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GATEKEEPER FAILURE AND REFORM:
The Challenge of Fashioning Relevant Reforms

by John C. Coffee, Jr.*

Securities markets have long employed “gatekeepers” - - independent professionals who pledge their reputational capital - - to protect the interests of dispersed investors who cannot easily take collective action.¹ The clearest examples of such reputational intermediaries are auditors and securities analysts, who in different ways verify or assess corporate disclosures in order to advise investors. But during the late 1990s, these protections seemingly failed, and a unique concentration of financial scandals followed, all involving the common denominator of accounting irregularities. What caused this sudden outburst of scandals, involving a seeming epidemic of accounting and related financial irregularities, that broke over the financial markets between late 2001 and mid-2002 - - e.g., Enron, WorldCom, Global Crossing, Tyco and others? To date, much commentary has broadly and loosely attributed these scandals to any or all of: (1)

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¹ Probably, the first systematic use of this term, “gatekeeper,” was in an article by Ronald Gilson and Ranier Kraakman. See Ronald Gilson and Ranier Kraakman, The Mechanisms of Market Efficiency, 70 Va. L. Rev. 549, 612-621 (1984) (discussing role of investment bankers as gatekeepers). See also John C. Coffee, Jr., Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation, 52 Bus. Law. 1195, 1210-13, 1232-33 (1999). For a fuller discussion of the concept of gatekeepers as “reputational intermediaries,” see text and notes *infra* at notes 13 to 14. The use of such private agents substantially predates the appearance of public regulation, either the federal securities laws or the state “Blue Sky” laws. The New York Stock Exchange began to require the publication of financial statements certified by an independent auditor around 1900, well before the passage of the first “Blue Sky” statute. See John C. Coffee, Jr., The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control, 111 Yale L.J. 1, 37-39 (2001).

a stock market bubble; (2) a decline in business morality; (3) weak boards of directors;² or (4) an increase in “infectious greed.”³ Without denying that any of these factors could have played some role, this article begins from the premise that explanations phrased in terms of greed and morality are unsatisfactory because they depend on subjective trends that cannot be reliably measured.

Even explanations that involve critiques of corporate governance involve a related problem in that they fail to account for the sudden increase in financial irregularity. While some boards certainly failed, the overall independence and power of outside directors has only increased over recent years, and the 2001-2002 epidemic of financial irregularity cannot be satisfactorily explained in terms of any recent decline in board performance. To explain an epidemic of irregularity, one must identify some force or factor that changed - - either intensifying or weakening - - so that its influence can account for the overall shift in behavior.

² For a representative such statement, see Stuart L. Gillan and John D. Martin, “Financial Engineering, Corporate Governance and the Collapse of Enron” (SSRN Working Paper id=350040) (2002) at 3 (finding first cause of Enron’s breakdown to have been “a lack of board independence and board oversight”). In contrast, this paper doubts the adequacy of such an explanation. Admittedly, boards did fail, and even a special committee of Enron’s own board has concluded that the Enron board failed to monitor officers for conflicts of interest adequately. See William C. Powers, Jr. et al., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. (Feb. 1, 2002), 2002 WL 198018. Similarly, a Senate Subcommittee has assigned the principal blame to the Enron Board. See Report of the Permanent Subcommittee on Investigations of the Committee of Governmental Affairs, United States Senate, “The Role of the Board of Directors in Enron’s Collapse,” (Report 107-70) (July 8, 2001). Nonetheless, such studies beg the larger question: why did these boards fail now and not earlier? Although board procedure or independence may have been deficient, they were almost certainly superior to a decade ago when such scandals were rare.

³ Federal Reserve Chairman Alan Greenspan coined this colorful phrase, saying that “An infectious greed seemed to grip much of our business community.” See Floyd Norris, “The Markets: Market Place: Yes, He Can Top That,” New York Times, July 17, 2002, at A-1.

Clearly, the performance of boards of directors of publicly-held corporations, even if inadequate, did not decline materially over the relevant interval of the 1990s.

A final oversimple explanation is that a “few bad apples” - - i.e., a small group of “rogue managers” who were corrupt - - caused these scandals. This explanation overlooks the pervasiveness of the sudden surge in financial irregularities in the late 1990s. As will be seen, approximately 10% of all publicly listed U.S. companies restated their financial statements at least once between 1997 and June 2002,⁴ and the annual rate of financial restatements soared during the latter half of the 1990s.⁵ Such financial irregularity is, of course, characteristic of a bubble, and little doubt now exists that a large frothy bubble burst in 2000-2001. As a historical matter, bubbles tend to produce scandals and, in turn, prophylactic legislation,⁶ but this loose generalization leaves unanswered the critical questions: what caused this bubble and how does the growth of a bubble relate to the apparent breakdown of our once-confident system of corporate governance?

This article will focus on an alternative explanation for the wave of accounting and financial reporting irregularities that surfaced in 2001-2002: namely, that the gatekeepers failed. That is, the professionals who serve investors by preparing, verifying, or certifying corporate disclosures to the securities markets acquiesced in managerial fraud - - not in all cases, to be sure, but at a markedly higher rate than during the immediately preceding period. While the concept

⁴ See United States General Accounting Office, Report to the Chairman, Committee on Banking, Housing and Urban Affairs, U.S. Senate, FINANCIAL STATEMENT RESTATEMENTS: Trends, Market Impacts, Regulatory Responses and Remaining Challenges (Oct. 2002) (GAO-03-138) at 4 (hereinafter, “GAO Study”).

⁵ See text and notes *infra* at notes 21 to 29.

⁶ Professor Stuart Banner has argued that, over the last 300 years, most major instances of legislation regulating the securities markets have followed a sustained price collapse on the securities market. See Stuart Banner, What Causes New Securities Regulation?: 300 Years of Evidence, 75 Wash. U. L.Q. 849, 850 (1997).

of gatekeeper will be discussed and refined later, this term certainly includes the auditors, securities analysts, and securities attorneys who prepare, review, or analyze disclosure documents. Part I of this article develops competing, but complimentary, explanations for gatekeeper failure. The behavior of gatekeepers cannot be examined in isolation, but rather appears to have been significantly influenced by the incentives that drove corporate managers over the same period. To this extent, the recent explosion of financial irregularity was less the product of ineffable factors - - such as “infectious greed” or mass irrationality - - than the natural and logical consequence of trends and forces that had been developing for some time. Ironically, the blunt truth is that both the recent accounting scandals and the broader phenomenon of earnings management were the by-products of a system of corporate governance that has indeed made corporate managers more accountable to the market. Sensitivity to the market, however, can be a mixed blessing - - particularly when the market becomes euphoric and uncritical. As a result, a corporate governance system that was adequate for a world in which the agents’ incentives to act opportunistically were weaker failed when these same agents - - managers, gatekeepers and financial intermediaries - - responded to stronger incentives and rationally pursued their own self-interests to the detriment of shareholders.

Part I will conclude that the factor that most destabilized our contemporary corporate governance system was the sudden change in executive compensation during the 1990s. As executive compensation shifted to being equity-based, instead of cash-based, a greatly enhanced incentive arose for managers to manipulate earnings - - and to induce their gatekeepers to let them. To this extent, blaming the board is a myopic theory of causation that leads nowhere, because it does not explain the sudden surge in irregularities. In truth, in most cases, boards

cannot detect earnings manipulation in the absence of warnings from their professional gatekeepers.

This focus on executive compensation as the destabilizing force that led managers to overreach gatekeepers is subject to a major qualification: gatekeepers do not have the same, identical relationship to corporate managements around the world. Outside the United States, no similar outburst of accounting irregularities or financial statement restatements occurred during 2000 to 2002, even though stock markets receded uniformly in the United States and Europe. Indeed, most of the non-U.S. companies that did experience accounting irregularities over this same era either had significant U.S. operations where the fraud originated or also relied on stock options to compensate senior management. Across most of the world, however, little use is made of equity compensation, because most firms have concentrated ownership, and their controlling shareholders do not need to rely on equity compensation to align shareholder interests with their own. Thus, the absence of accounting scandals in Europe over the 2000-2002 period, coupled with the limited use made in Europe of equity compensation, tends to corroborate the basic hypothesis advanced in Part I that changes in executive compensation destabilized American corporate governance.

Still, accounting scandals have recently surfaced in Europe, most notably in the case of Parmalat.⁷ Part I finds that these scandals were qualitatively different than Enron and WorldCom in several respects. Thus, these scandals demonstrate that gatekeeper failure is a worldwide problem, but one that has different causes and cures depending upon the different structures of corporate governance involved.

⁷ See Mark Landler, "Scandal Outrages Europeans; Solutions May Be Patchwork," New York Times, December 25, 2003 at C-1 (discussing Parmalat and other recent European accounting scandals).

Although Part I offers a diagnosis, it proposes no prescription, in part because effective prescriptions must be context-specific and not universal. Part II approaches the task of prescription by first mapping the range of strategies available to regulators. Basically, it groups the realistic regulatory options for dealing with conflicts of interest under four headings: (1) structural rules, which, for example, subject gatekeepers to greater public oversight; (2) prophylactic rules, which typically seek to preclude conflicts of interest; (3) “empowerment” rules, which seek to assure greater independence or to give the gatekeeper greater leverage over the principal that it is expected to monitor; and (4) liability-enhancing rules. Seeking to curb the conflicts of interest that compromised auditors and analysts, the Sarbanes-Oxley Act of 2002,⁸ passed by Congress in response to the wave of corporate scandals that crested in 2002, utilizes all these strategies - - except the last. Although enhancing liability rules is probably the most obvious and traditional response to scandals, this was also the one strategy that business interests effectively resisted during the enactment of Sarbanes-Oxley. Ironically, even though Congress has not used this technique, Part II finds that courts in today’s “post-Enron” environment appear to be enhancing the risk of legal liability on their own through the creative reinterpretation of ambiguous doctrines.

But therein lies a host of problems. Although gatekeepers need to face some legal threat if they are to remain faithful to shareholders, the optimal level of deterrence is much harder to estimate. Some recent commentators have proposed a strict liability regime for gatekeepers, arguing that only strict liability provides gatekeepers with optimal incentives to prevent client

⁸ Technically, this statute is entitled the “Public Company Accounting Reform and Investor Protection Act of 2002,” 15 U.S.C. § 7201 et seq., 107 Pub. L. No. 204, 116 Stat. 745.

misconduct.⁹ Other commentators have disagreed, replying that strict liability may cause the market for gatekeepers to fail or may simply deny some law-abiding, but higher risk, issuers access to the capital markets.¹⁰ Although the magnitude of the litigation “threat” that is now facing gatekeepers can reasonably be debated, and probably varies with the type of gatekeeper, the increasing risk of gatekeeper insolvency in at least the U.S. context suggests the need to consider alternative reforms that may be desirable because they can modify gatekeeper behavior by means that do not directly threaten gatekeeper solvency.

In this light, Part III proposes alternative reforms intended to make gatekeepers more responsive to the interests of investors. Initially, Part III proposes a modified form of strict liability for auditors that caps their maximum exposure at a multiple of their expected revenues from the client. The attraction of this combination is that it combines the superior incentives of a strict liability regime with both reduced transaction costs (as courts are spared the costly obligation of determining when gatekeepers acted with scienter or without reasonable care) and a reduced risk of gatekeeper insolvency or market failure in the market for gatekeeper services. Similarly, the prospect that law-abiding issuers might be denied access to the capital markets because of their liability risk they posed to their gatekeepers is also alleviated. Concededly, this proposal does subordinate the goal of victim compensation to that of deterrence, but gatekeepers simply lack the economic scale to be able to fund significant compensation to investors, particularly in the new era of mega-litigation. Finally, by moving closer towards a strict liability

⁹ See, e.g., Frank Partnoy, Barbarians at the Gatekeepers? A Proposal for a Modified Strict Liability Regime, 79 Wash. U.L.Q. 491 (2001); Trotter Hardy, The Proper Legal Regime for “Cyberspace”, 55 U.P.H. L. Rev. 993 (1994) (proposing strict liability for internet service providers).

¹⁰ Assaf Hamdani, Gatekeeper Liability, 77 S. Cal. L. Rev. 53 (2003). Professor Reinier Kraakman has also warned that strict gatekeeper liability may be undesirable. See Reinier Kraakman, Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy, 2 J.L. Econ. & Org. 53, 76 (1986).

system, this proposal eliminates the incentive for auditors to rationalize or overlook fraud or irregularity and later assert on its discovery that they were deceived by management. Rather, the auditor would know that it sinks or swims with its client; hence, half-hearted or pro forma monitoring, which may be a rational strategy under a negligence or fault-based legal regime, no longer protects the gatekeeper.

Part III recognizes, however, that all gatekeepers are not alike, that strict liability only makes sense when the gatekeeper can effectively prevent client misconduct, and that the attorney is not as well positioned as the auditor to detect client misconduct. In that light, Part III does not propose strict liability for attorneys, but instead a structural reform: namely, imposing gatekeeper responsibilities on attorneys to monitor their corporation's disclosures, with a special emphasis on non-financial disclosures. The goal here is to empower the gatekeeper and increase its leverage with respect to its client. To achieve this goal, Part III proposes that the attorney should be given a functionally corresponding responsibility for non-financial disclosures as the auditor now has for financial disclosures. Easy as this is to say, the devil lies in the details. Specifically, Part III outlines a "negative assurance" certification requirement, an enhanced independence standard for special contexts, and a due diligence obligation under which the SEC could suspend or disbar securities attorneys who failed negligence or malpractice tests. To be sure, the SEC has already begun to move modestly and tentatively in this same direction by adopting an "up-the-ladder" internal reporting requirement under which attorneys must report evidence of certain material violations of law that they acquire in their representation of the corporation to the corporation's general counsel or, if necessary, its audit committee.¹¹ The SEC is also

¹¹ See Securities Act Release No. 33-8185 ("Implementation of Standards of Professional Conduct for Attorneys"), 2003 SEC LEXIS 256 (January 29, 2003); see also text and notes *infra* at notes 159 to 174.

considering, and a number of academics have urged, a further reform under which the attorney would be required to make a “noisy withdrawal” if the violation continued and threatened serious injury to the corporation.¹² Without disputing the justifications for such a broader rule, Part III predicts that only modest benefits can be expected from such a reform, because it demands heroism on rare and isolated occasions from the attorney without resting its obligation on a broader functional foundation. In contrast, certification requirements create the broader framework within which the attorney must function on an on-going basis as a gatekeeper.

Of course, any claim that the attorney is, or should be, a gatekeeper, will trigger predictable responses from the bar that such a role conflicts with the other roles that attorneys perform or that it will dry up the flow of information between attorneys and clients. Part III assesses and rejects these arguments, concluding that the principal consequence of expressly recognizing attorneys as gatekeepers will be instead to enhance their leverage with their clients. In short, the unrecognized consequence of expanded ethical or professional obligations is to empower the gatekeeper, thus responding appropriately to the phenomenon of “gatekeeper failure.”

Part I: Gatekeepers: Past and Present

A. Defining the Concept. The term “gatekeeper” has been widely used to refer to the outside professionals who serve the board or investors.¹³ Broadly as the term may be sometimes

¹² See Securities Act Release No. 33-8186 (“Implementation of Standards of Professional Conduct for Attorneys”), 2003 SEC LEXIS 266 (January 29, 2003).

¹³ The SEC regularly uses this term. See Securities Act Release No. 7870 (June 30, 2000) (noting that “the federal laws....make independent auditors ‘gatekeepers’ to the public securities markets”). 2000 SEC LEXIS 1389, *13; see also Securities Act Release No. 7314 (July 25, 1996) (discussing “The Role of Gatekeepers in Maintaining the Quality of Disclosure”). Professor Kraakman has defined gatekeepers as “private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers.” See Kraakman, *supra* note 10, at 53. Assaf

used, two core elements underlie the concept of gatekeeper, and it is important to distinguish between them: First, the gatekeeper is a person who has significant reputational capital, acquired over many years and many clients, which it pledges to assure the accuracy of statements or representations that it either makes or verifies. Second, the gatekeeper receives a far smaller benefit or payoff for its role, as an agent, in approving, certifying, or verifying information than does the principal from the transaction that the gatekeeper facilitates or enables. Thus, because of this lesser benefit, the gatekeeper is easier to deter. This latter premise applies even if the gatekeeper has little or no reputational capital. These two elements--that the gatekeeper is a reputational intermediary and that it receives only a limited payoff from any involvement in misconduct--suggest a strategy for law compliance: the more the law makes the involvement of gatekeepers in sensitive transactions mandatory, the more it acquires a lever by which it can effectively discourage law violations.

To be sure, the term “gatekeeper” has also been used more broadly to describe any person or entity who provides a necessary service or certification without which the corporation cannot accomplish a transaction.¹⁴ This may accurately describe their organizational position, but it

¹⁴ Hamdani uses a similarly broad definition, describing them as “parties who sell a product or service that is necessary for clients wishing to enter a particular market or engage in particular services.” Hamdani, *supra* note 10, at 58. Professor Reinier Kraakman originally defined “gatekeepers” simply in terms of their blocking capacity as private parties who are able to prevent misconduct by withholding their cooperation from wrongdoers. See Reinier Kraakman, Gatekeepers: The Anatomy of a Third Party Enforcement Strategy, 2 J.L. Econ. & Org. 53, 53 (1986); see also Kraakman, Corporate Liability Strategies and the Costs of Legal Controls, 93 Yale L.J. 857 (1984); Hamdani, *supra* note 10, at 58. This definition strikes me as overly broad, at least for purposes of discussing the role of professionals. It would potentially hold liable persons who sold pencils to Al Capone’s gang on the theory that one could not run a brewery and tavern business without using pencils to keep records. Ignored by this definition is whether the gatekeeper possessed the ability to monitor whether its product or service has been misused.

seems overly broad because it ignores both the deterrent capacity of the gatekeeper and whether it possesses reputational capital. Under this broader definition, Microsoft might become a “gatekeeper” for most of the business world (on the assumption that its basic Windows technology was indispensable). Thus, this article will use the term “gatekeeper” more narrowly to mean a reputational intermediary who provides verification or certification services to investors. Still, the focus on the gatekeeper’s role in providing a necessary service or certification is useful, because it suggests a regulatory strategy on which this article will focus: by mandating gatekeepers, the law can maximize the probability of deterrence by creating a necessary actor whose compliance with the law it can more effectively influence.

Obvious examples of gatekeepers who provide such verification or certification services would include: (1) the auditor providing its certification of the issuer’s financial statements; (2) the debt rating agency certifying the issuer’s creditworthiness (or relative creditworthiness); (3) the security analyst providing its objective assessment of the corporation’s technology, competitiveness, or earnings prospects; (4) the investment banker providing its “fairness opinion” as to the pricing of a merger; and (5) the securities attorney for the issuer providing its opinion to the underwriters that all material information of which it is aware concerning the issuer has been properly disclosed. The underwriter in an initial public offering is probably also a gatekeeper in the sense that its reputation is implicitly pledged and it is expected to perform due diligence services. Some professions (most notably, the auditor) provide services that consist primarily of gatekeeping, whereas other professions engage in such services only as an ancillary activity (for example, as discussed later, the attorney is primarily an advocate or a transaction engineer and only sometimes a gatekeeper).

Characteristically, the professional gatekeeper essentially assesses or vouches for the corporate client's own statements about itself or a specific transaction. This duplication is desired because the market recognizes that the gatekeeper has a lesser incentive to deceive than does its client and thus regards the gatekeeper's assurance or evaluation as more credible. Unavoidably, the gatekeeper as a watchdog is compromised to a degree by the fact that it is typically paid by the party that it is to monitor. Still, the gatekeeper's relative credibility stems from the fact that it in effect pledges a reputational capital that it has built up over many years of performing similar services for numerous clients. In theory, the gatekeeper as an entity would not rationally sacrifice its reputational capital for a single client or a modest fee.

