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Journal

UCLA School of Law Public Law & Legal Theory Series

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Publication Date

2021-06-21

DO LAWYERS MAKE GOOD GATEKEEPERS?

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In THE CAMBRIDGE HANDBOOK OF INVESTOR PROTECTION, edited by Arthur Laby (Cambridge University Press, forthcoming 2021)

Do Lawyers Make Good Gatekeepers?

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Draft dated June 16, 2021

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I. Introduction

As we approach the twentieth anniversary of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), which sought to prevent future frauds such as Enron and WorldCom, it makes sense to revisit one of the statute's most controversial provisions. Section 307 of Sarbanes-Oxley gave the U.S. Securities and Exchange Commission (SEC) sweeping authority to establish "minimum standards of professional conduct" that would enable it to discipline lawyers "appearing and practicing before the [SEC] in any way in the representation of [public] issuers."¹ Specifically, section 307 ordered the SEC to implement regulations requiring lawyers who encounter "evidence of material violation" of law to report such evidence up the corporate ladder to the full board or an appropriate committee

¹ 15 U.S.C. § 7245 (2018). The lawyers covered by section 307 include all lawyers who communicate with the SEC, represent issuers in their dealings with the SEC, and advise on matters pertaining to securities laws. *See* 17 C.F.R. § 205.2(a)(1)(i)–(iii) (2021). Also, only attorneys for SEC-reporting companies are covered by the rule. *See id.* § 205.2(h).

thereof, if necessary, to ensure that “appropriate remedial measures or sanctions” are taken.²

Section 307 was controversial because it embraced the central premise that lawyers were important gatekeepers of the securities markets and thus should be charged with greater responsibilities in helping to maintain the integrity of the securities markets. (“Gatekeepers” are “private intermediaries who can prevent harm to the securities markets by disrupting the misconduct of their client representatives.”³) As I’ve

² 15 U.S.C. § 7245 (2018).

³ This definition of “gatekeepers” first appeared in Sung Hui Kim, *Gatekeepers Inside Out*, 21 GEO. J. LEGAL ETHICS 411, 413 (2008), and is modified and adapted from that set forth in Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J. L. ECON. & ORG. 53 (1986) (describing “gatekeeper liability” as “liability imposed on private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers”). *See also* JOHN C. COFFEE JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 2-3 (2006) [hereinafter Coffee, *Gatekeepers*]; Stephen Choi, *Market Lessons for Gatekeepers*, 92 NW. U. L. REV. 916, 917 (1998); Assaf Hamdani,

recounted elsewhere, prominent segments of the legal profession have long resisted such responsibilities, insisting that lawyers were exceptional and fundamentally different from other gatekeeping professionals, such as investment bankers and auditors. When Sarbanes-Oxley was being debated, the bar argued that lawyers should be categorically exempt from any gatekeeping obligations to avert any kind of managerial malfeasance, including massive corporate frauds that harm public investors.⁴

In the face of this continued resistance, the SEC promulgated regulations, codified in 17 C.F.R. Part 205 (the “Sarbanes-Oxley regulations”), which prescribed when and how lawyers must report evidence of a material violation up-the-ladder and when lawyers may report confidential client information relating to the material violation to the SEC.⁵ Those regulations also designated the chief legal officer

Gatekeeper Liability, 77 S. CAL. L. REV. 53, 58 (2003); Arthur B. Laby, *Differentiating Gatekeepers*, 1 BROOK. J. CORP. FIN. & COM. L. 119 (2006).

⁴ See Sung Hui Kim, *Lawyer Exceptionalism in the Gatekeeping Wars*, 63 S.M.U. L. REV. 73 (2010) [hereinafter Kim, *Lawyer Exceptionalism*].

⁵ See 17 C.F.R. §§ 205.3(b), (d)(2) (2021).

(typically, the company's general counsel) as one of two main recipients of an up-the-ladder report and imposed special obligations on general counsel for handling such reports and piloting investigations into alleged corporate misconduct.⁶ In doing so, the SEC recognized and identified the general counsel as a critical gatekeeper of the securities markets.

This Chapter argues that there is a strong case for imposing gatekeeping duties on lawyers. Specifically, it contends that there are significant efficiencies in the form of economies of scope to be exploited from imposing gatekeeping duties on lawyers. These efficiencies form the foundation of a gatekeeper's *capacity to monitor* corporate affairs for the purpose of averting material law violations. Both outside and in-house lawyers possess a form of proprietary knowhow that can be usefully and efficiently exploited in the service of gatekeeping. Perhaps more so than any other securities market professional, lawyers are skilled and experienced at collecting, processing, and evaluating information that may contain the red flags of corporate misconduct—i.e., evidence of material violations of law. As a result, lawyers can simply perform some gatekeeping as a byproduct of their normal work, and it is efficient for

⁶ 17 C.F.R. § 205.3(b)(2) (2021).

regulators to add some gatekeeping obligations to the tasks that lawyers are already performing on behalf of their corporate clients.

Of course, the contention that imposing gatekeeping obligations on lawyers would be meaningfully *efficient* does not mean that lawyers, given their guild-like resistance to regulation, will necessarily be *effective* gatekeepers. How have lawyers fared in performing their Sarbanes-Oxley gatekeeping duties? Have lawyers reported evidence of material violations up-the-ladder? Have general counsel properly handled the up-the-ladder reports, investigating and addressing the underlying allegations? Answers to these questions have long been elusive, because corporate wrongdoing is inherently sensitive and confidential, and the actions of elite research targets are often not directly observable.

Fortunately, there is a growing body of empirical studies in the accounting and finance journals that partially illumine whether lawyers will act in ways that ultimately inhibit managerial malfeasance and benefit public investors. While the evidence is both complex and mixed, the weight of the evidence generally supports that general counsel are effective (albeit conflicted) gatekeepers, who appear willing to police material illegalities but who also tolerate a good deal of aggressive and perhaps unethical conduct. The more limited evidence about outside lawyers suggests that they may be less likely to press their client

representatives to comply with the law, opting instead to perform their strictly advisory role as neutral risk-assessors. Nonetheless, their involvement in disclosure matters appears to generate some salutary, longer term effects, demonstrating perhaps a net benefit to public investors.

Section II briefly describes the traditional gatekeeping theory, the key elements of a gatekeeper enforcement strategy, and the principal attributes commonly ascribed to gatekeepers. It explains why the designation of lawyers as gatekeepers has been so controversial and argues that the case for imposing gatekeeping obligations on both outside and in-house lawyers is strong in light of the economies of scope that can be exploited from adding gatekeeping to the tasks that lawyers already perform for their clients. It then specifically addresses the potential efficacy of in-house lawyers as gatekeepers.

Section III surveys the recent empirical evidence in the accounting and finance literatures investigating the effectiveness of the general counsel and outside law firms as gatekeepers.

Section IV reviews the findings of one study, which highlighted the promising gatekeeping potential of board members with legal backgrounds. It raises the possibility that appointing lawyers to the board may offer the best strategy for promoting compliance within the firm and

detering corporate malfeasance. It calls for further research to be conducted on the efficacy of these understudied legal gatekeepers.

II. The Theoretical Background

A. Gatekeeper Defined

In 1986, Reinier Kraakman introduced gatekeeping theory and described gatekeeper liability as a genre of third party liability used by the government to “supplement efforts to deter primary wrongdoers directly by enlisting their associates and market contacts as de facto ‘cops on the beat.’”⁷ There are three key elements of a law enforcement strategy that relies on these de facto cops to detect and deter unlawful activity: (1) a gatekeeper—someone who can and will prevent misconduct reliably; (2) a gate—some service that the gatekeeper provides and that the primary wrongdoer needs to accomplish his illicit goal; and (3) a law enforcement mechanism—an enforceable duty—that obligates gatekeepers to take some action to avert misconduct or warn third parties. The gatekeeping duty may range from the least burdensome—such as withholding one’s cooperation from the wrongdoer—to something more onerous—such as “noisy withdrawal”—withdrawal accompanied by notice to third parties,

⁷ Kraakman, *supra* note 3, at 53.

including investors or law enforcement authorities.⁸ Whatever the specific duty, the action prescribed by the duty must functionally deprive the wrongdoer of access to the capital markets, effectively closing the gate.

