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Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms

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ARTICLES

GATEKEEPER FAILURE AND REFORM: THE CHALLENGE OF FASHIONING RELEVANT REFORMS

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INTRODUCTION

Securities markets have long employed "gatekeepers"—independent professionals who pledge their reputational capital—to protect the interests of dispersed investors who cannot easily take collective action.[1] The clearest examples of such reputational intermediaries are auditors and securities analysts, who verify or assess corporate disclosures in order to advise investors in different ways. But during the late 1990s, these protections seemingly failed, and a unique concentration of financial scandals followed, all involving the common denominator of accounting irregularities. What caused this sudden outburst of scandals, involving an apparent epidemic of accounting and related financial irregularities, that broke over the financial markets between late 2001 and mid-2002—e.g., Enron, WorldCom, Global Crossing, Tyco, and others? To date, much commentary has broadly and loosely attributed these scandals to any or all of a number of circumstances: (1) a stock market bubble; (2) a decline in business morality; (3) weak boards of directors;[2] or (4) an

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[1] Probably the first systematic use of this term, "gatekeeper," was in an article by Ronald Gilson and Ranier Kraakman. *See* Ronald J. Gilson & Ranier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 613-21 (1984) (discussing the role of investment bankers as gatekeepers). *See also* John C. Coffee, Jr., *Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation*, 52 BUS. LAW. 1195, 1210-13, 1232-33 (1999) (discussing the role of underwriters, accountants, lawyers, and directors as "gatekeepers" and "reputational intermediaries"). For a fuller discussion of the concept of gatekeepers as "reputational intermediaries," see *infra* notes 13-14 and accompanying text. The use of such private agents substantially predates the appearance of public regulation, either the federal securities laws or the state "Blue Sky" laws. The New York Stock Exchange began to require the publication of financial statements certified by an independent auditor around 1900, well before the passage of the first "Blue Sky" statute. *See* John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 37-39 (2001).

[2] For a representative such statement, see Stuart L. Gillan & John D. Martin, Financial Engineering, Corporate Governance and the Collapse of Enron 3 (2002) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=354040 (last accessed Mar. 12, 2004) (finding that the first cause of Enron's breakdown was "a lack of board independence and board oversight"). In contrast, this article doubts the adequacy of such an explanation. Admittedly, boards did fail, and even a special committee of Enron's own board has concluded that the Enron board failed to adequately monitor officers for 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., Feb. 1, 2002, *available at* 2002 WL 198018 (describing the board's failure to monitor for conflict

increase in "infectious greed."[3] Without denying that any of these factors could have played some role, this article begins from the premise that explanations phrased in terms of greed and morality are unsatisfactory because they depend on subjective trends that cannot be reliably measured.

Even explanations that involve critiques of corporate governance involve a related problem in that they fail to account for the sudden increase in financial irregularity. While some boards certainly failed, the overall independence and power of outside directors has only increased over recent years, and the 2001-2002 epidemic of financial irregularity cannot be satisfactorily explained in terms of any recent decline in board performance. To explain an epidemic of irregularity, one must identify some force or factor that changed—either intensifying or weakening—so that its influence can account for the overall shift in behavior. Clearly, the performance of boards of directors of publicly held corporations, even if inadequate, did not decline materially over the relevant interval of the 1990s.

A final over-simple explanation is that a "few bad apples"—i.e., a small group of "rogue managers" who were corrupt—caused these scandals. This explanation overlooks the pervasiveness of the sudden surge in financial irregularities in the late 1990s. As will be seen, approximately ten percent of all publicly listed U.S. companies restated their financial statements at least once between 1997 and June 2002,[4] and the annual rate of financial restatements soared during the latter half of the 1990s.[5] Such financial irregularity is, of course, characteristic of a bubble, and little doubt now exists that a large frothy bubble burst in 2000-2001. As a historical matter, bubbles tend to produce scandals and, in turn, prophylactic legislation,[6] but this loose

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of interest regarding a number of major transactions and business relationships). Similarly, a Senate Subcommittee has assigned the principal blame to the Enron board. *See* PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE COMM. OF GOVERNMENTAL AFFAIRS, THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE, S. REP. NO. 107-70, at 60 (2001) ("By failing to provide sufficient oversight and restraint to stop management excess, the Enron Board contributed to the company's collapse and bears a share of the responsibility for it."). Nonetheless, such studies beg the larger question: why did these boards fail now and not earlier? Although board procedure or independence may have been deficient, they were almost certainly superior to a decade ago when such scandals were rare.

[3] Federal Reserve Chairman Alan Greenspan coined this colorful phrase, saying that "An infectious greed seemed to grip much of our business community." Floyd Norris, *The Markets: Market Place: Yes, He Can Top That*, N.Y. TIMES, July 17, 2002, at A1.