Nonetheless, here as elsewhere, logic and experience can conflict. Despite the clear logic of the gatekeeper rationale, reliance on gatekeepers can prove to have been misplaced for any of the following reasons:

(1) A sudden decline in the deterrent threat facing gatekeepers could occur, thereby increasing their willingness to take legal risks;

(2) The inducements offered to gatekeepers to breach their duties could similarly be increased, with the same likely result;

(3) The value of their reputational capital could decline, possibly because investors came to undervalue gatekeeping services in a "bubble market;"

(4) The prospective injury to a gatekeeper's reputational capital from involvement in a scandal could also decline, possibly because, in a very concentrated market (such as the market for auditing services), it becomes foreseeable that all the principal firms in the market will be

involved in some scandals and hence investors cannot distinguish meaningfully among them (i.e., the information costs become too high for ordinary investors); and

(5) Principal/agent problems can arise within gatekeeper firms with the result that agents can rationally decide to risk the firm's reputational capital to a degree that the firm as a whole would not. This decision to risk reputational capital that primarily belongs to others may be rational for the agent, but not for the firm.

For all these reasons, professional gatekeepers may sometimes acquiesce in managerial fraud, even though the apparent reputational losses seem to dwarf the gains to be made from the individual client.¹⁵

Much evidence corroborates each of the foregoing hypotheses and suggests that the "few bad apples" theory is simply incorrect as applied to the performance of gatekeepers in the late 1990s. Still, if we shift from theory to the world of real actors, the facts surrounding Arthur Andersen's fall in 2002. In theory, Andersen should not have acquiesced in accounting irregularities, because it had many clients, each of whom pay a fee that was modest in proportion to the firm's overall revenues. Specifically, Arthur Andersen had approximately 2,300 audit clients.¹⁶ On this basis, the firm seemingly had little incentive to risk its considerable reputational capital for any one client, even if that client paid a multi-million dollar fee. As will be seen however, each of the foregoing hypothesis can contribute to an explanation of gatekeeper failure.

¹⁵ This observation is hardly original with this author. See, for example, Robert A. Prentice, The Case of the Irrational Auditor: A Behavioral Insight Into Securities Fraud Litigation, 95 Nw. U. L. Rev. 1333 (2000).

¹⁶ See Michelle Mittelstadt, Andersen Charged With Obstruction, Vows to Fight, @ Dallas Morning News, March 15, 2002, at p.1.

Nonetheless, during the 1990s, many courts bought the logic that gatekeepers do not fail hook, line and sinker. For example, in DiLeo v. Ernst & Young,¹⁷ Judge Easterbrook, writing for the Seventh Circuit, outlined precisely the foregoing theory:

“The complaint does not allege that [the auditor] had anything to gain from any fraud by [its client]. An accountant’s greatest asset is its reputation for honesty, closely followed by its reputation for careful work. Fees for two years’ audits could not approach the losses [that the auditor] would suffer from a perception that it would muffle a client’s fraud [The auditor’s] partners shared none of the gain from any fraud and were exposed to a large fraction of the loss. It would have been irrational for any of them to have joined cause with [the client].”¹⁸

Of course, the modest fees in some of these cases (for example, the audit fee was only \$90,000 in Robin v. Arthur Young & Co.)¹⁹ were well less than the \$100 million in prospective annual fees from Enron that Arthur Andersen & Co. explicitly foresaw. But this difference in magnitude cannot really explain Arthur Andersen’s collapse. Even if Arthur Andersen saw Enron as a potential \$100 million client, it must be remembered that Arthur Andersen generated over \$9 billion in revenues in 2001 alone (so that its expected Enron revenues would total only around 1% of its aggregate revenues).²⁰ Hence, a fuller explanation seems necessary.

B. The Auditing Profession During the 1990s: A Study in Transition

Once among the most respected of all professional service firms (including law, accounting, and consulting firms), Andersen became involved in a series of now well-known

¹⁷ 901 F.2d 624 (7th Cir. 1990); see also Melder v. Morris, 27 F.3d 1097, 1103 (5th Cir. 1994); Robin v. Arthur Young & Co., 915 F.2d 1120, 1127 (7th Cir. 1990) (mere \$90,000 annual audit fee would have been an irrational motive for fraud).

¹⁸ See Dileo v. Ernst & Young, 901 F.2d at 629.

¹⁹ See Robin v. Arthur Young & Co., 915 F.2d 1120, 1127 (7th Cir 1990).

²⁰ Arthur Andersen’s website reports that revenues for 2001 were \$9.34 billion. See www.andersen.com. Also, the \$100 million figure was the expected revenue per year that Andersen partners foresaw in the future, when overall revenues would presumably also increase.

securities frauds - - e.g., Waste Management, Sunbeam, HBOCMcKesson, The Baptist Foundation, and Global Crossing - - that culminated in its disastrous association with Enron. Those who wish to view the recent corporate scandals as simply the work of a “few bad apples” may seek to characterize Arthur Andersen as a deviant firm, in effect an “outlaw” that masqueraded as an honest sheriff. This theory, however, simply does not hold water. The available evidence in fact suggests that, in terms of the percentage of accounting restatements experienced by its audit clients, Andersen was not significantly different from its peers and experienced the same (or lesser) rate of financial restatements.²¹ To the extent it was different, the leading difference may have been only that it was less lucky. All in all, the more logical inference to draw from the “accounting irregularity” scandals of 2001-2002 is that an erosion in the quality of financial reporting occurred sometime during the 1990s.

Indeed, this is the area where the data seems the clearest. During the 1990s, earnings restatements, long recognized as a proxy for fraud, suddenly soared. One study, conducted in 2001 by Moriarty and Livingston, found that the number of earnings restatements by publicly held corporations averaged 49 per year from 1990 to 1997, next increased to 91 in 1998, and

²¹ Compared to its peers within the Big Five accounting firms, Arthur Andersen appears to have been responsible for less than its proportionate share of earnings restatements. While it audited 21% of Big 5 audit clients, it was responsible for only 15% of the restatements experienced by the Big Five firms between 1997 and 2001. On this basis, it was arguably slightly more conservative than its peers. See APeriscope: How Arthur Andersen Beggars for Business, @ Newsweek, March 18, 2002, at p. 6. In discussions with industry insiders, the only respect in which I have ever heard Andersen characterized as different from its peers in the Big Five was that it marketed itself as a firm in which the audit partner could make the final call on difficult accounting questions without having to secure approval from senior officials within the firm. Although this could translate into a weaker system of internal controls, this hypothesis seems inconsistent with Arthur Andersen’s apparently below average rate of earnings restatements.

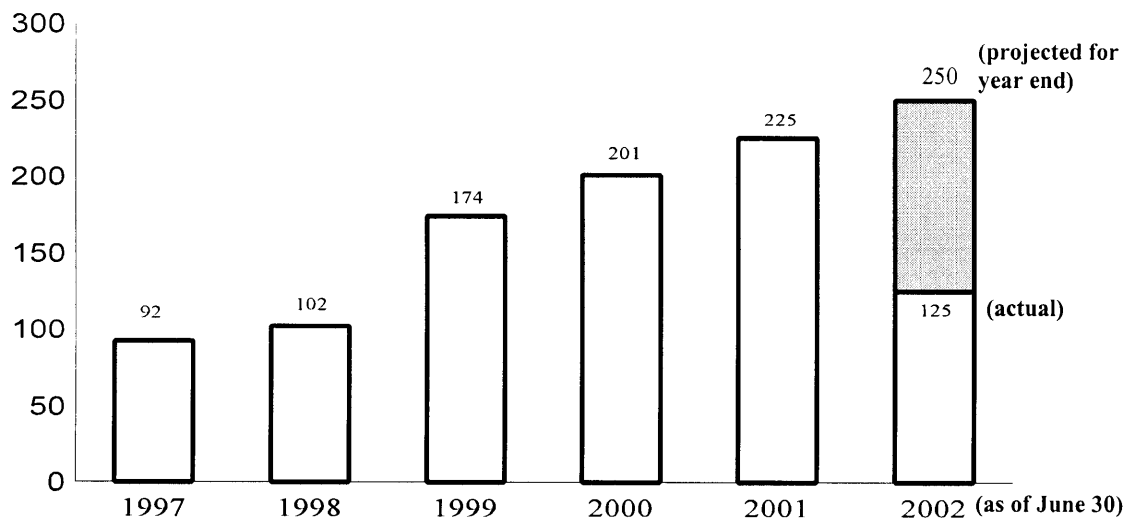
then skyrocketed to 150 and 156 in 1999 and 2000, respectively.²² A later, fuller study conducted by the United States General Accounting Office in October, 2002, examined all financial statement restatements (not just earnings restatements) and also found a similarly sharp, discontinuous spike in 1999 that has continued through 2002.²³ The GAO Study's data shows the following trend line:²⁴

²² See Moriarty and Livingston, Quantitative Measures of the Quality of Financial Reporting, 17 Financial Executive 53, 54 (July/August 2001).

²³ See United States General Accounting Office, Report to the Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses and Remaining Challenges (October 2002) (GAO-03-138) at 4-5 (hereinafter, "GAO Study").

²⁴ Id. at 15.

Figure 1: Total Number of Restatement Announcements Identified, 1997-2002



Not all restatements, however, are equal. Some may involve small, infrequently traded companies or involve only trivial changes or trigger only modest stock price reactions, while others may be on a scale with Enron or WorldCom. Therefore, it is useful to focus more precisely on financial statement restatements by companies listed on the NYSE, Amex, and

Nasdaq, thereby excluding smaller companies that trade only on regional exchanges or over the counter. On this basis, between 1997 and 2001, the proportion of listed companies on the NYSE, Amex and Nasdaq that restated their financial statement approximately tripled, increasing from less than 0.89 percent in 1997 to approximately 2.5 percent in 2001.²⁵ Indeed, the GAO Study further predicted that this percentage would reach nearly 3 percent in 2002.²⁶ Overall, the GAO Study found that from January 1997 to June 2002, approximately “10 percent of all listed companies announced at least one restatement.”²⁷ Also noteworthy was the fact that the size (in terms of market capitalization) of the typical restating company rose rapidly over this period,²⁸ and in 2002, companies listed on the NYSE or Nasdaq accounted for over 85 percent of all restatements identified in that year.²⁹

In theory, financial restatements could simply be the product of changes in regulatory rules and this could signify relatively little. But any possibility that issuers are indifferent to restatements can quickly be dispelled. In the real world, issuers resist restatements because they fear that stock price drops, securities class actions, and SEC investigations generally follow in the wake of financial statement restatements. Indeed, the GAO Study found that stock prices of restating companies over the 1997 to 2001 period suffered an immediate market-adjusted decline of almost 10 percent on average, measured on the basis of the stock’s three day price movement

²⁵ Id. at 4.

²⁶ Id.

²⁷ Id.

²⁸ Specifically, the average (median) size by market capitalization of a restating company rose from \$500 million (\$143 million) in 1997 to \$2 billion (\$351 million) in 2002. Id.

²⁹ Of the 125 actual restatements identified through mid-2002, 54 were listed on Nasdaq, and 53 were listed on the NYSE (for a total of 107 or 85%). Id.

from the trading day before the announcement through the trading day after the announcement.³⁰ Between 1997 to 2002, restating firms lost over \$100 billion in market capitalization just over this three trading day period surrounding a restatement announcement.³¹ Given these significant and adverse stock price effects, it is implausible to read the sharp increase in restatements at the end of the 1990s as the product of any new tolerance for, or indifference to, restatements. Even if (as some audit firms have contended) some portion of the change might be attributed to a new SEC pronouncements or, more generally, to a SEC activism about earnings management,³² which became an SEC enforcement priority by 1998,³³ this explanation cannot carry us very far. Although SEC activism might trigger some increase in the number of restatements, it cannot explain the growth in the magnitude of restatements or the sharp stock price decline (averaging 10%) on their announcement.³⁴ “Technical” restatements made simply to comply with new SEC

³⁰ *Id.* at 5. The GAO Study also found a longer term market-adjusted decline of 18 percent over the period from 60 trading days before the announcement to 60 trading days after the announcement. *Id.* at 29.

³¹ *Id.* at 28.

³² Accounting firms have sometimes attempted to explain this increase in restatements on the basis that the SEC tightened the definition of materiality in the late 1990s. This explanation is not very convincing, in part because the principal SEC statement that tightened the definition of materiality - Staff Accounting Bulletin No. 99 - was issued in mid-1999, after the number of restatements had already begun to soar in 1998. Also, SAB No. 99 did not truly mandate restatements, but only advised that any rule of thumb employed by auditors and issuers that assumed that amounts under 5% were inherently immaterial could not be applied reflexively. See Staff Accounting Bulletin No. 99, 64 F.R. 45150 (August 19, 1999).

³³ The SEC's prioritization of earnings management as a principal enforcement target can be approximately dated to SEC Chairman Arthur Levitt's now famous speech on the subject in 1998. See Arthur Levitt, *The Numbers Game*, Remarks at NYU Center for Law and Business (Sept. 28, 1998).

³⁴ See text and notes *supra* at notes 30 to 31.

interpretations should not produce these stock price reactions. Clearly, such reactions show that the market was surprised.

The available data shows that, during the late 1990s, the magnitude of financial restatements increased, both in absolute terms (nearly doubling) and as a percentage of the issuer's rapidly increasing market capitalization.³⁵ This suggests that managers became progressively willing over this period to take greater risks. Moreover, as the decade of the 1990s wore on, earnings restatements were increasingly experienced by large, mature, publicly-held firms, rather than by smaller or newly public companies that might be expected to be more inexperienced or rash. Managerial behavior within the largest firms then seems to have changed over this period.

In particular, the GAO Study's data corroborates this interpretation that managerial behavior changed, because it shows a significant change in motive. Although there are many reasons why a company may restate its financial statements (e.g., to adjust costs or expenses or to recognize liabilities), one particular reason dominated during the period from 1997 to 2002. The GAO study found that issues involving revenue recognition accounted for almost 39 percent of the 919 announced restatements that it identified over the 1997 to 2002 period.³⁶ In effect, attempts by management to prematurely recognize income appear to have been the most common cause of restatements. Earlier in the decade and during prior decades, earnings

³⁵ According to Moriarty and Livingston, *supra* note 22, companies that restated earnings suffered market losses of \$17.7 billion in 1998, \$24.2 billion in 1999, and \$31.2 billion in 2000. *Id.* at 55. Expressed as a percentage of the overall capitalization of the market (which was ascending hyperbolically over this period), these losses for 1998 through 2000 came to 0.13%, 0.14% and 0.19%, respectively, of market capitalization. In short, however expressed, the relative size of the losses increased over this period.

³⁶ See GAO Study, *supra* note 4, at 5. Revenue recognition was also the leading reason for restatements in each individual year over this period. *Id.*

management was more a game of “smoothing out” the peaks and valleys in a corporation’s income flow in order to reduce the apparent volatility in the corporation’s returns. Thus, managements characteristically attempted to hide “excess earnings” in “rainy day reserves” in order to use such funds later to smooth out undesired declines in the firm’s earnings.

Despite this earlier preference for income-smoothing, by the end of the 1990s, these same firms were robbing future periods for earnings that could be recognized immediately. In short, “income smoothing” gave way to more predatory behavior. Interestingly, restatements involving revenue recognition produced disproportionately large losses.³⁷ Seemingly, the market feared revenue-timing restatements more than others because of the apparent signal they carried that reported earnings could not be trusted. Yet, despite the market’s antipathy for them, revenue recognition restatements became the most common form of restatement. At a minimum, this suggests that the interests of management and shareholders were not aligned, and gatekeepers appear to have been progressively caught in the middle.

B. Security Analysts During the 1990s

Before any attempt is made to generalize about the motivations that led managements to pressure their auditors for premature revenue recognition, it is useful to recognize that this pattern of increased acquiescence by the gatekeeper to its clients’ demands during the 1990s was not limited to the auditing profession. Security analysts are probably the only other profession that has experienced equivalent (or harsher) criticism since the collapse of the high-tech bubble in 2000. Again, growing conflicts of interest appear to explain their change in behavior.

³⁷ While revenue recognition restatements accounted for 39 percent of restatements over the 1997 to 2002 period, they were associated with \$56 billion (or roughly 56%) of the \$100 billion in market capitalization that restating companies lost over this period. *Id.* at 28.

Some of the evidence relating to gatekeeper failure involving analysts is anecdotal, but striking. As late as October 2001, shortly before Enron's bankruptcy, 16 out of the 17 securities analysts covering Enron maintained a buy or a strong buy recommendations on its stock.³⁸ Yet, months earlier as of December 31, 2000, Enron already had a stock price that was 70 times earnings and six times its book value, and had earned an 89% return for the year (despite a 9% decrease over the same period for the S&P 500 index).³⁹ Such a profile should have seemingly alerted any analyst who was even half awake to the possibility that Enron was seriously overvalued. Symptomatically, however, the first brokerage firm to downgrade Enron to a sell rating in 2001 was Prudential Securities, which did not then engage in investment banking activities.⁴⁰ Prudential was also believed to have the highest proportion of sell ratings among the stocks it evaluated.⁴¹ Perhaps, Prudential also woke up late, but it is still at least revealing that the least conflicted were the first to awake.

How close then are the similarities between analysts and auditors? Much like auditors, analysts are also reputational intermediaries, whose desire to be perceived as credible and objective may often be subordinated to their desire to retain and please investment banking

³⁸ See "Statement of Frank Torres, Legislative Counsel, Consumers Union, Before the United States Senate, Committee on Governmental Affairs, on the Collapse of Enron: The Role Analysts Played and the Conflicts They Face," February 27, 2002, at p.6 ("In the case of Enron, 16 out of 17 analysts had a buy or a strong buy rating, one had a hold, none had a sell - - even as the company stock had lost over half its value and its CEO suddenly resigned."). 2002 WL 2011028; see also testimony of Frank Partnoy, Professor of Law, University of San Diego School of Law, Hearings before the United States Senate Committee on Governmental Affairs, January 24, 2002 (similar 16 out of 17 tabulation).

³⁹ See Paul M. Healy and Krishna Palepu, *Governance and Intermediation Problems in Capital Markets: Evidence From the Fall of Enron* (Harvard NOM Research Paper No. 02-27) (August 2002) at 2.

⁴⁰ See Lauren Young, *Independence Day*, SMARTMONEY, May 1, 2001, p. 28. Vol. XI, No. V, 2002 WL 2191410.

⁴¹ Id.

clients. One statistic inevitably comes up in any assessment of analyst objectivity: namely, the curious fact that the ratio of Abuy@ recommendations to Asell@ recommendations has recently been as high as 100 to 1.⁴² In truth, this particular statistic may not be as compelling as it initially sounds because there are obvious reasons why Abuy@ recommendations will normally outnumber Asell@ recommendations, even in the absence of conflicts of interest.⁴³ Yet, a related statistic may be more revealing because it underscores the apparent transition that took place in the 1990s and parallels the earlier noted increase in accounting restatements during the 1990s. According to a study by Thomson Financial, the ratio of Abuy@ to Asell@ recommendations increased from 6 to 1 in 1991 to 100 to 1 by 2000.⁴⁴

Other evidence corroborates this picture of a systematic analyst bias towards optimism. Studying security analyst career patterns over the last two decades, Hong and Kubik find that career advancement for analysts depended more on a bias towards optimism than on the overall

⁴² A study by Thomas Financial/First Call has found that less than one percent of the 28,000 stock recommendations issued by brokerage firm analysts during late 1999 and most of 2000 were Asell@ recommendations. See Opening Statement of Congressman Paul E. Kanjorski; Ranking Democratic Member, House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, AHearing on Analyzing the Analysts,@ June 14, 2001 at p. 1 (citing and discussing this study).

⁴³ ASell-side@ analysts are employed by brokerage firms that understandably wish to maximize brokerage transactions. In this light, a Abuy@ recommendation addresses the entire market and certainly all the firm's customers, while a Asell@ recommendation addresses only those customers who own the stock (probably well less than 1%) and those with margin accounts who are willing to sell the stock Ashort.@ In addition, Asell@ recommendations annoy not only the issuer company, but also institutional investors who are afraid that sell recommendations will Aspook@ retail investors, causing them to panic and sell, while the institution is Alocked into@ a large position that cannot easily be liquidated.