Traditionally, the best candidates for gatekeeping were thought to be independent private professionals, such as auditors, investment bankers, and those corporate lawyers who facilitate securities transactions and prepare, assess, and verify corporate disclosures drafted to inform the securities marketplace (“corporate lawyers”). Today, credit rating agency officials,⁹ who routinely examine corporate disclosures for purposes of assessing corporate bonds, and securities analysts¹⁰ are commonly identified as important gatekeepers.

⁸ Kim, *Gatekeepers Inside Out*, *supra* note 3, at 415. For the debate over noisy withdrawal, *see* Kim, *Lawyer Exceptionalism*, *supra* note 4, at 88-93.

⁹ *See, e.g.*, Andrew F. Tuch, *Multiple Gatekeepers*, 96 VA. L. REV. 1583, 1664 (2010).

¹⁰ *See* Jill E. Fisch & Hillary A. Sale, *The Securities Analyst as Agent: Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035 (2003).

At least two reasons explain why the foregoing professionals are seen as important targets of regulation by policy makers and government agencies seeking to deter corporate crime.¹¹ First, these professionals all possess some *capacity to interdict*¹² managerial misconduct by virtue of their indispensable role in securities market transactions. Indeed, the formal consent, approval, or rating given by these professionals is typically necessary for public companies to complete major transactions or maintain some desired status; in short, these professionals all keep a “gate.” For example, as former SEC Commissioner A.A. Sommer observed about legal gatekeepers, corporate lawyers are the “keeper[s] of the stop and go signal”: their legal opinions determine whether securities get sold; their judgments determine whether information gets included in the registration statement.¹³

¹¹ John C. Coffee, Jr., *The Attorney as Gatekeeper: An Agenda for the SEC*, 103 COLUM. L. REV. 1293, 1296-97 (2003) [hereinafter Coffee, *Attorney as Gatekeeper*].

¹² See Kim, *Gatekeepers Inside Out*, *supra* note 3, at 422, 457-60.

¹³ A. A. Sommer, Jr., Comm’r, Sec. & Exch. Comm’n, Address at the Banking, Corporation and Business Law Section of the New York

Second, these professionals are believed to have some *willingness to interdict*¹⁴ managerial misconduct by virtue of their having relatively little to gain but a lot to lose, especially in terms of potential damage to their firm's reputation, from facilitating or acquiescing in managerial misconduct. Hence, they can theoretically be deterred more easily than those primary wrongdoers who presumably have much to gain from the crime or fraud.

In contrast to these conventional gatekeepers, the corporate general counsel is commonly believed to fall short on these critical characteristics. Though many public companies have general counsel, there is no formal requirement that they do or that a general counsel bless a securities market transaction, casting doubt on general counsel's capacity to interdict. General counsel are also seen as comparatively *unwilling* to interdict: they presumably have a lot to lose by resisting or interdicting wrongdoing managers. After all, in-house counsel are economically dependent on a single corporate client; to the extent that the client is effectively controlled

State Bar Association: The Emerging Responsibilities of the Securities Lawyer (Jan. 24, 1974).

¹⁴ Kim, *Gatekeepers Inside Out*, *supra* note 3, at 422-36.

by a rogue group of managers, the general counsel will be highly vulnerable to reprisals and recriminations.

In prior work, I expressed doubts about whether in-house lawyers could prove to be effective gatekeepers. I argued that while in-house lawyers enjoy distinct advantages over outside lawyers in averting managerial malfeasance and may even—on net—be superior gatekeepers,¹⁵ in-house lawyers will nevertheless remain seriously compromised by pressures to acquiesce in managerial wrongdoing. In the absence of structural reform, in-house lawyers will continue to be “mere employees” subject to self-preserving psychological pressures to obey commands from higher-ups, peers subject to “team player” pressures to conform—to go along in order to get along, and legal professionals subject to formal and informal “faithful agent” norms to maximize client interests according to the dictates of the client’s representatives.¹⁶ Given these formidable pressures to acquiesce in managerial wrongdoing and Sarbanes-Oxley’s failure to mitigate them, I predicted that most in-house

¹⁵ See Kim, *Gatekeepers Inside Out*, *supra* note 3.

¹⁶ Sung Hui Kim, *The Banality of Fraud: Re-Situating the Inside Counsel as Gatekeeper*, 74 FORDHAM L. REV. 983, 1041-52 (2005) [hereinafter Kim, *Banality of Fraud*].

lawyers would choose most of time the safest course available.¹⁷ And the safest course, as explained by Robert Gordon, would be to:

take a relatively passive role: to assume that whichever manager consults them is their “client” (even if that manager seems to be proposing action that might disserve the actual client, the corporate entity), to present the manager with options and estimates of legal risk likely to attach to each, and to let the manager decide (while adding a covering memo to the file noting that they have advised on the legal risk). In this role, the lawyer is simply a neutral risk assessor, an advocate neither for legal compliance nor for legal avoidance or evasion.¹⁸

B. The Controversy over Lawyers

Of the conventional gatekeepers, corporate lawyers are the most controversial—at least politically. The controversy stems from ongoing

¹⁷ *Id.* at 1014-18, 1053.

¹⁸ Robert W. Gordon, *The Return of the Lawyer-Statesman?*, 69 STAN. L. REV. 1731, 1752-53 (2017); *see also* Kim, *Banality of Fraud*, *supra* note 16, at 1014-18 (characterizing the “agnostic” approach to lawyering).

resistance from prominent segments of the organized bar (i) to the idea that lawyers owe obligations to anyone other than their client representatives and (ii) to the “subversive” notion that the legal profession could be regulated by a government agency.¹⁹ As I’ve recounted elsewhere, since at least the 1970s, the organized bar and the SEC have battled over lawyers’ duties to stop client fraud and the reach of SEC authority over lawyers’ (mis)behavior.²⁰

In the most recent of those battles, during the SEC notice-and-comment rulemaking that led to the promulgation of the Sarbanes-Oxley regulations, the bar trotted out the trope of the “zealous advocate” as the reason why lawyers should never be placed in the same category with auditors—the paradigmatic gatekeepers. Take, for example, the following comment, which is representative of many others, submitted by the Association of the Bar of the City of New York, objecting to the SEC’s initial draft rules:

¹⁹ See Sung Hui Kim, *Naked Self-Interest? Why the Legal Profession Resists Gatekeeping*, 63 FLA. L. REV. 129 (2011) [hereinafter Kim, *Self-Interest*].

²⁰ See Kim, *Lawyer Exceptionalism*, *supra* note 4, at 77-93.

Attorneys act as *advocates* and advisors to their clients. Unlike accountants, their role is not to “attest” to information, “certify” information or vouch to the public. Nor are they employed to enforce the law or regulations governing their issuer clients. Unlike an *auditor* whose very role is to be *skeptical and utterly independent*, an attorney acting as an *advocate* must be able to make full use of the attorney–client privilege (consistent with the crime–fraud exception) to make effective and zealous *advocacy* possible.²¹

These characterizations of the roles of lawyers and auditors amount to little more than caricatures. But it’s important to recognize that such rhetoric would not have been deployed but for the shared cultural understanding about the lawyer’s role that is antagonistic to the notion that lawyers are gatekeepers. In our society, lawyers are the ultimate protectors who stand with their clients against all the world. Their role is depicted in television and film by the archetype of the valiant criminal defense lawyer,

²¹ Letter from E. Leo Milonas, Ass’n of the Bar of the City of N.Y. to Jonathan G. Katz, Sec’y, Sec. & Exch. Comm’n (Dec. 17, 2002), <https://www.sec.gov/rules/proposed/s74502/elmilonas1.htm> (emphasis added).

who zealously advocates for his unpopular and beleaguered client. Famous portrayals include: Perry Mason, Atticus Finch in *To Kill A Mockingbird*, Daniel Kaffee in *A Few Good Men*. In these media portrayals, lawyers are close to their clients, expressing compassion, solicitude and undivided loyalty toward their clients. Rarely are these lawyers depicted as standing in moral judgment of their clients' choices. Even though lawyers devoted to criminal defense practice represent just a fraction of the bar,²² their emotionally resonant role has come to symbolize—in the minds of many—the normative role of *all* lawyers.²³

The problem with this cultural construct is that it poorly approximates the reality of *corporate* legal representation. Unlike the flesh-and-blood clients of criminal defense lawyers who risk imprisonment and sometimes capital punishment, “[c]orporations have neither bodies to be punished, nor souls to be condemned . . .”²⁴ If the client’s representatives are actually

²² See David Luban, *Are Criminal Defenders Different?* 91 MICH. L. REV. 1729, 1732 (1993).

