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What Caused Enron? A Capsule Social and Economic History of the 1990s

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The sudden explosion of corporate accounting scandals and related financial irregularities that burst over the financial markets between late 2001 and the first half of 2002—Enron, WorldCom, Tyco, Adelphia and others—raises an obvious question: Why now? What explains the concentration of financial scandals at this moment in time? Much commentary has rounded up the usual suspects and placed the blame on a decline in business morality,1 an increase in "infectious

1 See William H. Widen, Enron at the Margin, 58 Bus. Law. 961, 962–63 (2003) ("The problem is that corporate and legal culture has lost all sense of right and wrong."). I hope that Professor Widen has overstated the matter, but I cannot prove him wrong.
greed,” or other similarly subjective trends that cannot be reliably measured. Although none of these possibilities can be dismissed out of hand, approaches that simply reason backwards, proceeding from the observation that the number of scandals has increased to the conclusion that a decline in business morality has therefore occurred, merely assume what is to be proven.

Alternatively, others have blamed these scandals either on a few “rogue” managers who somehow fooled the capital markets, or on negligent, inattentive boards of directors. No doubt, there were some rogues and some particularly bad boards. Yet the most reliable evidence, when properly read, suggests that Enron and related scandals were neither unique nor idiosyncratic; rather, pervasive problems arose that undercut existing systems of corporate governance. Thus, a focus on the deficiencies of any individual board of directors cannot explain the sudden surge of governance failures. As no plausible theory suggests that board performance has generally deteriorated over recent years, one must look beyond the board, in particular to those who provide or control its informational inputs, to explain this concentration of scandals.

Still another unsatisfactory response to the concentration of recent scandals has been to posit that a wave of recriminations, soul-searching, and scapegoating necessarily follows the collapse of any market bubble. Clearly, a large frothy bubble did burst in 2001. As a historical matter, bubbles do tend to produce scandals and prophy-

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3 Although some boards certainly did fail, this explanation again seems intellectually unsatisfactory. Admittedly, a special committee of Enron’s own board has concluded that the Enron board failed to monitor adequately officers or conflicts of interest. See William C. Powers, Jr. et al., Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp. 148–77 (2002), 2002 WL 198018. A Senate subcommittee has similarly assigned the principal blame to the Enron board. See Permanent Subcomm. on Investigations of Comm. on Governmental Affairs, United States Senate, The Role of the Board of Directors in Enron’s Collapse, S. Rep. No. 107-70, at 59 (2002). Nonetheless, such studies beg the larger question: Why did these boards fail now and not earlier?


5 Revealingly, the stock market bubble of the late 1990s burst in two stages, first in 2001 with the demise of the internet related stocks (the “dot-com” bubble) and then again in the late spring of 2002 as WorldCom and other crises further shook market confidence. The S&P 500 index fell 31% between the beginning of 2002 and July 23, 2002. See E.S. Browning, Nasdaq Stocks Sustain Biggest Loss of Year, WALL ST. J., July 24, 2002, at C1. The Dow Jones Average similarly hit its low for the period January 1, 1998 to January 1, 2003, on October 9, 2002, when it closed at 7286.27. See E.S. Browning, Bears Claw Markets Yet Again, as Dow Industrials Fall Nearly 3%, WALL ST. J., Oct. 10, 2002, at A1 (noting that 7286.27 was the Dow Jones’s lowest finish since October 27, 1997). This low point was after the passage
lactic legislation, 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 a once-confident system of corporate governance?

This Article seeks to move beyond the "few bad apples" or "rogue managers" explanation, or the cynical assumption that scandals are inevitable and cyclical, to identify common denominators across the range of recent cases. Although this Article does not seek to explain what happened in any individual case (including Enron) or to generalize from any specific case to reach broader conclusions about corporate governance, it does suggest that the explosion of financial irregularity in 2001 and 2002 was the natural and logical consequence of trends and forces that had been developing for some time. Ironically, the blunt truth is that recent accounting scandals and the broader phenomenon of earnings management are by-products of a system of corporate governance that has indeed made corporate managers more accountable to the market. Yet sensitivity to the market can be a mixed blessing, particularly when the market becomes euphoric and uncritical. To the extent that the market becomes the master, governance systems that were adequate for a world in which market focuses were weaker need to be upgraded in tandem with market developments to protect against manipulation and distortion by self-interested managers. This, in turn, takes us back to the central role of gatekeepers.

Above all, the fundamental developments that destabilized our contemporary corporate governance system were those that changed the incentives confronting both senior executives and the corporation's outside gatekeepers. In contrast, little reason exists to believe that the behavior of boards deteriorated over recent years. Thus, a focus on gatekeepers and managers provides a better perspective for analyzing both what caused these scandals and the likely impact of the recent congressional legislation passed in their wake. Accordingly, this Article will initially relate the recent scandals to changes in managerial and gatekeeper compensation over the last two decades. Yet, although the incentives of managers and gatekeepers clearly changed over the 1990s because of exogenous changes in legal rules and mar-

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6 Professor Stuart Banner has argued that, over the last three hundred 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).

7 See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (stating that this is "[an act to] protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes").
ket conditions, this is not the entire story. Bubbles—here defined to
mean a state of market euphoria in which investors lose their normal
skepticism—also change the behavior of gatekeepers, managers, and
shareholders. To some degree, responsibility must be allocated
among three different groups: (1) gatekeepers; (2) managers; and (3)
shareholders, particularly institutional investors. Initially, this Article
will focus on the special institution of corporate gatekeepers (on
whom it argues modern corporate governance depends) and how
their behavior may logically change during a bubble. Then, it will
turn to managers and shareholders. This Article's conclusions have
policy implications and in particular provide a perspective on the
likely impact of Congress's efforts to address these recent scandals in
the Sarbanes-Oxley Act.

I
THE PRIOR EQUILIBRIUM: AMERICAN CORPORATE
GOVERNANCE AS OF 1980

The world of corporate governance changed quickly and rad-
ically during the final two decades of the last century. If one turned
back the clock to before 1980, one would find that the dominant aca-
demic commentary on the corporation of the pre-1980 era articulated
a "theory of managerial capitalism" that essentially saw the public cor-
poration as a kind of bloated bureaucracy that maximized sales,
growth, and size, but not profits or stock price. Academic writers
such as Robin Marris and William Baumol viewed the firms of that era
as pursuing an empire-building policy, which "profit satisfied," rather
than profit maximized. Professional managers balanced the interests
of different constituencies and, at least according to some commenta-
tors, assigned no special priority to the interests of shareholders. Such
a management strategy was motivated in large part by the desire of the
corporation's managers to increase their own security and perqui-
sites. Conglomerate mergers, for example, achieved these self-inter-
ested ends by reducing the risk of insolvency, thereby protecting
senior managers by providing them with a diversified but largely unre-
related portfolio of businesses that could cross-subsidize each other and

8 See e.g., William J. Baumol, Business Behavior, Value and Growth (2d ed. Har-
court, Brace & World, Inc. 1967) (discussing oligopoly theory and the theory of economic
development); Robin Marris, The Economic Theory of 'Managerial' Capitalism (1967)
discussing managerial capitalism and proposing an internal theory of the firm); see also
Oliver E. Williamson, Managerial Discretion and Business Behavior, 53 AM. ECON. REV. 1032,
1055 (1963) (suggesting that either corporations are operated according to a managerial,
utility-maximizing model "or, if 'actual' profits are maximized, that reported profits are
reduced by absorbing some fraction of actual profits in executive salaries and [a variety of
perquisites]").

9 See Baumol, supra note 8, passim; Marris, supra note 8, passim.

10 See Williamson, supra note 8, at 1055.
thereby mitigate the impact of the business cycle.\textsuperscript{11} Also, with greater size came greater cash income to managers and a reduced risk of corporate control contests or shareholder activism.

Some academic writers in this era—most notably Oliver Williamson—did not view the conglomerate as necessarily inefficient; rather, Williamson argued that internal capital markets could be as efficient as external ones.\textsuperscript{12} Still, both sides in this debate concurred that managers were effectively insulated from shareholder demands and could treat shareholders as just one of several constituencies whose interests were to be “balanced.”\textsuperscript{13} Some criticized, while others defended, this lack of accountability, but few denied that managers possessed broad discretion in how they ran the business corporation.

During the 1980s, the advent of the hostile takeover profoundly destabilized this equilibrium. While hostile takeovers predated the 1980s, it was only during that decade, beginning in 1983,\textsuperscript{14} that they first began to be financed with junk bonds. Junk bond financing made the conglomerate corporate empires of the prior decade vulnerable and tempting targets for the financial bidder, who could reap high profits in a bust-up takeover.\textsuperscript{15} In turn, this gave managers of potential targets a stronger interest than they had in the past in their firm’s short-term stock price because, despite the availability of defensive tactics, a target firm could seldom remain independent if its market price fell significantly below its breakup value for a sustained period.

Less noticed at the time, but possibly even more significant from today’s perspective, was the change in the nature of executive compensation. Leveraged buyout firms, such as Kohlberg Kravis Roberts, entered the takeover wars, seeking to buy undervalued companies,


\textsuperscript{13} See, e.g., Williamson, The Modern Corporation, supra note 12, at 1559 (noting the “evident disparity of interest between managers and stockholders”).

\textsuperscript{14} The Congressional Research Service identified the year 1983 as the first occasion on which “junk bonds” were used to finance hostile takeovers. See Cong. Research Serv., 99th Cong., The Role of High Yield Bonds (Junk Bonds) in Capital Markets and Corporate Takeovers: Public Policy Implications 23 (Comm. Print 1985).

\textsuperscript{15} See Coffee, supra note 11, at 2–7 (arguing that the characteristic pattern of takeovers began to shift in the early 1980s from synergistic acquisitions to bust-up takeovers); John C. Coffee, Jr., The Uncertain Case for Takeover Reform: An Essay on Stockholders, Stakeholders and Bust-Ups, 1988 Wis. L. Rev. 435, 444.
often in league with these firms' incumbent management. Alternatively, they sometimes installed new management teams to turn the company around. Either way, the goal of the leveraged buyout firms was to create strong incentives that would link management's interest to the firm's stock market value. Thus, firms began compensating senior managers with much greater ownership stakes than had customarily been awarded in the past.