⁴⁴ See Opening Statement of Congressman Paul E. Kanjorski, *supra* note 42, at 1. (citing study by First Call).

accuracy of their forecasts.⁴⁵ Although accuracy did matter, a tendency to be more optimistic than the consensus of analysts seemed to protect analysts from downward movement within their industry's hierarchy, and this tendency was most pronounced in the case of analysts who covered stocks underwritten by their own firms.⁴⁶ More importantly, this tendency for optimism to outweigh accuracy increased during the late 1990s.⁴⁷ They interpret their findings as at least consistent with the view "that Wall Street lost any self-discipline to produce accurate research during the recent stock market mania."⁴⁸ Perhaps, this assessment overstates, but the conclusion seems hard to escape that something happened during the 1990s that compromised the independence and objectivity of the gatekeepers on whom our private system of corporate governance depends.⁴⁹ Even before Enron, much evidence showed that the most sophisticated market participants understood the extent of these conflicts and had ceased to rely on "sell side" analysts.⁵⁰

C. Explaining Gatekeeper Failure.

⁴⁵ See Harrison Hong and Jeffrey Kubik, Analyzing the Analysts: Career Concerns and Biased Earnings Forecasts, 58 J. Fin. 313 (2003).

⁴⁶ Id. at 341.

⁴⁷ Id. at 342 and 346 (finding that between 1996 and 2000, a strong bias towards optimism decreased an analyst's risk of downward movement in the industry).

⁴⁸ Id. at 345-46.

⁴⁹ Participants in the industry also report that its professional culture changed dramatically in the late 1990s, particularly as investment banking firms began to hire Astar® analysts for their marketing clout. See Gretchen Morgenson, A Requiem for an Honorable Profession, New York Times, May 5, 2002, at Section 3-1 (suggesting major change dates from around 1996).

⁵⁰ Although the empirical evidence is limited, it suggests that A independent® analysts (i.e., analysts not associated with the underwriter for a particular issuer) behave differently than, and tend to outperform, analysts who are associated with the issuer's underwriter. See R. Michaely and K. Womack, Conflict of Interest and the Credibility of Underwriter Analyst Recommendations, 12 Review of Financial Studies 653 (1999).

The same observation has probably occurred to many: none of the watchdogs that should have detected Enron's collapse - - auditors, analysts or debt rating agencies - - awoke before the penultimate moment. This is the common denominator, not just in the case of Enron, but also in many of the other "accounting irregularity" cases of 2001-2002. What plausible hypothesis can explain the collective failure of these gatekeepers? Here, several different, although ultimately complementary, stories can be told. Initially, this section will first review two generalized stories: the first will be called the "general deterrence" story; and the second, the "bubble" story. Then, it will focus on allocating responsibility among gatekeepers, managers, and investors.

1. The Deterrence Explanation: The Underdeterred Gatekeeper

The general deterrence story focuses on the decline in the expected liability costs associated with acquiescence by auditors in aggressive accounting policies favored by managements. It postulates that, during the 1990s, the risk of auditor liability declined, while the benefits of acquiescence increased. Economics 101 teaches us that when the costs go down, while the benefits associated with any activity go up, the output of the activity will increase. Here, the activity that increased was auditor acquiescence.

Prior to the 1990s, auditors faced a very real risk of civil liability, principally from class action litigation.⁵¹ Why did the legal risks go down during the 1990s? The obvious list of reasons would include:

⁵¹ As of 1992, Congress was advised that the securities fraud litigation costs for just the six largest accounting firms (then the "Big Six") accounted for \$783 million, or more than 14% of their audit revenues. Potential exposure to loss was in the billions. See Private Litigation Under the Federal Securities Laws: Hearings Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 103rd Cong., 1st Sess. No.103-431 (1993) (statement of Jake L. Netterville), reprinted in Fed. Sec. L. Rep. (CCH) No. 1696, (January 10, 1996). One major auditing firm, Laventhol & Horwath, did fail and entered bankruptcy as a result of litigation and associated scandals growing out of the

(a) the Supreme Court's Lampf, Pleva decision, which in 1991 significantly shortened the statute of limitations applicable to securities fraud;⁵²

(b) the Supreme Court's Central Bank of Denver decision,⁵³ which in 1994 eliminated private "aiding and abetting" liability in securities fraud cases;

(c) the Private Securities Litigation Reform Act of 1995 ("PSLRA"), which (i) raised the pleading standards for securities class actions to a level well above that applicable to fraud actions generally; (ii) substituted proportionate liability for "joint and several" liability; (iii) restricted the sweep of the RICO statute so that it could no longer convert securities fraud class actions for compensatory damages into actions for treble damages; and (iv) adopted a very protective safe harbor for forward-looking information;⁵⁴ and

(d) the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), which abolished state court class actions alleging securities fraud.⁵⁵

savings and loan scandals of the 1980s. See "What Role Should CPA's be Playing in Audit Reform?," Partner's Report for CPA Firm Owners, April, 2002 (discussing experience of Laventhol & Horwath). The accounting profession's bitter experience with class litigation in the 1980s and 1990s probably explains why it became the strongest and most organized champion of the Private Securities Litigation Reform Act of 1995.

⁵² Lampf, Pleva, Lipkind & Petigrow v. Gilbertston, 501 U.S. 350, 359-61 (1991) (creating a federal rule requiring plaintiffs to file within one year of when they should have known of the violation underlying their action, but in no event more than three years after the violation). This one to three year period was typically shorter than the previously applicable limitations periods which were determined by analogy to state statutes and often permitted a five or six year delay - - if that was the period within which a common law fraud action could be maintained in the particular state.

⁵³ Central Bank of Denver, N.A., v. First Interstate of Denver, N.A., 511 U.S. 164 (1994).

⁵⁴ The relevant provisions of the PSLRA are contained in Section 21D of the Securities Exchange Act of 1934, except for the "safe harbor," which is in Section 21E of that Act.

⁵⁵ See Pub. L. No. 105-353, 112 Stat. 3227 (codified in scattered sections of 15 U.S.C.). For an analysis and critique of this statute, see Richard Painter,

The individual impact of each of these changes probably cannot be reliably measured, but their concurrent aggregate impact is clear: they greatly reduced the plaintiffs' incentives in securities class actions to sue secondary participants, such as auditors, analysts, and attorneys. As an SEC study noted, the number of audit-related suits filed against the then "Big Six" accounting firms in 1990 to 1992 was 192, 172, and 141, respectively.⁵⁶ Yet, in the first year following the passage of the PSLRA (1996), the SEC found that out of the 105 securities class actions it found to have been filed in that year, accounting firms were named in only six cases, corporate counsel in no cases, and underwriters in nineteen cases.⁵⁷ It concluded:

"Secondary defendants such as accountants and lawyers, are being named less frequently in securities class actions."⁵⁸

Responding to A False Alarm: Federal Preemption of State Securities Fraud Causes of Action, 84 Cornell L. Rev. 1 (1998).

⁵⁶ See U.S. Securities and Exchange Commission, Office of the General Counsel, REPORT TO THE PRESIDENT AND THE CONGRESS ON THE FIRST YEAR OF PRACTICE UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995. (April, 1997) at 22 (available on SEC website at <http://www.sec.gov/news/studies/lreform.txt>). The figures for the years 1990 to 1992 were reported to the SEC by the Big Six and include all class actions against them, which could include some non-securities class actions. Nonetheless, the number of such non-securities actions seems likely to have been small. As the above SEC study further notes: "[D]uring the period from 1991 through June 1996, accountants were defendants in 52 reported settlements (as opposed to complaints),...and law firms were defendants in 7. Thus, there seems to be a real decline in the number of lawsuits against secondary defendants." *Id.* at 22. This low incidence of securities class actions against auditors appears to have continued through 2001--and then began to rise dramatically. See PriceWaterhouseCoopers LLP 2002 Securities Litigation Study (2003) at 7 (reporting that number of securities class actions against auditors fell from 1998 to 2001).

⁵⁷ U.S. Securities and Exchange Commission, *supra* note 56, at 21 to 22.

⁵⁸ *Id.* at 4. As this study expressly noted, this decline could have been caused both by the PSLRA and the Supreme Court's decision in Central Bank of Denver in 1994 that ended private "aiding and abetting" liability under Rule 10b-5. See text and notes *supra* at notes 54 to 55.

Not only did the threat of private enforcement decline, but the prospect of public enforcement similarly subsided. In particular, there is reason to believe that, from some point in the 1980s until the late 1990s, the SEC shifted its enforcement focus away from actions against the Big Five accounting firms towards other priorities.⁵⁹ In any event, the point here is not that any of these changes were necessarily unjustified or excessive, but rather that their collective impact was to appreciably reduce the risk of liability. Auditors were the special beneficiaries of many of these provisions. For example, the pleading rules and the new standard of proportionate liability protected them far more than it did most corporate defendants.⁶⁰ Although auditors are still sued today, the settlement value of cases against auditors has gone way down.

⁵⁹ This point has been orally made to me by several former SEC officials, including Stanley Sporkin, the long-time former head of the Commission's Division of Enforcement. They believe that the SEC's enforcement action against Arthur Andersen, which was resolved in June, 2001, was one of the very few (and perhaps the only) enforcement action brought against a Big Five accounting firm on fraud grounds during the 1990's. See *Securities and Exchange Commission v. Arthur Andersen LLP*, SEC Litigation Release No. 17039, 2001 SEC LEXIS 1159 (June 19, 2001). Although the Commission did bring charges during the 1990s against individual partners in these firms, the Commission appears to have been deterred from bringing suits against the Big Five themselves because such actions were extremely costly in manpower and expense and the defendants could be expected to resist zealously. In contrast, during the 1980s, especially during Mr. Sporkin's tenure as head of the Enforcement Division, the SEC regularly brought enforcement actions against the Big Five.

⁶⁰ At a minimum, plaintiffs today must plead with particularity facts giving rise to a *Astrong* inference of fraud. See, e.g., *Novak v. Kasaks*, 216 F.3d 300 (2d Cir. 2000), cert. denied, 521 U.S. 1012 (2000). At the outset of a case, it may be possible to plead such facts with respect to the management of the corporate defendant (for example, based on insider sales by such persons prior to the public disclosure of the adverse information that caused the stock drop), but it is rarely possible to plead such information with respect to the auditors (who by law cannot own stock in their client). In short, the plaintiff faces a "Catch 22" dilemma in suing the auditor: it cannot plead fraud with particularity until it obtains discovery, and it cannot obtain discovery under the PSLRA until it pleads fraud with particularity.

Correspondingly, the benefits of acquiescence to auditors rose over this same period, as the Big Five learned during the 1990s how to cross-sell consulting services and to treat the auditing function principally as a portal of entry into a lucrative client. Prior to the mid-1990s, the provision of consulting services to audit clients was infrequent and insubstantial in the aggregate.⁶¹ Yet, according to one recent survey, the typical large public corporation now pays its auditor for consulting services three times what it pays the same auditor for auditing services.⁶² Not only did auditing firms see more profit potential in consulting than in auditing, but they also began during the 1990s to compete based on a strategy of *low balling* under which auditing services were offered at rates that were marginal to arguably below cost. The

⁶¹ Consulting fees paid by audit clients exploded during the 1990s. According to the Panel on Audit Effectiveness, who was appointed in 1999 by the Public Oversight Board at the request of the SEC to study audit practices, *audit firms' fees from consulting services for their SEC clients increased from 17% ... of audit fees in 1990 to 67% . . . in 1999.* See the Panel on Audit Effectiveness, *REPORT AND RECOMMENDATIONS* (Exposure Draft 2000), at p. 102. In 1990, the Panel found that 80% of the Big Five firms' SEC clients received no consulting services from their auditors, and only 1% of those SEC clients paid consulting fees exceeding their auditing fees to the Big Five. *Id.* at 102. While the Panel found only marginal changes during the 1990s, later studies have found that consulting fees have become a multiple of the audit fee for large public corporations. See text and note *infra* at note 62.

⁶² A survey by the Chicago Tribune this year finds that the one hundred largest corporations in the Chicago area (determined on the basis of market capitalization) paid consulting fees to their auditors that were on average over three times the audit fee paid the same auditor. See Janet Kidd Stewart and Andrew Countryman, *Local Audit Conflicts Add Up: Consulting Deals, Hiring Practices In Question*, *Chicago Tribune*, February 24, 2002, at C-1. The extreme example in this study was Motorola, which had over a 16:1 ratio between consulting fees and audit fees.

rationale for such a strategy was that the auditing function was essentially a loss leader by which more lucrative services could be marketed.

Although this argument that the provision of consulting services eroded auditor independence has considerable explanatory power, there is an obvious reply: those who defend the propriety of consulting services by auditors respond that the growth of consulting services made little real difference, because the audit firm was already conflicted by the fact that the client paid its fees. Put as bluntly as possible, the audit partner of a major client (such as Enron) is always conflicted by the fact that such a partner has virtually a *one-client* practice. Whoever is the gatekeeper - - attorney, auditor, or analyst - - a “one client” practice compromises the agent. Should the partner lose that client for any reason, the partner will likely need to find employment elsewhere. In short, both critics and defenders of the status quo tend to agree that the individual audit partner is already inevitably compromised by his or her desire to hold the client on whom the agent’s career depends. From this premise, a prophylactic rule prohibiting the firm’s involvement in consulting would seemingly achieve little.

Even if true in part, this rebuttal nonetheless misses one key point: namely, the difficulty faced by the client in firing the auditor in the real world. As discussed below, there are real costs associated with firing an auditor (but, in contrast, none to speak of in firing a consultant). Given this disparity, an unintended consequence of combining consulting services with auditing services in one firm is that the union of the two enables the client to more effectively threaten the auditing firm in a *low visibility* way. To illustrate this point, let us suppose, for example, that a client becomes dissatisfied with an auditor who refuses to endorse an aggressive accounting policy favored by its management. Today, the client cannot easily fire the auditor. Firing the

auditor may result in public embarrassment, potential public disclosure of the reasons for the auditor's dismissal or resignation, or a probable SEC intervention.⁶³ However, if the auditor also becomes a consultant to the client, the client can then easily terminate the auditor as a consultant (or reduce its use of the firm's consulting services) in retaliation for the auditor's intransigence. This low visibility response neither requires any disclosure, nor invites any SEC oversight, and yet incentivizes the audit firm to replace the intransigent audit partner. In effect, the client can bribe (or coerce) the auditor in its core professional role by raising (or reducing) its use of consulting services.

Of course, this argument that the client can discipline and threaten the auditor/consultant in ways that it could not discipline the simple auditor is based more on logic than actual case histories. But it does fit the available data. A recent study by academic accounting experts, based on proxy statements filed during the first half of 2001, finds that those firms that purchased more non-audit services from their auditor (as a percentage of the total fee paid to the audit firm) were more likely to fit the profile of a firm engaging in earnings management.⁶⁴

2. The Market Bubble Story

⁶³ Item 4 (Changes in Registrants Certifying Accountant) of Form 8-K requires a reporting company to file a Form 8-K within five days after the resignation or dismissal of the issuer's independent accountant or that of the independent accountant for a significant subsidiary of the issuer. The Form 8-K must then provide the elaborate disclosures mandated by Item 304 of Regulation S-K relating to any dispute or disagreement between the auditor and the accountant. See 17 CFR 228.304 (Changes in and Disagreements With Accountants on Accounting and Financial Disclosure).

⁶⁴ See Richard Frankel, Marilyn Johnson, and Karen Nelson, The Relation Between Auditors' Fees for Non-Audit Services and Earnings Quality, MIT Sloan Working Paper No. 4330-02 (available from Social Sciences Research Network at www.ssrn.com at id= 296557). Firms purchasing more non-audit services were found more likely to just meet or beat analysts' forecasts, which is the standard profile of the firm playing the numbers game.

Alternatively, Enron's and Arthur Andersen's downfalls, and the host of other sudden stock declines in 2001 to 2002, can be seen as the consequence of a classic bubble that overtook the equity markets in the late 1990s and produced a market euphoria.⁶⁵ But what exactly is the connection between a market bubble and gatekeeper failure? Here, a hypothesis needs to be advanced that cannot be rigorously proven, but that is consistent with modern behavioral economics: in a bubble, gatekeepers become less relevant and hence experience a decline in both their leverage over their client and the value of their reputational capital. That is, in an atmosphere of market euphoria, investors rely less on gatekeepers, and managements in turn regard them as more a formality than a necessity. Gatekeepers provide a critical service only when investors are cautious and skeptical and therefore rely on their services. Conversely, in a market bubble, caution and skepticism are by definition largely abandoned. In such an environment, auditors continue to be used more because SEC rules mandate their use (or because no individual firm wishes to call attention to itself by becoming the first to dispense with them) than because investors actually demand their use. As a result, because gatekeepers have reduced relevance in such an environment, they also have reduced leverage with their clients. Thus, if we assume that the auditor will be largely ignored by euphoric investors, the rational auditor's best

⁶⁵ The literature on bubbles is now burgeoning. Perhaps the best known scholar in this field was Charles Kindleberger, who viewed bubbles as "demand determined" and the product of irrational investors. See Charles P. Kindleberger, *MANIA, PANICS AND CRASHES: A History of Financial Crises* (2000) at 76-78. See also Robert J. Shiller, *IRRATIONAL EXUBERANCE* (2001); Andrei Schleifer, *INEFFICIENT MARKETS* (2000); Kenneth A. Froot & Maurice Obstfeld, *Intrinsic Bubbles: The Case of Stock Prices*, 81 *Amer. Econ. Rev.* 1189 (1991). While most of these recent accounts focus on and assign causal responsibility to "noise traders," the account offered here focuses more on a behavioral phenomenon: "persistence bias" and the tendency of investors to expect recent exceptional returns to continue.

competitive strategy (at least for the short term) was to become as acquiescent and low cost as possible.

Although this thesis assigns some causal responsibility to investors, themselves, for their own losses, it does not absolve gatekeepers from responsibility. For example, even if shareholders do not care much during a bubble about the auditor's reputation, it is still possible for an auditor to intervene effectively and prevent fraud, either by refusing to certify the issuer's financial statements, by withdrawing its certificate on a later discovery of the fraud, or by notifying the SEC.⁶⁶

The key element in this story involves why investors cease to care about the gatekeeper's reputation. After all, the rise of auditing as a profession was the product of investors' own concerns about fraud and irregularity, not regulatory requirements. What then caused this concern to weaken? Here, behavioral economics supplies a plausible answer. Modern economics recognizes that individuals, including investors, have "bounded rationality" and do not pursue all information relevant to an optimal decision.⁶⁷ The Nobel Prize-winning research of Professors Kahneman and Tversky has in particular demonstrated that individuals typically make decisions by using heuristics - - that is, rules of thumb - - rather than by incorporating all

⁶⁶ Section 10A of the Securities Exchange Act of 1934 requires the auditor of a public company to notify the Commission where the auditor discovers an "illegal act [that] has a material effect on the financial statements of the issuer" and management and the board of the issuer have not taken "timely and appropriate remedial action" after notification by the auditor. See 15 U.S.C. §78(j)(A). Since its adoption in 1995, this provision has been seldom, if ever, employed.

⁶⁷ For overviews of behavioral economics, see Christine Jolis, Cass Sunstein, and Richard Thaler, A Behavioral Approach to Law and Economics, 50 Stan. L. Rev. 1471 (1998); Cass Sunstein, Behavioral Analysis of Law, 64 U.Chi. L. Rev. 1175 (1997). The term "bounded rationality" was coined by Herbert Simon, a Nobel prize winner, and is broadly accepted by most economists. See 1 Herbert A. Simon, Rationality As Process and Product of Thought, 68 Am. Econ. Rev.: Papers & Proceedings 1 (1978).

obtainable information. A heuristic that they find to be pervasively used by individuals and that has particular relevance to the context of securities markets is the “availability heuristic.”⁶⁸ It asserts that individuals estimate the frequency of an event by recalling recent instances of its occurring (even if these instances are normally rare or infrequent, when viewed from a longer term perspective). Hence, if the stock market has recently experienced extraordinary returns for several years, it becomes predictable that individuals will overestimate the likelihood of such extraordinary gains continuing.⁶⁹ In effect, there is a status quo or persistence bias - - what has recently occurred is expected to continue. Thus, as the market soared in the early and mid-1990s, investors, operating on heuristics, came to assume that this pattern would continue. Further aggravating this tendency is the deep-seated bias displayed by many individuals toward optimism in predicting future events.⁷⁰

Thus, from the perspective of behavioral economics, “bubbles” are not irrational moments of speculative excess or frenzy, but rather are the product of the predictable expectations of individuals who tend to assume that whatever has recently occurred will persist. To trigger this persistence bias, it is arguably only necessary that market returns have in fact been extraordinary for a few successive years in order to cause investors to treat this phenomenon as normal and likely to continue. Such an explanation helps us understand why

⁶⁸ See Jolis, Sunstein and Thaler, *supra* note 67, at 1477-78. See also, Amos Tversky and Daniel Kahneman, “Judgment Under Uncertainty: Heuristics and Biases” in JUDGMENT UNDER UNCERTAINTY 3 (Daniel Kahneman, Paul Slovic, and Amos Tversky eds. 1982).