²³ See Kim, *Lawyer Exceptionalism*, *supra* note 4, at 97-107.

²⁴ 1 JOHN POYNTER, LITERARY EXTRACTS FROM ENGLISH AND OTHER WORKS; COLLECTED DURING HALF A CENTURY: TOGETHER

committing material law violations that may be imputed to the corporate client, then the corporate client may face civil or criminal liability—either expressly by statute or through the doctrine of respondeat superior. If the material law violation happens to be securities fraud, then the client may face enormous financial liability to its defrauded investors. It would thus seem incumbent on the lawyer to take swift and decisive action to avert or mitigate the potential harm to her corporate client, even if it means blowing the whistle on malfeasant managers as a last resort. As the New Jersey Supreme Court once famously pontificated about the fiduciary duty of directors, “when . . . insiders are bleeding the corporation to death, a director should notice and stanch the flow of blood.”²⁵ Surely, lawyers, too, have an obligation to stanch the flow of blood.

C. The Case for Corporate Lawyers

The fact that gatekeeping duties may be theoretically consistent with lawyers’ fiduciary duty to prevent harm to their corporate clients may not be enough to justify making lawyers the targets of a third party enforcement strategy. As with any law enforcement strategy, the benefits

WITH SOME ORIGINAL MATTER 268 (1844) (citing Lord Chancellor Thurlow).

²⁵ Francis v. United Jersey Bank, 432 A.2d 814, 826 (N.J. 1981).

to deputizing third parties as gatekeepers must outweigh the costs of doing so, including the much bemoaned costs of suppressing full and frank lawyer-client communications. Though I have argued elsewhere that those costs are exaggerated²⁶ and—in any event—would be offset by the benefits of targeted structural reform,²⁷ here is not the place to offer a full-blown cost-benefit analysis of imposing gatekeeping obligations on lawyers under various regulatory scenarios. Rather, I want to suggest only that there are efficiencies to be exploited (and that regulators would be foolish to ignore) from imposing gatekeeping duties on lawyers. While those efficiencies alone—without meaningful structural reform—may not win the day, they shift the burden of persuasion to those who argue that lawyers should be exempt from gatekeeping obligations already imposed on other professionals, such as auditors and investment bankers.²⁸

²⁶ For some responses to that objection, *see, e.g.*, Kim, *Banality of Fraud*, *supra* note 16, at 1069-71.

²⁷ Sung Hui Kim, *Inside Lawyers: Friends or Gatekeepers?* 84 FORDHAM L. REV. 1867, 1882-86 (2016) [hereinafter Kim, *Inside Lawyers*].

²⁸ Auditors are subject to a statutory obligation to report to the SEC any material illegal actions that their publicly held clients fail to

The efficiencies that I am referring to are the *economies of scope* that arise when lawyers add gatekeeping to the tasks that they already perform on behalf of their clients.²⁹ Economies of scope are “cost savings which

remediate. Private Securities Litigation Reform Act of 1995, Pub. L.

No. 104-67, § 301(b)(3), 109 Stat. 737, 762, 763 (codified at 15

U.S.C. § 78j-1(b)(3) (2018)). Investment bankers must conduct a

“reasonable investigation” of the public issuer whose securities they underwrite, and this reasonable investigation must form the basis of their reasonable belief in the accuracy of the company’s assertions.

Securities Act of 1933 § 11(b), 15 U.S.C. § 77k(b) (2018). Both

auditors and investment banks are potentially liable under the federal

securities laws. *See* Securities Act of 1933 §§ 11(a)(4) & (5), 15

U.S.C. §§ 77k(a)(4) & (5) (2018).

²⁹ For works discussing economies of scope by market intermediaries, *see, e.g.*, Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 600 (1984); Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 298 (1984); Steven L. Schwarcz, *Explaining the Value of Transactional Lawyering*, 12 STAN. J.L. BUS. & FIN. 486 (2007).

result from . . . combining two or more product lines in one firm” rather than having two or more specialized firms produce each product line separately.³⁰ Diversified multi-product enterprises that operate several businesses—such as the manufacturer 3M Corporation—tend to enjoy significant economies of scope. As economists have observed, economies of scope in manufacturing firms tend to arise when the production processes of two distinct final products share one or more common inputs that are not exhausted by the production process of a single final product line, such as when the fabrication of one product line leaves excess capacity in some stage of the production.³¹ Those common inputs may be specialized physical assets or proprietary (managerial or technological)

³⁰ John C. Panzar & Robert D. Willig, *Economies of Scope*, 71 AM. ECON. REV. 268, 268 (1981); *see also* David J. Teece, *Towards an Economic Theory of the Multiproduct Firm*, 3 J. ECON. BEHAV. & ORG. 39 (1982) (defining economies of scope as reflecting the reduction in production costs that result from the joint production of a number of different products).

³¹ See David J. Teece, *Economies of Scope and the Scope of the Enterprise*, 1 J. ECON. BEHAV. & ORG. 223, 226 (1980) [hereinafter Teece, *Economies of Scope*].

knowhow,³² both of which are characterized by relatively high degrees of nonrivalry³³ such that they can be used for a variety of non-competing end product applications without their value in any one application being depleted or substantially impaired.³⁴ Because several of 3M's multiple businesses reportedly share the same manufacturing assets and proprietary knowhow, the company enjoys significant cost savings, giving it a distinct advantage over some of its competitors.

Corporate lawyers, too, possess a form of proprietary knowhow that could be usefully and efficiently exploited in service of gatekeeping. They

³² Knowhow is defined as “informal practical knowledge, experience, and ability.” *Know-How*, CAMBRIDGE BUSINESS ENGLISH DICTIONARY (2011).

³³ Nonrivalry characterizes a good where “a unit of [the] good can be consumed by one individual without detracting, in the slightest, from the consumption opportunities still available to others from that same unit.” RICHARD CORNES & TODD SANDLER, *THE THEORY OF EXTERNALITIES, PUBLIC GOODS, AND CLUB GOODS* 8 (1996).

³⁴ Teece, *Economies of Scope*, *supra* note 31, at 226, 231; Roy Radner, *Problems in the Theory of Markets under Uncertainty*, 60 AM. ECON. REV. 457 (1970).

are highly adept at discharging two categories of tasks, both of which are responsible for creating economies of scope and which form the basis of a gatekeeper's *capacity to monitor*.³⁵ First, corporate lawyers are proficient and experienced at *gathering the necessary facts* that may represent the indicia or “red flags” of corporate misconduct. For example, they are regularly retained to coordinate the complex process of registering a corporation's securities in connection with a public offering. In their role as the “quarterbacks” or “field marshals”³⁶ of the public offering process, issuer's counsel conduct comprehensive factual investigations of the issuer's background and activities for the primary purpose of drafting and corroborating the accuracy of the facts asserted in the issuer's registration statement filed with the SEC. The “due diligence” performed by these lawyers is needed (i) to ensure that the registration statement—on which investors rely and for which the corporate issuer is strictly liable—is free of material misrepresentations and omissions and (ii) to enable the directors and the top executive officers who sign the registration statement to establish their “due diligence” defense to liability

³⁵ See Kim, *Gatekeepers Inside Out*, *supra* note 3, at 421, 448-57.