Ironically, the principal actors who destabilized the existing corporate equilibrium were institutional investors and Congress. Institutional investors encouraged greater use of stock options to compensate both managers and directors in order to increase their sensitivity to the market. Congress unintentionally hastened this process by placing a ceiling on the cash compensation that senior executives could be paid. First, in 1984, Congress levied a punitive excise tax on "excess parachute payments" in order to discourage "windfall" compensation paid in connection with change of control transactions. Then, in 1993, Congress enacted § 162(m) of the Internal Revenue Code, which basically denies a tax deduction to a publicly held corporation for annual compensation paid to its chief executive officer, or to any of the next four most highly paid officers, where the amount paid to any such individual officer exceeds $1 million. Predictably, once restricted in the cash compensation they


17 Concerned that target company executives were receiving unjustified "windfall" compensation in connection with "golden parachute" arrangements, Congress enacted the Deficit Reduction Act of 1984, which added §§ 280G and 4999 to the Internal Revenue Code. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (codified as amended at 26 U.S.C. §§ 280G, 4999 (2000)) (providing that the corporation could not take a deduction for any "excess parachute payment," 26 U.S.C. § 280G(a), and levying a 20% nondeductible excise tax on any executive who received such a payment, id. § 4999(a)). Parachute payments consisted of compensation contingent on a change in corporate control, and "excess" payments subject to disfavorable tax treatment were those that exceeded three times the executive's average taxable compensation from the corporation over the past five years. See id. § 280G(b). Hence, if the corporation paid the executive an average compensation of $600,000 over that period, any payment in excess of $1,800,000, which was contingent on a change in control, would be subject to this special excise tax. For a more detailed explanation of the mechanics of this tax, see Bruce A. Wolk, The Golden Parachute Provisions: Time for Repeal?, 21 VA. TAX REV. 125, 129-134 (2001).

18 See 26 U.S.C. § 162(m). Two exceptions to this prophylactic rule are: (1) commissions, such as those from sales that are paid for income generated by the individual, and (2) performance-based compensation based on performance goals established by outside directors and approved by a majority of the shareholders. See id. §§ 162(m)(4)(B)–(C). Stock options fall within the second exemption. See James R. Repetti, The Misuse of Tax Incentives to Align Management-Shareholder Interests, 19 CARDOZO L. REV. 697, 708 (1997). The effect of this provision was not to impose an absolute ceiling, because some firms decided
could pay, corporate planners shifted to greater use of equity compensation, where fewer prophylactic rules governed.\textsuperscript{19} Although this shift towards equity compensation accelerated in the 1990s, it began in the 1980s as a by-product of the takeover movement.

\section*{II}
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THE OLD ORDER CHANGETH: THE NEW GOVERNANCE PARADIGM OF THE 1990s
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The two principal forces that initially changed American corporate governance over the 1990s have already been identified: the takeover movement and the growing use of equity compensation. Other forces that crested during the 1990s—including the heightened activism of institutional investors, a deregulatory movement that sought to dismantle arguably obsolete regulatory provisions, and the media’s increasing fascination with the market as the 1990s progressed—reinforced the impact of the initial forces as each made managers more sensitive to their firm’s market price. In so doing, however, these forces also induced managers to take greater risks to inflate their stock price.

The dimensions of this transition are best revealed if we contrast compensation data from the early 1990s with that from a decade or so later. As of 1990, equity-based compensation for chief executive officers of public corporations in the United States constituted approximately five percent of their total annual compensation; by 1999, this percentage had risen to an estimated sixty percent.\textsuperscript{20} Moreover, between 1992 and 1998, the median compensation of Standard and Poor’s (S&P) 500 chief executives increased by approximately 150\%, with option-based compensation accounting for most of this increase.\textsuperscript{21} The critical point is that in the 1990s, senior executive compensation shifted from being primarily cash-based to primarily stock-based. With this change, management’s focus shifted from the relationship between the firm’s market price and the firm’s break-up

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value, which the advent of the bust-up takeover compelled them to watch, to the likely future performance of their firm's stock over the short run. Far more than the hostile takeover, equity compensation induced management to obsess over their firm's day-to-day share price.

Not only did market practices change during the 1990s, but deregulation facilitated both the use of equity compensation and the ability of managers to bail out at an inflated stock price. Prior to 1991, § 16(b) of the Securities Exchange Act of 1934 required a senior executive of a publicly held company to hold the underlying security for six months after the exercise of a stock option. 22 Otherwise, § 16(b) compelled the executive to surrender any gain from sale to the corporation as a "short swing" profit. 23 In 1991, the Securities and Exchange Commission (SEC) reexamined its rules under § 16(b) and broadly deregulated. 24 In particular, the SEC relaxed the holding period requirements under § 16(b) so that the senior executive could tack the holding period of the stock option to the holding period for the underlying shares. Thus, if the stock option had already been held six months or longer, the underlying shares could be sold immediately upon exercise of the option. As qualified stock options by their terms usually must be held several years before they become exercisable, this revision meant that most senior executives were free to sell the underlying stock on the same day that they exercised the option; thus, they could exploit a temporary spike in the price of the firm's shares. This quickly became the prevailing pattern. Although it was not the goal of deregulation to encourage bailouts, this was an unintended consequence that might have been foreseen.

Even prior to the 1990s, earnings management was a pervasive and longstanding practice. 25 Its goal, however, had traditionally been to smooth out fluctuations in income in order to reduce the volatility of the firm's cash flows and present a simple, steadily ascending line from period to period. 26 Thus, management perfected techniques such as "cookie jar reserves" to save earnings for a rainy day. 27 During

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23 See id.
26 See id. (discussing management's "zeal to . . . project a smooth earnings path").
27 See id. (suggesting that "companies try to meet or beat Wall Street earnings projections in order to grow market capitalization and increase the value of stock options").
the 1990s, however, the nature of earnings management changed, with managers shifting their focus from moderating earnings swings to advancing the moment of revenue recognition. Accounting scandals rose commensurate with this shift toward premature recognition.

At least in part, the increased willingness of managers to recognize income prematurely—in effect, to misappropriate it from future periods—appears linked to the need to satisfy the forecasts of security analysts covering the firm. By the mid-1990s, even a modest shortfall in earnings below the level forecasted could produce a dramatic market penalty as dissatisfied investors dumped the firm’s stock. Yet one must face a circularity problem before blaming earnings management failures on management’s fear of a market overreaction to a modest shortfall below predicted earnings. Typically, the security analyst’s chief source of information about the company is its senior management. If management doubted its ability to meet the analyst’s projection, why did it not encourage the analyst to make a less aggressive forecast in the first instance? The most logical answer again involves the growing importance of equity compensation. Aggressive forecasts drove the firm’s stock price up and enabled management to sell at an inflated price. Premature revenue recognition then became a means

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28 The best evidence of this shift is that the leading cause of financial statement restatements in the late 1990s was revenue recognition errors. The General Accounting Office (GAO) has found that 39% (by far the largest category) of the financial restatements between 1997 and 2002 were the consequence of revenue recognition errors. See U.S. GEN. ACCOUNTING OFFICE, PUB. NO. 03-158, FINANCIAL STATEMENT RESTATEMENTS: TRENDS, MARKET IMPACTS, REGULATORY RESPONSES, AND REMAINING CHALLENGES 5 (2002), available at http://www.gao.gov/new.items/d0.pdf [hereinafter GAO REPORT]. For a brief review of recent accounting scandals, which have been numerous, see Lawrence A. Cunningham, Sharing Accounting’s Burden: Business Lawyers in Enron’s Dark Shadow, 57 BUS. L. 1421, 1423–30 (2002).


30 For the suggestion that management became obsessed with maximizing earnings in the 1990s, see Jeffrey N. Gordon, What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections, 69 U. CHI. L. REV. 1233, 1244–47 (2002) (noting the “obvious” temptations where relatively small changes in earnings have significant impact on the stock price, particularly where management receives a portion of its compensation through stock options).
by which managers satisfied aggressive forecasts that they had themselves encouraged in order to achieve high market valuations.

High market valuations were not, however, simply the product of aggressive forecasting. Beginning in 1995 and continuing until March 2000, the stock market in the United States entered its longest, most sustained bull market in U.S. history.\(^{31}\) In such an excited environment, aggressive forecasting produces a predictable market reaction. Moreover, in a bubble, investors, analysts, auditors, and other gatekeepers may relax their usual skepticism amidst the market euphoria that a sustained bull market generates.

Accounting scandals have had a long history over the last half-century.\(^{32}\) Viewed from a distance, Enron and the related scandals of 2001 and 2002 are probably most comparable to the Savings and Loan (S&L) crisis of the late 1980s, an episode that similarly resulted in draconian legislation.\(^{33}\) Both episodes reveal that perverse managerial incentives were the driving force behind managers' acceptance of high risks on behalf of their firms that they did not fully bear themselves. After the S&L crisis, investigators quickly identified a classic "moral hazard" problem. Because the government guaranteed banks' financial obligations to depositors, these depositors had little reason to monitor management, and accordingly bank promoters were able to leverage their firms excessively. In the case of the Enron-era scandals, the impact of executive stock compensation may have played a similar explanatory role. This comparison leads to a tentative generalization: Perverse incentives, not declines in ethics, cause scandals.\(^{34}\)

Still, an alternative hypothesis also remains plausible. Namely, that a market bubble better explains the failure of those monitors who should have restrained management. Because both explanations can

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\(^{31}\) On January 1, 1995, the Dow Jones Average stood at 3,838.48, up only modestly from the 3,756.60 figure at which it stood on January 1, 1994. See http://djindexes.com/downloads/xlspages/DJIA_Hist_Perf.xls (on file with Cornell Law Review). During 1995, it rose 33.45%, and by January 1, 2002, it had reached 10,073.40, peaking on March 19, 2002 at an all-time high of 10,635.25. See id. It fell that year to a low of 7,286.27 on October 9, 2002 and closed at 8,341.63, for a net decline in 2002, the year of Enron's bankruptcy, of 16.76%. See id.

\(^{32}\) For a review of recent accounting scandals, see Cunningham, supra note 28, at 1423–30.


\(^{34}\) Although one could argue that a decline in ethics occurred, at least within the S&L industry, during the 1980s, economic misincentives better explain that scandal, the accounting irregularities scandals of the 1990s, the securities analyst crisis of 2002, and the current controversy involving mutual funds. Indeed, commentators have so overused the concept of ethical decline that it has lost much of its meaning and now seems merely a post hoc rationalization.
account for the pervasive gatekeeper failures that have accompanied recent financial and accounting scandals, a synthesis seems necessary. Such a synthesis requires, however, that we focus more closely on what defines and motivates the professional gatekeeper.