⁶⁹ This is by no means the only way to explain bubbles without resorting to claims of mass delusion. An alternative theory is that institutional money managers have rational incentives to engage in “herding behavior,” preferring a common wrong decision to a risky correct one. See text and notes *infra* at notes 80 to 82.

⁷⁰ See Jolis, Sunstein and Thaler, *supra* note 67, at 1524-25; see also Neil D. Weinstein, Unrealistic Optimism About Future Life Events, 39 J. Personality & Soc. Psychology 806 (1980).

bubbles have re-occurred throughout history. Their re-occurrence is explained not by the hypothesis that investors are inherently gullible, but by the explanation that a period of extraordinary returns creates an expectation that such returns are normal and will persist.

Such heuristic biases are not, of course, the whole story. For the securities analyst, a market bubble presents a different and more serious challenge: during a bubble, those who are cautious and prudent will be outperformed by those who recklessly predict extraordinary returns. Hence, in a bubble, extreme optimism for analysts becomes less a heuristic bias than a competitive necessity. Put more bluntly, it is dangerous to be sane in an insane world. As a result, the securities analyst who prudently predicted reasonable growth and stock appreciation during the 1990s was increasingly left in the dust by the investment guru who prophesized a new investment paradigm in which revenues and costs were less important than the number of Ahits@ on a website.

Institutional factors compounded this problem. As the initial public offering (or “IPO”) market soared in the 1990s, securities analysts became celebrities and valuable assets to their firms;⁷¹ indeed, they became the principal means by which investment banks competed for IPO clients, as the underwriter with the Astar@ analyst could produce the greatest first day stock price spike in an IPO. But as their salaries thus soared, analyst compensation came increasingly from the investment banking side of their firms. Hence, just as in the case of the auditor, the analyst’s economic position became progressively dependent on favoring the interests of persons outside their profession (i.e., consultants in the case of the auditor and investment bankers in the case of

⁷¹ For the view that investment banking firms changed their competitive strategies on or around 1996 and thereafter sought the Apopular, high-profile analyst@ as a means of acquiring IPO clients, see Morgenson, *supra* note 49 at Section 3-1 (quoting chief investment officer at Trust Company of the West).

the analyst) who had little reason to respect or observe the standards or professional culture within the gatekeeper's profession.⁷²

One common denominator linking these examples is that, as auditors increasingly sought consulting income and as analysts became more dependent on an investment banking subsidy, these gatekeepers' normal desire to preserve their reputational capital for the long run become subordinated to their desire to obtain extraordinary returns in the short run by risking that reputational capital. Alternatively, the value of gatekeepers' reputational capital may have simply declined in a bubble, because investors in such an environment rationally reduce their reliance on gatekeeping services based on their false belief that extraordinary returns will persist. Under either story (or both together), it could have become more profitable for firms to realize the value of their reputational capital by trading on it in the short-run than by preserving it forever. Indeed, during the 1990s, to the extent that auditing became a loss leader for multi-service accounting firms eager to sell more lucrative consulting services and, to the extent that securities analysts began to be subsidized by investment banking, each profession became less self-supporting and more dependent on those who wished to profit from the liquidation of their reputational capital.

3. Allocating Responsibility Among Gatekeepers, Managers and Investors

The foregoing explanations still do not fully explain the mechanisms by which reputational capital built up over decades might be sacrificed (or, more accurately, liquidated), once legal risks declined and/or a bubble developed. Because gatekeepers are agents who must

⁷² This idea that professional gatekeepers became dominated by persons outside their profession is at the heart of a recent lawsuit initiated by the New York Attorney General against five chief executive officers of major U.S. corporations. See Patrick McGeehan, "Spitzer Sues Executives of Telecom Companies Over 'Ill Gotten' Gains," New York Times, October 1, 2002, at C-1.

compete in increasingly competitive markets to win and hold clients, changes that affect their principals will necessarily affect them as well. Whether we view the gatekeeper's principal as corporate management or as shareholders, the behavior and incentives of both changed during the 1990s, and thereby placed gatekeepers, as their agents, under increased pressure.

a. The Changing Motivations of Managers. The pressure on gatekeepers to acquiesce in earnings management was not constant over time, but rather accelerated during the 1990s as managerial incentives changed. Executive compensation shifted during the 1990s from being primarily cash-based to being primarily equity-based. By 2001, equity-based compensation constituted approximately two thirds of the median annual compensation of chief executives of large public corporations, up from 8% in the 1990 and 0% in 1984.⁷³ Another measure of this shift is the growth in stock options. Over the last decade, stock options rose from five percent of shares outstanding at major U.S. companies to fifteen percent - - a three hundred percent increase.⁷⁴ The value of these options rose by an even greater percentage and over a dramatically shorter period: from \$50 billion in 1997, in the case of the 2,000 largest corporations to \$162 billion in 2000 - - an over three hundred percent rise in three years.⁷⁵ Stock options create an obvious and potentially perverse incentive to engage in short-run, rather than

⁷³ See Brian J. Hall, "Six Challenges in Designing Equity-Based Pay," in 15 *Accenture Journal of Applied Corporate Finance* 21, at 23 and Figure 1 (Spring 2003).

⁷⁴ See Gretchen Morgenson, "Corporate Conduct: News Analysis; Bush Failed to Stress Need to Rein in Stock Options," *New York Times*, July 11, 2002 at C -1; see also Gretchen Morgenson, "Market Watch: Time For Accountability At the Corporate Candy Store," *New York Times*, March 3, 2002, Section 3, p.1.

⁷⁵ See Morgenson, "Corporate Conduct," *supra* note 74, at C-1 (citing study by Sanford C. Bernstein & Co.). Thus, if \$162 billion is the value of all options in these 2,000 companies, aggressive accounting policies that temporarily raise stock prices by as little as ten percent create a potential gain for executives of over \$16 billion - - a substantial incentive.

long-term, stock price maximization because executives can exercise their stock options and sell the underlying shares on the same day.⁷⁶

The key problem here is not that stock options provide excessive compensation, but that they provide excessive liquidity.⁷⁷ This excess liquidity was, in turn, partially the product of deregulatory reform in the early 1990s, which relaxed the rules under Section 16(b) of the Securities Exchange Act of 1934 to permit officers and directors to exercise stock options and sell the underlying shares without holding the shares for the previously required six month period.⁷⁸ Thus, if executives inflate the stock price of their company through premature revenue recognition or other classic earnings management techniques, they could quickly bail out in the

⁷⁶ See Hall, *supra* note 73, at 24-29 (surveying misincentives in stock options). This point has also been made by a variety of commentators who have called for minimum holding periods or other curbs on stock options. These include Henry M. Paulson, Jr., chief executive of Goldman, Sachs, and Senator John McCain of Arizona. See David Leonhardt, “Corporate Conduct: Compensation: Anger At Executives’ Profits Fuels Support for Stock Curb,” *New York Times*, July 9, 2002, at A-1.

⁷⁷ See Hall, *supra* note 73, at 24-29. It should be noted here that other forms of equity compensation, such as restricted stock, do not give rise to this same conflict because management must either hold the stock longer or can only sell a modest percentage of it in any given year, thus precluding the possibility of a bail-out.

⁷⁸ Rule 16b-3(d) expressly permits an officer or director otherwise subject to the “short-swing” profit provisions of Section 16(b) of the Securities Exchange Act of 1934 to exercise a qualified stock option and sell the underlying shares immediately “if at least six months elapse from the date of the acquisition of the derivative security to the date of disposition of the ... underlying equity security.” See 17 C.F.R. 240.16b-3(d). The SEC comprehensively revised its rules under Section 16(b) in 1991, in part to facilitate the use of stock options as executive compensation and to “reduce the regulatory burden” under Section 16(b). See Securities Exchange Act Release No. 34-28869, 1991 SEC LEXIS 171 (February 8, 1991). A premise of this reform was that “holding derivative securities is functionally equivalent to holding the underlying equity security for purpose of Section 16.” *Id.* at *35 to *36. Hence, the SEC permitted the tacking of the option holding period with the stock’s holding period, thereby enabling officers and directors to exercise options and sell on the same day (if the option had already been held six months).

short-term by exercising their options and selling, leaving shareholders to bear the cost of the stock decline when the inflated stock price could not be maintained over subsequent periods. Given these incentives, it became rational for corporate executives to use lucrative consulting contracts, or other positive and negative incentives, to induce gatekeepers to engage in conduct that assisted their short-term market manipulations. The bottom line is then that the growth of stock options resulted in gatekeepers being placed under greater pressure to acquiesce in short-term oriented financial and accounting strategies.

b. The Role of Investors. Investors cannot be fairly presented as entirely innocent victims in the recent epidemic of financial irregularities. At a minimum, a bubble reflects investors' acquiescence in unrealistic valuations. More importantly, conflicts of interest on the part of gatekeepers that might alarm investors in other circumstances may be accepted (or at least repressed) during a bubble. To be sure, many investors were likely misled by biased analyst research and overstated earnings, but this does not absolve the "buy side" of all responsibility. Particularly in the case of institutional investors, who account for over half the ownership and seventy-five percent of the trading in NYSE-listed equities,⁷⁹ financial intermediaries may again have failed. According to one estimate, at the peak of the market, sixty percent of Enron stock was held by large institutional investors.⁸⁰ Why didn't they see that Enron was overvalued, at least once alarm bells began to sound? A plausible explanation for the failure of institutional investors to respond to warning signals in the case of Enron starts from the premise that professional money managers are principally motivated by the desire to perform no worse than

⁷⁹ For these statistics, see James D. Cox and Randall Thomas, Leaving Money on the Table: Do Institutional Investors Fail to File Claims in Securities Class Actions?, 80 Wash. U. L. Q. 855 n. 4 (2002).

⁸⁰ See Healy and Palepu, *supra* note 39, at 22.

their major institutional rivals; this pressure quickly leads to herding behavior.⁸¹ According to this analysis, fund managers attract investor funds and maximize their fees based on their “quarterly reported performance relative to comparable funds or indices.”⁸² Thus, if a fund manager discovers that Enron is overvalued and sells his firm’s investment, the manager and the managers clients do well - - but only if the market agrees and Enron’s stock price falls that quarter. If the market persists in overvaluing Enron or actually climbs based on biased “sell-side” research, the manager becomes an unfortunately premature prophet, and the manager’s performance relative to his rivals falls. Precisely to the extent that this manager is accountable to the market, clients’ funds flow out of their manager’s account to those of rival fund managers, thereby collapsing like an accordion the funds under his management, so that this manager does not profit significantly even when Enron ultimately does collapse. In such an environment, there is little incentive to be ahead of the crowd and considerable incentive to ride the bubble to its top in order not to underperform rival investment managers. The result is “herding” because, by following the herd, the fund manager will not underperform most of the manager’s rivals. Put differently, the fund manager can survive mistakes that others also make, but will be more severely injured by correct decisions that the market only belatedly recognizes. In turn, this may explain why institutions would herd and follow “sell-side” research that they know to be biased: that is, because they anticipated that others would follow it also, leaving them in the safe position of being part of the herd.

c. The Role of Gatekeepers. This conclusion that even sophisticated investors will follow and rely on “sell-side” research that they know to be biased brings us back to the central

⁸¹ The term “herding” was coined over a decade ago by Scharfstein and Stein. See David S. Scharfstein and Jeremy Stein, Herd Behavior and Investment, 80 Amer. Eco. Rev. 465 (1990); see also Healy and Palepu, *supra* note 39, at 26-27.

⁸² *Id.* at 26.

role of gatekeepers. To some degree, gatekeepers will be followed even when they are not trusted, because it is expected that they will influence the market. In addition, there is evidence that gatekeepers “herd” for careerist reasons. For example, career concerns appear to motivate security analysts not to deviate far from the consensus earnings forecasts, and particularly to avoid downward deviations.⁸³ As a result, it becomes predictable that some degree of bias will distort analyst recommendations (and that such advice will be followed), even when the market expects inflation. Moreover, ending the most obvious conflicts of interest (as Sarbanes-Oxley and related reforms attempt to do) will not solve this problem, because the careerist motives will remain.

4. A Preliminary Evaluation. Does it matter which of the foregoing two stories - - the deterrence story or the bubble story - - is deemed more persuasive? Although they are complementary rather than contradictory, their relative plausibility may bear on whether particular reforms are necessary, desirable, or sufficient. To the extent one accepts the deterrence story, the logical prescription is legal change aimed at restoring an adequate legal threat. In principle, these changes could either raise the costs or lower the benefits of acquiescence to auditors (or both). To the extent one accepts the bubble story, the problem may be self-correcting. That is, once the bubble bursts, gatekeepers come back into fashion, as investors become skeptics who once again demand assurances that only credible reputational intermediaries can provide.⁸⁴ Alternatively, structural reforms may be desirable to enhance the

⁸³ See Harrison Hong, Jeffrey D. Kubik, and Amit Solomon, Security Analysts’ Career Concerns and the Herding of Earnings Forecasts, 31 *RAND Journal of Economics* 121 (2000). See also Hong and Kubik, *supra* note 45, at 341-46 (finding systematic tendency towards overly optimistic advice based on careerist considerations).

⁸⁴ Federal Reserve Chairman Alan Greenspan has indeed suggested that market corrections will largely solve the problems uncovered in the wake of Enron. See

independence of analysts, auditors, and other gatekeepers. Clearly, all gatekeepers are not alike. Thus, the deterrence story may work better for auditors than for analysts, while in the case of analysts, structural reforms aimed at increasing the independence of the gatekeeper may outperform litigation remedies.

5. An International Perspective. Although gatekeepers are universal and found in all systems of corporate governance, corporate governance itself varies widely around the world. In particular, the structure of share ownership is polarized between a system of dispersed ownership that prevails largely in the United States and the United Kingdom (and some other common law countries) and a system of concentrated ownership that is prevalent elsewhere.⁸⁵ In the dispersed ownership structure that characterizes the U.S. and the U.K., controlling shareholders or controlling blocks are uncommon; managers have at least relatively greater autonomy as a result;⁸⁶ and dispersed shareholders must rely on indirect means, such as equity compensation, to

Remarks by Chairman Alan Greenspan, "Corporate Governance" at the Stern School of Business, New York University, New York, New York, March 26, 2002" (available on the Federal Reserve's website at www.federalreserve.gov/boarddocs/speeches/). In his view, earnings management came to dominate management's agenda, and as a result: "It is not surprising that since 1998 earnings restatements have proliferated. This situation is a far cry from earlier decades when, if my recollection serves me correctly, firms competed on the basis of which one had the most conservative set of books. Short-term stock price values then seemed less of a focus than maintaining unquestioned credit worthiness." *Id.* at 4. He goes on to predict that: "A change in behavior, however, may already be in train." *Id.* at 5. Specifically, he finds that "perceptions of the reliability of firms' financial statements are increasingly reflected in yield spreads of corporate bonds" and that other signs of self-correction are discernible. *Id.*

⁸⁵ For an overview of the differences between dispersed and concentrated ownership systems, see John C. Coffee, Jr. The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control, 111 Yale L.J. 1 (2001); for empirical support, see Rafael La Porta, et. al., Corporate Ownership Around the World, 54 J. Fin. 471 (1999).

⁸⁶ This relative autonomy is evidenced by the enormous differential between chief executive compensation in the United States and that in other major economies.

align managers' self-interests with those of the shareholders. In contrast, in concentrated ownership systems, there is normally a controlling shareholder who can directly monitor the firm's management and who thus does not need to rely on indirect mechanisms, such as equity compensation, to incentive management. As a result, Europe has made far less use of stock options and other forms of equity compensation than has the United States and the United Kingdom.

A further reason why European corporations have less incentive to manage for short-term profit maximization is that controlling shareholders seldom, if ever, sell their control blocks into the market; rather, they sell to an incoming controlling shareholder in privately negotiated transactions at a control premium. As a result, they have less interest in the day to day stock price, because it does not determine the price they will receive on such a sale (whereas managers in the U.S. and the U.K. do sell their shares at the market price and so are more concerned with maximizing it).

These factors probably explain why there was no corresponding wave of accounting irregularity cases in Europe when Enron, WorldCom and their progeny exploded across the American business scene in 2001 to 2002. Because European managers were less compensated with equity and because European controlling shareholders had less reason to manage for the short-term, they had far less incentive to "cook the books." To be sure, some accounting irregularity cases did arise in Europe, but they usually had an American dimension. Thus, Royal

According to a study by Towers Perrin, a compensation consulting firm, chief executive compensation as a multiple of average employee compensation is 531 times greater in the United States, but the multiple is only 16 in France, 11 in Germany, 10 in Japan, and 21 in Canada. Even in Britain, which also has dispersed ownership and uses stock options, chief executive compensation is only 25 times average employee compensation. See Gretchen Morgenson, "Explaining (or Not) why the Boss Is Paid So Much," New York Times, January 25, 2004 at Section 3-1.

Ahold, the Dutch retailing firm, experienced a \$1.2 billion fraud, but its accounting irregularities were largely localized within its U.S. Foodservice division.⁸⁷ Similar controversies arose at Skandia Insurance, a Swedish company, and at Vivendi Universal, a French company, but both had sought to convert themselves into American style conglomerates that made frequent acquisitions and utilized equity compensation.⁸⁸ Most recently, problems (and whistleblowers) at the North American subsidiary of Adecco, a Swiss Company and the world's largest employment services company, have triggered the latest financial scandal.⁸⁹ Given this American nexus, European commentators could continue to dismiss Enron and WorldCom as examples of American "greed," which would never arise in Europe.⁹⁰

Then, the Parmalat scandal broke. At least \$4.8 billion in cash simply disappeared from its balance sheet, and approximately \$16 billion in net debt was hidden from the market according to PriceWaterhouseCoopers.⁹¹ Unlike American scandals, the evidence suggests that the fraud had continued for years and had been assisted by Parmalat's bankers. The principal victims were Parmalat's creditors, not its shareholders (indeed, the controlling shareholders appear chiefly responsible for the fraud). Yet, while the end goal of the fraud was different from the typical American scandal, the means used were similar and involved use of some of the same

⁸⁷ See Landler, *supra* note 7, at C-3.

⁸⁸ Id.

⁸⁹ See Fionna Fleck, "2 Executives Resign at Adecco in Fallout Over Its Accounting," *International Herald Tribune*, January 17, 2004 at p. 9; Haig Simonsian, "Adecco's Problems are Shrouded in Mystery," *Financial Times*, January 17, 2004, at 2.

⁹⁰ See Landler, *supra* note 7, at C-3. (quoting Sophie L'Helias, a French corporate governance expert, that "Europeans used to say, 'this could never happen here; such greed is limited to America.'").