³⁶ Sommer, *supra* note 13, at 3.

for material misstatements and omissions contained in the registration statement.³⁷

The corporate lawyers from those elite law firms who routinely represent underwriters of public offerings also perform extensive due diligence to verify the accuracy of the registration statement and to evaluate the risks associated with the underwriting.³⁸ For example, they may verify that the corporate issuer holds valid, unexpired leases for every

³⁷ Investors may sue under Section 11 of the Securities Act of 1933 or Section 10(b) of the Securities Exchange Act of 1934. *See* Securities Act of 1933 § 11, 15 U.S.C. § 77k (2018); Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b) (2018). The due diligence defense is a showing that, after a reasonable investigation, the defendant had reasonable grounds to believe and did believe that the statements contained in the registration statement were true and free of material omissions. Securities Act of 1933 § 11(b)(3), 15 U.S.C. § 77k(b)(3) (2018).

³⁸ *See* Valerie Ford Jacob, *The Due Diligence Process from the Underwriter's Perspective*, in CONDUCTING DUE DILIGENCE IN M&A AND SECURITIES OFFERINGS 2008 93 (PLI Corp. Law & Practice, Course Handbook Ser. No. 14933, 2008).

property that it purports to occupy. For more complex statements, such as statements describing the risk factors associated with the issuer's business, underwriters' counsel will consult with representatives of the underwriters and the issuer and evaluate the accuracy of those statements from the perspective of a reasonable investor.³⁹ The due diligence performed by these lawyers is critical for securing the underwriters' "due diligence" defense in the event that the registration statement is found to contain false and misleading statements. For all intents and purposes, the due diligence performed by issuer's and underwriters' counsel draws on precisely the same truth-searching and fact-corroborating faculties that auditors employ for an audit.

Second, corporate lawyers are skilled and experienced in the art of disinterested evaluation—evaluating facts to form an objective, independent judgment on whether laws have been materially violated. For example, issuer's counsel must perform a disinterested evaluation of the law and facts in order to issue a statutorily prescribed, limited legal opinion that attests to the legality of the securities being registered. Also,

³⁹ See Kim, *Lawyer Exceptionalism*, *supra* note 4, at 125. The "reasonable investor" standard is prescribed by statute. Securities Act of 1933 § 11(c), 15 U.S.C. § 77k(c) (2018).

for public offerings, issuer's and underwriters' counsel routinely provide legal opinions to their clients or counterparties as a condition of the underwriting agreement and based on the due diligence performed.⁴⁰ These legal opinions, known as Rule 10b-5 or "negative assurance" opinions, assure the opinion recipient (the client or counterparty) that counsel is not aware of any material misrepresentation or omission by the issuer in the registration statement.⁴¹ These opinions are basically certifications about the presence (or absence) of law violations and thus are worthless *unless* they are grounded in the lawyer's disinterested evaluation of the facts and law. In sum, because lawyers already possess the knowhow—of gathering the critical facts and conducting a disinterested evaluation of the materiality and legality of the relevant

⁴⁰ Underwriters generally require both their own counsel as well as issuer's counsel to release a certification. *See* Jacob, *supra* note 38, at 103.

⁴¹ John C. Coffee, Jr., *Can Lawyers Wear Blinders? Gatekeepers and Third-Party Opinions*, 84 TEX. L. REV. 59, 64 (2005); ABA Task Force on Sec. Law Opinions, *Negative Assurance on Securities Offerings*, 59 BUS. LAW. 1513, 1513-16 (2004).

conduct—economies of scope can be gained by rechanneling that knowhow in the service of gatekeeping and investor protection.⁴²

The insight that imposing gatekeeping duties on lawyers would be meaningfully efficient is not novel. In 1974, Commissioner Sommer famously suggested that corporate lawyers had emerging responsibilities to public investors who rely on their work. He derided the notion—often promoted by the bar—that corporate lawyers were merely “blind scrivener[s] of the thoughts of [their] client[s]”⁴³ and that they were paid merely to “put the representations of their clients in good English, or give opinions which assume a pure state of facts upon which any third year law student could confidently express an opinion.”⁴⁴ Recognizing the lawyers’ role as the “passkey” to securities transactions,⁴⁵ he identified the various tasks that they already perform—coordinating the registration process, writing the registration statements, making judgments about what

⁴² To be sure, some lawyers may be limited in their ability to assess a pure accounting fraud. But pure accounting frauds are rare. *See* Kim, *Self-Interest*, *supra* note 19, at 152 n.169.

⁴³ Sommer, *supra* note 13, at 9.

⁴⁴ *Id.* at 6.

⁴⁵ *Id.* at 5.

information is material, ensuring compliance with registration requirements, rendering legal opinions—that could be redirected to explicitly promote investor protection.⁴⁶

Sommer favored expanding the lawyer’s responsibilities to include “exercis[ing] a measure of independence that is perhaps uncomfortable if he is also the close counselor of management in other matters, often including business decisions[,]” and “adopt[ing] a healthy skepticism toward the representation of management which a good auditor must adopt.” He predicted and affirmed that “in securities matters (other than those where advocacy is clearly proper) the attorney will have to function in a manner more akin to that of auditor than to that of the advocate.” Finally, he insisted that “when confronted with an intransigent client,” the lawyer must “do the same thing as the auditor” and resign.⁴⁷

D. The Question of In-House Lawyers

In light of the economies of scope, the case for imposing gatekeeping duties on outside corporate lawyers seems strong. But what about those senior and subordinate in-house counsel who may not be quarterbacking large securities transactions but who nonetheless hold crucial day-to-day

⁴⁶ *Id.* at 3-5.

⁴⁷ *Id.* at 7.

responsibilities across the legal departments of corporate America and are increasingly indispensable intermediaries between the law and economic power? Are there economies of scope with respect to in-house lawyers?

As noted, I previously expressed doubts about whether—in the absence of meaningful structural reform—in-house lawyers could successfully resist the formidable psychological pressures to acquiesce in managerial misconduct.⁴⁸ Still, I maintained that in-house lawyers were no worse and, in some crucial respects, superior to outside lawyers for the charge of gatekeeping. Specifically with respect to general counsel, I argued that general counsel should enjoy a comparatively high capacity to interdict because the costs of replacing an unyielding general counsel are higher than replacing an outside law firm. Indeed, a general counsel's unexplained termination can set off alarm bells with enforcement authorities and the markets.⁴⁹ In terms of their capacity to monitor—the knowhow that generates economies of scope, in-house lawyers are equally adept as outside lawyers at both gathering facts that may serve as the red flags of corporate misconduct and evaluating those facts to form a disinterested judgment on whether material law violations have occurred.

⁴⁸ See text accompanying notes 15 to 18

⁴⁹ See Kim, *Gatekeepers Inside Out*, *supra* note 3, at 459.

In fact, in-house lawyers may have an edge over outside law firms in regard to the *quality* of the information flows to which they have access.

As I've discussed more extensively elsewhere, facts can be garnered through both formal and informal communication channels.⁵⁰ While in-house lawyers routinely gain critical information through both channels, they have a monitoring advantage over outside counsel in accessing facts through *informal* channels. In contrast to formal channels, which are generally planned, organized, routinized and incident to employees' day-to-day job responsibilities, informal communication channels are less purposeful, less constrained, and less organized; they consist of accidental, everyday social interactions among employees of the company who share the same physical space. Because information concerning wrongdoing is inherently sensitive, it tends to be shielded from public view and to spread through informal, discreet back-channels. Because in-house lawyers are physically proximate to employees who hold information about misconduct, they may learn of misconduct simply on their occasional trips to the local "water cooler."⁵¹ As a result, in-house lawyers—by virtue of their position as employees—face lower costs of

⁵⁰ *Id.* at 448-54.

⁵¹ *Id.* at 453.

identifying and gathering the relevant information as a byproduct of their normal work.⁵² At least one empirical study suggests that general counsel have ready access to information held by top executives.⁵³

To be sure, having ample capacity to monitor will not lead to effective gatekeeping without the threshold *willingness to interdict* misconduct—i.e., a willingness to intervene with the purpose of disrupting misconduct, including, if necessary and as a last resort, taking some action to signal to the securities markets that wrongdoing is afoot.⁵⁴ And in-house lawyers may be quite unwilling to interdict precisely because of the psychological pressures arising out of their roles as mere employees, team players and faithful agents of their client representatives. That said, the fact that in-house lawyers generally may be unwilling to stop the misconduct of their colleagues does not mean that outside lawyers—or for that matter any other professional—will be any more willing. Outside lawyers, who

⁵² Alexander Dyck, Adair Morse & Luigi Zingales, *Who Blows the Whistle on Corporate Fraud?*, 65 J. FIN. 2213, 2214 (2010). I thank Deborah DeMott for highlighting this source.