[4] U.S. GEN. ACCOUNTING OFFICE, REPORT TO THE CHAIRMAN, COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, U.S. SENATE, FINANCIAL STATEMENT RESTATEMENTS: TRENDS, MARKET IMPACTS, REGULATORY RESPONSES AND REMAINING CHALLENGES 4 (2002) [hereinafter GAO STUDY] ("From January 1997 through June 2002, about 10 percent of all listed companies announced at least one restatement.").

[5] *See infra* notes 21-29 and accompanying text.

[6] Professor Stuart Banner has argued that, over the last 300 years, most major instances of legislation regulating the securities markets have followed a sustained price collapse on

generalization leaves unanswered the critical questions: what caused this bubble and how does the growth of a bubble relate to the apparent breakdown of our once-confident system of corporate governance?

This article will focus on an alternative explanation for the wave of accounting and financial reporting irregularities that surfaced in 2001-2002: namely, that the gatekeepers failed. That is, the professionals who serve investors by preparing, verifying, or certifying corporate disclosures to the securities markets acquiesced in managerial fraud—not in all cases, to be sure, but at a markedly higher rate than during the immediately preceding period. While the concept of gatekeeper will be discussed and refined later, this term certainly includes the auditors, securities analysts, and securities attorneys who prepare, review, or analyze disclosure documents. Part I of this article develops competing, but complimentary, explanations for gatekeeper failure. The behavior of gatekeepers cannot be examined in isolation, but rather appears to have been significantly influenced by the incentives that drove corporate managers over the same period. To this extent, the recent explosion of financial irregularity was less the product of ineffable factors—such as "infectious greed" or mass irrationality—than the natural and logical consequence of trends and forces that had been developing for some time. Ironically, the blunt truth is that both the recent accounting scandals and the broader phenomenon of earnings management were the by-products of a system of corporate governance that has indeed made corporate managers more accountable to the market. Sensitivity to the market, however, can be a mixed blessing—particularly when the market becomes euphoric and uncritical. As a result, a corporate governance system that was adequate for a world in which the agents' incentives to act opportunistically were weaker failed when these same agents—managers, gatekeepers, and financial intermediaries—responded to stronger incentives and rationally pursued their own self-interests to the detriment of shareholders.

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

This focus on executive compensation as the destabilizing force that led managers to overreach gatekeepers is subject to a contextual qualification: gatekeepers do not have the same economic or legal relationship to corporate managements around the world. Outside the United States, no similar outburst

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the securities market. *See* Stuart Banner, *What Causes New Securities Regulation?: 300 Years of Evidence*, 75 WASH. U. L.Q. 849, 850 (1997).

of accounting irregularities or financial statement restatements occurred during 2000 to 2002, even though stock markets receded uniformly in the United States and Europe. Indeed, most of the non-U.S. companies that did experience accounting irregularities over this same era either had significant U.S. operations where the fraud originated or also relied on stock options to compensate senior management. Across most of the world, however, little use is made of equity compensation because most firms have concentrated ownership and their controlling shareholders do not need to rely on equity compensation to align shareholder interests with their own. Thus, the relative absence of accounting scandals in Europe over the 2000-2002 period, coupled with the limited use of equity compensation in Europe, tends to corroborate the basic hypothesis advanced in Part I that changes in executive compensation destabilized American corporate governance.

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

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

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[7] *See* Mark Landler, *Scandal Outrages Europeans; Solutions May Be Patchwork*, N.Y. TIMES, Dec. 25, 2003, at C1 (discussing Parmalat and other recent European accounting scandals).

[8] Technically, this statute is entitled the "Public Company Accounting Reform and Investor Protection Act of 2002." 107 Pub. L. No. 204, 116 Stat. 745 (2002) (codified at 15 U.S.C. § 7201).

But therein lies a host of problems. Although gatekeepers need to face some legal threat if they are to remain faithful to shareholders, the optimal level of deterrence is much harder to estimate. Some recent commentators have proposed a strict liability regime for gatekeepers, arguing that only strict liability provides gatekeepers with optimal incentives to prevent client misconduct.[9] Other commentators have disagreed, replying that strict liability may cause the market for gatekeepers to fail or may simply deny some law-abiding, but higher risk, issuers access to the capital markets.[10] Although the magnitude of the litigation "threat" that is now facing gatekeepers can reasonably be debated and probably varies with the type of gatekeeper, the increasing risk of gatekeeper insolvency in at least the U.S. context suggests the need to consider alternative reforms that can modify gatekeeper behavior by means that do not directly threaten gatekeeper solvency.