⁹¹ See Alessandra Galloni, "Scope of Parmalat's Problems Emerges," *The Wall Street Journal*, January 27, 2004, at A-3; Henry Sender and Michelle Pacelle, "Parmalat Probers Are Likely to Focus On Role of Banks," *The Wall Street Journal*, December 24, 2003 and C-1.

exotic financial engineering that characterized Enron's failure.⁹² Attorneys, auditors and investment bankers have similarly been implicated. In short, gatekeeper failure is now a recognized problem on both sides of the Atlantic.⁹³

But it is not the same problem. While Enron, WorldCom and similar cases appear to have been driven by managers seeking to inflate earnings and maximize the stock price, Parmalat looks more like a fraud primarily directed at creditors and intended to hide the diversion of assets to controlling shareholders.⁹⁴ While accounting irregularities in the U.S. most commonly involve revenue recognition issues relating to the income statement, the characteristic problem in a concentrated ownership system is overstated, fictitious, or diverted assets--in effect, fraud on the balance sheet. In short, different systems of corporate governance have different vulnerabilities: in a dispersed ownership system, the typical securities fraud will be a management-engineered and intended to create a short term stock price spike, while in concentrated ownership systems, the goal is instead to permit controlling shareholders to divert "private benefits of control" to themselves. The common denominator is, however, that gatekeeper acquiescence is necessary for either form of fraud to be consummated.

Part II: The Near Future of Gatekeepers: Sarbanes-Oxley and the Looming Litigation Crisis

Historically, bubbles are followed by crashes, which in turn are followed by punitive legislation.⁹⁵ The 1999-2003 era is fully consistent with this pattern, and this section will focus

⁹² See Sender and Pacelle, *supra* note 91, at C-1.

⁹³ See John Plender, "Problems at Ahold, Parmalat and Now Adecco Raise New Questions About How Global Accounting Firms Should Work With Multinationals and Risk of Modern Investment Management Techniques," *Financial Times*, January 22, 2004 at p. 15.

⁹⁴ See "Parma Splat--European Corporate Governance," *The Economist* (United States Edition), January 17, 2004. (noting that the Tanzi family held 51% of Parmalat's voting power and appears to have diverted assets to itself).

⁹⁵ For a discussion of this cycle over history, see Banner, *supra* note 6.

on the likely impact of these reforms on gatekeepers. Still, because the problem of gatekeeper failure is not uniform, either in its character or intensity, it is important initially to outline the range of strategies that regulators could follow in response to corporate scandals and conflicts of interest.

A. A Typology of Conflict of Interest Reforms

A range of well recognized strategies exist for responding to corporate financial scandals, each of which has well-known precedents. Although other typologies can undoubtedly be constructed, the following four categories probably capture most of the realistic regulatory options:

1. Structural Reform. A new body or agency can be created, either public or private, to monitor conflicts and assure higher quality disclosure. The Securities and Exchange Commission, created by the Securities Exchange Act of 1934 in the wake of the 1929 market crash, is probably the clearest example of such a response, but the creation of the Public Company Accounting Oversight Board (“PCAOB”) by the Sarbanes-Oxley Act to monitor auditing firms is a modern example that follows in its wake.⁹⁶

Structural reforms can also change the obligations of private actors. For example, the law can create a new gatekeeper. In the 1930s, the federal securities laws and the SEC effectively made auditors into gatekeepers for the public (and not just for the clients who retained their services), and to a limited extent Sarbanes-Oxley has imposed new gatekeeping responsibilities

⁹⁶ Title I of the Sarbanes-Oxley Act creates the PCAOB as a regulatory body subject to SEC oversight, and Section 101(c) of the Act further directs the PCAOB to “establish or adopt...auditing, quality control, ethics, independence and other standards relating to the preparation of audit reports for” publicly held issuers. See 15 U.S.C. § 7211(c).

on attorneys and securities analysts. Part III will suggest that these initial steps should be generalized.

2. Prophylactic rules. Fiduciary law has long forbidden some forms of self-dealing between the fiduciary and the beneficiary. Thus, the trustee cannot transact business with the trust estate, because such transactions are either void or voidable. Over the course of the 20th Century, American corporate law largely relaxed the prohibition on self-dealing, provided that certain procedures were followed.⁹⁷ Offsetting this trend in state law, however, the federal securities laws introduced new prophylactic prohibitions, including a prohibition on a corporate officer or director retaining the proceeds of certain forms of short-term trading in his or her company's stock.⁹⁸ Sarbanes-Oxley has now introduced similar rules, most notably including a prohibition on a public company making or arranging for loans to its executives.⁹⁹

3. Independence and empowerment rules. For the gatekeeper to be an effective monitor of management on behalf of investors, it must be independent of management. Sarbanes-Oxley

⁹⁷ For a detailed discussion of the gradual relaxation over the last 150 years of American corporate law of the once standard prophylactic rule against self-dealing, see Harold Marsh, Jr., Are Directors Trustees?, 22 Bus. Law 35 (1966). Essentially, disclosure to, and approval by, disinterested directors replaced proof of the transaction's intrinsic fairness as the necessary precondition to sustaining a self-dealing transaction's validity.

⁹⁸ Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b), mandates that senior officers, directors and 10% shareholders must return to the corporation any profits they make, or losses they avert, on purchasing and selling the corporation's stock in any sequence within six months. The provision is a federal rule intended to discourage manipulation of the corporation's stock price by insiders.

⁹⁹ Section 402 of the Sarbanes Oxley Act, which has been codified as Section 13(k) of Securities Exchange Act of 1934, forbids public companies "directly or indirectly,...to extend or maintain credit, to arrange for an extension of credit, or to renew an extension of credit, in the form of personal loan to or for any director or executive officer...of that issuer." See 15 U.S.C. § 78m(k). This is in effect a throwback to the form of strict prophylactic rule that characterized 19th and early 20th Century American corporate law.

recognized this by transferring all responsibility for the hiring, supervision, retention, and compensation of the auditor to the audit committee, whose own independence it also enhanced.¹⁰⁰ Some have argued that this step does not go far enough; instead, they have proposed procedures by which persons even more independent than directors would select and hire the independent auditor.¹⁰¹ Although the feasibility of these proposals is debatable, they are an example of an “empowerment” rule that increases the independence and thus the monitoring capacity of the gatekeeper.

4. Liability rules. The standard response to a corporate scandal is to enhance liability rules, either by increasing penalties, eliminating defenses, or creating new private causes of action. The Securities Act of 1933 is here the classic example, as it creates virtual strict liability for the corporate issuer if issuer’s registration statement contains a material misstatement or omission.¹⁰² Yet, as discussed below, Sarbanes-Oxley basically did not follow this path, except to the extent that it increased criminal penalties and SEC powers.

B. The Sarbanes-Oxley Act: What It Did and Did Not Do.

¹⁰⁰ Section 301 of the Sarbanes-Oxley Act mandates that the audit committee “be directly responsible for the appointment, compensation, and oversight of the work” of the independent auditor. This provision has been codified as Section 10A(m)(2) of the Securities Exchange Act of 1934.

¹⁰¹ See Joshua Ronen, Post-Enron Reform: Financial Statement Insurance, and GAAP Re-visited, 8 Stan. J.L. Bus. & Finance 39 (2002).

¹⁰² Section 11 of the Securities Act of 1933 creates strict liability for the issuer (but grants a variety of affirmative defenses to secondary participants) if the registration statement contains a material misstatement or omission of which the purchaser was unaware. See 15 U.S.C. § 77(k).

Passed almost without dissent, the Sarbanes-Oxley Act essentially addresses the problem of accounting irregularities by shifting control of the accounting profession from the profession to a new body: the Public Company Accounting Oversight Board (“PCAOB”), which is authorized to regulate the profession, establish auditing standards, and impose professional discipline.¹⁰³ Conceptually, this is not a new approach, as the PCAOB’s authority largely parallels that of the National Association of Securities Dealers (“NASD”) over securities brokers and dealers. What is new, however, is explicit recognition of the significance of conflicts of interest, because the Act expressly bars auditors from providing a number of categories of professional services to their audit clients and further authorizes the PCAOB to prohibit additional categories of consulting services.¹⁰⁴ To be sure, auditors might still be compromised by the ability of management to reduce their audit fees, or terminate them as the company’s auditor, but Sarbanes-Oxley addresses these concerns by transferring all control and supervision of the auditor to the audit committee, whose independence it also enhanced.¹⁰⁵ Thus, to the extent that conflicts of interest compromised auditors, the Act responds with a relevant answer.

Yet, if Enron and similar cases of accounting irregularities were more caused by the principal than the agent and were the product of the increased incentive of corporate executives

¹⁰³ Section 101(c) of the Act enumerates broad powers, including the authority to “establish ... auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers....”

¹⁰⁴ Section 201 of the Act, which is to be codified as Section 10A(g) of the Securities Exchange Act of 1934, specifies eight types of professional services which the auditor of a public company may not perform for its audit client, and also authorizes the PCAOB to prohibit additional services if it determines that they may compromise auditor independence.

¹⁰⁵ Section 301 of the Sarbanes-Oxley Act gives the audit committee full responsibility for supervision and compensation of the outside auditor. See text and note at note 100 supra. In addition, Section 301 establishes minimum standards for audit committee members and bars them from accepting “any consulting, advisory or other compensatory fee from the issuer.” See Section 10A(m)(3)(B) of the Securities Exchange Act of 1934.

to “cook the books” because of the temptations created by stock options, then Sarbanes-Oxley is less clearly responsive to these problems. Nor does it increase the deterrent threat facing gatekeepers to offset the predictably increased pressure from managements. For example, except in one minor respect, the Act does not seek to revise or reverse the PSLRA.¹⁰⁶ Finally, the Act never addresses stock options or executive compensation, except to the extent that it may require the forfeiture of such compensation to the corporation if the corporation later restates its earnings.¹⁰⁷ In short, while the potential benefits from acquiescing in accounting irregularities appear to have been reduced for auditors, the expected costs to them from such acquiescence also remain low because the level of deterrence that they once faced has not been restored.¹⁰⁸ Arguably then, the Sarbanes-Oxley Act represents an incomplete response--relevant in its desire to reduce agent conflicts of interest, but still not sufficient to the extent that underdeterrence remains the problem. But this assessment must be qualified to the extent that courts have begun to act on their own to fill this void.

C. The Judicial Response

Any assessment of gatekeeper liability that presupposes that their exposure to liability has remained constant is probably inaccurate. Although the Congress has been cautious about

¹⁰⁶ Section 804 of the Act does extend the statute of limitation for securities fraud suits, thereby reversing a 1991 Supreme Court decision that had shortened the time period. See *supra* note 52.

¹⁰⁷ Section 304 of the Act requires the forfeiture of certain bonuses “or other incentive-based or equity-based compensation” and any stock trading profits received by a chief executive officer or chief financial officer of an issuer during the 12-month period following the filing of an inflated earnings report that is later restated. This does cancel the incentive to inflate earnings and then bail out, but the enforcement methods applicable to this provision are unspecified and the provision applies only if the earnings restatement is the product of “misconduct.” Ambiguities abound here.

¹⁰⁸ Prior to the 1990s, private litigation was a real (and arguably even excessive) constraining force on auditors, which required them to devote as much as 14% of their revenues to litigation costs and expenses. See text and note *supra* at note 51.

changing the balance of advantage in civil litigation involving gatekeepers, a wave of post-Enron jurisprudence is sweeping across state and federal courts and has already shifted the balance of advantage in civil litigation significantly in the plaintiff's direction. The most obvious example of this shift is the decision in late 2002 in In re Enron Corp. Secs., Derivative & ERISA Litig.,¹⁰⁹ which seemingly has outflanked the Supreme Court's decision in Central Bank of Denver,¹¹⁰ and largely restored private "aiding and abetting" liability under a different name. In the Enron case, the district court denied the motions to dismiss filed by Enron's auditors, its principal outside law firm, and six major banks, all of whom asserted that they could not be deemed primary violators and so were immune from private suit under Central Bank. Adopting the position urged by the SEC in an amicus curiae brief,¹¹¹ the Court ruled that primary liability could extend to any person who contributes materially false or misleading information to persons who it understands to be preparing or drafting a report or press release to be filed with the SEC or disseminated to the investing public, even though this peripheral defendant neither solicited sales, participated in the actual drafting of the document, nor was otherwise identified in the document so filed or released.¹¹² The Enron decision not only rejected the majority rule in the federal courts, which seems to permit a private suit against the secondary participant only when the latter makes or

¹⁰⁹ 235 F. Supp. 2d 549 (S.D. Tex. 2002).

¹¹⁰ Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A. 511 U.S. 164, 177 (1994).

¹¹¹ The SEC's amicus brief was largely modeled on a similar brief filed by the SEC (and initially adopted by the Third Circuit) in Klein v. Boyd, 1998 U.S. App. LEXIS 2004 (3rd Cir. Feb 12, 1998), vacated and reh'q en banc granted, 1998 U.S. App. LEXIS 4121 (March 9, 1998).

¹¹² 235 F. Supp. 2d 549, 582-591. Judge Harmon added that a defendant "can be a primary violator if he or she writes misrepresentations for inclusion in a document to be given to investors, even if the idea for those misrepresentations came from someone else." Id. at 693.

authorizes an “attributed statement” that specifically identifies it and its conclusion,¹¹³ but also went well beyond the few cases that have allowed primary liability to extend to persons who “substantially participate” in the drafting of an SEC document.¹¹⁴ Under the Enron ruling, most who could formerly be reached under “aiding and abetting” liability now seemingly can be reached as a “maker” or “creator” of a public statement.¹¹⁵

¹¹³ See Wright v. Ernst & Young LLP, 152 F.3d 169, 175 (2d Cir. 1998) (requiring that “the misrepresentation must be attributed to the specific actor at the time of public dissemination”).

¹¹⁴ In re Software Toolworks Secs. Litig., 50 F.3d 615, 627 (9th Cir. 1994) (using “substantial participation” test).

¹¹⁵ For this common assessment, see Kurt Eichenwald, “Ruling Leaves Most Players Exposed to Suits on Enron,” N.Y. Times, December 21, 2002 at C3; Bart Schwartz and Jonathan Freedman, “Aiding and Abetting Liability and Enron,” New York Law Journal, January 23, 2003 at 5; William Gleeson and Jesse Minier, Financial Institutions and the Enron Whiplash: The Growing Pain of Rule 10b-5 Liability, 22 Banking & Financial Services Policy Report 1 (February 2003); Anthony E. Davis, “Professional Responsibility--Who Should Regulate Lawyers?,” New York Law Journal, January 6, 2003 at 3.

Whether the Enron decision is correct can be (and is being hotly) debated. But the more relevant point for this article is that the decision seemingly signals a judicial shift - - whether conscious or unconscious - - toward imposing greater liability on gatekeepers. Symptomatically, Enron is not the only recent post-scandal decision to have expanded the scope of liability for secondary participants. In a series of decisions involving Lernout & Hauspie,¹¹⁶ another federal court has refused to dismiss securities fraud allegations in private class actions against a variety of secondary defendants, including the firm's outside directors, auditors, stock analysts, and others. Unlike the Enron Court, the Lernout & Hauspie Court did not need to focus on whether the defendant corporation's audit committee members had substantially participated in the drafting of SEC reports or press releases. Rather, because each director had signed the defendant's Form 10-K, the Court found this fact alone sufficient to deem the audit committee members to have made a fraudulent statement.¹¹⁷

In an even more sweeping conclusion, the Court further found that audit committee members could be held liable as "controlling persons" under Section 20(a) of the Securities Exchange Act of 1934. Under long-established SEC rules, "control" "means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person."¹¹⁸ Although the Lernout & Hauspie Court acknowledged that outside directors were not inherently "control persons," it relied on an earlier decision to find that: "[A]n outside director and audit committee member who is in a position to approve a corporation's financial

¹¹⁶ See In re Lernout & Hauspie Sec. Litig., 286 B.R. 33, 2002 U.S. Dist. LEXIS 22708, 2002 WL 31662595 (D. Mass. Nov. 18, 2002); see also Bomberg v. SG Cowen, 2002 U.S. Dist. LEXIS 23527 (D. Mass. Dec. 9, 2002) (declining to dismiss action against security analyst who covered the issuer); In re Lernout & Hauspie Sec. Litig., 236 F. Supp. 2d 161 (D. Mass. 2003).

¹¹⁷ 2002 U.S. Dist. LEXIS 22708 at ** 11 to **13.

¹¹⁸ See 17 C.F.R. § 240.12b-2 (defining term "control").

statements can be presumed to have the ‘power to direct or cause the direction of the management and policies of’ the corporation, at least insofar as the ‘management and policies’ referred to relate to ensuring a measure of accuracy in the content of company reports and SEC registrations that they actually sign.”¹¹⁹ Unmentioned by the Lernout & Hauspie decision was the Sarbanes-Oxley Act, which, of course, could not apply retroactively to the facts of Lernout & Hauspie; still, that statute only reinforces this mode of analysis because it greatly enhances the powers of the audit committee, thus making them look more like “controlling persons.” As a result, audit committee members would now seem significantly more exposed to personal liability. Finally, although a plaintiff is still required to plead facts raising a strong inference of fraud, the Lernout & Hauspie Court found this last requirement satisfied by the fact that the audit committee members all allegedly had known that their corporation lacked an adequate system of internal controls and that its outside auditor had raised specific problems with its financial reporting.¹²⁰ Again, on this basis, many audit committee members could be held liable in the near future.

The net impact of these rulings is to substantially heighten the prospective liability of audit committee members. By signing a periodic report, by helping to draft such a report, or by acquiring knowledge of adverse facts as a “controlling person,” such a person faces a non-trivial risk of personal liability. Already, there are signs that the major auditing firms recognize that

¹¹⁹ 286 B.R. 33; 2002 U.S. Dist. LEXIS 22708 at **14 (quoting In re Livent, Inc. Noteholders Sec. Litig., 151 F. Supp. 2d 371, 437 (S.D.N.Y. 2001); see also In re Reliance Sec. Litig., 135 F. Supp. 2d 480, 518 (D. Del. 2001).

¹²⁰ Id. at ** 8 to ** 10.

they face increased liability and are beginning to internalize new controls and standards in light of it.¹²¹

On the state level, some signs of a similar, if milder, shift toward imposing heightened responsibilities on directors are also evident in Delaware, where respected members of its judiciary have called for new legislation and an expanded meaning to be given to the critical Delaware concept of “good faith.”¹²² These comments have warned that a conflicted director may not be found to have acted in “good faith.” “Good faith” is a key requirement under Delaware law, because, in its absence, a Delaware corporation generally cannot indemnify an officer or director;¹²³ in addition, charter provisions eliminating monetary liability for breach of the duty of care (which most public companies in the U.S. now have) are ineffective if the director did not act in “good faith.”¹²⁴ Following in the wake of these comments have come a flurry of recent Delaware decisions that have declined to dismiss derivative actions and that have

¹²¹ See Jonathan Glater, “PriceWaterhouse Taking A Stand and A Big Risk,” N.Y. Times, January 1, 2003 and C1 (noting pledge of PriceWaterhouseCoopers to resign as auditors “in any case where we cannot resolve concerns about the quality of the information we are receiving or about the integrity of the management teams with whom we are working.”). Of course, from a distance, it is impossible to determine if such assurances are largely self-promotional or whether they reflect a real change in behavior.

¹²² See William B. Chandler III and Leo E. Strine, Jr., The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State, (SSRN Working Paper No. id=367720) (2003). Mr. Chandler is the Chancellor and Mr. Strine a Vice Chancellor of the Delaware Chancery Court. See also Tom Becker, “Delaware Judge Warns Boards of Liability for Executive Pay,” The Wall Street Journal, January 6, 2002 at A-14.

¹²³ See Delaware General Corporation Law Section 145(a) (Delaware corporation has power to indemnify person who “acted in good faith and in a manner such person reasonably believed to be in or not opposed to the best interests of the corporation”).

¹²⁴ See Delaware General Corporation Law Section 102(b)(7) (permitting charter provision to eliminate due care liability if director acted in “good faith”).

otherwise raised the standards both for director independence and for the duty of care.¹²⁵

Outside of Delaware, the trend has been the same, as plaintiffs have repeatedly won since Enron.¹²⁶ Although derivative actions are not the normal mechanism by which liability is asserted against gatekeepers, both the holdings and dicta in these recent cases have upgraded the level of care and attention that courts are expecting all corporate fiduciaries to exercise. In short, all the judicial straws in the wind point towards a higher risk of liability, although for the present the principal target of this new litigation appears to be directors, rather than gatekeepers.