⁵³ See S. Burcu Avci & H. Nejat Seyhun, *Why Don't General Counsels Stop Corporate Crime?*, 19 U. PA. J. BUS. L. 751 (2017).

⁵⁴ See *id.* at 422-46.

overwhelmingly face hyper-competitive practice environments characterized by multiple-tier partnerships, de-equitization, summary terminations and “eat-what-you-kill” partner compensation schemes that reward rainmaking, are also deeply compromised in their willingness to interdict.⁵⁵

There is a strong case for imposing gatekeeping duties on lawyers. As I’ve argued, both in-house and outside lawyers appear to have a high capacity to monitor. Because of their education, training and skill-set, in-house and outside lawyers possess the relevant knowhow, promising significant economies of scope that may be exploited. Also, outside lawyers’ role in securities transactions and the general counsel’s increasingly indispensable role in large public corporations suggest a sufficient capacity to interdict. But, given the guild-like resistance from segments of the bar who cringe at the notion of legal gatekeepers, whether in-house and outside lawyers are *willing* to monitor corporate affairs robustly and interdict when they encounter evidence of managerial wrongdoing is an open question.

⁵⁵ Kim, *Gatekeepers Inside Out*, *supra* note 3, at 431-33. Also, they have a comparatively inferior capacity to monitor. *See id.* at 423-60.

In light of the efficiency case for imposing some gatekeeping obligations on lawyers, are lawyers *willing* to serve as a robust check on their client representatives? Are they willing to perform the monitoring necessary to discover the red flags of misconduct? Are they willing to interdict when confronted with evidence of material law violations?

III. The Empirical Evidence on In-House and Outside Lawyers

This section provides an overview of the empirical evidence compiled over the last decade in the finance and accounting fields that sheds some light on whether in-house and outside lawyers make effective gatekeepers. Due to space constraints, this overview is cursory and omits detailed discussion of methodology, estimates of effects, control variables or robustness tests.

A. In-house Lawyers: Conflicted Gatekeepers

Perhaps the most impressive evidence of in-house counsel inhibiting material law violations and playing an effective gatekeeping role comes from a study published in 2011, which examined the role of the general counsel (“GC”) in mitigating informed trading by corporate insiders. Alan Jagolinzer et al. examined the insider trading policies of 260 publicly-traded firms and trades made by Section 16 insiders from June 2003 to

December 2005.⁵⁶ Comparing the returns on trades in firms requiring GC approval with the returns on trades in firms *not* requiring such approval, the researchers found that the former earned, on average, 0.04% per day less than the latter.⁵⁷ Comparing the returns on trades inside restricted trading windows and requiring GC approval with the returns on trades inside restricted trading windows *not* requiring GC approval, they found that the former earned, on average, 0.07% per day less than the latter.⁵⁸ The researchers also concluded that policies prescribing restricted trading windows alone were not effective at reducing informed trading but were only effective when prior GC approval was required.⁵⁹ Also, while the net purchases of insiders (both inside and outside restricted trading windows)

⁵⁶ Alan D. Jagolinzer, David F. Larcker & Daniel J. Taylor, *Corporate Governance and the Information Content of Insider Trades*, 49 J. ACCT. RSCH. 1249, 1255 (2011).

⁵⁷ Over the 180 days following the trade, the difference was 7.20%. *Id.* at 1252. Eighty percent of the insider trading policies required the GC's prior approval. *Id.* at 1251.

⁵⁸ Over the 180 days following the trade, the difference is 12.6%. *Id.* at 1252.

⁵⁹ *Id.*u

positively predicted future earnings surprises, only those trades *not* requiring GC approval predicted future earnings surprises.⁶⁰ In sum, this study suggests that GCs, when given a veto power over trades by insiders, are inclined to take action to reduce the level of informed trading and appear willing to interdict material illegalities when confronted with problematic evidence.

Another study published in 2016 found evidence not only of GCs' willingness to interdict misconduct but also of their willingness to monitor corporate affairs to reduce legal exposure. Adair Morse et al. investigated the influence of lawyers residing in the top echelon of their companies by comparing two groups of firms across several measures of compliance and monitoring failures from 1995 to 2012.⁶¹ The first group was a treatment group of 536 firms, which had hired a lawyer who became one of the top paid officers of the firm ("high-GC firms") and who remained

⁶⁰ *Id.* at 1252, 1263-64.

⁶¹ See Adair Morse, Wei Wang & Serena Wu, *Executive Lawyers: Gatekeepers or Strategic Officers*, 59 J. L. & ECON. 847, 853-55 (2016). The proxies for compliance failures required the GC's signature on forms. For a discussion of the measures for compliance and monitoring breaches, see *id.* at 855-56.

for at least three years. The second group was a control group of 792 firms, which did not make such hires but were matched with the treatment group according to key characteristics (“low-GC firms”).⁶² The researchers found that the high-GC firms were associated with on average a 50 percent reduction in compliance breaches, including a 47 to 60 percent reduction in insider trading breaches. They also found that high-GC firms were associated with a 32 percent reduction in monitoring breaches, as indicated by decreases in measures for lawsuits in which securities fraud is alleged but not proven, securities lawsuits excluding Accounting and Auditing Enforcement Releases (AAERs), and general lawsuits.⁶³ These results suggest that highly-paid GCs are not only willing to interdict misconduct but also willing to monitor for the purpose of reducing a firm’s overall legal exposure.

Two additional studies suggest that high-status GCs are willing to expend the necessary resources to monitor corporate conduct—specifically, voluntary corporate financial disclosures—in an effort to provide more transparency to public investors and potentially reduce the

⁶² *Id.* at 862-63.

⁶³ *Id.* at 863, 864 (tbls.3 & 4). AAERs are issued at the conclusion of an SEC investigation into alleged accounting/auditing misconduct.

legal exposure of the firm. In a study published in 2010, Linda Bamber et al. tracked 303 executives (8 percent of whom were GCs) who were among the five highest paid officers of their firms and who worked for at least two different S&P 1500 firms and remained at each firm for at least three years between 1995 and 2005. They compared this sample group to a control group of firms across five attributes of management earnings forecasts.⁶⁴ They found that highly-paid GCs in the sample displayed certain conservative characteristics: such GCs favored disclosure styles that guided expectations downward, consistent with sensitivity to litigation risk.”⁶⁵

In 2012, Byungjin Kwak et al. published a study that constructed a panel data set, consisting of firms with GCs in top management (43% of the firms) (“GC firms”), and firms without GCs in top management (57%

⁶⁴ Linda Smith Bamber, John Jiang & Isabel Yanyan Wang, *What’s My Style? The Influence of Top Managers on Voluntary Corporate Financial Disclosure*, 85 ACCT. REV. 1131, 1139, 1143, 1151 (2010).

The five attributes of management earnings forecasts were: frequency, precision, news, direction of bias relative to actual earnings, and accuracy. *Id.* at 1139.

⁶⁵ *Id.* at 1151, 1153 (tbl.8), 1156.

of the firms) (“non-GC firms”) out of a database of 2,000 public firms.⁶⁶ The researchers compared the two groups across five attributes of management earnings forecasts from 1997 to 2009.⁶⁷ They found that GC firms were more likely to issue earnings forecasts than non-GC firms and that this propensity was much stronger for bad news forecasts than good news forecasts.⁶⁸ Also, they found that forecasts of GC firms were more accurate and less optimistically biased than those of non-GC firms.⁶⁹ Finally, forecasts of GC firms appeared to be more credible to investors than those of non-GC firms: the price reaction to management earnings

⁶⁶ Byungjin Kwak, Byung T. Ro & Inho Suk, *The Composition of Top Management with General Counsel and Voluntary Information Disclosure*, 54 J. ACCT. & ECON. 19, 23 (2012). The GCs in the sample group consisted of GCs who were among the five highest paid officers, as well as those identified as members of the senior leadership.

