool and servicing is often what is most important to investors. Many of the Commission's existing disclosure and reporting requirements, which are designed primarily for corporate issuers and their securities, do not elicit relevant information for most asset-backed securities transactions.”).

First, perhaps the horse was already out of the barn when the SEC adopted Regulation AB in 2005<sup>8</sup>, setting forth what it claimed was largely the codification of staff interpretations and existing disclosure practices generated in the market for asset-backed securities. Yet there does not seem to be any doubt that the SEC understood, as did the market participants, just how complex the relatively simple concept had gotten in practice. The SEC acknowledged that sophisticated institutions, not retail purchasers, were the primary holders of asset-backed securities.<sup>9</sup> It knew that the value of the pooled securities depended not just on the creditworthiness of the individual borrowers, but on the quality of the servicing at the level of those interacting with individual borrowers.<sup>10</sup> The slicing and dicing of the pools into tranches was no secret. Nor was there any doubt about the role of the credit rating agencies in evaluating the information. Finally, it was understood that credit enhancements, like credit default swaps, were available for the purpose of hedging risk.<sup>11</sup> In short, the disclosure system existed by which presumably rational and, indeed, sophisticated issuers and buyers could understand what they were buying and selling. The question we will need to address is why the availability of the information did not help.

Second, despite the patina or mystery, derivative instruments, whether insurance contracts or currency futures, are not in themselves good or bad, and, used well, are part of a sound strategy of giving up some of the upside to insure against undue loss on the downside, assuming that the insurer or the derivative counter-party is around and able to pay on the contract. The reason the derivative industry is simple in concept is that it goes back to algorithms law students learn in their first year contract law class.<sup>12</sup> The simple hypothetical demonstrating the measure of damages for the contract for the future delivery of bushels of wheat is essentially an algorithm for risk allocation. Assume Sam Seller contracts with Barbara Buyer to sell her 100 bushels of wheat at a dollar per bushel ninety days hence. The spot price over that period rises to \$1.20 per bushel. The formula embodied in the law of contract expectation damages tells us that Barbara Buyer wins a right worth twenty cents. Conversely, if the price falls to eighty cents a bushel, Sam Seller wins because of his right to force Barbara Buyer to take the wheat at twenty cents above the market price.

That is a forward contract. In my little hypothetical, if the parties do not really intend to deliver, the contract itself (not the underlying wheat) is a futures contract, and on the delivery date worth about twenty cents less transaction costs.<sup>13</sup> In other words, the holder of the right should be able

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<sup>8</sup> *Id.* at 1,506.

<sup>9</sup> *Id.* at 1,511.

<sup>10</sup> *Id.* at 1,510-11.

<sup>11</sup> *Id.* at 1,511.

<sup>12</sup> See RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 125-26 (6th ed., 2003).

<sup>13</sup> *Id.* at 126.

that day to sell the contract to somebody for, say, up to nineteen cents a bushel, because the buyer of the contract is still better off by a penny. The irony here, of course, is that futures contracts have real value in being conservative, which is why they are “hedged” as in hedging your bet. Assume a U.S.-based company, which reports its earnings in dollars, sells a widget in Europe with the price denominated in euros on March 1, and the terms are that the buyer is to pay €1,000 in ninety days. At the moment, the exchange rate is 1.5 U.S. dollars to the euro. If the company were interested in making money on currency fluctuation as well as widgets, it could take its chances. If the euro rises in value to 1.75 to the dollar, it can make some money when it repatriates that cash. The company also, however, runs the risk of having the euro fall. As to currency, however, the company is far more interested in being safe than in making money. If it buys a ninety-day futures contract on euros at the rate of 1.5 to the dollar, the company has insurance against currency devaluation. Assume that on the ninetieth day, the euro falls in relation to the dollar, and the company would bring home only \$1,200 rather than the \$1,500 that it expected when it made the sale. The company receives the buyer’s €1,000, fulfills its futures contract obligation by buying the \$1,500, and some counter-party loses a bet. The company has lost the opportunity to profit if the euro went up in value, but it is hedged against the downside.<sup>14</sup>