In this light, Part III proposes alternative reforms intended both to introduce a new gatekeeper into the disclosure process and to make existing gatekeepers more responsive to the interests of investors. Initially, Part III proposes a modified form of strict liability for auditors that caps their maximum exposure at a multiple of their expected revenues from the client. The attraction of this combination is that it combines the superior incentives of a strict liability regime with both reduced transaction costs (as courts are spared the costly obligation of determining when gatekeepers acted with scienter or without reasonable care) and a reduced risk of gatekeeper insolvency or market failure in the market for gatekeeper services. Similarly, the prospect that law-abiding issuers might be denied access to the capital markets because of the liability risk they posed to their gatekeepers is also alleviated. Concededly, this proposal does subordinate the goal of victim compensation to that of deterrence, but gatekeepers simply lack the economic scale to be able to fund significant compensation to investors, particularly in the new era of mega-litigation. Finally, by moving towards a strict liability system, this proposal eliminates the incentive for auditors to rationalize or overlook fraud or irregularity and later assert, on its discovery, that they were deceived by management. Rather, the auditor would know that it sinks or swims with its client; hence, half-hearted or pro forma monitoring, which may be a rational strategy under a negligence or fault-based legal regime, no longer protects the gatekeeper.

Part III recognizes, however, that all gatekeepers are not alike, that strict

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[9] *See, e.g.*, Trotter Hardy, *The Proper Legal Regime for "Cyberspace"*, 55 U. PITT. L. REV. 993 (1994) (proposing strict liability for internet service providers); Frank Partnoy, *Barbarians at the Gatekeepers? A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491 (2001).

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

liability only makes sense when the gatekeeper can effectively prevent client misconduct, and that the attorney is not as well positioned as the auditor to detect client misconduct. In that light, Part III does not propose strict liability for attorneys but, instead, a structural reform: namely, imposing gatekeeper responsibilities on attorneys to monitor their corporation's disclosures, with a special emphasis on non-financial disclosures. The goal here is to empower the gatekeeper and increase its leverage with respect to its client. To achieve this goal, Part III proposes that the attorney should be given a limited responsibility for non-financial disclosures functionally corresponding to those the auditor now has for financial disclosures. Easy as this is to say, the devil lies in the details. Specifically, Part III outlines a "negative assurance" certification requirement, an enhanced independence standard for special contexts, and a due diligence obligation under which the Securities and Exchange Commission ("SEC") could suspend or disbar securities attorneys who failed negligence or malpractice tests. To be sure, the SEC has already begun to move modestly and tentatively in this same direction by adopting an "up-the-ladder" internal reporting requirement under which attorneys must report evidence of certain material violations of law that they acquire in their representation of the corporation to the corporation's general counsel or, if necessary, its audit committee.[11] The SEC is also considering, and a number of academics have urged, a further reform under which the attorney would be required to make a "noisy withdrawal" if the violation continued and threatened serious injury to the corporation.[12] Without disputing the justifications for such a broader rule, Part III predicts that only modest benefits can be expected from such a reform because it demands heroism from the attorney on rare and isolated occasions without resting its obligation on a broader functional foundation. In contrast, certification requirements create the broader framework within which the attorney must function on an on-going basis as a gatekeeper.

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

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[11] *See* Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No. 33-8185, 68 Fed. Reg. 6296 (Feb. 6, 2003) (to be codified at 17 C.F.R. pt. 205) (requiring that, as a minimum standard of professional conduct, attorneys must "report evidence of a material violation of securities law . . . to the chief legal counsel or the chief executive officer . . . (or the equivalent thereof)"). *See also infra* notes 126-130 and accompanying text.

[12] *See* Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No. 33-8186, 79 S.E.C. Docket 1392 (Jan. 29, 2003).

obligations is to empower the gatekeeper, thus responding appropriately to the phenomenon of "gatekeeper failure."

I. GATEKEEPERS: PAST AND PRESENT

A. *Defining the Concept*

The term "gatekeeper" has been widely used to refer to the outside professionals who serve the board or investors.[13] Broadly as the term may be sometimes used, two core elements underlie the concept of gatekeeper, and it is important to distinguish between them. First, the gatekeeper is a person who has significant reputational capital, acquired over many years and many clients, which it pledges to assure the accuracy of statements or representations that it either makes or verifies. Second, the gatekeeper receives a far smaller benefit or payoff for its role, as an agent, in approving, certifying, or verifying information than does the principal from the transaction that the gatekeeper facilitates or enables. For example, the founders of an issuer seeking to effect an initial public offering may each expect $100 million if the offering is successful; hence, they have incentives to misrepresent material facts that may make them virtually undeterrable. In contrast, the firm's auditors probably expect a much smaller payoff and have considerable reputational capital at risk. Thus, because of this lesser benefit, the gatekeeper is easier to deter. This latter premise applies even if the gatekeeper has little or no reputational capital. These two elements—that the gatekeeper is a reputational intermediary and that it receives only a limited payoff from any involvement in misconduct—suggest a strategy for law compliance: the more the law makes the involvement of gatekeepers in sensitive transactions mandatory, the more it acquires a lever by which it can effectively discourage law violations.