⁶⁷ The five attributes of management earnings forecasts were: likelihood, frequency, bias, accuracy, and price reaction. *Id.* at 24-26.

⁶⁸ *Id.* at 28, 29.

⁶⁹ *Id.* at 30.

forecasts was stronger for GC firms than for non-GC firms.⁷⁰ These findings suggest that high-status GCs play an important role in inducing firms to provide more candor about litigation risks, thereby reducing information asymmetry vis-a-vis investors.

Other findings, however, complicate the picture of a willing and able gatekeeper. Although the Morse study found that highly-paid GCs inhibited both compliance and monitoring breaches, this tendency was lessened when compensated with high equity incentives. High sign-on equity incentives contracts (indicative of the importance of strategic goals in compensation contracts) were associated with *less* monitoring—that is, those GCs prevented 25 percent fewer monitoring breaches than what would have been mitigated by having a highly paid GC.⁷¹ That said, high-equity incentives contracts appeared to have little to no effect on

⁷⁰ *Id.* at 31. *See also* Robert C. Bird, Paul A. Borochin & John D. Knopf, *The Role of the Chief Legal Officer in Corporate Governance*, 34 J. CORP. FIN. 1 (2015) (finding that in firms targeted by securities class actions, highly paid GCs are correlated with increased firm market value).

⁷¹ Morse, Wang & Wu, *supra* note 61, at 874.

compliance.⁷² According to the authors, these findings provide “evidence that executive lawyers are incentivized to compromise time spent monitoring internal governance when faced with the call to add strategic input[.]” On the other hand, these incentive contracts do not seem to compromise compliance, “which implies that these executive lawyers on average remain gatekeepers, at least along some dimensions[.]”⁷³

The Morse study’s finding that high equity incentives may compromise GCs’ willingness to monitor is consistent with a number of studies. In 2015, Justin Hopkins et al. investigated whether compensating GCs similarly to CEOs and CFOs, including providing for equity-based incentive compensation, would impair the professional judgment of GCs, compromising their effectiveness as gatekeepers.⁷⁴ The researchers compared firms in which the GC was among the top five best compensated officers (“high-GC firms”) and firms lacking such a GC (“low-GC firm”) across several measures of financial reporting quality

⁷² *Id.* at 870.

⁷³ *Id.* at 876.

⁷⁴ Justin J. Hopkins, Edward L. Maydew & Mohan Venkatachalam, *Corporate General Counsel and Financial Reporting Quality*, 61 MGMT. SCI. 129 (2015).

from 2001 to 2011.⁷⁵ High-GC firms were found to be correlated with poorer financial reporting quality and an increased propensity to manage earnings.⁷⁶ Moreover, they found that the economic effect was significant—comparable in magnitude (but in the opposite direction) to the effect that having an accounting expert on the board has on the firm’s financial reporting quality. Interestingly, GCs with financial expertise, which represented one-third of the sample, were correlated with even poorer reporting quality and an even greater likelihood of engaging in earnings management.⁷⁷ These findings are consistent with the

⁷⁵ *Id.* at 135-36. The proxies for financial reporting quality were (i) an accruals quality measure, an inverse measure of reporting quality, which represents the variability of residuals, (ii) an absolute value of abnormal accruals measure, an inverse measure of reporting quality, and (iii) an income-increasing discretionary accruals measures, which represents the propensity to engage in earnings management. *Id.* at 134.

⁷⁶ *Id.* at 135-36.

⁷⁷ *Id.* at 141.

explanation that highly-compensated GCs facilitate or at least tolerate more aggressive reporting practices.⁷⁸

Two studies on highly-paid GCs' impact on corporate tax planning confirm the story of a weaker monitor. In a study published in 2016, John Abernathy et al. tracked a treatment group of companies that experienced the ascension of their GC into top management (as defined by being among the top five highest-paid officers of the firm) ("high-GC firms") from 1993 to 2011. They compared that group with a propensity score matched sample of control companies that did not experience such an ascension ("low-GC firms") across two known measures of tax aggressiveness.⁷⁹ The researchers found that high-GC firms were associated with greater ex post tax aggressiveness,⁸⁰ a finding consistent

⁷⁸ *Id.* at 136.

⁷⁹ John L. Abernathy, Thomas R. Kubick & Adi Masli, *General Counsel Prominence and Corporate Tax Policy*, 38 J. AM. TAX'N ASS'N 39, 43 (2016). The two measures of tax aggressiveness are: (i) the level of total book-tax differences, a measure of the extent to which book income exceeds taxable income, and (ii) tax sheltering likelihood. *Id.* at 45.

⁸⁰ *Id.* at 46.

with the proposition that highly-paid GCs exhibit a reduced willingness to monitor. In the second (unpublished) study, Beng Wee Goh et al. found that high-GC firms were associated with three known measures of tax planning aggressiveness used in prior literature,⁸¹ again providing support for the proposition that high-status GCs are less willing to monitor.

Despite this evidence of highly-paid GCs' reduced willingness to monitor, the Hopkins study also found that highly-paid GCs seemed to inhibit material law violations. Hopkins et al. also investigated whether generously compensating GCs was associated with (i) the incidence of financial restatements classified as "intentional"—i.e., the product of a fraudulent misrepresentation, a class action lawsuit, or an SEC investigation and (ii) the estimated probability of financial fraud as represented by a known measure used in prior literature.⁸² They found that

⁸¹ The three measures of tax aggressiveness are: (i) discretionary permanent book-tax difference, (ii) tax sheltering likelihood, and (iii) predicted unrecognized tax benefits. Beng Wee Goh, Jimmy Lee & Jeffrey Ng, *The Composition of Top Management with General Counsel and Tax Avoidance* 2, 13-15 (Jan. 10, 2014) (unpublished paper).

⁸² *Id.* at 139.

the presence of a highly-compensated GC mitigated the likelihood of restatement and financial fraud, suggesting that GCs appear to help keep the firm within the bounds of GAAP and SEC regulations.⁸³ This finding is consistent with the Morse study's finding that equity incentive contracts did not appear to compromise compliance, suggesting that GCs remain willing to interdict misconduct even when they become weaker monitors overall.

What shall we make of this complicated set of findings? These findings provide preliminary evidence of a conflicted gatekeeper. On the one hand, high-status GCs seem willing to interdict when empowered to police material illegalities, such as when accorded a veto over trading by insiders, or when drawn directly into higher-level strategic decisions potentially implicating material illegalities, such as with major policy decisions that may trigger financial restatements. They also appear to be willing monitors where litigation risk is salient—for example, when the firm makes earnings forecasts or other voluntary corporate disclosures. In those situations, GCs appear to play a crucial role in reducing the firm's legal exposure. On the other hand, their willingness to monitor does not seem to extend to all areas of corporate activity. Highly-paid GCs appear

⁸³ *Id.* at 138.

reluctant to robustly monitor tax and accounting matters, potentially tolerating unethical tax planning and the strategic use of discretion permitted under GAAP to achieve financial reporting objectives in ways that may partially obscure the true financial picture of the firm. One study also found a strong correlation between high equity incentives in the GC's compensation contract and reduced monitoring.⁸⁴

As I've explained elsewhere, experienced lawyers are socialized to understand that their authority and responsibility are bounded.⁸⁵ Whereas violations of law and breaches of legal obligation are commonly recognized as falling within the lawyer's province of concern, so-called "policy" and operational decisions do not.⁸⁶ Also, lawyers appreciate that even *legal* risks must be differentiated according to their significance and

⁸⁴ See *supra* notes 71-73 and accompanying text.

⁸⁵ Sung Hui Kim, *The Ethics of In-House Practice*, in *LAWYERS IN PRACTICE: ETHICAL DECISION MAKING IN CONTEXT* 197, 203 (Leslie Levin & Lynn Mather eds., 2012).