It is fair to say we do not want to ban this market. There are currency traders who gamble on the changes of relative values of currencies, and that is their business.<sup>15</sup> We staid middle-American businesses in Dayton and Elkhart and Moline and Omaha, however, can use them for our very conservative and cautious purposes.<sup>16</sup> While those gamblers may make or lose money on dumb luck, there is nothing dumb or lucky about the currency hedging strategy, as long as the counter-party to my contract is around and has the dollars to deliver.<sup>17</sup> By the way, generally accepted accounting principles require that there be a linkage between my sales and my future contracts or otherwise I have to disclose the extent to which I am speculating in the currency markets.<sup>18</sup> If it is appropriate to securitize mortgage pools, then some form of derivative hedging in them is almost

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<sup>14</sup> Assume that the Euro increases in value relative to the dollar, say, to two to one. If there had been no hedge, the company would be able to convert the €1,000 into \$2,000, making \$500 on currency in addition to the \$1,500 it expected in product revenue. But with the hedge in place, it needs to fulfill its obligation to buy \$1,500 for €1,000, rewarding a counterparty that guessed right. Effectively, the company gives up the \$500 of currency gain. There is a strategy as well to hedge by purchasing an option, but that complication is not necessary for my point here.

<sup>15</sup> See Schwarcz, *supra* note 4, at 218.

<sup>16</sup> René M. Stulz, *In Defense of Derivatives and How to Regulate Them*, WALL ST. J., Apr. 7, 2009, at A15.

<sup>17</sup> See Schwarcz, *supra* note 4, at 220-22.

<sup>18</sup> See generally FIN. ACCOUNTING STANDARDS BD., SUMMARY OF STATEMENT 133, ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES (1998), <http://www.fasb.org/st/summary/stsum133.shtml>.

certainly appropriate as well.

I do not consider Warren Buffett a secular saint; I do, however, appreciate the fact that I can understand what he is saying most of the time. It is here I want to move from disclosure to judgment, because it seems to me the systems to insure the former were in place, but that the latter broke down in the current crisis. The global solution is therefore not more disclosure (which is the SEC's basic tool) but better judgment. Despite Buffett's well-known penchant for buying companies whose products he understands—soft drinks, department stores, carpet companies<sup>19</sup>—Berkshire Hathaway's primary business is financial and casualty risk allocation.<sup>20</sup> It is founded in precisely the algorithms that flow from contracts; in no business like insurance do contract words link to value. The question Buffett lays before us, however, is how much we can rely on algorithms to do our thinking for us, even in this most algorithmic of businesses.<sup>21</sup>

Before I get to Buffett's concrete examples of the practice of judgment, I want to touch on a subject dear to my heart: the theory of judgment. This is not the place for my full exegesis on all the aspects of judgment, like moral judgment or the objective-subjective problem, or self-deception; here I just want to focus on the narrow subject of judgment in predicting the future, as in making judgments about risk and return. One element of judgment is an objective assessment, based on what we know, of what we think will happen. This, we would think, is hardly mysterious at all. Science is all about coming up with theories and laws of the physical world—of cause and effect—that we rely on without even thinking about it. There is, however, a kernel of mystery. When we say “science,” we usually think “formula” or “theorem” or “physical law.” The goal of science is to continue to reduce events and processes to their most fundamental rules and regularities.<sup>22</sup> But even science involves judgment in the forming of hypotheses. Of all the various rules and regularities, when we come up with a hypothesis, we are choosing one—we are making a judgment, and that part of science remains mysterious and irreducible.

Let's unpack those two points.

*Point A. The goal of science is to reduce events and processes to their most fundamental rules and regularities.*

Understanding something about the world means we have ordered

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<sup>19</sup> *Buffett Says Many Stocks Still Overvalued*. HOUSTON CHRON., Mar. 28, 2001, at 4.

<sup>20</sup> Berkshire Hathaway, Inc., ANNUAL REPORT 3 (2008), available at <http://sec.gov/Archives/edgar/data/1067983/000119312509042455/dex991.htm> [hereinafter ANNUAL REPORT].

<sup>21</sup> *Id.*

<sup>22</sup> Jeffrey M. Lipshaw, *Law's Illusion: Scientific Jurisprudence and the Struggle with Judgment* 9, (Suffolk Univ. Law Sch. Res. Paper 08-20, 2008) available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1163256](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1163256) (discussing the philosophy of science).

it. Ordering means that we have implied regularities. Regularities mean that we have inferred a set of rules. “The sun will come up in the east every morning.” “[My crazy dog] Annie will bark at a dog walking up the street.”<sup>23</sup> What we call “causation” is merely our repeated observation of constant conjunction or regular sequence, leading to singular causal statements that are general propositions asserting universal connections between types of events. We say that one billiard ball causes another to move in a certain way, but there is nothing except our repeated observations that keeps us from thinking the ball will not just fly off the table and land at Logan Airport. God does not cause airplanes to crash for a reason, nor does God cause Captain Sullenberger to land safely in the Hudson River.