III
THE CHANGING POSITION OF THE GATEKEEPER
DURING THE 1990s

Although commentators often use the term gatekeeper, its meaning is not self-evident. As used in this article, the term refers to intermediaries who provide verification and certification services to investors. These services may include verifying a company's financial statements (as the independent auditor does), evaluating the creditworthiness of the company (as the debt rating agency does), assessing the company's business and financial prospects vis-à-vis its rivals (as the securities analyst does), or appraising the fairness of a specific transaction (as the investment banker does in delivering a fairness opinion). Attorneys may also act as gatekeepers when they pledge their professional reputations to a transaction, as the counsel for the issuer typically does in delivering its opinion in connection with an initial public offering. However, as later discussed, the more typical role of attorneys serving public corporations is that of the transaction engineer, rather than that of a reputational intermediary. Thus, the auditor and the attorney are located at the opposite poles of


36 For a fuller, more theoretical consideration of the concept of the gatekeeper, see generally Stephen Choi, Market Lessons for Gatekeepers, 92 Nw. U. L. Rev. 916 (1998) (discussing the function of intermediary gatekeepers in different markets and how market failures lead to a decline in gatekeepers); Reinier H. Kraakman, Corporate Liability Strategies and the Costs of Legal Controls, 93 Yale L.J. 857 (1984) (discussing liability rules as a means to induce corporate participants to control corporate wrongdoing); Reinier H. Kraakman, Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy, 2 J.L. Econ. & Org. 53 (1986) (examining liability imposed on private party gatekeepers who “disrupt misconduct by withholding their cooperation from wrongdoers”).

37 Today, in most public, underwritten offerings of securities, issuer’s counsel delivers an opinion to the underwriters—typically called a “negative assurance” opinion—stating that it is not aware of any material information required to be disclosed that has not been disclosed. See Richard R. Howe, The Duties and Liabilities of Attorneys in Rendering Legal Opinions, 1989 Colum. Bus. L. Rev. 283, 287. Such opinions are not truly legal opinions in that they do not truly state any legal conclusion, but rather pledge the lawyer’s reputational capital to assure the underwriters that adverse material information is not being hidden by the issuer. In this sense, the lawyer functions as a gatekeeper, pledging his reputational capital and accepting the risk of liability if he has recklessly misstated. See also John C. Coffee, Jr., The Attorney as Gatekeeper: An Agenda for the SEC, 103 Colum. L. Rev. 1293, 1313 (2003) (discussing “negative assurance” opinions).
a continuum: each can act as a reputational intermediary, but the attorney tends to function as the engineer and the auditor more often as the certifier or reputational intermediary.

Characteristically, the professional gatekeeper assesses or vouches for the corporate client’s own statements about itself or a specific transaction. This duplication is efficient because the market recognizes that the gatekeeper has less incentive to deceive than does its client and thus regards the gatekeeper’s assurance or evaluation as more credible than the client’s statements. To be sure, the gatekeeper’s role as watchdog is arguably compromised by the fact that it is typically paid by the party that it is supposed to monitor. Still, the gatekeeper’s relative credibility stems from the fact that it is, in effect, pledging reputational capital that it has built up over many years of performing similar services for numerous clients. In theory, a gatekeeper would not sacrifice such reputational capital for a single client or a modest fee. Nonetheless, here as elsewhere, logic and experience conflict: Despite the seemingly clear logic of the gatekeeper rationale, experience during the 1990s suggests that professional gatekeepers will acquiesce in managerial fraud, even though the apparent reputational losses would seem to dwarf the gains to be made from an individual client. In this light, the deeper question underlying Enron and related scandals is not: Why did some managers engage in fraud? Rather, it is: Why did the gatekeepers let them?

Initially, the gatekeeper’s reasons for resisting fraud and not acquiescing in accounting irregularities seem obvious. In theory, a gatekeeper generally has many clients, each of whom pays it a fee, which is modest in proportion to the firm’s overall revenues. Arthur Andersen had, for example, 2,300 separate audit clients. On this basis, the firm had little incentive to risk its considerable reputational capital for any one of them.

During the 1990s, many courts wholeheartedly subscribed to this logic. For example, in DiLeo v. Ernst & Young, 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, followed closely by its reputation for careful work. Fees for two years’ audits could not approach the losses

39 See Michelle Mittelstadt, Andersen Indicted in Enron Case, DALLAS MORNING NEWS, Mar. 15, 2002, at 1A.
40 901 F.2d 624 (7th Cir. 1990).
[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].

Of course, the modest fees in some cases were much less than the $100 million in prospective annual fees that Arthur Andersen explicitly foresaw coming from Enron. Yet, this difference in fees fails to explain Arthur Andersen's apparent willingness to accept high risk. 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 and thus its expected Enron revenues would total only around one percent of its aggregate revenues. Hence, a fuller explanation seems necessary to understand gatekeeper failure.

A. The Auditing Profession During the 1990s

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 securities frauds—Waste Management, Inc., Sunbeam, McKesson HBOC, Inc., Baptist Foundation of Arizona, and Global Crossing—that culminated in its disastrous association with Enron.

Those who wish to characterize the recent corporate scandals as simply the work of a few "bad apples," naturally wish to present Arthur Andersen as an outlier or "outlaw" firm unrepresentative of the profession. This theory, however, simply cannot be supported with objective data. The available evidence on the overall

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41 "Id. at 629; see also Melder v. Morris, 27 F.3d 1097, 1103 (5th Cir. 1994) (concluding that the plaintiffs failed to allege sufficient motive for an accounting firm to engage in securities fraud and stating that earning two years' fees from one client would not establish such motivation); Robin v. Arthur Young & Co., 915 F.2d 1120, 1127 (7th Cir. 1990) (finding that a mere $90,000 annual audit fee would have been an irrational motive to commit fraud).

42 See, e.g., Robin, 915 F.2d at 1127 (involving $90,000 in annual audit fees).

43 Arthur Andersen's total revenues for its fiscal year ended August 31, 2001 were $9.3 billion. See Melissa Klein, Guilty Verdict Draws Mixed Reactions: Profession Mulls Post-Andersen Future, ACCOUNTING TODAY, July 8, 2002, at 1. In a February 6, 2001 email to David Duncan, the principal Enron audit partner for Arthur Andersen, from Michael Jones, another Arthur Andersen partner in Houston, the latter notes that the Enron audit team at Arthur Andersen believes "that it would not be unforeseeable that fees could reach a $100 million per year amount considering the multi-disciplinary services being provided" by Andersen to Enron (copy on file with Cornell Law Review). Even on this basis, however, the prospective fees from Enron to Arthur Andersen would come to just over 1% of its $9.3 billion revenues in that year.

experiences of the Big Five\textsuperscript{45} accounting firms suggests that Andersen was not significantly different from its peers and experienced the same, or even a lesser, rate of earnings restatements.\textsuperscript{46} All in all, the more logical inference to draw from the "accounting irregularity" scandals of 2001 and 2002 is that erosion occurred during the 1990s in the quality of financial reporting.

Indeed, this is the area where the data is the clearest. During the 1990s, earnings restatements, long recognized as a proxy for fraud, suddenly soared. One study, conducted in 2001 by George Moriarty and Philip Livingston, found that the number of earnings restatements issued by publicly held corporations averaged forty-nine per year from 1990 to 1997, increased to ninety-one in 1998, and then skyrocketed to 150 and 156 in 1999 and 2000, respectively.\textsuperscript{47} A later, more complete study conducted by the General Accounting Office (GAO) in October 2002 examined all financial statement restatements (not just earnings restatements) and found a similarly sharp spike in 1999 that has continued through 2002.\textsuperscript{48} A table from the GAO Report displays this trend:\textsuperscript{49}

\begin{itemize}
\item \textsuperscript{45} The Big Five firms were Arthur Andersen LLP, Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP, and PricewaterhouseCoopers LLP. See In re \textit{IKON} Office Solutions, Inc., 277 F.3d 658, 662 n.1 (3d Cir. 2002).
\item \textsuperscript{46} 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 Five audit clients, it was responsible for only 15\% of the restatements issued by Big Five firms between 1997 and 2001. See Allan Sloan, \textit{Periscope: How Arthur Andersen Begs for Business}, \textit{Newsweek}, Mar. 18, 2002, at 6. On this basis, it was arguably more conservative than its peers. Industry insiders have characterized Andersen as different from its peers only in 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 at Andersen. Although this could indicate a weaker system of internal controls, that hypothesis seems inconsistent with Arthur Andersen's proportionately low rate of earnings restatements.
\item \textsuperscript{48} See GAO Report, supra note 28, at 4–5, 15–16.
\item \textsuperscript{49} Id. at 15.
\end{itemize}
When we compare Moriarty and Livingston's figure of forty-nine restatements in 1996 with the GAO's estimate of 250 for 2002, it shows that the number of restatements increased by approximately 270 percent over the five years ending in 2002.50

Not all restatements, however, are equal. Some may involve small, infrequently traded companies, or involve only trivial accounting adjustments, or trigger only modest stock price reactions. Others may be on a scale with those issued by Enron or WorldCom. For our purposes, it is useful to focus more precisely on financial restatements issued by companies listed on the NYSE, Amex, and Nasdaq, thereby excluding smaller companies with limited trading. Between 1997 and 2001, the proportion of NYSE, Amex and Nasdaq companies that restated their financial statements almost tripled, increasing from less than 0.89 percent in 1997 to approximately 2.5 percent in 2001.51

The GAO Report further predicted that the number of restating companies would reach nearly three percent in 2002.52 Overall, the GAO Report found that from January 1997 to June 2002, approximately

50 This comparison does slightly mix apples and oranges, as Moriarty and Livingston include only earnings statement restatements, while the GAO Report focuses more broadly on all financial statement restatements. Compare Moriarty & Livingston, supra note 47 (discussing only earnings statement restatements), with GAO REPORT, supra note 28 (examining financial restatements broadly). The differences are, however, likely to be modest because the vast majority of financial restatements involve earnings restatements.

51 See GAO REPORT, supra note 28, at 4.

52 See id.
"[ten] percent of all listed companies announced at least one restate-
ment." Equally revealing was that the size (in terms of market capi-
talization) of the typical restating company rose rapidly over this
period, and in 2002, companies listed on the NYSE or Nasdaq ac-
counted for over eighty-five percent of all restatements identified in
that year.