To be sure, the term "gatekeeper" has also been used more broadly to describe any person or entity who provides a necessary service or certification without which the corporation cannot accomplish a transaction.[14] This may

[13] The SEC regularly uses this term. *See* Revision of the Commission's Auditor Independence Requirements, Securities Act Release No. 33-7870, 72 S.E.C. Docket 1901 (June 30, 2000) (noting that "the federal laws . . . make independent auditors 'gatekeepers' to the public securities markets"); *see also* Securities Act Concepts and Their Effects of Capital Formation, Securities Act Release No. 33-7314, 61 Fed. Reg. 148 (July 25, 1996) (discussing the role of gatekeepers in maintaining the quality of disclosure). Professor Kraakman has defined gatekeepers as "private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers." Kraakman, *supra* note 10, at 53. Assaf Hamdani uses a similarly broad definition, describing them as "parties who sell a product or service that is necessary for clients wishing to enter a particular market or engage in particular services." Hamdani, *supra* note 10, at 58.

[14] Professor Kraakman originally defined "gatekeepers" simply in terms of their blocking capacity as private parties who are able to prevent misconduct by withholding their cooperation from wrongdoers. *See* Kraakman, *supra* note 10, at 53; Reinier Kraakman,

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

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

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

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Corporate Liability Strategies and the Costs of Legal Controls, 93 YALE L.J. 857 (1984); *see also* Hamdani, *supra* note 10, at 58. This definition strikes me as overly broad, at least for purposes of discussing the role of professionals. It would potentially hold liable persons who sold pencils to Al Capone's gang on the theory that one could not run a brewery and tavern business without using pencils to keep records. Ignored by this definition is whether the gatekeeper possessed the ability to monitor whether its product or service has been misused.

rationally sacrifice its reputational capital for a single client or a modest fee.

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

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

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

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

(4) The prospective injury to a gatekeeper's reputational capital from involvement in a scandal could also decline, possibly because, in a very concentrated market (such as the market for auditing services), it becomes foreseeable that all the principal firms in the market will be involved in some scandals and hence investors cannot distinguish meaningfully among them (i.e., the information costs become too high for ordinary investors); and

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

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

Much evidence corroborates each of the foregoing hypotheses and suggests that reputational capital was knowingly risked and arguably even expended by gatekeepers during the late 1990s. Indeed, Arthur Andersen's fall in 2002 seems best understood in terms of such a rational risk-taking explanation. In theory, Andersen should not have acquiesced in accounting irregularities because it had many clients, each of whom pay a fee that was modest in proportion to the firm's overall revenues. Specifically, Arthur Andersen had approximately 2300 audit clients.[16] On this basis, the firm seemingly had little incentive to risk its considerable reputational capital for any one client, even if

[15] This observation is hardly original with this author. *See, e.g.*, Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight Into Securities Fraud Litigation*, 95 NW. U. L. REV. 1333 (2000) (rejecting the economic behavior assumption that loss of reputation will prevent auditors from ever committing fraud).

[16] Michelle Mittelstadt, *Andersen Charged With Obstruction, Vows to Fight*, DALLAS MORNING NEWS, Mar. 15, 2002, at 1 (stating that Arthur Andersen had 2300 publicly held auditing clients)

that client paid a multi-million dollar fee. As will be seen, however, each of the foregoing hypotheses can contribute to an explanation of gatekeeper failure.

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

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

Of course, the modest fees in some of these cases were well under the $100 million in prospective annual fees from Enron that Arthur Andersen & Co. explicitly foresaw.[19] But this difference in magnitude cannot really explain Arthur Andersen's collapse. Even if Arthur Andersen saw Enron as a potential $100 million client, it must be remembered that Arthur Andersen generated over $9 billion in revenues in 2001 alone (so that its expected Enron revenues would total only around 1% of its aggregate revenues).[20] Hence, a more nuanced explanation seems necessary.

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

Once among the most respected of all professional service firms (including law, accounting, and consulting firms), Andersen became involved in a series of now well-known securities frauds—e.g., Waste Management, Sunbeam, HBOCMcKesson, The Baptist Foundation, and Global Crossing—that culminated in its disastrous association with Enron. Those who wish to view the recent corporate scandals as simply the work of a "few bad apples" may seek to characterize Arthur Andersen as a deviant firm, in effect an "outlaw" that masqueraded as an honest sheriff. This theory, however, simply does not

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

[18] *See Dileo*, 901 F.2d at 629.

[19] For example, the audit fee was only $90,000 in *Robin v. Arthur Young & Co. See Robin*, 915 F.2d at 1127.