*Point B. But even science involves judgment in the forming of hypotheses. Of all the various rules and regularities, when we come up with a hypothesis, we are choosing one—we are making a judgment, and that part of science remains mysterious and irreducible.*

So science is the process of developing rules, regressions, and regularities. What is the mark of a good scientific theory? It is predictive. We have done such a good job in observing regularities that we can make good predictions about what will happen in the future.

How do we develop a theory? We have to start with a hypothesis. But where does the hypothesis come from? A hypothesis is a guess, albeit educated, about whether indeed there is some regularity in the data. But there is no rule or regularity that tells us how to develop a hypothesis. We know a hypothesis should be conservative, modest, simple, general, and refutable. But it is a leap, and that leap is the judgment. That is, somehow I have managed to see a pattern in the data, and my judgment is that the pattern is significant enough to spend time testing it. The pattern at which I'm guessing as a hypothesis may turn into a theory or a scientific law.

Even in science, there is judgment that precedes rules. Looking backward, we take a mass of observed experience and think there may be regularity in that experience. But if judgment precedes these rules, what are the rules for judgment? Well, that is the key problem. There are no rules for judgment. A rule for judgment would mean that there is a rule for determining whether a particular experience fits a rule. But applying that rule would in turn require judgment. If there were a rule for that judgment, it would again require judgment to determine whether it applied. It is an infinite regress.

Put another way, suppose we have decided that the rules for hypotheses are that they be conservative, modest, simple, general, and

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<sup>23</sup> *Id.*

refutable. Well, that is a hypothesis about hypotheses. What is the rule for coming up about hypotheses about hypotheses? Do those have to be conservative, etc.? It is irreducible because we are in a loop. In other words, we have to take a mental leap at some point that is not defined by another rule. In Potter Stewart terms, we cannot define it, even though we know it when we see it.<sup>24</sup>

I now return to the somewhat provocative sub-title of this talk: “we have met Madoff and he is ours.” At some point in the chain, somebody is making a leap of judgment. In my investment portfolio, I am actually relying on leaps all the way down. I rely on my account executive’s judgment to select fund managers; my account executive relies on the managers’ judgment in picking stocks; the managers rely on CEOs and CFOs who run the companies and so on. Any time someone tells you they have the algorithm, like Economic Value Added,<sup>25</sup> or Value at Risk,<sup>26</sup> that is the time to check your wallet and count your fingers. The heuristics of relying on Bernie Madoff or Robert Allen Stanford were simply the most recent and egregious examples of faith in another’s judgment gone very much awry; there but for the grace of God go all of us who rely on the judgments of our financial advisers, doctors, lawyers, civil engineers, and auto mechanics. If we really think about the necessity of judgment somewhere in the system upon which we base our investment decisions, we are fortunate not to have to say, “we have met Madoff and he is ours.”

This is not to say there is no science left, nor that science has been discredited. It is only to say that scientism in many things, law among them, is one of the more interesting leaps of faith of the last century. Let us look at Buffett’s letter to the Berkshire Hathaway shareholders in the 2008 annual report,<sup>27</sup> and the extent to which it focuses on diligence in addition to disclosure, and judgment in addition to algorithm. I want to focus on two pieces of data, because they have a common theme.

First, it is no secret that insurance companies are investment vehicles that are, in addition, required to pay casualty losses. In other words, most insurance companies lose money on the actual underwriting (the claims and claims servicing would exceed the amount of the premium), but make their profit on investment of the “float,” i.e., the premium dollars they take in and hold for future payment of claims. In 2008, Berkshire Hathaway’s insurance business reported an underwriting *gain* for the sixth consecutive year.<sup>28</sup> In simple terms, underwriting judgment is the process of looking at the information about the potential insured, and making a

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<sup>24</sup> See *Jacobellis v. Ohio*, 378 U.S. 184, 197 (1964) (Stewart, J., concurring).

<sup>25</sup> G. BENNETT STEWART, III, *THE QUEST FOR VALUE* 136-38 (1991).