What drove this sudden spike in restatements? Restatements are
generally resisted internally because public corporations fear stock
price drops, securities class actions, and SEC investigations that usu-
ally follow in the wake of financial statement restatements. Indeed,
the GAO Report found that stock prices of restating companies over
the 1997 to 2001 period suffered an immediate market-adjusted de-
cline of almost ten percent on average, measured on the basis of the
stock’s three-day price movement from the trading day before the an-
nouncement through the trading day after the announcement. From
1997 to 2002, restating firms lost over $100 billion in market
capitalization during this three-day trading period alone. 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.
Perhaps, as some audit firms have argued, some portion of the change
can be attributed to recent SEC activism about "earnings manage-
ment," which became an SEC priority as of 1998. But this explana-
tion does not seem capable of accounting for most, or even many, of
these restatements. Corporate issuers are not likely to voluntarily ex-
pose themselves to large stock price declines and potential securities
fraud liability simply to please the SEC; nor would the market react

53 Id.
54 Specifically, the median size by market capitalization of a restating company rose
from $143 million in 1997 to $351 million in 2002. Id.
55 Of the 125 accounting irregularity restatements identified through mid-2002, 85%
were listed on the Nasdaq and the NYSE. Id.
56 See id. at 5. The GAO Report also found a longer term market-adjusted decline of
18% over the period from sixty trading days before the announcement to sixty trading days
after the announcement. See id. at 29.
57 See id. at 28.
58 Accounting firms have attempted to explain this increase in restatements by noting
that the SEC tightened the definition of materiality in 1999. This explanation is not very
convincing, however, because the principal SEC statement that redefined materiality was
issued in mid-1999, one year after the number of restatements began to soar. See Staff
211). Further, Staff Accounting Bulletin No. 99 did not mandate restatements, but rather
advised that any standard practice employed by auditors and issuers that assumed amounts
under 5% were inherently immaterial could not be applied reflexively. See id. at 45,151.
59 The SEC’s prioritization of earnings management as a principal enforcement tar-
get can be dated approximately to former SEC Chairman Arthur Levitt’s speech on the
with such surprise to "technical" or other modest accounting adjustments.

Not only did the number of earnings restatements increase over this period but the magnitude of the market reaction to these restatements grew as well.\(^6^0\) This suggests that during this period, managers became progressively willing to take greater risks. Moreover, as the 1990s wore on, earnings restatements were increasingly issued by large, mature, publicly held firms, rather than by smaller, less experienced companies. Managerial behavior within the largest firms, therefore, appears to have changed over this period.

Data from the earlier noted GAO Report also supports this thesis that managerial behavior changed.\(^6^1\) Although there are many reasons for a company to restate its financial statements (e.g., to adjust costs or expenses or to recognize liabilities), one particular reason drove the issuance of restatements during the period from 1997 to 2002. The GAO Report found that revenue recognition issues accounted for almost thirty-eight percent of the 919 announced restatements that it identified over the 1997 to 2002 period.\(^6^2\) In effect, attempts by management to prematurely recognize income appear to have been the most common cause of restatements. Earlier in the decade, corporate management may have hid "excess earnings" in "rainy day reserves" to smooth out undesired fluctuations in the firm's earnings in order to minimize the appearance of volatility. By the end of the decade, however, these same firms robbed future periods for earnings they could immediately recognize. In short, "income smoothing" gave way to increasingly predatory behavior.

Interestingly, during this period restatements involving revenue recognition produced disproportionately large losses.\(^6^3\) Seemingly, the market especially feared revenue recognition restatements because they signaled that reported earnings could not be trusted. Nonetheless, revenue recognition restatements remained the most common form of restatement.\(^6^4\) Overall, the interests of management and shareholders became increasingly misaligned, and gatekeepers were caught in the middle.

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\(^6^0\) According to Moriarty and Livingston, companies that restated earnings suffered market losses of $17.7 billion in 1998, $24.2 billion in 1999, and $31.2 billion in 2000. See Moriarty & Livingston, supra note 47, at 55. Expressed as a percentage of the overall capitalization (which ascended dramatically during this period), the market losses for 1998 through 2000 came to 0.13%, 0.14% and 0.19%, respectively.

\(^6^1\) See GAO Report, supra note 28, at 5.

\(^6^2\) See id. Revenue recognition was also the leading reason for restatements in each individual year over this period. See id.

\(^6^3\) While revenue recognition restatements accounted for only 38% of restatements over the 1997 to 2002 period, they were associated with $56 billion of the $100 billion in market capitalization that restating companies lost during this period. See id. at 28.

\(^6^4\) See id. at 5.
B. Security Analysts During the 1990s

The pattern of increasing auditor acquiescence in accounting irregularities during the 1990s was not unique. Much the same pattern can be discerned in the behavior of securities analysts over the same period. Securities analysts were, if anything, more conflicted than auditors. While much of the evidence here is anecdotal, it is striking nonetheless.

As late as October 2001, shortly before Enron declared bankruptcy, fifteen of the sixteen securities analysts covering the company maintained “buy” or “strong buy” recommendations on its stock. Yet, months earlier, as of December 31, 2000, Enron already had a stock price that was seventy times its earnings and six times its book value. Further, it had earned an eighty-nine percent return for the year despite a nine percent decrease over the same period for the S&P 500 index. Such a profile should have alerted any half-awake analyst to the possibility that Enron was seriously overvalued. Yet the first brokerage firm to downgrade Enron to a “sell” rating in 2001 was Prudential Securities, which did not engage at the time in investment banking activities. Prudential also had the highest proportion of sell ratings among the stocks it evaluated. Thus, even if Prudential also woke up late, it is 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 need to retain and please investment banking clients may often dominate their desire to be perceived as credible and objective. One statistic that inevitably arises in any assessment of analyst objectivity is the curious fact that the ratio of “buy” to “sell” recommendations has recently been as high as 100 to 1. In truth, this particular statistic may not be as compelling as it initially sounds because there are obvi-

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65 See The Watchdogs Didn’t Bark: Enron and the Wall Street Analysts: Hearing Before the S. Comm. on Governmental Affairs, 107th Cong. 5 (2002) (statement of Sen. Thompson); see also The Fall of Enron: How Could it Have Happened?: Hearing Before the S. Comm. on Governmental Affairs, 107th Cong. 119 (testimony of Frank Partnoy, Professor of Law, University of San Diego School of Law) (testifying that “as late as October 2001 sixteen of seventeen of the securities analysts covering Enron rated it a ‘strong buy’ or ‘buy’”).


67 See id.


69 See id.

70 See Analyzing the Analysts: Hearing Before the Subcomm. on Capital Mkts., Ins., & Gov’t Sponsored Enters. of the H.R. Comm. on Fin. Seres., 107th Cong. 120 (2001) [hereinafter Analyzing the Analysts] (statement of Paul E. Kanjorski, Member, House Subcomm. on Capital Mkt., Ins., & Gov’t Sponsored Enters.) A study by First Call also found that less than 1% of the 28,000 stock recommendations issued by brokerage firm analysts during late 1999 and most of 2000 were sell recommendations. See id.
ous reasons why "buy" recommendations will normally outnumber "sell" recommendations, even in the absence of conflicts of interest.\footnote{Sell-side analysts are employed by brokerage firms that understandably wish to maximize brokerage transactions. In this light, a buy recommendation addresses the entire market and certain all of the firm's customers, while a sell recommendation addresses only those customers who own the stock (probably well under 1%) and those with margin accounts who are willing to sell the stock short. In addition, sell recommendations annoy not only the company that is adversely rated, but also institutional investors who fear that sell recommendations will spook retail investors, causing them to panic and sell, while the institution is locked into a large position that it cannot easily liquidate.}

A more revealing statistic shows the rapid shift in the ratio of "buy" to "sell" recommendations that took place in the 1990s, which shift parallels the earlier noted increase in accounting restatements during the 1990s. According to a study by First Call, the ratio of "buy" to "sell" recommendations actually increased from 6 to 1 in the early 1990s to 100 to 1 by 2000.\footnote{See Analyzing the Analysts, supra note 70, at 120.} Again, it appears that something happened in the 1990s that compromised the independence and objectivity of the gatekeepers on whom our private system of corporate governance depends.\footnote{Participants in the industry also report that the professional culture changed dramatically in the late 1990s, particularly as investment banking firms began to hire star analysts for their marketing clout. See Gretchen Morgenson, Requiem for an Honorable Profession, N.Y. TIMES, May 5, 2002, § 3, at 1 (suggesting that the change in research culture dates from around 1996).} Even before Enron, the most sophisticated market participants had come to understand the extent of these conflicts in the case of analysts and had ceased to rely on "sell side" analysts.\footnote{Although the empirical evidence is limited, research suggests that independent analysts (i.e., analysts not associated with the underwriter for a particular issuer) behave differently than, and tend to outperform in terms of accuracy, analysts associated with the issuer's underwriter. The market in turn gave greater weight to the former's recommendations. See Roni Michaely & Kent L. Womack, Conflict of Interest and the Credibility of Underwriter Analyst Recommendations, 12 REV. FIN. STUD. 653, 655–56 (1999).}

IV

EXPLAINING GATEKEEPER FAILURE

A pattern of mounting irregularity in financial reporting became evident as the 1990s progressed. But what explains it? As a starting point, none of the watchdogs that should have detected Enron's collapse—auditors, analysts or debt rating agencies—did so before the penultimate moment. Yet, considerable evidence was available that should have alerted them to the pending collapse.\footnote{See supra notes 66–67 and accompanying text (noting that Enron was trading at seventy times earnings and six times its book value and earned an 89% return for the year 2000). These are hallmarks of an overvalued company, and should serve to discourage investment unless firm-specific information suggests continued strong earnings growth.} What plausible hypothesis can explain the collective failure of the gatekeepers? Two quite different, although complementary, hypotheses are available. The first is the "general deterrence" hypothesis and the second is the...
"bubble" hypothesis. The first is essentially economic in its premises, while the second is essentially psychological.

A. The Deterrence Explanation: The Under-deterred Gatekeeper

The general deterrence hypothesis focuses on the decline in the expected liability costs that faced auditors who were considering whether or not to acquiesce in aggressive accounting policies favored by managers. It postulates that, during the 1990s, the risk of auditor liability declined, while the benefits associated with acquiescence increased. As Economics 101 teaches, when both the costs go down and the benefits associated with the 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. Why did the legal risks decrease during the 1990s? The obvious list of reasons includes:

(1) The Supreme Court’s 1991 decision in Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, which significantly shortened the statute of limitations applicable to securities fraud;

(2) the Supreme Court’s 1994 decision in Central Bank of Denver, N.A., v. First Interstate Bank of Denver, which eliminated private “aiding and abetting” liability in securities fraud cases;

(3) the Private Securities Litigation Reform Act of 1995 (PSLRA), which (a) raised the pleading standards for securities class actions to a level well above that applicable to fraud actions generally; (b) substi-

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78 See id. at 359-61 (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.