[20] Arthur Andersen's total revenues for its fiscal year ending August 31, 2001 were $9.3 billion. *See* Melissa Klein, *Guilty Verdict Draws Mixed Reactions: Profession Mulls Post-Andersen Future*, ACCT. TODAY, July 8, 2002, at 1. On this basis, even a projected $100 million in total fees from Enron would come to only slightly over 1% of Andersen's total revenues.

hold water. The available evidence in fact suggests that, in terms of the percentage of accounting restatements experienced by its audit clients, Andersen was not significantly different from its peers and experienced the same (or lesser) rate of financial restatements.[21] To the extent it was different, the leading difference may have been only that it was less lucky. All in all, the more logical inference to draw from the "accounting irregularity" scandals of 2001-2002 is that an erosion in the quality of financial reporting occurred sometime during the 1990s.

Indeed, this is the area where the data seems the clearest. During the 1990s, earnings restatements, long recognized as a proxy for fraud, suddenly soared. One study, conducted in 2001 by Moriarty and Livington, found that the number of earnings restatements by publicly held corporations averaged 49 per year from 1990 to 1997, next increased to 91 in 1998, and then skyrocketed to 150 and 156 in 1999 and 2000, respectively.[22] A later, fuller study conducted by the United States General Accounting Office ("GAO") in October 2002, examined all financial statement restatements (not just earnings restatements) and also found a similarly sharp, discontinuous spike in 1999 that has continued through 2002.[23] The GAO study's data shows the trend line presented in Figure 1.[24]

Not all restatements, however, are equal. Some may involve small, infrequently traded companies or involve only trivial changes or trigger only modest stock price reactions, while others may be on a scale with Enron or WorldCom. Therefore, it is useful to focus more precisely on financial statement restatements by companies listed on the NYSE, Amex, and Nasdaq, thereby excluding smaller companies that trade only on regional exchanges or over the counter. On this basis, between 1997 and 2001, the proportion of listed companies on the NYSE, Amex, and Nasdaq that restated their financial statement approximately tripled, increasing from less than 0.89% in 1997 to

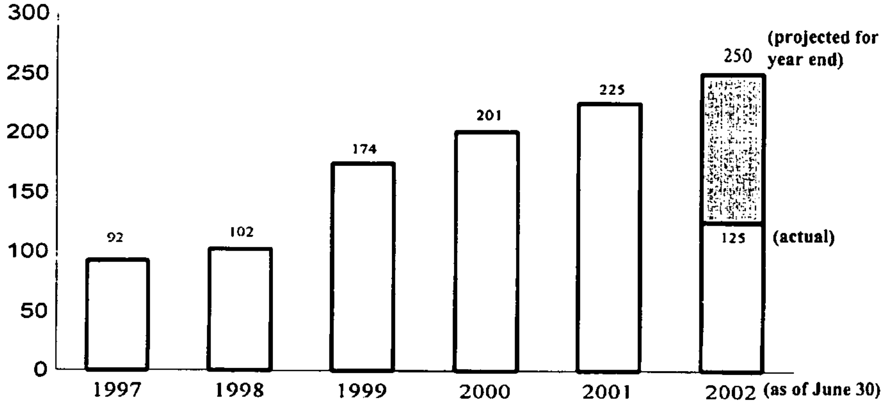
[21] Compared to its peers within the Big Five accounting firms, Arthur Andersen appears to have been responsible for less than its proportionate share of earnings restatements. While it audited 21% of Big Five audit clients, it was responsible for only 15% of the restatements experienced by the Big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

[22] *See* George B. Moriarty & Phillip B. Livingston, *Quantitative Measures of the Quality of Financial Reporting*, 17 FIN. EXECUTIVE 53, 54 (July/Aug. 2001) (detailing the chronological rise in earnings restatements by publicly held corporations).

[23] *See* GAO Study, *supra* note 4, at 4-5.

[24] *Id.* at 15.

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



approximately 2.5% in 2001.[25] Indeed, the GAO study further predicted that this percentage would reach nearly 3% in 2002.[26] Overall, the GAO study found that from January 1997 to June 2002 approximately "10 percent of all listed companies announced at least one restatement."[27] Also noteworthy was the fact that the size (in terms of market capitalization) of the typical restating company rose rapidly over this period,[28] and in 2002, companies listed on the NYSE or Nasdaq accounted for over 85% of all restatements identified in that year.[29]

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

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[25] *Id.* at 4 ("The proportion of listed companies on NYSE, Amex, and Nasdaq identified as restating their financial reports tripled from less than 0.89 percent in 1997 to about 2.5 percent in 2001 . . . .").

[26] *Id.* ("The proportion of listed companies on NYSE, Amex, and Nasdaq identified as restating their financial reports . . . may reach almost 3 percent by the end of 2002.").