A focus on individual cases, particularly at the lower court level, is open to criticism for relying on anecdotal evidence whose ultimate impact remains speculative. But aggregate data also indicates that the risk for gatekeepers is real and growing. Here, the most telling statistic is the rising settlement value of securities litigation. According to one recent survey, which extended through mid-2003, the average value of securities class action settlement has risen steadily since the mid 1990s:¹²⁷

¹²⁵ Chief among these decisions are: (1) In re Oracle Corp. Derivative Litigation, 824 A. 2d 917 (Del. Ch. 2003) (deeming directors not to be independent of an academic colleague or a university contributor); (2) In re Walt Disney Company Derivative Litigation, 825 A. 2d 275 (Del. Ch. 2003) (finding board's action in approving compensation and non-fault termination of Michael Ovitz, a senior officer, not to have been taken in good faith); (3) In re HealthSouth Corporation Shareholders Litigation, 2003 CVL 22769045 (Del. Ch. Nov. 24, 2003) (refusing to dismiss or stay derivative raising insider trading claims); (4) In re Pure Resources, Inc. Shareholders Litigation, 808 A. 2d 421 (Del. Ch. 2002) (finding tender by controlling shareholder to be coercive).

¹²⁶ See, e.g. In re Abbott Laboratories Derivative Shareholders Litigation, 325 F. 3d 795 (7th Cir. 2003); (derivative action for "conscious inaction" in face of potentially illegal corporate activities reinstated and demand futility test simplified); McCall v. Scott, 239 F. 3d 808 (6th Cir. 2001) (derivative action reinstated where plaintiffs had sufficiently alleged a sustained failure by board to exercise appropriate attention).

¹²⁷ See PriceWaterhouseCoopers LLP 2002 Securities Litigation Study at 2.

<u>Year</u>	<u>Average Settlement</u>
1996-2000 (excluding <u>Cendant</u> settlement)	\$14.2 million
2001	\$17.7 million
2002	\$19.9 million
2003 (through 8/21/03)	\$25.1 million

Compounding this rising settlement value is the additional fact that the number of securities class actions also appears to be rising, if more modestly.¹²⁸

Averages can be misleading. The real fear of the major auditing firms is one catastrophic experience that exceeds their total insurance and other reserves. Such a loss could not be offset by increasing client fees and would result in likely insolvency. Here, it is relevant that the six largest recoveries against audit firms have all occurred since 2000:¹²⁹

¹²⁸ Excluding very specialized “laddering” and “analyst” cases, some 217 securities class actions were filed in 2002, up from 207 in 1999, 201 in 2000, and 176 in 2001 (when over 300 “laddering” cases were, however, filed), but down from 1998 when 258 cases were filed. *Id.* at 1-2. From 1996 to 2001, securities class actions averaged 186 cases per year. *Id.* at 2. Hence, the recent total has been up, but only after some adjustments are made to the data.

¹²⁹ In compiling this list, I have relied on data made available to me by the firm of Milberg, Weiss, Bershad, Hynes & Lerach, for who I served as an expert witness during the Rite Aid Litigation. The principal cases on this list are, however, a matter of public record. See *In re Cendant Corp. Litig.*, 264 F. 3d 286 (3rd Cir. 2001) (approving \$335 million settlement by Ernst & Young and \$2.85 billion settlement by Cendant); *In re Rite Aid Corp. Secs. Litig.*, 269 F. Supp. 2d 603 (E.D. Pa. 2003) (approving \$125 million settlement by KPMG); “News in Brief: \$300 Million Oxford Settlement Approved,” *New York Law Journal*, June 19, 2003, p. 1, col. 1. (noting that Oxford Health would pay \$225 million and KPMG \$75 million). Arthur Andersen’s involvement in the Waste Management, Sunbeam, and Baptist Foundation of America litigation is all concisely summarized in *In re Enron Corp. Secs. Litig.*, 235 F. Supp. 2d 549, ____ nn. 109-

<u>Name of Case</u>	<u>Year</u>	<u>Settlement Amount</u>	<u>Firm</u>
1. Cendant	2000	\$335 million	Ernst & Young
2. Baptist Foundation of America	2002	\$217 million	Andersen
3. Rite Aid	2002	\$125 million	KPMG
4. Sunbeam	2001	\$110 million	Andersen
5. Waste Management I	2000	\$75 million	Andersen
6. Oxford Health	2003	\$75 million	KPMG

Had Andersen not liquidated following its criminal conviction, its Enron liabilities might easily have exceeded Ernst & Young's record settlement in Cendant. In any event, the risk of catastrophic loss, not the increase in average settlement value, is the factor that will most cause the market for gatekeeper services to unravel.

Although auditors continue to be sued only in the minority of securities class actions, the number of securities class actions naming auditors as defendants has also recently risen, climbing to 34 cases in 2002 (up 21% over the 1998-2001 period and by 89% over 2001).¹³⁰ For the future, the most ominous fact may be that accounting irregularities tend increasingly to be the

130

111 (noting that Andersen paid \$110 million to settle in the Sunbeam class action in 2001 and \$217 million to settle the Baptist Foundation litigation in 2002), 2002 U.S. Dist. LEXIS 25211 (S.D. Tex. December 20, 2002) at ** 323 to ** 325. See PriceWaterhouseCoopers LLP 2002 Securities Litigation Study at 7-8. This represented 34 out of 217 total securities class actions filed in that year (or 16%). Id. at 8. In contrast, the number of securities class actions brought against auditors declined from 1998 to 2001. See PriceWaterhouseCoopers LLP 2002 Securities Litigation Study at 7. Still, the highest number of such actions against auditors over the past five years was 39 in 1998. Id. at 8.

primary focus of securities class actions.¹³¹ The more actions filed against auditors, the greater the chance of a catastrophic judgment.

D. The Prospective Litigation Impact of Reform.

Little agreement exists about the overall impact of the Sarbanes-Oxley Act on civil litigation. Some critics have viewed it as more rhetoric than serious reform;¹³² others contend that it is a sweeping intrusion into the U.S.'s existing system of corporate governance. Both perspectives miss, however, what is most important: Sarbanes-Oxley ushers in and accelerates a major and probably inevitable transition, which will move us from a rules-based system of financial disclosure to a principles-based system. In contrast to Europe, the U.S. has long relied on a rules-based system in which generally accepted accounting principles (or "GAAP") were precise, technical and limited. Typically, these narrow rules afforded safe harbors from liability for issuers and gatekeepers. In contrast, European accounting principles were broader, more generalized, and sometimes indefinite to the point of being ineffable. As discussed below, Europe could live with this imprecision because Europe is characterized by a relatively low rate of litigation, and thus its issuers did not need to fear American-style entrepreneurial litigation.

Precisely for this reason, however, a shift to a principles-based system exposes American issuers and their gatekeepers to a substantially heightened threat of liability. At the core of a principles-based system is the notion that the issuer must not only comply with GAAP, but must make a "fair presentation" that provides a full, fair, and holistic picture of the issuer's financial

¹³¹ Over 50% of the securities class actions settled between the passage of the Private Securities Litigation Reform Act and December 31, 2002 appear to have involved accounting irregularities and over 60% involved a restatement of financials. See Cornerstone Research, "Post-Reform Act Securities Class Settlements Reported through December, 2002" (2003) at 10.

¹³² See Lawrence A. Cunningham, The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (and It Might Just Work), 35 U. Conn. L. Rev. 915 (2003).

condition and results of operations. In both Sections 302 and 906 of the Sarbanes-Oxley Act, Congress directed the chief executive officer and chief financial officer of every publicly held company to certify in every periodic report filed with the SEC “that information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer.”¹³³ This concept of “fair presentation” is not limited by any reference to GAAP, and compliance with GAAP is clearly not dispositive of whether the issuer has provided a “fair presentation.” Instead, the standard seems to intend that the issuer provide full and fair disclosure in the form of a holistic picture of the company that reveals all material financial weaknesses, even if their disclosure were not required by GAAP.

Historically, this concept of “fair presentation” was the standard prescribed by Judge Henry Friendly for the Second Circuit in United States v. Simon.¹³⁴ Although Simon has never been reversed or even called into question, it had over recent years seemingly become a forgotten decision, honored more in the breach than in the observance.¹³⁵ Virtually overnight, however, Enron and related scandals have resuscitated Simon’s concept of “fair presentation.” The reason for its revival is obvious: Enron showed beyond argument that a rules-based system of financial

¹³³ The quoted language is from Section 906, which has been codified as 18 U.S.C. § 1350, a penal code provision (emphasis added). Section 302 of Sarbanes-Oxley Act uses slightly different language: “the financial statements, and other financial information included in the report, fairly presents in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report.” No difference in scope or meaning seems intended by this slight difference in phrasing.

¹³⁴ 425 F.2d 796, 807-09 (2d Cir. 1969).

¹³⁵ No Circuit Court decision that I have found over the past twenty years appears to cite the Simon case in a decision upholding civil or criminal liability for securities fraud. The decision has been cited by dissenting judges who believed that a case should not have been dismissed or overturned. See, e.g., In re K-Tel Int’l Sec. Litig., 300 F.3d 881, 906 (8th Cir. 2002). The last decision citing it in a decision favoring private plaintiffs or the SEC appears to have been SEC v. Seaboard Corp., 677 F.2d 1301, 1313 (9th Cir. 1982).

disclosure could be gamed and distorted to the point that investors could have little confidence in it. Even if newer and tighter rules were drafted, practitioners would predictably stay one step ahead of regulators by finding new ways to game and evade narrow and specific rules. As a result, Congress and the SEC framed the Sarbanes-Oxley Act's new certification requirements in terms of the Simon case, and in interpreting this new requirement, the SEC has cited Simon for the proposition that: "Presenting financial information in conformity with generally accepted accounting principles may not necessarily satisfy obligations under the antifraud provision of the federal securities laws."¹³⁶

While this shift to a principles-based system is obviously consistent with the public's post-Enron mood, it poses significant risks for issuers and gatekeepers. Cases that might have been dismissed on summary judgment now seem more likely to survive, because the claim that full and fair disclosure was not provided is hard to resolve pre-trial. More importantly, the shift to a principles-based system reduces the prospect that the auditor can truly "audit" the more ineffable style of disclosure that such a system invites. Finally, this shift underlines the differences between the European and the American legal environment. Lacking class actions, contingent fees, or the "American rule" that generally precludes fee-shifting against the plaintiff, Europe experiences little securities litigation and hence can tolerate abstract generality in the formulation of its accounting rules. In contrast, U.S. issuers are likely to encounter greater difficulty in any transition to accounting principles framed in broad brush strokes. The combination of broad disclosure obligations and a legal environment that encourages class litigation means both a higher volume of litigation and higher settlement values to claims against gatekeepers and outside directors.

¹³⁶

See Securities Exchange Act Release No. 33-8124 (Sept. 9, 2002), at *57279 n.55

Nonetheless, this transition appears inevitable, not only because of recent scandals, but because of globalization as well. Globalization necessitates a common, world-wide accounting language. Under their “Norwalk treaty,” the Financial Accounting Standards Board (“FASB”) and the International Accounting Standards Board (“IASB”) are committed to developing international accounting standards that both U.S. and European regulators will accept.¹³⁷ Europe has little interest in moving towards a rule-based regime, and the FASB cannot credibly push in this direction after Enron. As a result, the development of a common global accounting language will likely finish what Enron started: namely, the demise of a rules-based system.

So where do these trends leave us? The original issue was what level of legal threat would optimize deterrence. Too high a level of liability may cause the contemporary markets for gatekeeping services to fail, and too low a level invites future Enrons. This recognition has two implications that inform Part III. First, public policy should attempt to focus liability rules so that they incentivize gatekeepers to search diligently for fraud and irregularity, but do not employ excess deterrence that threatens gatekeeper solvency. In this light, it will next be argued that a combination of stricter liability standards with a ceiling on damages represents a sensible compromise that is superior to an existing liability regime that both (a) predicates liability upon proof of scienter, and (b) sometimes immunizes even the intentional aider and abetter. Second, to the extent that some gatekeepers lack the ability to detect frauds by their clients, strict liability is an inappropriate legal standard, and other types of legal rules - - structural, prophylactic and empowering - - merit greater attention and should be blended into any overall policy response.

¹³⁷ The two bodies - - the FASB and the IASB - - announced in October, 2002, that they were committed to achieving convergence between their respective accounting standards by 2005 with an initial exposure draft being scheduled for late 2003. See “Convergence of Global Accounting Standards; Regulatory Watch,” *Accounting Today*, January 25, 2003, at p. 512 (describing memorandum of understanding between the two bodies).

The shift to a principles-based system aggravates this problem because it makes it more problematic whether the auditor can truly prevent fraud or irregularity as the principles of financial reporting become more open-ended and ambiguous.

Part III. The Future Gatekeeper: Remedies for Gatekeeper Failure.

Three linked problems dominate any attempt to redefine the role or restructure the obligations and liabilities of market gatekeepers:

First, in striking an appropriate balance between excessive liability and an inadequate legal threat, public policy must recognize the peculiarly American dimensions of this problem. The market for auditing services has become increasingly concentrated in the United States (and in consequence around the world, as most global corporations are either American or follow similar norms and standards). The ironic truth is that the four global accounting firms that today remain have become “too big to fail.” In addition, the threat of excessive liability is also uniquely an American problem because the prospect of large class actions and jury decision-making is almost unique to the American legal system.

Second, public policy must seek to minimize the perverse incentives that induce the gatekeeper not to investigate too closely. For example, in securities litigation against auditors, the defense is frequently raised by the auditors that they were deceived by corrupt managements on whom they had justifiably relied. Often, this may be true, but it can still create an incentive not to inquire too closely - lest one acquire information that should place one on notice. More generally, the Private Securities Litigation Reform Act requires a particularized pleading at the outset of the case that gives rise to a “strong inference of fraud.”¹³⁸ In the case of accountants,

¹³⁸ See Section 21D(b)(2) of the Securities Exchange Act of 1934, 15 U.S.C. §78u-3 (requiring complaint to “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind”).

this standard means that more than reckless indifference must be shown and as of the very outset of the action, when typically little is known about the accountant's involvement. As a result, the auditor who remains ignorant of the fraud, even though reckless inattentive, probably escapes liability.

But how much can we realistically expect of the auditor? Auditors have long argued that there is an "expectations gap" between what the public wants to do and their actual capacity.¹³⁹ This expectations gap is greatest, they assert, when it comes to the ability of auditors to detect fraud or illegal acts.¹⁴⁰ Of course, any profession has a collective self-interest in reducing its own risk of liability or public criticism. Still, independent observers agree that some elements of financial statements are simply "not verifiable" and could not accurately be audited by even the most diligent and well-motivated accountant.¹⁴¹ To this extent, an undiluted regime of strict liability could be counter-productive.

Third, public policy must also strike an acceptable balance between the obligation of client loyalty and the role of protecting the integrity of the market. This is the unique problem associated with asserting that securities attorneys owe gatekeeper obligations - - either legal or ethical - - to investors, as well as to their clients. Defenders of the traditional advocacy role of

¹³⁹ For an overview of asserted "expectations gap," see Carl Pacini, Mary Jill Martin, and Lynda Hamilton, At the Interface of Law and Accounting: An Examination of a Trend Toward a Reduction In the Scope of Auditor Liability to Third Parties in the Common Law Countries, 37 Am. Bus. L. J. 171, 215-217 (2000) (discussing the "expectations gap"); see also Brenda Porter, An Empirical Study of the Audit Expectation-Performance Gap, 24 Acct. & Bus. Res. 49 (1993).

¹⁴⁰ Over 70% of investors questioned in one survey expected absolute assurance that material misstatements due to fraud would be detected. See Marc Epstein & Marshall Geiger, Investor Views of Audit Assurance: Recent Evidence of the Expectations Gap, J. Acct. (Jan., 1994) at 60.

¹⁴¹ See Ronen, *supra* note 101, at 41. Professor Ronen objects that Generally Accepted Accounting Principles ("GAAP") contain many elements that are "simply not auditable." *Id.* Applying an undiluted regime of strict liability to such principles would achieve little of value, but would risk market failure.

the lawyer find this conflict unbridgeable, and argue that imposing gatekeeper obligations on attorneys will simply “dry up” the free flow of information between attorney and client, thus possibly resulting in greater illegality. This section finds this claim to be unsupportable. Rather, it concludes that the primary consequence of imposing gatekeeper obligations on attorneys will be to increase their leverage over their clients.

A. Striking the Balance on Liability. Recent commentators have divided over whether gatekeepers should be held strictly liable for client misconduct.¹⁴² Both sides in this debate recognize the advantages of strict liability over negligence liability: (1) strict liability gives the gatekeeper greater incentive to take precautions and exercise due diligence; (2) strict liability induces the gatekeeper to limit its level of activity, for example by rejecting overly risky corporations as clients; and (3) strict liability spares both courts and regulators the need to descend into the Serbonian bog of defining precise standards of care, thereby reducing transaction costs and increasing predictability.¹⁴³ Obviously, under a strict liability system, gatekeepers would raise their fees to cover their increased liability, but even this increase can be presented as one of the attractions of this approach because it forces the client to bear a higher fee precisely to the extent that it cannot convince its auditor that it presents a low risk of fraud or irregularity. In a perfect market, the issuer would thus bear the expected social cost of the fraud, which would in turn imply that the only issuers that could access the market would be “those for

¹⁴² Professor Partnoy has proposed such a strict liability regime for underwriters, auditors and attorneys in light of Enron. See Partnoy, *supra* note 9. To the contrary, Assaf Hamdani, has argued that strict liability would be excessive. See Assaf Handani, *supra* note 10.

¹⁴³ See Hamdani, *supra* note 10, at 59; Partnoy, *supra* note 9, at 514.

whom the value of the public financing exceeds the harm caused by fraud.”¹⁴⁴ Put more simply, very high audit fees should tend to deter the fraudulent actor.

Although possibly optimal in theory, enormous problems surround implementation of any such proposal. First, as even its proponents acknowledge, the gatekeeper may not be able to distinguish ex ante the “honest” client from the “fraudulent” one. Hence, it will charge both a single common fee - - but a much higher one. Predictably, this inflated fee structure would still allow the “fraudulent” client to access the market, but it might drive many honest clients from the market.¹⁴⁵ Even if we relax this assumption and assume that some broad risk classifications could be made, it still remains true that, to the extent these classifications are broad and general, then some clients within each category will pay too little and others too much.

Moreover, the increase in audit fees might have to be enormous in order to enable auditors to survive under a regime of strict liability. During the collapse of the high tech bubble in 2000 and 2001, the market value of publicly held firms audited by the then Big Five fell by over \$1 trillion.¹⁴⁶ Under a strict liability regime, the auditor would be jointly and severally liable for this amount with the issuer, at least if a material misrepresentation or omission and loss

¹⁴⁴ See Hamdani, *supra* note 10, at 60. These observations are not original to these authors. Conventional “law and economics” analysis sees strict liability as superior to negligence-based liability in two respects: first, strict liability gives the principal actors optimal incentives to comply with legal requirements, while freeing courts from the need to make imperfect and error-prone liability determinations, and, second, it induces the principal actors to adopt an optimal level of activity. See Steven Shavell, *ECONOMIC ANALYSIS OF ACCIDENT LAW* 5-18 (1987).

¹⁴⁵ This “adverse selection” problem can result in a “lemons market” that causes the honest company to leave the market. See George Akerlot, The Market for Lemons: Quality Uncertainty and the Market Mechanism, 84 Q. J. Econ. 488 (1970).

¹⁴⁶ One survey of 33 public firms that restated their earnings finds that companies audited by the Big Five fell in value by roughly \$1.3 trillion. See Stephen Taub, “Big Five Gets Low Grades For Performance,” *www.CFO.com*, July 12, 2002 (noting fall from \$1.8 trillion to only \$527 billion in market capitalization).

causation were shown. To protect itself against such exposure, the auditor would need to charge a fee that funded its expected liability costs - - which loss could potentially reach multi-billion dollar sums.¹⁴⁷ Not only would corporate clients be unable to pay such an amount, but they would predictably oppose such a fee increase with sufficient vigor as to make the adoption of strict liability politically infeasible.