80 See id. at 164.

tuted proportionate liability for "joint and several" liability;\(^2\) (c) 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;\(^3\) and (d) adopted a very protective safe harbor for forward-looking information;\(^4\) and

(4) the Securities Litigation Uniform Standards Act of 1998 (SLUSA), which abolished state court class actions alleging securities fraud.\(^5\)

Although the rapid succession of these developments prevents us from calculating their individual impacts, their aggregate impact is easily susceptible to measurement. Here, the available data appears to show that the willingness of class action plaintiffs to sue secondary defendants declined during the latter half of the 1990s. Following the passage of the PSLRA in 1995, the SEC undertook a study of the legislation's apparent impact on securities litigation.\(^6\) As its baseline, the SEC study began with the number of audit-related suits filed against the then Big Six accounting firms from 1990 to 1992.\(^7\) For those three years, the relevant numbers were 192, 172, and 141, respectively.\(^8\) In 1996, however, the first year following the passage of the PSLRA, the SEC found that, out of the 105 securities class actions filed in that year, accounting firms were named in only six cases, corporate counsel in zero cases, and underwriters in nineteen cases.\(^9\) It thus concluded that "[s]econdary defendants, such as accountants and law-

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\(^2\) See id. \$ 201, 109 Stat. at 758–62.
\(^3\) See id. \$ 107, 109 Stat. at 758.
\(^4\) See id. \$ 102, 109 Stat. at 749–56.
\(^6\) See id. at 21–22. The figures for the years 1990 to 1992 were reported to the SEC by the Big Six and include all class actions against them; thus, potentially some non-securities class actions could be included in this total. Nonetheless, the number of such nonsecurities actions seems likely to have been small. As the above SEC study further notes: "[D]uring the period 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.
\(^7\) Id. at 21–22.
yers, are being named much less frequently in securities class actions."90

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.91 Although reasonable persons can debate whether the judicial and legislative shift towards deregulation in the 1990s was justified or excessive,92 the collective impact of these changes 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.93 Thus, although auditors are still sued today, the settlement value of cases against auditors has significantly decreased.94

90 Id. at 4. As this study expressly noted, both 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 could have caused this decline. See supra notes 79–84 and accompanying text.

91 Several former SEC officials, including Stanley Sporkin, the longtime former head of the SEC’s Division of Enforcement, have made this point to me. 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 actions brought against a Big Five accounting firm on fraud grounds during the 1990s. See SEC v. Arthur Andersen LLP, SEC Litigation Release No. 17039 2001 SEC LEXIS 1159, (D.D.C. June 19, 2001). Although the SEC did bring charges during the 1990s against individual partners in these firms, the high cost and manpower required bring suits against the Big Five, and the expectation that these defendants could zealously resist appears to have deterred the SEC from bringing suits against them. 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.

92 Indeed, this author would continue to support proportionate liability for auditors on fairness grounds and agrees with the Second Circuit’s interpretation of the PSLRA’s heightened pleading standards. See, e.g., Novak v. Kasaks, 216 F.3d 300, 306 (2d Cir. 2000) (noting that “the PSLRA imposed stringent procedural requirements on plaintiffs pursuing private securities fraud actions”).

93 At a minimum, plaintiffs today must plead with particularity those facts giving rise to a “‘strong inference of [fraudulent intent].’” See id. at 307. 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 in that it cannot plead fraud with particularity until it obtains discovery and it cannot obtain discovery under the PSLRA until it pleads fraud with particularity.

94 Although no systematic data exists, recent cases have noted that, after the enactment of the PSLRA in 1995, the odds facing plaintiffs in class actions have climbed, particularly when they are suing secondary defendants. In particular, because the plaintiff is obliged to prove “that a professional acted with knowledge and/or recklessness with regard to material misstatements and omissions, a successful outcome can never be regarded as a sure thing.” See In re Rite Aid Corp. Sec. Litig., 269 F. Supp. 2d 603, 608 (E.D. Pa. 2003).
Correspondingly, the benefits of acquiescence to auditors rose during the 1990s as the Big Five learned how to cross-sell consulting services and to treat auditing services as a portal of entry into the lucrative client. Prior to the mid-1990s, few auditing firms provided significant consulting services to audit clients. Yet, according to one recent survey, the typical large public corporation now pays its auditor for consulting services three times what it pays for auditing services. Not only did auditing firms see more profit potential in consulting than in auditing, during the late 1990s, they also appeared to have begun to compete based increasingly on a strategy of "low balling," under which they offered auditing services at rates ranging from marginal to below cost. The rationale for such a strategy was that the auditing function was best viewed as a loss leader through which firms could market more lucrative services.

The argument that the provision of consulting services to audit clients eroded auditor independence is potentially subject to at least one important rebuttal. Those who defend the propriety of consulting services by auditors respond that the growth of such services made little real difference because the audit firm was already conflicted by...
the fact that the client paid fees for auditing services. Put as bluntly as possible, the audit partner of a major client (such as Enron) has virtually a "one-client" practice. The partner will likely need to find employment elsewhere should he lose that client. In short, both critics and defenders of the status quo recognize that the desire to hold the client can compromise the audit partner. From this premise, critics argue that a prophylactic rule prohibiting an auditing firm's involvement in consulting seemingly achieves little, because the auditor is already conflicted by the desire to receive fees.

Yet, even if this analysis is true to a degree, it overlooks the real-world difficulty faced by the client who wishes to fire its auditor. Under SEC rules, if a client fires an auditor or the auditor resigns because of a dispute over accounting principles, public disclosure is required. To illustrate this point, let us suppose that a client becomes dissatisfied with an auditor who refuses to endorse the aggressive accounting policy favored by its management. Firing the auditor is an unattractive and costly step that invites potential public embarrassment and disclosure of the reasons for the auditor's dismissal or resignation, as well as potential SEC intervention. If the auditor is also a consultant to the client, however, the client can instead terminate the auditor in its role as a consultant or at least reduce its use of the firm's consulting services. This low visibility response neither requires disclosure nor invites SEC oversight, but it creates incentives for the audit firm to replace the intransigent partner. Thus, in effect, the client can bribe or coerce the auditor in its core professional role by raising or reducing its use of consulting services. As a result, the combination of auditing and consulting services within a single professional firm gives the client a disciplinary tool with which to both seduce and threaten the firm.

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100 For a review of the empirical literature on this point, see Robert A. Prentice, The SEC and MDP: Implications of the Self-Serving Bias for Independent Auditing, 61 Ohio St. L.J. 1597, 1648-49 (2000) ("Most knowledgeable observers seem to believe . . . that auditor independence and objectivity are affected by auditors' self-interest in that, for example, the more revenue coming from a client, the more the likely auditors are to give [in to] client pressure for improper accounting treatment.") (footnote omitted).

101 The General Instructions of Form 8-K, and Item 4 ("Changes in Registrant's Certifying Accountant") of Form 8-K, both found in the Securities and Exchange Act of 1934, require a reporting company to file a Form 8-K within five days after the resignation or dismissal of the issuer's independent accountant or the independent accountant of a significant subsidiary. See 17 C.F.R. § 249.308; see also SEC. & EXCH. COMM'N, FORM 8-K, § B, Item 4 (SEC 873, 2003), http://www.sec.gov/about/forms/form8-k.pdf. The company must then provide the elaborate disclosures mandated by Item 304 of Regulation S-K, found in the Securities Act of 1933, relating to any dispute or disagreement between the auditor and the accountant. See 17 C.F.R. § 229.304.
Of course, the argument that the client can discipline and threaten the auditor-consultant in ways that it could not discipline the simple auditor relies more on logic than actual case histories. Yet it does fit the available data. For example, 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 nonaudit services from their auditor (as a percentage of the total fee paid to the audit firm) were more likely to match the profile of a firm engaging in earnings management.\footnote{See generally Richard M. Frankel et al., The Relation Between Auditors' Fees for Non-Audit Services and Earnings Management (MIT Sloan Working Paper No. 4330-02, 2002) (providing empirical evidence on the relation between auditor fees and earnings management), at http://www.ssrn.com/id=296557. Similarly, "firms purchasing more [nonaudit] services were found more likely to just meet [or beat] analysts' expectations," which is the standard profile of the firm playing "the numbers game." See id. at 20.}

B. The Irrational Market Story

Alternatively, Enron's and Arthur Andersen's downfalls, and the host of other sudden stock declines in 2001 and 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. Yet, what exactly links a market bubble with gatekeeper failure? Arguably, the services of gatekeepers become less relevant to investors in a bubble, and they therefore experience a decline in both their leverage over their client and the value of their reputational capital. As a result, in an atmosphere of market euphoria, because investors generally rely less on gatekeepers, managers, in turn, regard them as more of a formality than a necessity.

While this hypothesis may be impossible to rigorously prove, it nonetheless seems consistent with modern behavioral economics. Gatekeepers provide a critical service only when investors are cautious and skeptical and therefore rely on the gatekeeper's services. Conversely, in a market bubble, investors largely abandon caution and skepticism. In such an environment, companies continue to use auditors because the SEC rules mandate it, or because no individual firm wants the notoriety of being the first to dispense with them, rather than because investors demand their use. As a result, gatekeepers have less relevance and, consequently, reduced leverage with their clients. Accordingly, if we assume that euphoric investors will largely ignore the auditor, the rational gatekeeper's best competitive strategy, at least for the short term, is to become as acquiescent and low cost as possible. Although this thesis assigns some causal responsibility to investors for their own losses, it does not absolve gatekeepers of responsibility. Even if shareholders care little about the auditor's reputation,
it is still possible for an auditor to intervene effectively and prevent fraud 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. 103

The key element in the foregoing explanation involves the reason that investors ceased to care about the gatekeeper's reputation. After all, the auditing profession arose out of investors' own concerns about fraud and irregularity, not because of regulatory requirements. 104 What then caused this concern to weaken? Modern behavioral economics supplies a plausible answer as it recognizes that individuals, including investors, have "bounded rationality" and do not pursue all information relevant to an optimal decision. 105 In particular, the Nobel Prize-winning research of Professors Daniel Kahneman and Amos Tversky has demonstrated that individuals typically make decisions by using heuristics—i.e., rules of thumb—rather than by incorporating and processing all obtainable information. 106 Professors Kahneman and Tversky found that individuals pervasively use one such rule of thumb—the "availability heuristic" 107—that has special relevance to the context of securities markets. The availability heuristic asserts that individuals estimate the frequency of an event by recalling recent instances of its occurring, even if, when viewed from a longer-term perspective, these instances are normally rare or infre-

103 Section 10A of the Securities Exchange Act of 1934 requires the auditor of a public company to notify the SEC where the auditor discovers an "illegal act [that] has or may have occurred," which "has a material effect on the financial statements of the issuer" where management and the board of the issuer has not taken has not done so itself within one day of notification by the auditor. See 15 U.S.C. § 78j-1 (2000). Since its adoption in 1995 as part of the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737, this provision has been seldom, if ever, employed.