[27] *Id.*

[28] Specifically, "[t]he average (median) size by market capitalization of a restating company rose from $500 million ($143 million) in 1997 to $2 billion ($351 million) in 2002." *Id.*

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

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

The available data shows that, during the late 1990s, the magnitude of financial restatements increased, both in absolute terms (nearly doubling) and as a percentage of the issuer's rapidly increasing market capitalization.[35] This

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[30] *Id.* at 5. The GAO study 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. *Id.* at 29.

[31] *Id.* at 34 (reporting that these market losses ranged from "$4.6 billion in 1997 to about $28.7 billion in 2000," but acknowledging the difficulty of controlling for other factors that may have affected stock prices for restating companies during the three day period).

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

[33] The SEC's prioritization of earnings management as a principal enforcement target can be approximately dated to SEC Chairman Arthur Levitt's now famous speech on the subject in 1998. *See* SEC Chairman Arthur Levitt, The "Numbers Game", Remarks at the N.Y.U. Center for Law and Business (Sept. 28, 1998), *available at* http://www.corpforms99.com/205.html (last accessed Mar. 12, 2004).

[34] *See supra* notes 30-31 and accompanying text.

[35] 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. Moriarty & Livingston, *supra* note 22, at 55 (highlighting the large portion of the total market value lost by a small number of restating companies). Expressed as a percentage of the overall capitalization of the market (which was ascending hyperbolically over this period), these losses for 1998 through 2000 came to 0.13%, 0.14% and 0.19%, respectively,

suggests that managers became progressively willing over this period to take greater risks. Moreover, as the decade of the 1990s wore on, earnings restatements were increasingly experienced by large, mature, publicly-held firms, rather than by smaller or newly public companies that might be expected to be more inexperienced or rash. Managerial behavior within the largest firms then seems to have changed over this period.

In particular, the GAO study's data corroborates this interpretation that managerial behavior changed because it shows a significant change in motive. Although there are many reasons why a company may restate its financial statements (e.g., to adjust costs or expenses or to recognize liabilities), one particular reason dominated during the period from 1997 to 2002. The GAO study found that issues involving revenue recognition accounted for almost 39% of the 919 announced restatements that it identified over the 1997 to 2002 period.[36] In effect, attempts by management to prematurely recognize income appear to have been the most common cause of restatements. Earlier in the decade and during prior decades, earnings management was more a game of "smoothing out" the peaks and valleys in a corporation's income flow in order to reduce the apparent volatility in the corporation's returns. Thus, managements characteristically attempted to hide "excess earnings" in "rainy day reserves" in order to use such funds later to smooth out undesired declines in the firm's earnings.

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

C. *Security Analysts During the 1990s*

Before any attempt is made to generalize about the motivations that led managements to pressure their auditors for premature revenue recognition, it is useful to recognize that this pattern of increased acquiescence by the

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of market capitalization. In short, however expressed, the relative size of the losses increased over this period.

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

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

gatekeeper to its clients' demands during the 1990s was not limited to the auditing profession. Security analysts are probably the only other profession that has experienced equivalent (or harsher) criticism since the collapse of the high-tech bubble in 2000. Again, growing conflicts of interest appear to explain their change in behavior.

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

How close then are the similarities between analysts and auditors? Much like auditors, analysts are also "reputational intermediaries," whose desire to be perceived as credible and objective may often be subordinated to their desire to retain and please investment banking clients. One statistic inevitably comes up in any assessment of analyst objectivity: namely, the curious fact that the ratio of "buy" recommendations to "sell" recommendations has recently

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[38] *See The Collapse of Enron: The Role Analysts Played and the Conflicts They Face: Hearing before the S. Comm. on Governmental Affairs*, 107th Cong., 2d Sess. (Feb. 27, 2002) (prepared testimony of Frank Torres, Legislative Counsel, Consumers' Union) ("In the case of Enron, 16 out of 17 analysts had a buy or a strong buy rating, one had a hold, none had a sell—even as the company stock had lost over half its value and its CEO suddenly resigned."). *See also Hearing before the S. Comm. on Governmental Affairs*, 107th Cong., 2d Sess. (Feb. 25, 2002) (prepared testimony of Frank Partnoy, Professor of Law, University of San Diego School of Law) (similarly noting the sixteen out of seventeen tabulation).

[39] *See* Paul M. Healy & Krishna Palepu, *The Fall of Enron*, J. ECON. PERSP., Spring 2003, at 3 (indicating the high expectations held by the market for Enron's future performance).

[40] *See* Lauren Young, *Independence Day*, SMARTMONEY, May 1, 2001, at 28 (arguing that analysts for brokerage firms without investment banking departments feel less pressure to tout the stocks of investment banking clients and potential clients, and noting Prudential's "liberal use of the sell word[]" since eliminating its own investment banking department).