⁸⁶ Nonetheless, in some corporate settings, the final decision of whether to run any particular *legal* risk may be classified as a *policy* decision to be ultimately decided by a non-lawyer business executive. *Id.*

must be evaluated based on the magnitude of prospective harm and the probability of occurrence. Reflecting these nuances, the disciplinary rules governing lawyers' conduct distinguish (i) between legal and nonlegal (or "business") domains and (ii) between material and immaterial legal risks.⁸⁷ Although actual behavior will range widely, the conduct of most lawyers will be constrained by two ethical guidelines: (i) that they must not facilitate a crime or fraud and (ii) that they have (greater) responsibility to intervene to avert or reduce material legal risks.

Because informed trading and financial restatements more readily implicate potentially material, criminal violations of law, most lawyers will perceive those issues as falling comfortably within their traditional range of authority.⁸⁸ By contrast, much of the conduct associated with aggressive earnings management or aggressive tax avoidance are likely to be classified as arguably lawful—or at least not unambiguously illegal—albeit possibly unethical. Accordingly, lawyers may perceive their authority and responsibility over those areas to be lacking or diminished.

⁸⁷ *See id.*

⁸⁸ Also, informed trading and financial restatements may subject the corporation to a protracted investigation, gobbling up corporate time and resources.

Given that much of the policy-making in those areas will tend to be colorably legal, GCs may be reluctant to monitor robustly and may feel compelled to accommodate their colleagues up to the outer limits of legality in an effort to avoid alienating business colleagues and to maintain social harmony. As I've written in prior work, GCs are not only legal professionals but also corporate employees and thus subject to "team player" pressures not to rock the boat.⁸⁹ Moreover, equity compensation contracts that align GCs' incentives with aggressive accounting policies may exacerbate these team player pressures.⁹⁰ If so, then highly-compensated GCs may be even more reluctant than lowly-compensated GCs to weigh in on matters under the purview of non-lawyer business colleagues.

Whether these offered interpretations are explanatory of the findings cannot be resolved here. Qualitative surveys that interrogate the thought processes of GCs will likely be necessary to fully make sense of these findings. That said, what these studies seem to confirm is a portrait of a sophisticated and capable gatekeeper who discriminates between those risks that she will tolerate and those that she will not. While she may be

⁸⁹ Kim, *Banality of Fraud*, *supra* note 16, at 1019.

⁹⁰ *Id.* at 1006-07.

willing to stop material illegalities that are brought to her attention and that pose a substantial risk of litigation or reputational damage, she may be selective about the resources that she will expend to monitor ongoing corporate conduct.

B. Outside Lawyers: Advisors, Not Gatekeepers

Compared to GCs, who may be identified in the firm's public filings, there is much less research on the role of the outside corporate lawyers who typically work behind the scenes to assist in the firm's periodic SEC filings.⁹¹ The few studies available suggest that outside lawyers may be even less willing to interdict than GCs.

In a study published in 2013, Preeti Choudhary et al. investigated the question of whether the retention of a reputable, top-tier corporate law firm, as measured by whether the company retained one of the 100 most profitable law firms in the U.S., explained variations in a company's

⁹¹ For periodic SEC filings (Forms 10-K, 10-Q, 8-K), in contrast to filings relating to the registration of securities (Forms S-1, S-3), there is no legal requirement to disclose the names of outside securities counsel. See Patrick Schmidt, *The Ethical Lives of Securities Lawyers*, in *LAWYERS IN PRACTICE: ETHICAL DECISION MAKING IN CONTEXT* 221 (Leslie C. Levin & Lynn Mather eds., 2012).

compliance with mandatory disclosure requirements from 1999 to 2008.⁹² Focusing on whether lawyers influenced the *completeness* of mandatory corporate disclosures, the study measured whether the company filed a Form 12b-25, which is required when issuers know that they will be late with their annual reports on Form 10-K.⁹³ The researchers found “consistent evidence that retention of a top-tier corporate attorney is associated with a *lower* likelihood of Form 12b-25 compliance, indicating that top-tier corporate attorneys influence disclosure completeness by using their expertise to advise clients on mandatory disclosure decisions.”⁹⁴

⁹² Preeti Choudhary, Jason D. Schloetzer & Jason D. Sturgess, *Boards, Auditors, Attorneys and Compliance with Mandatory SEC Disclosure Rules*, 34 *MANAGERIAL & DECISION ECON.* 471 (2013).

⁹³ SEC Form 12b-25, the Notification of Late Filing, must be filed when a company anticipates that other key filings will not be completed by their deadlines. By filing Form 12b-25 in a timely manner, a company may avoid further penalties associated with failing to make the mandatory filings.

⁹⁴ *Id.* at 477 (emphasis added) (reporting the results of their unpublished study, *Do Corporate Attorneys Influence Financial*

In a 2019 study focusing on outside counsel, Zahn Bozanic et al. examined the SEC comment letter process and reviewed published correspondence from 2005 to 2012 between companies and the SEC relating to their Form 10-K filings, 35 percent of which involved the retention of outside counsel.⁹⁵ The researchers compared the written SEC interactions with firms that retained outside law firms and SEC interactions with firms that did not. They found that firms that retained outside lawyers were 1.8 percent less likely to amend their 10-Ks to cure an opaque, confusing or incomplete report as a response to SEC feedback than firms without outside lawyers.⁹⁶ Where the SEC expressly requested an amendment to the filing, firms retaining outside lawyers were 13.7 percent less likely to amend their filing to cure disclosure errors than firms

Disclosure? (May 29, 2012) (unpublished paper)). Findings relating to the *timeliness* and *readability* of public disclosures were also reported. *See id.* at 478-79.

⁹⁵ Zahn Bozanic, Preeti Choudhary & Kenneth J. Merkley, *Securities Law Expertise and Corporate Disclosure*, 94 ACCT. REV. 141, 149 (2018).

⁹⁶ *Id.* at 157.

without outside lawyers.⁹⁷ In other words, involvement of outside counsel was strongly associated with a reduced likelihood of correcting disclosure errors through amendment when amendments are requested by the SEC.⁹⁸

These findings from the Choudhary and Bozanic studies suggest that high-end corporate law firms are more likely to play an advisory role that is aligned with managerial interests than a gatekeeping role that is more aligned with investor interests. The Choudhary study's finding that outside lawyers are associated with a lower likelihood of Form 12b-25 compliance indicates that outside lawyers do not seem to press their clients to comply with regulations, even on legally unambiguous issues, such as the filing of a Form 12b-25. Rather, they are likely to provide an ethically neutral assessment of the legal risks based on the wide range of their experiences and defer to company representatives who make the final call on whether to comply with the regulations. With this accurate advice, a company may choose to not comply with the rules in the face of tolerable levels of legal risk. The Bozanic study's finding that firms retaining outside counsel are less likely to issue amendments to their 10-

⁹⁷ *Id.* at 167.

⁹⁸ *Id.*

Ks in response to SEC feedback or requests is consistent with outside lawyers playing an ethically neutral, advisory role.

That said, these findings do suggest that elite law firms appear to add value to their corporate clients. There is some evidence that retention of outside counsel during the SEC comment letter process may have a mid- to long-term salutary effect on firms' disclosure practices following the resolution of that process. The Bozanic study found evidence that retention of outside counsel is associated with improved readability and an increase in qualified or cautionary language in subsequent 10-Ks following the resolution of the SEC inquiry.⁹⁹ Also, companies that retained outside counsel were 14.8 and 5.3 percent less likely to have subsequent restatement or subsequent SEC comment letters, respectively. These findings suggest that outside counsel do contribute to mid- to long-term improvements in the firm's disclosure practices, which is consistent with companies learning from outside counsel about how to identify and resolve disclosure concerns that could trigger an SEC inquiry.¹⁰⁰

In sum, the foregoing empirical studies suggest that GCs are sophisticated but conflicted gatekeepers. They exhibit some—perhaps

⁹⁹ *Id.* at 159.

¹⁰⁰ *Id.*

impressive—willingness to interdict material illegalities and some willingness to expend resources to monitor corporate disclosures to reduce the risk of corporate liability. But their willingness to monitor does not seem to extend to all areas of corporate conduct. Moreover, highly-paid GCs appear to be weak monitors where unethical but colorably legal policy decisions are concerned. As conflicted as GCs may be, outside lawyers appear to be even less willing to play a gatekeeping role vis-a-vis their client representatives. The relatively scant evidence suggests that outside lawyers are unlikely to press client representatives to comply with the law. Instead, they will assume their traditional role as advisors, providing accurate and ethically neutral risk assessment so that client representatives can make decisions calibrated to their preferred levels of risk. That said, outside lawyers' expertise appears to provide a long-term benefit to their clients, potentially mitigating subsequent reporting problems and enhancing the quality of future disclosures.