104 The rise of the public accountant paralleled the rise of the publicly owned corporation, and was commensurate with the growing need of investors for objective financial information. This growth preceded the adoption of the federal securities laws in the 1930s. For example, the American Association of Public Accountants was formed in 1887, and in 1896, New York became the first state to certify public accountants who successfully passed a required state exam. See John L. Carey, The Rise of the Accounting Profession: From Technician to Professional 1896-1936, at 2, 6-7, 43-45 (1969); see also James Don Edwards, History of Public Accounting in the United States (1960).


107 See id. at 11-14; see also Jolls et al., supra note 105, at 1477-78 (applying the "availability heuristic" to the field of law and economics).
Hence, if the stock market has recently experienced extraordinary returns, it becomes predictable that individuals will overestimate the likelihood that such extraordinary gains will continue. In effect, there is a status quo or persistence bias; investors expect what has recently occurred to continue. As a result, when the market soared in the early and mid-1990s, investors, operating on heuristics, came to assume that this pattern would continue.

Thus, from the perspective of behavioral economics, bubbles are not irrational moments of speculative excess or frenzy, but rather 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, possibly because of real economic growth. This bias then causes investors to treat the market phenomenon as normal and likely to continue. Such an explanation also helps us understand why bubbles have reoccurred throughout history. To explain bubbles, one need not posit that investors are inherently gullible, but only that investors suffer from normal heuristic biases, which are created by a period of extraordinary market returns and which cause investors to expect such returns to continue.

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 such times, those who recklessly predict extraordinary returns will outperform those who are cautious and prudent. Hence, in a bubble, extreme optimism for analysts becomes less of a heuristic bias than a competitive necessity. Put 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 "hits" on a website.

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108 See Tversky & Kahneman, supra note 106, at 11.

109 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 infra text and accompanying notes 123–27.

110 The deep-seated bias displayed by many individuals toward optimism in predicting future events probably aggravated this trend. See Jolls et al., supra note 105, at 1524–25 (noting that people tend to think that bad events are far less likely to happen to them than to others); see generally Neil D. Weinstein, Unrealistic Optimism About Future Life Events, 39 J. PERSONALITY & SOC. PSYCHOL. 806 passim (1980) (reporting the results of two studies that investigated the tendency of people to be unrealistically optimistic about future life events).
Institutional factors compounded this problem. As the initial public offering (IPO) market soared in the 1990s, securities analysts became celebrities and valuable assets to their firms. Indeed, securities analysts became the principal means by which investment banks competed for IPO clients, as the underwriter with the "star" analyst could produce the greatest first day stock price spike in an IPO. As the salaries of such analysts soared, their 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 more dependent on favoring the interests of persons outside their profession—consultants in the case of the auditor and investment bankers in the case of the analyst—who had little reason to respect or observe the gatekeeper's professional standards or culture.

Ultimately, as auditors increasingly sought consulting income and as analysts became more dependent on an investment banking subsidy, their common desire to preserve their reputational capital for the long run became subordinated to their wish to obtain extraordinary returns in the short run at the risk of that reputational capital. The value of gatekeepers' reputational capital may have also declined during the bubble as investors rationally reduced their reliance on gatekeeping services because of their biased assumption that extraordinary returns would persist. Under either hypothesis or both, it

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111 For the view that investment banking firms changed their competitive strategies on or around 1996 and thereafter sought the "popular, high-profile analyst" as a means of acquiring IPO clients, see Morgenson, supra note 73, § 3, at 1 (citing Stefan D. Abrams, chief investment officer for asset allocation at Trust Company of the West).

112 One court has recently even taken judicial notice of the conflicted role of star securities analysts in landing IPOs for the investment banking firms that hired them away from smaller competitors. See In re Merrill Lynch & Co., Inc. Research Reports Sec. Litig., 273 F. Supp. 2d 351, 383–89 (S.D.N.Y. 2003). Judge Pollack quoted the Wall Street Journal, the Boston Globe and other publications, stating: "To bring a company public, a firm needs its analyst on board. It is the analyst that explains—and implicitly, trumpets—the investment merits of the offering." Id. at 383. Judge Pollack also quoted an article which stated that analysts have become an important sales tool for the investment bankers to land their super-profitable deals. A top analyst and the credibility that he or she brings can be the difference between landing a deal or not—and the pay for the most sought-after analysts can top $5 million a year. Id. at 383–84 (internal quotation marks omitted). In particular, the court cited the case of Henry Blodgett, who according to press reports, was lured to Merrill Lynch with a high salary in order to attract IPOs. Id. at 386 (citing Jon Birger, New Executive Henry Blodgett; Merrill Lynch's Top Pick; Internet Analyst Lured from CIBC; On-Target Research Should Attract IPOs, CRAiN's N. Y. Bus., Mar. 22, 1999, at 11).

113 The idea that persons outside of the profession began to dominate professional gatekeeping 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, N.Y. TIMES, Oct. 1, 2002, at C1.
may often have become profitable for firms to risk their reputational capital by trading on it in the short-run, rather than by preserving it for the long-run. Indeed, during the 1990s, to the extent that the auditing function became a loss leader for multi-service accounting firms eager to sell more lucrative consulting services and to the extent that investment banking firms began to subsidize securities analysts, each profession became less self-supporting and more dependent on those who could profit from the liquidation of their reputational capital.

C. Allocating Responsibility Among Gatekeepers, Managers and Investors

The foregoing explanations still fail to explain fully the mechanisms by which the gatekeepers sacrificed or liquidated their reputational capital, built up over decades, once the legal risks of doing so declined or a bubble developed. Here, an allocation of responsibility must be made among the various participants in corporate governance: managers, gatekeepers, and investors.

I. The Role 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. As noted earlier, executive compensation shifted during the 1990s from being primarily cash-based to primarily equity-based. The clearest measure of this change 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. The value of these options rose for the two thousand largest corporations by an even greater percentage, and over a dramatically shorter period: from $50 billion in 1997 to $162 billion in 2000, an over three hundred percent rise in three years.

Such stock options created an obvious and potentially perverse incentive for managers to engage in short-term, rather than long-term, stock price maximization because executives can exercise their

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114 See supra notes 20–21 and accompanying text.
116 See Morgenson, Bush Failed, supra note 115, at C7 (citing a 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 10% create a potential gain for executives of over $16 billion, a substantial incentive.
stock options and sell the underlying shares on the same day. 117 This ability was itself the product of deregulatory reform in the early 1990s, which relaxed the rules under § 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. 118 Thus, if executives inflated the stock price of their company through premature revenue recognition or other classic earnings management techniques, they could quickly bail out in the short-term by exercising their options and selling. Shareholders were left to bear the cost when the inflated stock could not maintain its price 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. As a result, the shift to stock options as the principal means of executive compensation, plus the removal of the legal impediment to exercising and selling them simultaneously, placed gatekeepers under greater pressure to acquiesce in short-term oriented financial and accounting strategies.

2. The Role of Investors

Investors cannot fairly be presented as entirely innocent victims in the recent epidemic of financial irregularities. During a bubble, investors may ignore, or at least overly discount, gatekeepers' conflicts of interest that might alarm investors in other circumstances. To be sure, biased analyst research and overstated earnings likely misled many investors, but investors also cheered on analysts who made the most optimistic predictions and disdained those who were more cautious. Even institutional investors, who own nearly fifty percent of the equity securities listed on the New York Stock Exchange and account

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117 A variety of commentators, calling for minimum holding periods or other curbs on stock options, have made this point. These include Henry M. Paulson, Jr., chief executive of Goldman Sachs, and Senator John McCain of Arizona. See David Leonhardt, Anger at Executives' Profits Fuels Support for Stock Curb, N.Y. TIMES, July 9, 2002, at A1.

118 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 acquisition of the derivative security to the date of disposition of the . . . underlying equity security." See 17 C.F.R. 240.16b-3(d) (2005). In 1991, the SEC engaged in a comprehensive revision of its rules under Section 16(b) to facilitate the use of stock options as executive compensation and to "reduce the regulatory burden" under Section 16(b). See Ownership Reports, supra note 24, at 7243. 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 7248. Hence, the SEC permitted the tacking of the option holding period onto the stock's holding period, thereby enabling officers and directors to exercise options and sell on the same day, so long as they had already held the option for six months.
for approximately seventy-five percent of its daily trading volume,\textsuperscript{119} overlooked or recklessly ignored abundant evidence that should have alerted them. According to one estimate, at the peak of the market bubble large institutional investors held sixty percent of Enron stock.\textsuperscript{120} Why didn’t they see that Enron was overvalued, particularly once alarm bells began to sound? The most plausible explanation for the failure of institutional investors to respond to such signals begins with the premise that professional money managers are rationally motivated by the desire to perform no worse than their major institutional rivals. This pressure quickly leads to herding behavior.\textsuperscript{121} 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.”\textsuperscript{122}

To illustrate, suppose that a hypothetical fund manager suspects that Enron is overvalued. What should this manager do? If the manager sells the fund’s investment in Enron, the manager and the manager’s clients may do well, but only if the market agrees and Enron’s stock price falls that quarter. Conversely, if the market persists in overvaluing Enron or actually climbs based on biased sell-side research, the fund manager becomes an unfortunately premature prophet and the manager’s performance falls relative to rival managers. Hence, clients’ funds flow out of the manager’s account and into the accounts of rival fund; the funds managed by our hypothetical manager contract like an accordion. As a result, this manager may not profit significantly even when Enron ultimately does fail.