<sup>26</sup> See Nocera, *supra* note 3; see also TALEB, *supra* note 3, at 289.

<sup>27</sup> ANNUAL REPORT, *supra* note 20, at 3.

<sup>28</sup> *Id.* at 4.



decision whether the company will place a bet. There is no doubt that great underwriters use heuristics, but at some point, it boils down to a judgment call. Moreover, reserving for claims, both incurred and what is known as IBNR (incurred but not reported), involves judgment.<sup>29</sup> One significant cause of insurance company insolvency is the chronic under-reserving for claims.<sup>30</sup>

Second, Berkshire Hathaway's entrant in the residential home industry is Clayton Homes, the largest manufactured home builder in the country.<sup>31</sup> It has a financing arm.<sup>32</sup> Clayton's borrowers have a median FICO score of 644, compared to a national median of 723, and about 35% are below 620, the threshold for “subprime” borrowers.<sup>33</sup> Yet “no purchaser of the mortgages it originated and then securitized has ever lost a dime of principal or interest.”<sup>34</sup> The question is why, when others in the industry have had “staggering losses.”<sup>35</sup> Buffett's explanation turns on judgment, not disclosure.

The answer is elementary, going right back to Lending 101. Our borrowers simply looked at how full-bore mortgage payments would compare with their actual--not hoped-for--income and then decided whether they could live with that commitment. Simply put, they took out a mortgage with the intention of paying it off, whatever the course of home prices.

Just as important is what our borrowers did not do. They did not count on making their loan payments by refinancing. They did not sign up for “teaser” rates that upon reset were oversized relative to their income. And they did not assume that they could always sell their home at a profit if their mortgage payments became onerous.<sup>36</sup>

While Buffett credits the borrowers, my intuition is that potential homebuyers walking into Clayton Homes are just as representative of the subprime population as any other group of borrowers. Underwriting mortgages, in the sense of deciding to whom you are going to lend, is just as much a matter of judgment as deciding whom to insure. Indeed, careful underwriting is precisely what responsible independent mortgage originators

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<sup>29</sup> *Id.* at 45.

<sup>30</sup> See CHARLES A. MCALEAR, *THE FOUNDERING ARK: INSURANCE ON THE ROCKS* 72 (1984).

<sup>31</sup> Warren E. Buffett, ‘*Our Country Has Faced Far Worse Travails: A Paralyzing Fear Has Engulfed the Country. But America’s Best Days Lie Ahead.*’, *NEWSWEEK*, Mar. 9, 2009, at 42 [hereinafter Buffett].

<sup>32</sup> ANNUAL REPORT, *supra* note 20, at 11.

<sup>33</sup> *Id.*

<sup>34</sup> Buffett, *supra* note 31, at 42.

<sup>35</sup> *Id.*

<sup>36</sup> *Id.* at 42-43.

and purchasers do. Without getting into a blame game as between the lenders and the borrowers, I will suggest that the “least-cost avoider,” in Coaseian terms, is the lender. Buffett's coda is that

[t]he present housing debacle should teach home buyers, lenders, brokers and government some simple lessons that will insure stability in the future. Home purchases should involve an honest-to-God down payment of at least 10% and monthly payments that can be comfortably handled by the borrower's income. That income should be carefully verified.<sup>37</sup>

I was taught some years ago that some problems are only capable of being managed, not solved.<sup>38</sup> Those are situations in which we need mutually dependent but polar opposite values to operate effectively. We see these in business all the time—teamwork versus individual initiative, centralization versus decentralization, hierarchy versus participation. Each polar value has positive and negative consequences attached to it. Organizations (or societies) adopt policies reflecting one polar value because of the positives, and find over time that the negatives kick in. So the move is to the positives of the other pole. Disclosure and judgment are just such a polar continuum. To paraphrase Kant, judgment without information is empty; information without judgment is blind.<sup>39</sup> Information without judgment gives us bubbles; judgment without information leaves us at the mercy of Madoffs.

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<sup>37</sup> *Id.* at 43.

<sup>38</sup> See generally BARRY JOHNSON, POLARITY MANAGEMENT: IDENTIFYING AND MANAGING UNSOLVABLE PROBLEMS (1992).

<sup>39</sup> IMMANUEL KANT, CRITIQUE OF PURE REASON 193-94 (Paul Guyer & Allen Wood trans., Cambridge Univ. Press 1998) (1781).