IV. Lawyers on the Board: The Future Gatekeepers?

Thus far, we have focused on in-house and outside lawyers, which is consistent with the emphasis in the academic literature. But a complete picture of the gatekeeping potential of lawyers cannot be attained without some attention given to one other group of lawyers: lawyers sitting on the

board, including on the audit committee, some of whom may be GCs or outside lawyers retained by the company.¹⁰¹ In the aftermath of Sarbanes-Oxley, companies have been adding proportionately more lawyers to their boards than any other category of new appointees, including financial

¹⁰¹To be sure, some will object to the designation of GC-directors, as well as non-director GCs, as potential gatekeepers, because gatekeepers are traditionally understood as third parties. But from law enforcement's perspective, any private person or group of private persons who is in a position to avert the misconduct of the principal wrongdoer—can be a potential gatekeeper. Because the principal perpetrators of corporate crimes tend to be the small group of executive officers (typically, the CEO and the CFO) who operate the firm's day-to-day business, all outside board members and GCs who sit on the board, *could* play a gatekeeping role. Prior literature has highlighted the gatekeeping role of outside directors. *See, e.g.,* Assaf Hamdani & Reinier Kraakman, *Rewarding Outside Directors*, 105 MICH. L. REV. 1677, 1679 (2007).

experts.¹⁰² Do these lawyers who occupy the seat of corporate power make effective gatekeepers?

In a study published in 2011, Jayanthi Krishnan et al. investigated whether the presence of general legal expertise on the audit committees of 591 Russell 1000 companies influenced the quality of a company's financial reporting during the post-Sarbanes-Oxley period from 2003 to 2005.¹⁰³ The researchers found that legal-only expertise on audit committees was positively associated with two measures of financial

¹⁰² Jayanthi Krishnan, Yuan Wen & Wanli Zhao, *Legal Expertise on Corporate Audit Committees and Financial Reporting Quality*, 86 ACCT. REV. 2099, 2100 (2011). After Sarbanes-Oxley, the share of board seats held by lawyers increased from 5.6 percent in 2001 to 8.6 percent in 2004. *Id.* (citing Linck et al.).

¹⁰³ *Id.* at 2107. To measure legal expertise and to control for any contribution arising from having joint legal and accounting expertise, the authors constructed measures of “legal-only” expertise, “accounting-only” expertise, and “joint” legal-accounting expertise. Legal expertise was defined as having a law school degree, such as a J.D., LL.M., or LL.D. and/or having working experience as a lawyer at a law firm or as inhouse counsel. *Id.* at 2105.

reporting quality used in prior research—an accruals quality measure and an absolute discretionary accruals measure.¹⁰⁴ Other things being equal, the addition of a legal-only expert on the audit committee was associated with a 36 percent improvement in the accruals quality measure and a 17 percent improvement in the absolute discretionary accruals measure.¹⁰⁵ By contrast, the addition of an accounting-only expert on the audit committee was associated with only a 5 percent improvement in the accruals quality measure and an 8 percent improvement in the absolute discretionary accruals measure.¹⁰⁶ Interestingly, the researchers found no

¹⁰⁴ *Id.* at 2113. The study employed: (1) an accruals quality measure, an inverse measure of reporting quality, which represents the variability in residuals, and (2) an absolute discretionary accruals measure, an inverse measure of reporting quality.

¹⁰⁵ *Id.*

¹⁰⁶ *Id.* The authors posit that in light of the fact that there is a greater concentration of accounting-only experts than legal-only experts in the sample firms, “the marginal benefit of additional accounting expertise seems to be lower than that of additional legal expertise.” *Id.* at 2101, 2127. Audit committees with separate legal and

association between the degree of legal expertise *outside* audit committees and financial reporting quality.¹⁰⁷ Krishnan et al. interpreted this finding as suggesting that “directors’ legal expertise is beneficial for financial reporting quality *only* when the experts are appointed to the audit committee.”¹⁰⁸

The Krishnan study supports the proposition that legal expertise may contribute positively to financial reporting quality beyond the positive effects of accounting expertise,¹⁰⁹ but that this effect may be confined to those narrow circumstances in which legal experts have authority over and direct responsibility for financial reporting, as would be the case with audit committee membership. As the authors of the study explain, legal experts should be more alert to litigation risks arising out of financial reporting and thus would be inclined to provide an additional layer of monitoring.¹¹⁰ The conclusion that lawyers on the audit committee may

accounting experts exhibited an incremental positive effect on reporting quality. *Id.* at 2126.

¹⁰⁷ *But see infra* note 112 and accompanying text.

¹⁰⁸ Krishnan, Wen & Zhao, *supra* note 102, at 2101, 2113.

¹⁰⁹ *Id.* at 2115, 2126.

¹¹⁰ *Id.* at 2126.

be more sensitive to legal risk is broadly consistent with a finding from the Hopkins study. While the Hopkins study found that high-GC firms were correlated with poorer financial reporting quality,¹¹¹ an additional test revealed that when highly-compensated GCs were also members of the board, the association with lower reporting quality was mitigated.¹¹² The conclusion is also broadly consistent with the findings of another 2012 study, which surveyed employees of the compliance departments of almost 1,000 Australian businesses and found that lawyers in compliance positions exhibited greater sensitivity than non-lawyers to their firms' potential exposure to legal and regulatory risks.¹¹³

¹¹¹ See Hopkins, Maydew & Venkatachalam, *supra* note 74; *see also* notes 74 to 78 and accompanying text.

¹¹² Hopkins, Maydew & Venkatachalam, *supra* note 74, at 140-41. This test did not isolate the effects of audit committee membership. *See* tbl.5.

¹¹³ Robert Eli Rosen, Christine E. Parker & Vibeke Lehman Nielsen, *The Framing Effects of Professionalism: Is There a Lawyer Cast of Mind? Lessons from Compliance Programs*, 40 FORDHAM URB. L.J. 297, 354 (2012). However, this greater sensitivity to legal risks was reflected merely in the increased likelihood of adopting written

The foregoing suggests that lawyers' professional experience and socialization may result in a particular "cast of mind"—an inclination to perceive or evaluate certain types of risks differently than other professionals—but that the structural context equally matters in determining whether this alternative inclination will translate into actual behavior. To the extent that the lawyer is situated from the perch of the board (or the board's audit committee), she would presumably be less concerned about reprisals and recriminations from non-lawyer business colleagues. Also, given the audit committee's clear authority and responsibility over financial reporting, the lawyer on that committee would be less likely to shirk her monitoring role due to a diffusion of responsibility. In sum, there is limited empirical support that a general counsel or other legal expert on the board, particularly on the audit committee, would be an effective, less conflicted, gatekeeper.

policies, manuals, and training programs designed to manage risks and did not reflect a fundamentally different approach to compliance or the organization's multiple stakeholders.

V. Conclusion

Do lawyers make good gatekeepers? Not surprisingly, the picture is complicated. While there are impressive economies of scope to be gained from imposing gatekeeping obligations on in-house and outside lawyers, ongoing resistance from the organized bar make the case for lawyers exceedingly controversial. The empirical evidence, however, suggests that some lawyers are effective, if imperfect, gatekeepers. GCs appear willing to take a stand when material illegalities are brought to their attention. On the other hand, highly-paid GCs seem reluctant to systematically monitor in certain areas in ways that might bring about a change in corporate culture or otherwise promote ethical conduct. Outside lawyers as a whole seem even less willing than GCs to induce compliance, although their involvement does seem to mitigate subsequent reporting problems and enhance the quality of future disclosures. Finally, preliminary empirical evidence suggests that legal experts on board audit committees are capable of serving as robust gatekeepers. More research on the gatekeeping potential of legal experts on the board would be fruitful in informing best practices.