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 with a similar strategy. The result is a phenomenon known as “herding,”\textsuperscript{123} because, by following the herd, the fund manager will not underperform most of his rivals. Put differently, it is far worse to be individually wrong than collectively wrong. The fund manager can survive mistakes that others also make, as he can claim that the error was undetectable (i.e., “Who knew? Enron fooled us all!”). But the manager may suffer immense injury when he makes correct decisions that the market only

\textsuperscript{120} See Healy & Palepu, supra note 66, at 22.
\textsuperscript{121} See id. at 26–27.
\textsuperscript{122} Id. at 26.
\textsuperscript{123} Professors David Scharfstein and Jeremy Stein coined the term herding over a decade ago. See David S. Scharfstein & Jeremy C. Stein, Herd Behavior and Investment, 80 AM. ECON. REV. 465, 465 (1990). However, the concept long predates this term and is implicit in Keynes’s 1936 analysis of the stock market. See John Maynard Keynes, The General Theory of Employment Interest and Money (1936).
belatedly recognizes. In turn, this may explain why institutions followed sell-side research that they knew to be biased during the bubble. Anticipating that others would follow it also, institutional investors took the safe course and followed the herd.\textsuperscript{124}

3. \textit{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 role of gatekeepers. Up to a point, investors will follow gatekeepers' advice even when they do not trust it because they expect that such advice will influence the market. When the advice can no longer move the market, however, the bubble bursts. Earlier this article argued that gatekeepers performed poorly in the 1990s, at least in the case of auditors and analysts, because they faced a reduced legal threat and because they could increase their benefits by acquiescing in managerial misbehavior. But there are further nuances regarding the absence of competition and the principal-agent relationship that also contributed to this story.

a. \textit{The Absence of Competition}

The Big Five (now Big Four) accounting firms obviously dominated a very concentrated market for auditing services.\textsuperscript{125} As a result, smaller competitors could not expect to develop the international scale or marketable brand names that the Big Four possessed simply by quoting a cheaper price. Thus, high barriers chilled entry into this market. More importantly, in a market this concentrated, implicit collusion easily develops. For example, each of the Big Four could in parallel develop and follow a common competitive strategy without fear of being undercut by a major competitor. Under such conditions, it would be rational for each of the Big Four firms to pursue a strategy under which it acquiesced to clients' preferences for risky accounting policies in order to obtain more lucrative consulting revenues. The cost of such a strategy would be an occasional litigation loss and some public humiliation, but this cost would be acceptable so long as all of the Big Four firms behaved similarly. The costs of such a policy would become prohibitive, however, if the firm was so humiliated that it stood out in contrast to a rival firm intent on marketing its high integrity.

\textsuperscript{124} There is considerable evidence that fund managers do think in these terms. See \textit{generally} Judith Chevalier & Glenn Ellison, \textit{Career Concerns of Mutual Fund Managers}, 114 Q.J. ECON. 389, 416–20 (1999) (finding that younger fund managers hold less unsystematic risk and have more conventional portfolios).

\textsuperscript{125} See Watts, \textit{supra} note 44, at P6.
Indeed, in a very concentrated market, collusion in any form is not a necessary element in this explanation. Rather, in such a market, it becomes more likely that every firm will incur some scandals and will bear some litigation scars from highly public frauds and insolvencies. The only necessary assumption is that of high information costs: namely, that investors will find it difficult to distinguish among these firms, once all have been implicated in some scandals. In a less concentrated market, some dissident firm would predictably market itself as distinctive for its integrity. In a market of just four firms, however, this is much less likely.

b. Principal/Agent Problems

Auditing firms have always known that a large client could dominate an individual partner in a manner that might inflict liability on the firm. Thus, auditing firms were quick to develop internal monitoring systems that were far more elaborate than anything that law firms have yet attempted. Yet, within the auditing firm, this internal monitoring function is not all-powerful, because, in large part, this function is not itself a profit center. Once firms added consulting services as a major profit center, however, a natural coalition developed between the individual audit partner and the consulting divisions; each had a common interest in overruling the firm’s internal monitoring division when its prudential decisions would prove costly to them. Finally, as the expected risk of liability fell during the 1990s, the influence of the internal monitoring staff logically declined correspondingly.

Cementing the marriage between the audit partner and the consulting division was the use of incentive fees. For example, if the internal division providing software consulting services for an accounting firm offered the principal audit partner an incentive fee of one percent of any contract sold to the partner’s audit client, the audit partner would have an enhanced reason to acquiesce in risky accounting policies. Under the software consulting contract, the audit partner might receive as much or more compensation from incentive fees for cross-selling as from auditing fees, and thus the partner would have even more reason to value his client’s satisfaction above his interest in the firm’s reputational capital. More importantly, the audit partner also acquires an ally in the consultants, who similarly would want to ensure that they satisfied their mutual client. Together, the audit partner and the consultants would form a coalition that was potentially able to override the protests of their firm’s internal monitoring unit. While case histories matching this exact pattern have not yet come to light, abundant evidence suggests that incentive fees can bias
Interestingly, Enron itself presents a fact pattern in which the audit firm's on-the-scene quality control officer was overruled and replaced.127

V

IMPLICATIONS: EVALUATING CONGRESS'S RESPONSE

This Article has presented a variety of explanations for the corporate governance failures of 2001 and 2002: (1) uncontrolled equity compensation that motivated executives to manipulate the market; (2) inadequate deterrence of gatekeepers; and (3) a broader phenomenon of a market bubble that implicates investors as well as gatekeepers. Which of the foregoing theories is most persuasive? Does it matter? Although they are complementary rather than contradictory, their relative plausibility bears on what reforms are most necessary or desirable. For example, the more one accepts the deterrence explanation, the more one might favor legislative changes aimed at restoring an adequate legal threat. In principle, these changes could either raise the costs or lower the benefits of acquiescence to auditors. Alternatively, to the extent one accepts the bubble hypothesis, the problem may be self-correcting: once the bubble bursts, gatekeepers may come back into fashion, as investors become skeptics and once again demand assurances that only credible reputational intermediaries can provide.128 Of course, not all gatekeepers are alike. Thus, it may be

126 One of the most notable recent accounting scandals involved the Phar-Mor chain of retail stores. There, an audit partner for Coopers & Lybrand was denied participation in profit sharing because he had insufficiently cross-sold the firm's services. The next year he sold $900,000 worth of business—most of it to Phar-Mor and its affiliates—but subsequently failed to detect $985 million in inflated earnings by Phar-Mor over the following three years. See Bazerman et al., supra note 99, at 89; Prentice, supra note 38, at 184.

127 Carl E. Bass, an internal audit partner, warned other Andersen partners in 1999 of Enron's dangerous accounting practices. See Robert Manor & Jon Yates, Faceless Andersen Partner in Spotlight's Glare, Chi. Trib., Apr. 14, 2002, § 5, at 1. One Enron-related lawsuit alleged that David Duncan, the Andersen partner in charge of the Enron account, joined with Enron executives to have Mr. Bass removed from the Enron account within a few weeks of his warning. See id. This evidence suggests, if nothing else, that executives of a Big Five firm could overcome the internal audit function when the prospective consulting fees were high enough.

128 Federal Reserve Chairman Alan Greenspan has indeed suggested that market corrections will largely solve the problems uncovered in the wake of Enron. See Alan Greenspan, Corporate Governance, Remarks at the Stern School of Business, New York University (Mar. 26, 2002), www.federalreserve.gov/boarddocs/speeches/2002/20020326/default.htm. 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." Id. Greenspan further stated that "[t]his 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. He goes on to suggest that: "[a] change in behavior, however, may already be in train." Id. Specifically, he finds that "perceptions of the reliability of firms' financial statements are increasingly reflected
Viewed historically, the Enron crisis is only one of several modern accounting crises, extending from the Penn Central crisis in the 1970s to the S&L crisis in the 1980s. The distinctive difference between the Enron crisis and the crises of the 1970s and the 1980s, however, is that in those eras only insolvency threatened management with ouster. Thus, management in those earlier crises had a strong incentive to "cook the books" only as their corporation approached insolvency. Today, as the mechanisms of corporate accountability—takeovers, control contests, institutional activism, and more aggressive boards—have shortened management's margin for error, the incentive to engage in earnings management and accounting irregularities is much greater. Although the increasingly competitive business environment makes management's survival less certain, the instant wealth promised by stock options also gives rise to an incentive to cheat, even when management's survival is not in question. Together, the fear of ouster and the temptation of instant wealth increase the likelihood of fraud.

A. Congress's Response: The Sarbanes-Oxley Act

Passed almost without dissent, the Public Company Accounting Reform and Investor Protection Act of 2002, popularly known as the Sarbanes-Oxley Act, essentially addresses the problem of accounting irregularities by shifting control of the auditing profession from the profession itself to a new body, the Public Company Accounting Oversight Board (the Board). Conceptually, this is a familiar approach,
as the Board’s authority largely parallels that of the National Association of Securities Dealers (NASD) over securities brokers and dealers. 133 What is new, however, is that the Act explicitly recognizes the significance of conflicts of interest, as it bars auditors from providing a number of categories of professional services to their audit clients and authorizes the Board to prohibit additional categories of services if necessary. 134 Thus, to the extent that conflicts of interest compromised auditors, the Act responds with an appropriate answer.

There is less reason for optimism, however, if accounting irregularities stem from a lack of general deterrence or the increased incentive of corporate executives to “cook the books” to maximize the value of their stock options. The Act simply fails to address these problems. For example, the Act neither revises the PSLRA (except in a minor way), 135 nor does it make gatekeepers who knowingly aided and abetted a securities fraud liable to investors in private litigation. 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. 136 In short, while the potential benefits from acquiescing in accounting irregularities appear to have been reduced for auditors, the expected costs to gatekeepers from accounting irregularities seemingly remains low because the level of deterrence that they once faced has not been restored. 137

This same critique applies with even greater force to the recent efforts of the NYSE and Nasdaq to reform their listing standards. Af-

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133 See 15 U.S.C. § 78o-3 (regarding the creation and activities of registered securities associations).

134 Section 201 of the Act, amending § 10A of the Securities Exchange Act of 1934, specifies eight types of professional services which the auditor may not perform for an audit client and authorizes the Board to prohibit additional services if it determines that they may compromise auditor independence. See § 201(a), 116 Stat. at 771–72 (codified at 15 U.S.C. § 7231).

135 Note, however, that section 804 of the Act does extend the statute of limitation for securities fraud suits, thereby reversing a 1991 Supreme Court decision that shortened the time period. See id. § 804, at 801 (codified at 28 U.S.C. § 1658) (setting the statute of limitations for securities fraud); see also Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 504, 801–807 (1991) (creating the former federal rule requiring plaintiffs to file within one year of when they should have known of a particular securities violation underlying their action, but in no event more than three years after the violation).

136 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 twelve-month period following the filing of an inflated earnings report that is later restated. See § 304, 116 Stat. at 778 (codified at 15 U.S.C. § 7243). This does cancel the incentive to inflate earnings and then bail out, but ambiguities abound as the enforcement methods applicable to this provision are unspecified and the provision applies only if the earnings restatement is the product of “misconduct.” See id.

137 Prior to the 1990s, private litigation was a genuine and arguably an excessive constraining force on auditors. See supra note 76 and accompanying text.
ter much study, both bodies have proposed new independence standards that will require listed companies to have both majority independent boards and entirely independent audit, nominating, and compensation committees, and to utilize a tighter definition of independence.\textsuperscript{138} Although such reforms and heightened independence requirements seem desirable, it does not appear that they would have affected the boards of Enron or WorldCom.\textsuperscript{139} Nor does enhanced independence for board members sound like the most appropriate response if the deeper problem, as this Article has suggested, is gatekeeper failure.