[41] *Id.* (noting that Prudential's twenty-nine "sell" ratings exceeded all other brokerage firms).

been as high as 100-to-1.[42] In truth, this particular statistic may not be as compelling as it initially sounds because there are obvious reasons why "buy" recommendations will normally outnumber "sell" recommendations, even in the absence of conflicts of interest.[43] Yet, a related statistic may be more revealing because it underscores the apparent transition that took place in the 1990s and parallels the earlier noted increase in accounting restatements during the 1990s. According to a study by Thomson Financial, the ratio of "buy" to "sell" recommendations increased from 6-to-1 in 1991 to 100-to-1 by 2000.[44]

Other evidence corroborates this picture of a systematic analyst bias towards optimism. Studying security analyst career patterns over the last two decades, Hong and Kubik find that career advancement for analysts depended more on a bias towards optimism than on the overall accuracy of their forecasts.[45] Although accuracy did matter, a tendency to be more optimistic than the consensus of analysts seemed to protect analysts from downward movement within their industry's hierarchy, and this tendency was most pronounced in the case of analysts who covered stocks underwritten by their own firms.[46] More importantly, this tendency for optimism to outweigh accuracy increased during the late 1990s.[47] They interpret their findings as at least consistent with the view "that Wall Street lost any self-discipline to produce accurate research during the recent stock market mania."[48] Perhaps this assessment overstates,

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[42] A study by Thomson Financial/First Call has found that less than one percent of the 28,000 stock recommendations issued by brokerage firm analysts during late 1999 and most of 2000 were sell recommendations. *See Analyzing the Analysts: Are Investors Getting Unbiased Research from Wall Street? Hearing Before the House Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises*, 107th Cong. (Jun. 14, 2001) (opening statement of Congressman Paul E. Kanjorski, Ranking Democratic Member, House Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises).

[43] "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 certainly all the firm's customers, while a sell recommendation addresses only those customers who own the stock (probably well under one percent) and those with margin accounts who are willing to sell the stock short. In addition, sell recommendations annoy not only the issuer company, but also institutional investors who are afraid that sell recommendations will spook retail investors, causing them to panic and sell, while the institution is locked into a large position that cannot be easily liquidated.

[44] *See id.* at 1 (citing study by Thomson Financial/First Call).

[45] *See* Harrison Hong & Jeffrey Kubik, *Analyzing the Analysts: Career Concerns and Biased Earnings Forecasts*, 58 J. FIN. 313, 345 (2003) (concluding that brokerage houses care about and reward the accuracy of their analysts' predictions, but also that "they reward optimistic analysts").

[46] *Id.* at 341.

[47] *Id.* at 342, 346 (finding that between 1996 and 2000 a strong bias towards optimism decreased an analyst's risk of downward movement in the industry, and that accuracy generally mattered less during this period in determining movement of an analyst either up or down in the industry hierarchy).

[48] *Id.* at 345-46.

but the conclusion seems hard to escape that something happened during the 1990s that compromised the independence and objectivity of the gatekeepers on whom our private system of corporate governance depends.[49] Even before Enron, much evidence showed that the most sophisticated market participants understood the extent of these conflicts and had ceased to rely on "sell-side" analysts.[50]

D. *Explaining Gatekeeper Failure*

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

1. The Deterrence Explanation: The Underdeterred Gatekeeper

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

Prior to the 1990s, auditors faced a very real risk of civil liability, principally from class action litigation.[51] Why did the legal risks go down

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[49] Participants in the industry also report that its professional culture changed dramatically in the late 1990s, particularly as investment banking firms began to hire "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 major change in the Wall Street research culture dates from around 1996).

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

[51] As of 1992, Congress was advised that the securities fraud litigation costs for just the six largest accounting firms (then the "Big Six") totaled $783 million, or more than 14% of their audit revenues. Potential exposure to loss was in the billions. *See Private Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 103rd Cong., lst Sess. No.103-431 (1993) (statement of Jake L. Netterville, Chairman of the Board, American Institute of

during the 1990s? The obvious list of reasons would include:

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

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

(c) the Private Securities Litigation Reform Act of 1995 ("PSLRA"), which

  (i) raised the pleading standards for securities class actions to a level well above that applicable to fraud actions generally;

  (ii) substituted proportionate liability for "joint and several" liability;

  (iii) restricted the sweep of the Racketeer Influenced and Corrupt Organizations ("RICO") statute so that it could no longer convert securities fraud class actions for compensatory damages into actions for treble damages; and

  (iv) adopted a very protective safe harbor for forward-looking information;[54] and

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

Certified Public Accountants), *reprinted in* Fed. Sec. L. Rep. (CCH) No. 1696 (Jan. 10, 1996). One major auditing firm, Laventhol & Horwath, did fail and entered bankruptcy as a result of litigation and associated scandals growing out of the savings and loan scandals of the 1980s. *See What Role Should CPA's be Playing in Audit Reform?*, PARTNER'S REPORT FOR CPA FIRM OWNERS 1, 11 (Apr. 2002) (discussing experience of Laventhol & Horwath). The accounting profession's bitter experience with class litigation in the 1980s and 1990s probably explains why it became the strongest and most organized champion of the Private Securities Litigation Reform Act of 1995.