Given the risk of being rendered insolvent by a single client, some auditors also might simply cease to offer auditing services, concentrating instead on consulting services or simply on providing bookkeeping services without the provision of any certification. If some firms were to exit, replacements might well enter. But in all likelihood, new entrants would be smaller, risk-preferring “fly-by-night” firms that might seek to charge very high fees for the short-term and then liquidate on an adverse judicial determination. Increasingly, audit firms would seek to protect their partners’ assets by minimizing their capital investments in their firms and by use of limited liability organizational forms, such as the limited liability company or limited partnership. Even if auditor exit from the market were deemed a remote risk, it is a virtual certainty that heightened liability would cause existing auditors to be far more selective in the public companies that they would accept as clients. Although this might desirably result in some “lawless” corporation being denied access to public markets, auditors lack the ability to distinguish ex ante the “law-abiding” client from the “lawless” one; hence, some “law-abiding” firms would be denied access to the market with a resulting social loss. Some recent evidence

¹⁴⁷ Of course, securities class actions today settle for a fraction of their asserted losses. But this fraction will certainly rise (and steeply) if we moved to a strict liability regime. Even today, neutral third parties have placed the likely settlement value of some outstanding securities class actions at \$1 billion or higher. See Martin Peers, “Suits Cloud AOL’s Optimism; Cost of Settling Holder Litigation May Hurt Effort to Cut Debt,” Wall St. J., May 1, 2003, at B2 (estimating settlement cost of securities class action against AOL Time Warner Inc. at \$1 billion).

suggests that this screening process may already have intensified¹⁴⁸ and that audit fees are rising dramatically.¹⁴⁹

Finally, there still remains the possibility of litigation error. Even under a regime of strict liability, it would still be necessary to show that the issuer made a material misrepresentation or omission before the auditor could be held vicariously liable.¹⁵⁰ Given the potential of stock price drops resulting in damages in the multi-billion dollar range, this means that litigation errors could easily be bankrupting to the auditor, which in turn means that the auditor would be under great pressure to settle such litigation. Such pressure in turn exacerbates the problem of “extortionate” or “frivolous” litigation. Stock prices can fall for a variety of reasons that are unrelated to fraud or misrepresentation. Yet, if the stock price decline is great enough, an almost irresistible incentive arises for the plaintiff’s attorney to sue, as it has now been freed from the burden of alleging, pleading, or proving fraud or scienter. Hence, the prospect of “frivolous” or

¹⁴⁸ In 2003, over 1,460 public companies changed auditors, which was the highest number in at least five years. Although such switches could be because the client was dissatisfied with the auditor, many were because the auditor considered the client too risky--or because the auditor raised its fees in light of that increased risk. This phenomenon of auditor switching affected over one third of the firms in the Russell 3,000, which covers most smaller market capitalization firms. See Matt Krantz, “More Firms Part Way With Auditors,” USA Today, February 9, 2004 at page 1B. This evidence may not prove that auditors are becoming significantly more selective with regard to clients, but it is at least consistent with such a hypothesis.

¹⁴⁹ Audit fees appear to have increased “by as much as 30% or more this year...” See Deborah Salomon and Cassell Bryan-Low, “Companies Complain About Cost of Corporate-Governance Rules,” The Wall Street Journal, February 10, 2004 at A-1. This increase could be because of the increased compliance costs of Sarbanes-Oxley, as this story implies, or it could also in part be attributable to the increased risk and litigation exposure faced by auditors, which they need to pass back to their clients.

¹⁵⁰ In addition, it would be necessary for the plaintiff to prove loss causation, as otherwise in its absence the plaintiff would receive a seeming windfall. Thus, some complex litigation issues will still remain.

“extortionate” litigation increases in direct proportion to the degree to which one moves toward a strict liability regime.

B. Designing a “Stricter” Liability Approach: A Proposal. For all these reasons, the “real world” issue becomes whether a second-best substitute can be devised for a strict liability regime that sidesteps or minimizes the foregoing problems. In this article’s view, the most direct and practical means to this end would be to convert the gatekeeper into the functional equivalent of an insurer, who would back its auditor’s certification with an insurance policy that was capped at a realistic level.¹⁵¹ As a result, the gatekeeper’s liability would be divorced from any showing of fault, but it would also be limited to a level that achieves adequate deterrence without causing the market for gatekeeping services to unravel.

Under this approach, for example, if the corporate client were found liable for \$100 million, then the auditor would have to contribute toward that liability up to the amount of its policy. The one mandatory element in this proposal would be that a minimum floor on the gatekeeper’s insurance policy that would have to equal some adequate multiple of the highest annual revenues received by the gatekeeper from its client over the last several years. For purposes only of illustration, let us assume a multiplier of ten. Now, on the facts of the Enron case, where it has been widely reported that Arthur Andersen received roughly \$52 million from Enron in its final year, Andersen’s liability would be not less than \$520 million (i.e., \$52 million times ten). This is a large number, but it does not approach the roughly \$80 billion loss in

¹⁵¹ Professor Joshua Ronen has offered a somewhat similar idea that does not combine the two roles of auditor and insurer, but does integrate them. Under his proposal, public firms would purchase financial statement insurance from insurers, who would then select the auditors. See Ronen, *supra* note 101. Among the problems with this proposal is the danger that the insurer might prefer that the auditor hide, rather than reveal, accounting irregularities if their revelation would trigger its obligation to pay under its policy. Still, Professor Ronen has properly recognized the close connection between auditing and insurance.

market capitalization that Enron experienced and for which Andersen could conceivably be held liable under a strict liability regime. In a more typical cases where the auditor receives only a \$2 million audit fee from the client, the damages would be reduced to only \$20 million. Hence, the market for gatekeeping services could easily function under this proposal. The auditor might also purchase insurance to cover its exposure, but to the extent it passed along this added insurance cost on to its clients, it would automatically increase the minimum required floor on its policy under the mandatory 10:1 ratio between minimum liability and direct or indirect revenues from the client.

Some will recognize this proposal as bearing considerable resemblance to Professor Partnoy's modified strict liability proposal.¹⁵² Under his innovative proposal, the client and the gatekeeper would contract for the gatekeeper to bear a minimum percentage of the issuer's losses, possibly subject to a requirement that the gatekeeper must bear some "specified minimum percentage."¹⁵³ For sake of illustration, assume that the minimum percentage set by Congress in an amendment to the federal securities laws were 5%. If so, on the earlier Enron example, Andersen would be required to pay 5% of Enron's \$80 billion loss or \$4 billion.

There are essentially three practical differences between these two similar proposals: (1) Professor Partnoy's system is essentially contractual, while this proposal is essentially regulatory; (2) Professor Partnoy uses a percentage of the total damages as his minimum floor, while this

¹⁵² See Partnoy, *supra* note 9, at 540-46; see also Stephen Choi, Market Lessons for Gatekeepers, 92 Nw. U. L. Rev. 916, 951-59 (1998). Professor Choi appears to have been the first to suggest that the issuer and the gatekeeper should contract over the share of the gatekeeper's liability for the losses experienced by the issuer's investors.

¹⁵³ Partnoy, *supra* note 9, at 540. Actually, Professor Partnoy does not clearly insist that there be a minimum floor placed on the auditor's liability below which they could not deviate by agreement, but notes that Congress could impose such a minimum percentage. *Id.*

proposal uses a multiple of the gatekeeper's highest annual revenues from the client; and (3) while the potential damages, as calculated under Professor Partnoy's proposal, could often bankrupt the gatekeeper, bankruptcy would rarely follow when a multiple of the revenues from the client generated the required minimum floor on the gatekeeper's insurance obligation. Thus, this proposal could actually be supported by the relevant profession, once they recognized that their existing exposure to liability could be even higher. It thus falls (if only barely) within the range of political feasibility.

This proposal's refusal to accept private contracting (in contrast to Professor Partnoy, who relies primarily on contracting and disclosure) is based on three considerations: First, the market for services in some gatekeeping professions (most notably, auditing) is extremely concentrated, and thus conscious parallelism in the pricing behavior of the few actors in the industry becomes likely. Put more simply, if there are only four major auditing firms at present, it becomes unlikely that they would compete vigorously and accept liability significantly above any minimum required threshold. Hence, it is simpler to specify that threshold (but also permit the parties to provide by contract for even greater liability). Second, in a bubble, investors might not care that their gatekeepers were accepting only a minimum liability, and thus the disclosure of the contract between the gatekeeper and the market might have too little impact on the market to be an adequate deterrent. Third, a contractual approach overlooks that the corporate client may have little incentive to bargain for high liability on the part of the auditor. Not only will higher auditor liability not meaningfully reduce the liability of the client (given the typical relative disparity in their assets), but corporate managers may actually want the auditor to have a low ceiling on its liability in order to make it easier to induce the auditor to acquiesce in risky

accounting practices favored by management. Put more simply, if management wants to inflate earnings in order to maximize the value of their stock options, the lower the liability faced by their auditors, the easier it will be for management to convince them to acquiesce in dubious accounting policies.

The key conceptual difference between the two proposals involves this proposal's more explicit adoption of a deterrence framework. Prior proposals for making the auditor an insurer have relied on a tort law rationale, which tries to force the tortfeasor to internalize the social costs of its actions by making it pay a higher fee. Neither Professor Partnoy's proposal nor the proposal made here compels the auditor to internalize the full costs of the issuer's fraud, but to the extent that Partnoy's proposal would often lead to higher damages, it should encourage greater precaution and more monitoring. But to that same extent, his proposal would also lead to a greater risk of market failure, either because auditing firms would become insolvent, exit the market, or cease to offer their services to deserving clients. While the relative balance of costs and benefits may seem indeterminate, the real issue is how much additional incentive do auditors need to monitor optimally? Deterrence is excessive to the extent it serves only to shift losses from the issuer to the auditor without reducing the risk of fraud. To the extent that auditor acquiescence in fraud is willful, one can deter it simply by eliminating the expected gain. Under standard deterrence theory, prevention simply requires that the expected punishment cost exceed the expected gain.¹⁵⁴ Professor Partnoy's proposal to use a percentage of the issuer's losses as the minimum floor on contracting does not bear any functional relationship to the expected gain; nor does it increase the penalty to compensate for the limited risk of detection. To the extent, however, that auditor failure is the result of negligence or inadequate precaution, the need for

¹⁵⁴ See generally, Gary S. Becker, Crime and Punishment: An Economic Approach, 76 J. Pol. Econ. 169 (1968).

higher penalties becomes clearer, and a focus on the total social loss (rather than simply the expected gain) becomes more justifiable. But even here, we return to a basic dilemma: many aspects of GAAP principles may simply not be “auditable.”¹⁵⁵ If so, additional deterrence is unjustified because it cannot reduce the overall social loss.

Obviously, this article’s proposal of stricter liability with a lower ceiling based on a multiple of the revenues from the client will typically (but not inevitably) result in lesser liability than under the Partnoy proposal.¹⁵⁶ But it still gives the gatekeeper ample incentive to utilize all monitoring controls (including closer monitoring of its own agents) that are reasonably likely to reduce the prospect of fraud or earnings manipulation. Above all, this approach prevents the market for gatekeeping services from unraveling.

How strict need a stricter system of liability be? Here, we enter the thicket of political realism. Pure strict liability might be the best rule, but it is probably not politically acceptable to auditors, who represent a powerful political lobby. Nor does it seem defensible to impose a significantly higher standard of liability on the auditor than on its client, the issuer. In this light, the highest standard of liability that might be politically attainable in the case of auditors would be that set forth already for auditors in Section 11 of the Securities Act of 1933, which requires the auditor as an expert to prove as an affirmative defense that the auditor “had, after reasonable

¹⁵⁵ See Ronen, *supra* note 101, at 41.

¹⁵⁶ To illustrate the difference between the two proposals consider a very large issuer that experiences a sudden \$50 billion decline in its market capitalization as the result of accounting irregularities. Assume further that the issuer’s auditor had received only \$10 million in fees, and that Professor Partnoy would limit the auditor’s exposure to 10% of the total loss (or \$5 billion). Thus, there is here a 500:1 ratio between the auditor’s projected liability (\$5 billion or 10% of the losses) and its own gain (\$10 million). This represents overdeterrence - unless one thinks there is less than a 1% chance of detection. In even a minimally efficient market, however, the prospect of detection of accounting irregularities seems far higher than that. In contrast, this article would impose a ceiling on auditor liability on these facts at \$100 million (or 10 times its gain).

investigation, reasonable grounds to believe and did believe that “its statement were true.”¹⁵⁷ In effect, the burden would be shifted to the auditor in all Rule 10b-5 actions to prove its non-negligence and good faith belief in its statements.

C. Implementing the Gatekeeper Role of Attorneys. The foregoing proposal for “stricter liability” has been primarily framed with auditors in mind. But should it apply to other gatekeepers, such as, for example, attorneys or securities analysts? Because the economic case for strict liability assumes both that the gatekeeper can prevent misconduct by investing more resources in precaution and that the gatekeeper can pass on its increased costs to the principal, some basic distinctions need to be recognized about gatekeepers. Some are more able than others to prevent and detect misconduct. While the auditor inhabits a relatively precise and rule-bound world, the securities analyst is essentially a prognosticator whose predictions about the future are frequently wrong. Thus, imposing strict liability on the securities analyst, given the analyst’s necessarily higher rate of error, may amount to a virtual death sentence for the analyst. In addition, the analyst cannot pass on its higher exposure to liability to its client in the form of higher fees, because the analysts is not paid by the corporate issuer (but rather by investors through brokerage commissions). If brokerage commissions were increased, investors simply turn to discount brokers (or others), who did not use securities analysts.

The case of the attorney forces us to focus on other differences: First, functionally, attorneys act only occasionally as gatekeepers, certifying or verifying information for investors, while auditors perform this function primarily (and increasingly exclusively). Second, the role of gatekeeper arguably conflicts with the more typical roles performed by attorneys as either advocates or transaction engineers for their clients. Third, asking attorneys to serve as

¹⁵⁷ See Section 11(b)(3)(B) of the Securities Act of 1933, 15 U.S.C. § 77(k).

gatekeepers may dry up the flow of confidential information between attorney and client, thereby jeopardizing the ability of the attorney to serve the client. Based on these premises, the bar (and its academic defenders) have vehemently argued that, if the attorney were compelled to serve as a watchdog, instead of as an advocate or transaction engineer, for the client, the client could no longer depend on the attorney as a zealous advocate or transaction engineer.¹⁵⁸

Although this debate has generated much heat, little empirical light has been focused on just what could be reasonably expected if attorneys were subjected to a “noisy withdrawal” standard. Yet, one natural experiment exists that does shed useful light on this question. In 1995, as part of the PSLRA, Congress added Section 10A to the Securities Exchange Act of 1934, which section requires auditors to report to the SEC likely illegal acts that have a material impact on the issuer’s financial statement, which an auditor discovers during the course of an audit, unless the issuer takes appropriate remedial action to remedy them.¹⁵⁹ This is the functional equivalent of the noisy withdrawal requirement that the SEC has proposed (but not adopted) for securities attorneys.¹⁶⁰ The existence of this provision raises the obvious question: what has been the experience under it? The short answer is that not much has happened. A 2003 report by the United States General Accounting Office finds that over the period between when Section 10A became effective for fiscal years beginning after January 1, 1996 through May 15, 2003, the

¹⁵⁸ For a detailed exposition of this argument that the roles of the attorney and the gatekeeper are essentially inconsistent and that attorneys make poor informational and reputational intermediaries, see Jill E. Fisch and Kenneth M. Rosen, Symposium: Lessons from Enron, How Did Corporate and Securities Law Fail? Is there Role for Lawyers in Preventing Future Enrons? 48 Vill. L. Rev. 1097 (2003).

¹⁵⁹ See Section 10A (“Audit Requirements”) of the Securities Exchange Act of 1934, 15 U.S.C. [78j].

¹⁶⁰ See Securities Exchange Act Release 34-8186 (January 29, 2003).

SEC has received a grand total of 29 Section 10A reports from auditors.¹⁶¹ Yet, Section 10A's enactment was not resisted by the auditing profession, which instead viewed the section as part of a highly desirable political compromise that would secure it litigation protection through the enactment of other provisions of the PSLRA.

From such evidence, it seems a fair inference that attorneys would be even less likely to report misconduct to the SEC under an SEC rule requiring "noisy withdrawal." After all, auditors are expected to audit and report damaging information, while such reporting runs counter to the professional culture of attorneys. This conclusion does not mean that attorneys should not be asked to perform a gatekeeping role, but rather that, to be effective, such an obligation must be placed in a context whereby the attorney is playing a clearly defined professional role that the client has invited. Otherwise, the attorney is risking professional disaster and will predictably resist. A serious strategy for converting the attorney into a gatekeeper must also address the tension between the roles of gatekeeper and advocate, possibly by separating the two roles and encouraging firms to employ multiple counsel. That is, the corporation could use different law firms, one to plan and structure a transaction and the other to supervise disclosure. Obviously, this would involve increase costs, because duplicative work would be performed. Yet, this is essentially what Sarbanes-Oxley did to the accountant, divorcing the roles of auditor and consultant because of the clear conflict of interest. In any event, such a separation need not be legally mandated in the case of the attorney, because it

¹⁶¹ See U.S. General Accounting Office, Securities Exchange Act: Review of Reporting Under Section 10A, GAO-03-982R (Washington, D.C. September 3, 2003) at p. 1. The SEC has also brought seven enforcement actions over this same interval against auditors for violations of Section 10A. *Id.* This may also suggest that the SEC is slow to bring enforcement proceedings against professional firms (and would remain similarly reluctant to enforce a "noisy withdrawal" rule against attorneys).

could be left to the corporation to decide if it felt sufficiently threatened by an attorney who was under a legal obligation perform a gatekeeping function that it wished to hire multiple counsel. Firms would not need to specialize in one or the other role, but ideally a law firm would not serve in both capacities to the same client.

Such a proposal is well in advance of where the SEC is today. To date, the SEC has never articulated any general statement of the attorney's gatekeeper role. Although Section 307 of the Sarbanes-Oxley Act authorizes the SEC to promulgate minimum standards of professional conduct for securities attorneys, the SEC has to this point addressed only the narrow, but sensitive, context of the attorney's obligations when the attorney discovers a material violation of law. Beyond this point, it has made no broader attempt to provide any conceptual overview of the attorney's overall responsibility to investors.¹⁶² Yet the statutory authority to do so seems clearly contained in Section 307. For example, minimum standards of professional conduct could (1) require the attorney to perform reasonable due diligence with respect to the statements made in disclosure documents that the attorney drafts for the corporate client; (2) mandate standards of independence for attorneys performing certain sensitive tasks incident to securities practice; and (3) subject the attorney to professional discipline for negligence or malpractice, thus giving the SEC a useful enforcement tool in cases where it suggest misconduct but cannot easily prove scienter.

On the premise that securities attorneys should serve as gatekeepers for investors, this article will make three specific proposals. First, the SEC should adopt a limited certification requirement mandating that a securities attorney acknowledge that it has reviewed the non-

¹⁶² See Securities Release No. 33-8185 (January 29, 2003) (adopting final rule establishing standards of professional conduct for attorneys who appear or practice before the Commission).

financial disclosure in publicly filed reports; second, it should establish independence standards for securities attorneys performing certain tasks that require them to be independent of management, such as the conduct of internal corporate investigations for publicly held firms; and third, the SEC should deem negligence by attorneys in the preparation of SEC disclosure documents to amount to unprofessional conduct for which attorneys could be disciplined under the SEC's Rules of Practice (just as auditors can be disciplined today).¹⁶³ Uniting these proposals is the idea that the attorney should perform a due diligence investigation of the corporation's non-financial disclosures that roughly corresponds to the auditor's role with respect to financial disclosures.

1. A Negative Assurance Certification. A certification requirement applicable to attorneys can be justified simply on the grounds of consistency. Today, a publicly-held corporation's CEO and CFO must certify that each periodic report "fairly presents in all material respects" the issuer's "financial condition and results of operations."¹⁶⁴ Similarly, the securities analyst must also today certify that the analyst truly agrees with his or her research advice to investors.¹⁶⁵ Thus, managers, auditors and analysts all certify their work, but the corporations' principal counsel does not. Arguably, the attorney should not be able to escape a corresponding obligation, particularly because the auditor takes no responsibility for the textual portion of the disclosure document, which is independent of the financial statements that the auditor certifies.