Thus, from this article's perspective, a relevant public policy agenda should address three goals that Sarbanes-Oxley failed to address: (1) increasing the legal threat to deter sufficiently gatekeeper acquiescence in managerial fraud; (2) reducing the perverse incentives created by the unconstrained use of stock options; and (3) addressing the structural conflicts that cause herding, analyst bias, and an excessive market bias towards optimism.

B. The Unused Lever: Shareholder Power

Initially, let us assume that the most difficult issue left by Sarbanes-Oxley involves the misaligned incentives of managers, caused by the sudden shift in the form of executive compensation during the 1990s. This is a fair premise because other problems, such as the need for greater deterrence, can be addressed by any of several means. For example, Congress could restore private aiding and abetting liability, thereby overruling \textit{Central Bank of Denver},\textsuperscript{140} and increasing the expected costs to gatekeepers of acquiescence in financial irregularity. Such a reform may be unlikely in the current political environment, but it poses no conceptual problem.

In contrast, reforming executive compensation poses a more serious conceptual challenge. Why? The short answer is that neither Congress nor the SEC can legislate or formulate optimal executive compensation rules for all publicly held companies. One size simply does not fit all. What works for a dot-com company does not work for a public utility, and vice versa. Who then could propose and imple-

\textsuperscript{138} For a brief overview of these reforms, see Amy Borrus et al., \textit{Reform: Business Gets Religion}, Bus. Wk, Feb. 3, 2003, at 40, 41 (noting that corporations have adopted these reforms with little resistance, but also noting that some "governance gurus fear that companies are checking the boxes rather than taking changes to heart").

\textsuperscript{139} Ironically, one survey by Yale School of Management Professor Jeffrey Sonnenfeld has found that when it comes to the standard measures of good governance—the independence, attendance, and financial acumen of directors—the "least admired" companies do about as well as the "most admired" companies. See Jerry Useem, \textit{From Heroes to Goats and Back Again? How Corporate Leaders Lost Our Trust}, \textit{Fortune}, Nov. 18, 2002, at 40, 48.

\textsuperscript{140} See 511 U.S. 164, 164 (1994).
ment more specific reforms? One answer is the board of directors. Yet one has to be an extreme optimist to expect activism from boards on this issue. Boards are populated by fellow CEOs, who are not likely to be excited about restricting executive compensation or their own liquidity.

Thus, the more practical answer is to encourage institutional investors to address this problem. This year shareholders placed a record number of proposals on corporate proxy statements for a shareholder vote at corporations’ annual meetings.141 The majority of these proposals dealt with executive compensation.142 These propositions, however, are generally only precatory and can be ignored by managers.143 Missing, therefore, is some next step that shareholders can take when a proposal receives majority support at the annual shareholder meeting and yet management ignores it. In theory, shareholders could commence a proxy contest, but the costs are prohibitive and the problems of shareholder collective action are considerable.144

What else could be done? Institutional shareholders have a preferred answer: they want to be able to nominate one or more minority directors on the corporation’s own proxy statement in order to economize on the costs of shareholder activism. The SEC has begun to study this proposal,145 but the business community is actively organiz-

142 See id. (noting that “[m]ore than 50 percent of the record number of shareholder proposals during this proxy season dealt with executive compensation issues”).
143 Most state statutes permit shareholders to amend the bylaws of the corporation. See, e.g., DEL. CODE ANN. tit. 8, § 109(a) (2003) (providing that “[a]fter a corporation has received any payment for any of its stock, the power to adopt, amend or repeal bylaws shall be in the stockholders entitled to vote”). This power, however, conflicts with the universal provision, which most states have adopted, giving the board of directors control of the business and affairs of the corporation. See, e.g., id. § 141(a) (providing that the “business and affairs of every corporation organized ... shall be managed by or under the direction of a board of directors”). The law in this area remains unsettled. See generally John C. Coffee, Jr., The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests?, 51 U. MIAMI L. REV. 605 (1997) (discussing legal theories in connection with the questions raised by the allocation of power between boards and shareholders). For contrasting recent decisions, compare International Brotherhood of Teamsters General Fund v. Fleming Cos., 975 P.2d 907, 908 (Okla. 1999) (upholding a bylaw adopted by shareholders against the claim that it impermissibly invaded the authority accorded to the board under Oklahoma law), with Invacare Corp. v. Healthdyne Technologies, Inc., 968 F. Supp. 1578, 1582 (N.D. Ga. 1997) (invalidating a mandatory bylaw adopted by a shareholder because it invaded the authority given to board under Georgia law).
ing against it. Its central attraction is that it gives shareholders a next step, without threatening a full scale control contest, if management ignores their proxy proposal. If adopted, its real impact would not be a spate of minority directors suddenly elected to boards, but rather a significant number of negotiations between institutional shareholders and corporate managers over specific executive compensation issues. In effect, enhanced shareholder rights to nominate board members may be the procedural solution to the substantive problem of reforming executive compensation.

C. Curbing Excessive Optimism

Earlier, this Article noted that serious principal-agent problems compromise the effectiveness of fund managers. Therefore, if stock prices tend to be systematically inflated by biased research and if fund managers are reluctant to combat such inflation, a different champion must be found to bring the market back into equilibrium. In an unregulated market, that natural champion would be the short seller. Under U.S. securities laws, however, the short seller is disfavored and heavily regulated. Relaxing these regulations, while not politically popular, would be one way of creating a countervailing force to those that inflate stock prices. Ironically, in this particular regard, deregulation—that is, deregulation of the short seller—might be a legitimate response to Enron.

changes in its proxy rules in order to facilitate direct shareholder nomination of “watchdog” directors under some circumstances. See Div. of Corp. Fin., Sec. & Exch. Comm’n, Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors 30–31 (2003).


147 See supra notes 120–24 and accompanying text.

148 Increasing economic evidence suggests that short sale constraints can cause stocks to be overvalued. See generally Charles M. Jones & Owen A. Lamont, Short-Sale Constraints and Stock Returns, 66 J. Fin. Econ. 207 (2002) (presenting a study of the costs of short selling stock). The best known of the legal constraints on short selling is the up-tick rule, which permits short sales only at a price higher than the previous price (an up-tick) or at the previous price if the last different price was lower. See 17 C.F.R. § 240.10a-1 (2003). Securities Exchange Act Release No. 13091 outlines the purposes of the up-tick rule. See Short Sales of Securities, Exchange Act Release No. 34-13,091, 41 Fed. Reg. 56,530, 56,535 (Dec. 28, 1976) (codified at 17 C.F.R. § 240.10a-1). Today, the advent of decimalization of securities prices has weakened the impact of the up-tick rule. Further, recent commentators have argued that the tax laws impose the primary constraints on short selling. See, e.g., Michael Powers et al., Market Bubbles, Wasteful Avoidance, and Tax and Regulatory Constraints on Short Sales (2003) (unpublished manuscript, on file with author) (detailing both tax and regulatory constraints on short selling).

149 The SEC has recently shown some willingness to reconsider and liberalize its rules regarding short sales. See Securities Exchange Act Release No. 34-8709, 2003 SEC LEXIS 2594 (Oct. 28, 2003). In that Release, the SEC has proposed a new Regulation SHO that would permit short sales to be effected at a price one cent below the consolidated best bid; however, the Release would also tighten the restrictions on “naked” short sales. Thus, its
This Article has reviewed several different explanations for the surge in financial irregularities in the late 1990s. Chief among these are:

1. The Gatekeeper Explanation. Professional “reputational intermediaries” faced less legal risk and had more reason to defer to their clients as the 1990s wore on. This combination of increased market incentives and legal deregulation may explain why auditors acquiesced and analysts became more biased, but it cannot stand alone as a comprehensive explanation. One still needs some further explanation of why managers and underwriters became more interested in bribing their gatekeepers than they were in the past.

2. The Executive Compensation Explanation. As executive compensation changed during the 1990s, it increased the incentive for managers to inflate earnings, even if the resulting stock prices were not sustainable, because management could bail out ahead of their shareholders. This explanation accounts for the increased incentive on the part of managers to induce gatekeepers to acquiesce in aggressive accounting. In particular, the fact that the plurality of financial statement restatements in the late 1990s involved revenue recognition issues supports this explanation. Still, it must be stressed that the real problem here is not equity compensation, or even excessive compensation, but rather excessive liquidity that allows managers to bail out at will. Only firm-specific answers, such as holding periods and retention ratios, seem likely to work effectively to solve this problem.

3. The Herding and Investor Bias Explanations. These explanations can help account for the market myopia underlying a bubble, but they lack quantitative support. Although it can be asserted that individual investors expect extraordinary returns to persist, this hypothesis is less credible when applied to institutions. Still, fund managers have their own reasons to herd and persist in buying stocks they consider overvalued. Ultimately, they fear being individually wrong much more than being collectively wrong, and this bias inclined them to “ride the

actual provisions may have offsetting effects. More importantly, SEC proposed in this Release to relax its short sale rules for certain liquid securities for a two-year pilot period in order to test the effects of less regulated short selling on market volatility, price efficiency, and liquidity. Although these proposals do not appear to be Enron-related, the fact remains that the short seller should be as motivated to serve as a private attorney general, eagerly seeking to detect fraud, as the plaintiff’s attorney.

In recommending some relaxation of the constraints on the short seller, this author does not mean to suggest that the prohibition against market manipulation should be relaxed, but only that the more prophylactic rules, such as the up-tick rule, should be revised, and that tax penalties should be eased.

150 See supra notes 61–62 and accompanying text.
bubble." As a result, the market did not respond to available evidence of overvaluation.

If weight is accorded to any of these explanations, then it becomes clear that the Sarbanes-Oxley Act, while useful, still addresses only one aspect of the first explanation for gatekeeper failure by curbing the ability of managers to seduce auditors with consulting income. A more relevant public policy agenda should also: (1) increase the legal threat to deter acquiescence in managerial fraud; (2) reduce the perverse incentives created by the unconstrained use of stock options; and (3) address the structural conflicts that cause herding, analyst bias, and an excessive market bias towards optimism. As discussed, enhanced shareholder rights to nominate board members may be the best procedural solution to the substantive problem of reforming executive compensation. Furthermore, deregulation of the short seller may be the most direct means to combat stock price inflation. Currently, however, these issues have gone unaddressed. Thus, to conclude, one can only paraphrase George Santayana: those who ignore conflicts of interest are destined to repeat history, cycle after cycle.\textsuperscript{151}

\textsuperscript{151} See GEORGE SANTAYANA, \textit{The Life of Reason; Or, the Phases of Human Progress} 284 (1st ed. New York Charles Scribner's Sons 1905).