¹⁶³ See Rule 102(e)(1)(iv) of the SEC Rules of Practice, 17 CFR § 2001.102(e)(1)(iv) (authorizing SEC to suspend or censure an accountant for "a single instance of highly unreasonable conduct...[or]...repeated instances of unreasonable conduct."

¹⁶⁴ See text and notes *supra* at notes 125 to 129 (discussing certification requirements under Sections 302 and 906 of Sarbanes-Oxley).

¹⁶⁵ See Securities Act Release 33-8193 (February 20, 2003) (adopting Regulation AC, which requires a research analyst employed by a broker or dealer to certify that the views expressed in the research report accurately reflect his or her personal views).

In effect, attorney certification mandates a parallel expert to review the non-financial disclosures of the public corporation, but the attorney as gatekeeper would not be asked to perform an audit or check facts in the manner that an auditor does.

Specifically, the attorney principally responsible for preparing a document or report filed with the SEC should certify (1) that such attorney believes the statements made in the document or report to be true and correct in all material respects, and (2) that such attorney is not aware of any additional material information whose disclosure is necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.¹⁶⁶ The real thrust of this proposal is to require the issuer to subject its principal disclosure documents to the scrutiny of an attorney who would be under a professional obligation to exercise a reasonable level of “due diligence” in his or her review.¹⁶⁷ Today, there is no barrier to the preparation and filing of such non-financial documents entirely by non-professionals.

At first glance, this proposed certification simply tracks the language of Rule 10b-5. Yet, the bar will object that by subjecting the attorney to the requirement that the attorney exercise reasonable care, the attorney is being subjected to unreasonable liability. In truth, however, this proposed obligation would only generalize existing practices in the market because today, in most public underwritten offerings, issuer’s counsel does deliver an opinion to the underwriters stating that it is not “aware” of any material information required to be disclosed that has not

¹⁶⁶ Issues could arise as to which attorney was principally responsible for preparing a document. The simplest answer to this issue is to require the corporation to disclose the identity of such attorney in the filing and then require that attorney’s certification.

¹⁶⁷ An open question, on which this article takes no position, is whether such review should be by an attorney “independent” of management - - a term that additional SEC rules could define.

been disclosed.¹⁶⁸ SEC rules would therefore simply be requiring for 1934 Act periodic filings what is already done in the primary market for 1933 Act disclosure documents; the real difference is that the case of periodic filings under the Securities Exchange Act, there is no analogue to the underwriter to demand such an opinion or certification from the attorney. Thus, SEC action would fill this void. In addition, such a requirement would have a profound symbolic and psychological effect on the bar because it would recognize the attorney's obligations as a gatekeeper. Ideally, the SEC should go even further and require the attorney to certify that the attorney so believed "after making such inquiry that the attorney reasonably believed appropriate in the circumstances;" this would establish at least a minimal due diligence obligation. To be sure, this is a far cry from the strict liability that the auditor would face, but it

¹⁶⁸ For a description of this standard opinion in registered public offerings, see Richard Howe, Rethinking Legal Opinion Letters: The Duties and Liabilities of Attorneys in Rendering Legal Opinions, 1989 Colum. Bus. L. Rev. 283, 287 (1989). The author of this article, a partner at the New York firm of Sullivan and Cromwell, properly observes that "such opinions are not really 'legal opinions' at all in that they do not state any legal conclusion but only say that the attorney believed certain facts to be true." *Id.* Precisely for this reason, such an opinion is more a pledge of the law firm's reputational capital, which the underwriters demand. The counsel giving such opinion does not purport to conclude that all information required to be disclosed has been disclosed (as an auditor might by analogy), but only that it lacks personal knowledge or belief as to any such failure. See also Ronald J. Gilson, Value Creation by Business Lawyers: Legal Skills and Asset Pricing, 94 Yale L. J. 239, 291 (1984) (also describing such opinions); Richard W. Painter, Toward A Market for Lawyer Disclosure Services: In Search of Optimal Whistleblowing Rules, 63 Geo. Wash. L. Rev. 221, 226-27 and n.19 (1991) (discussing judicial interpretation of such opinions). The American Bar Association has characterized this type of opinion as a "negative assurance" and finds such opinions to be "unique to securities offerings." See ABA Comm. on Legal Opinions, Third-Party Opinion Report, Including the Legal Opinion Accord of the Section of Business Law, American Bar Association, 47 Bus. Law. 167, 228 (1991). Although the ABA considers it generally inappropriate for attorneys to request such "negative assurance" opinions from other attorneys, the special context of securities offerings is exempted, reflecting the fact that underwriters consider such an assurance to be necessary to them. That the ABA, as the representative of the bar, "disfavors" such opinions, because of the demands they place on the attorney, probably only underscores the value of such a reform.

is a meaningful enhancement, designed to elicit greater precaution from, and investigation by, attorneys. Indeed, law firms would likely to agree to provide such certification only if they could maintain a continuing oversight of the firm; one-time-only certifications would be a service that few firms would dare to provide.

Admittedly, limits need to be recognized on what an attorney can certify. Because the attorney does not audit its client, the attorney should not be asked to certify the accuracy and completeness of all information disclosed in SEC filings; nor should it be asked to investigate the financial statements that auditor certifies (although the attorney should be required to certify his or her belief that these statements contain no material misrepresentations or omissions).¹⁶⁹ Thus, the proposal here made requires only a negative certification that the attorney had no reason to believe, and did not believe, that the information was materially false or misleading. Legally, such a certification would trigger “aiding and abetting” liability if the attorney was aware of materially false or misleading information, and it could even trigger criminal liability under various federal statutes. But its primary effect is to recognize that the securities attorney is a gatekeeper for investors.

2. Independence. Auditors, of course, must be independent of their client, and SEC rules have long defined tests for auditor independence. Increasingly, a new literature has warned that attorneys are becoming too economically interconnected with their client to exercise independent judgment, as the result in part of the increasing practice of law firms taking (and even demanding) equity stakes in the client in return for professional services.¹⁷⁰ If some level of independence is

¹⁶⁹ The attorney thus would not be required to certify that it exercised reasonable care or otherwise investigated the financial statements.

¹⁷⁰ See John S. Dzienkowski and Robert J. Peroni, The Decline in Lawyer Independence: Lawyer Equity Investments in Clients, 81 Texas L. Rev. 405

necessary for an attorney to function as a gatekeeper, SEC rules of professional conduct could define these limits. To illustrate, a law firm that holds in its portfolio 10% of the corporate client's equity (or, alternatively, equity in the client equal to 10% of its own net asset value) will probably be a poor, or at least a biased, monitor.

In any event, the context that is most sensitive and would most benefit from such rules is that of internal corporate investigations. Often, such investigations are mandated by the SEC, and typically the resulting reports are filed with the SEC. Should the corporation's normal outside counsel perform such an investigation? Or, should SEC rules define the level of independence necessary to conduct such a more sensitive inquiry? Absent SEC action, individual state bar associations will either do nothing (the most likely outcome) or prescribe different and inconsistent standards, thereby creating needless disparities. Uniform standards for corporate internal investigations are desirable and as a practical matter can only come from the SEC. There is no need to offer precise rules here, but only to recognize that professionals are expected to be independent of their clients. Accordingly, the SEC should read Section 307 to grant it authority to define the point at which the attorney is not sufficiently independent of the client to perform certain sensitive tasks.

3. The Due Diligence Obligation. Certification is only a first step. The next logical step would be to mandate due diligence by the attorney in preparing or reviewing SEC filings as a minimum standard of professional conduct. Here, Sarbanes-Oxley changes the picture significantly, because Section 307 of Sarbanes-Oxley authorizes the SEC to establish "minimum standards of professional conduct for attorneys appearing and practicing before the Commission...." This reference to "professional conduct" would certainly seem to empower the

(2002); Royce de R. Barondes, Professionalism Consequences of Law Firm Investments In Clients: An Empirical Assessment, 39 Am. Bus. L. J. 379 (2002).

SEC to adopt rules requiring the attorney both to conduct a minimal due diligence review before the attorney files a document or report with the SEC and to certify its good faith belief in the accuracy of the statements made therein. Indeed, in its existing Rules of Practice, the SEC already holds auditors to precisely such a standard and asserts the power to suspend or disbar them for merely negligent conduct.¹⁷¹ If this can be done without special statutory authority, then it seems to follow a fortiori, after the enactment of Section 307, that the SEC could require attorneys to take reasonable steps to investigate the accuracy of statements made in documents that they prepare.¹⁷²

The bottom line then is that the SEC is today empowered to adopt rules that could suspend or disbar an attorney for negligence as a form of professional misconduct. Negligence would clearly not support a private cause of action under Rule 10b-5, but it may be the appropriate standard for the imposition of sanctions under Section 307.¹⁷³ Such a tradeoff - - i.e., public liability but not private liability for negligence - - again seems desirable in that it enhances deterrence without threatening insolvency for law firms.

d. Accessing Counter-Arguments: Can Attorneys Be Gatekeepers? Any assertion that the SEC should compel the securities attorney to play a greater gatekeeping role inevitably runs into the argument that such a role is either inappropriate for attorneys or will reduce their clients'

¹⁷¹ See 17 C.F.R. § 201.102(e)(iv) (specifying that two forms of “negligent conduct” - - either “a single instance of highly unreasonable conduct” or “repeated instances of unreasonable conduct” - - could trigger sanctions under Rule 102(e)).

¹⁷² The attorney would, of course, be entitled to rely on the auditor with respect to financial information certified by the auditor, as in the case of the “reliance on an expert” defense under Section 11(b)(3)(c) of the Securities Act of 1933. See 15 U.S.C. Section 77(k)(b)(3)(c).

¹⁷³ Historically, the SEC did once hold attorneys liable for professional negligence in “aiding and abetting” cases. See SEC v. Spectrum Ltd., 489 F.2d 535, 536 (2d Cir. 1973). This is no longer possible after the Supreme Court mandated a scienter standard in Hochfelder, but sanctions for professional misconduct could look to a similar standard.

willingness to confide in them. The first claim that such a role is inappropriate depends largely on one's vantage point. Litigators tend to view the attorney as an advocate for, and protector of, the client - - a bulwark between the client and an oppressive state.¹⁷⁴ Securities attorneys are less ready to buy into this rhetoric, however, and do not have the same self- image of themselves. For the most part, they agree that they have at least an ethical responsibility to perform due diligence on documents they draft and file with the SEC. For over a quarter century, prominent securities attorneys have recognized that, as a result, their professional role is closer to that of the auditor than to that of the litigator.¹⁷⁵ The key elements that distinguish the attorney as advocate

¹⁷⁴ Evans A. Davis, The Meaning of Professional Independence, 103 Colum. L. Rev. 1281 (2003) (arguing that the SEC's up-the-ladder reporting rules inhibit professional independence).

¹⁷⁵ The literature here is enormous, but one brief statement by a securities lawyer of iconic reputation stands out above the field. In 1974, in a famous and much quoted address, A.A. Sommer, Jr., then an SEC Commissioner, gave an address in which he initially described the securities attorney not as an advocate but rather as "the field marshal who coordinate[s] the activities of others engaged in the registration process." See A.A. Sommer, Jr., "The Emerging Responsibilities of the Securities Lawyer, Address to the Banking, Corporation & Business Law Section, N.Y. State Bar Ass'n" (January 24, 1974), reprinted in Larry D. Soderquist & Theresa Gabaldon, SECURITIES REGULATION 617 (4th ed.1999). Then, based on his description of the attorney as more a transaction engineer than an advocate, he offered his normative assessment:

"I would suggest 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 attorney. This means several things. It means that he will have to exercise a measure of independence that is perhaps uncomfortable if he is also the close counselor of management in other matters, often including business decisions. It means he will have to be acutely cognizant of his responsibility to the public who engage in securities transactions that would never have come about were it not for his professional presence. It means that he will have to adopt the healthy skepticism toward the representation of management which a good auditor must adopt. It means that he will have to do the same thing the auditor does when confronted with an intransigent client - - resign."

Id. at 317-319.

from the attorney as gatekeeper are: (1) a need for greater independence from the client; (2) a recognition of a duty to the public; and (3) professional skepticism.¹⁷⁶ Exactly these differences need to be recognized by the SEC under Section 307.

The more important counter-argument to imposing gatekeeper obligations on securities attorneys is that attorneys will be unable to communicate as freely with their clients if gatekeeper obligations or “noisy withdrawal” requirements were imposed. In response to this claim, it is first necessary to recognize that the ultimate goal of the law is to achieve law compliance, not to maximize uninhibited communications between the attorney and the client.¹⁷⁷ The norm of client confidentiality is a means to an end, not the end in itself.

Still, even with this concession, it remains true that lawyers can counsel most effectively when there is open, relatively unconstrained communication between their clients and themselves. Hence, the practical issue becomes whether gatekeeper obligations would necessarily chill desirable attorney/client communications. Here, two arguments need to be considered.

First, lawyer/client relationships are less likely to be chilled if corporate clients use the gatekeeping attorney as a specialist, employing one attorney to consult on the transaction and

Although Commissioner Sommer never used the term “noisy withdrawal” in this speech, the same concept seems to have been, more or less, on his mind, and the elements that he does specifically enunciate - - high independence, duty to public investors, professional skepticism - - probably are the key elements that distinguish the attorney as advocate from the attorney as gatekeeper.

¹⁷⁶ See A.A. Sommer, *supra* note 175, at 317-319.

¹⁷⁷ Thus, the “crime/fraud” exception to the attorney/client privilege makes some communications between attorney and client discoverable, even though this result thereby arguably makes clients less ready to confide in their attorneys. The justification for this result, which applies similarly to this context, is that communications so excluded from the privilege are deemed socially undesirable. For the current status of this exception, see *In re Richard Roe, Inc.*, 168 F.3d 69 (2d Cir. 1999). See also David N. Zarnow & Keith Krakaur, *On the Brink of a Brave New World: The Death of the Privilege in Corporate Criminal Investigation*, 37 Am. Crim. L. Rev. 147 (2000) (suggesting that the attorney/client privilege is already highly qualified in this context).

another to review and prepare the disclosures. This may be duplicative, but it is essentially the same duplication that exists between the in-house bookkeeper and the outside auditor. Indeed, because the gatekeeper could prepare the disclosure document, there would not be complete duplication, as there is in the case of financial statements. In addition, specialization by attorneys as gatekeepers also mitigates the “one client practice” problem that challenges all professional service firms, auditors as well as attorneys. A professional with a single dominating client has an incentive to subordinate his own firm’s interest in preserving its reputation to his client’s demands for acquiescence. But gatekeepers, as specialists, would typically serve multiple clients and hence would be less dominated. Law firms could specialize in this role, or more likely service some clients as gatekeepers and others as transactional engineers.

A second response to the claim that attorney/client communication will be chilled is to focus both on when such communications are most desirable and least desirable. A plausible case can be made that a “noisy withdrawal” rule threatens primarily the least desirable communications. The starting point for this analysis is the recognition that the typical client knows little law and will almost always want to know if contemplated action is illegal. From this premise, it follows that the corporate official contemplating prospective action will still inquire of counsel whether the course of action under consideration is lawful. Indeed, the more the government pursues white collar criminal prosecutions and punitive regulatory actions in the contemporary post-Enron environment, the more in turn that corporate officers are likely to inquire before they act. When then will communications be most likely to be chilled? The likely answer is that the officer who has already acted may fear inquiring of an attorney if the officer’s conduct was lawful - - precisely because the officer fears that the attorney may be under an

obligation to report unlawful actions to higher authorities or, indirectly, to the SEC. In short, it is the “ex post” inquiry by the client of the attorney that is most likely to be chilled.

If one accepts this premise that ex ante communications between counsel and the client are less likely to be chilled than ex post communications, several implications follow: First, the impact of imposing gatekeeper obligations on attorneys may be socially desirable. In a well-known article, Professors Kaplow and Shavell have argued that the case for protecting ex ante communications between attorneys and clients is far stronger than the case for protecting ex post communications.¹⁷⁸ Advice before action leads individuals to comply with the law, they argue, whereas ex post advice does not provide a guide for action and may simply allow the defendant to reduce the expected penalty costs, thus encouraging illegality. It is not necessary to fully accept the Kaplow/Shavell analysis to see that its core distinction between ex ante and ex post advice suggests that we should be more concerned about chilling “ex ante” communications between attorney and client. But this is not what most gatekeeper obligations do; rather, they may induce such communications by making “ex post” advice less possible.

Second, requiring “noisy withdrawals” and “up-the-ladder” reporting also has a deterrent value that is independent of this issue of whether the initial corporate actor will still consult counsel. Few significant actions within a corporation can be taken by a single actor. Decisions made by one person still need to be implemented by others. Thus, even after the initial corporate actor has taken an irrevocable step (and will thereafter be arguably less willing to consult with counsel ex post), other corporate actors will need to be contracted and convinced to cooperate with the initial actor. They will have every incentive to consult with counsel because they are

¹⁷⁸ See Louis Kaplow and Steven Shavell, Legal Advice About Information to Present in Litigation: Its Effects and Social Desirability, 102 Harv. L. Rev. 565 (1989); see also Richard Posner, An Economic Approach for the Law of Evidence, 51 Stan. L. Rev. 1477, 1531-33 (1999).

still at the “ex ante” stage. In turn, knowledge that others are necessarily likely to learn of the original actor’s conduct and to consult with counsel about its legality may deter the original actor. The modern public corporation is embedded with in-house attorneys, and even the possibility that they will report “up the ladder” should deter some illegal conduct. Hence, even if under some conditions there may be less direct communication between corporate actors and counsel, knowledge that sooner or later counsel is likely to learn ex post can still deter corporate actors ex ante.

As a result, the principal practical effect that imposing gatekeeper obligations will have on clients is that a client who has been advised by an attorney that contemplated action is unlawful now has greater reason to heed that attorney’s advice - - again precisely to the extent that the client believes that the attorney may be under a legal obligation to report any misconduct (either inside the corporation or outside). Thus, even if it were true that clients would consult less, this impact could be more than fully offset by the fact that it would become more dangerous to disregard the lawyer’s advice. Add to this mix the likelihood that “ex ante” advice will not be chilled, and the net impact is to increase the attorney’s leverage over the client by making it more dangerous to ignore the attorney’s advice. If law compliance is the goal, such an impact seems socially desirable.

CONCLUSION

The diagnosis of “gatekeeper failure” made in Part I of this article leads naturally to a multi-part prescription for law compliance: the law should create, empower and deter gatekeepers. Deterrence is easy, but it can be overdone. Thus, although this article has favored a shift towards stricter liability, it has coupled this recommendation with a proposed ceiling on

liability set at the level necessary to deter the gatekeeper. This proposal may subordinate compensation to deterrence - - but only with regard to litigation against gatekeepers, who are seldom in any event in a position to fund full compensation to the investor class.

Empowerment is a trickier question. If we are to reduce accounting and financial reporting irregularities, the optimal strategy must both motivate and empower gatekeepers to insist upon law compliance. In the case of the attorney, the first step toward making the securities attorney a gatekeeper should be to enhance their leverage over their clients in order to enable them to exert greater pressure for law compliance. A mandatory attorney certification standard, enforced by a due diligence obligation, does essentially this by forcing the client to seek the attorney's review. The end goal of these reforms should be to encourage the emergence of a new specialist: the lawyer/gatekeeper, who would practice alongside and not in conflict with the lawyer/advocate and the lawyer/transaction engineer.

Gatekeeper empowerment necessarily requires intruding upon our existing guild-like structure of private self-regulation of the professions. Sarbanes-Oxley already does this in the case of the accounting and analyst professions, but the SEC has not yet compelled the legal profession to recognize its mandatory obligations to the public. Professions, like guilds, will predictably resist any increase in their responsibilities and liabilities to the public, but, as the accounting profession has already found, the professional cannot remain aloof and self-governing once the social cost of gatekeeper failure has become apparent.