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

[53] Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 191 (1994) (holding "that a private plaintiff may not maintain an aiding and abetting suit under § 10(b)" of the Securities Exchange Act of 1934).

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

[55] *See* Pub. L. No. 105-353, 112 Stat. 3227 (codified in scattered sections of 15 U.S.C.).

The individual impact of each of these changes probably cannot be reliably measured, but their concurrent aggregate impact is clear: they greatly reduced the incentives of plaintiffs in securities class actions to sue secondary participants such as auditors, analysts, and attorneys. As an SEC study noted, the number of audit-related suits filed against the then "Big Six" accounting firms in 1990 to 1992 was 192, 172, and 141, respectively.[56] Yet, in the first year following the passage of the PSLRA (1996), the SEC found that out of the 105 securities class actions it found to have been filed in that year, accounting firms were named in only 6 cases, corporate counsel in no cases, and underwriters in 19 cases.[57] It concluded: "Secondary defendants such as accountants and lawyers, are being named less frequently in securities class actions."[58]

Not only did the threat of private enforcement decline, but the prospect of public enforcement similarly subsided. In particular, there is reason to believe that, from some point in the 1980s until the late 1990s, the SEC shifted its enforcement focus away from actions against the Big Five accounting firms towards other priorities.[59] In any event, the point here is not that any of these

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For an analysis and critique of this statute, see Richard Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 CORNELL L. REV. 1 (1998) (arguing that state law securities fraud actions will play a much reduced role in securities regulation following adoption of the SLUSA).

[56] *See* U.S. SECURITIES & EXCHANGE COMM'N, OFFICE OF THE GEN. COUNSEL, REPORT TO THE PRESIDENT AND THE CONGRESS ON THE FIRST YEAR OF PRACTICE UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995, at 22 (Apr. 1997), *available at* http://www.sec.gov/news/studies/lreform.txt (last accessed Mar. 12, 2004) (noting a decline in the frequency of securities lawsuits against accountants and law firms). The figures for the years 1990 to 1992 were reported to the SEC by the Big Six and include all class actions against them, which could include some non-securities class actions. Nonetheless, the number of such non-securities actions seems likely to have been small. As the above SEC study further notes: "[D]uring the period from 1991 through June 1996, accountants were defendants in 52 reported settlements (as opposed to complaints) . . . and law firms were defendants in 7. Thus, there seems to be a real decline in the number of lawsuits against secondary defendants." *Id.* (internal footnotes omitted). This low incidence of securities class actions against auditors appears to have continued through 2001—and then began to rise dramatically. *See* PRICEWATERHOUSECOOPERS, LLP, 2002 SECURITIES LITIGATION STUDY 7 (2003) (reporting that the number of securities class actions against auditors fell from 1998 to 2001, but increased 89% between 2001 and 2002).

[57] U.S. SECURITIES & EXCHANGE COMM'N, *supra* note 56, at 21-22.

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

[59] This point has been orally made to me by several former SEC officials, including Stanley Sporkin, the long-time former head of the Commission's Division of Enforcement. They believe that the SEC's enforcement action against Arthur Andersen, which was resolved in June 2001, was one of the very few (and perhaps the only) enforcement actions

changes were necessarily unjustified or excessive, but rather that their collective impact was to appreciably reduce the risk of liability. Auditors were the special beneficiaries of many of these provisions. For example, the pleading rules and the new standard of proportionate liability protected them far more than it did most corporate defendants.[60] Although auditors are still sued today, the settlement value of cases against auditors has gone way down.

Correspondingly, the benefits of acquiescence to auditors rose over this same period, as the Big Five learned during the 1990s how to cross-sell consulting services and to treat the auditing function principally as a portal of entry into a lucrative client. Prior to the mid-1990s, the provision of consulting services to audit clients was infrequent and insubstantial in the aggregate.[61] Yet, according to one recent survey, the typical large public corporation now pays its auditor for consulting services three times what it pays the same auditor for auditing services.[62] Not only did auditing firms see more profit

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brought against a Big Five accounting firm on fraud grounds during the 1990s. *See* SEC v. Arthur Andersen LLP, S.E.C. Litigation Release No. 17039 at 3 (June 19, 2001), 2001 SEC LEXIS 1159. Although the Commission did bring charges during the 1990s against individual partners in these firms, the Commission appears to have been deterred from bringing suits against the Big Five themselves because such actions were extremely costly in manpower and expense and the defendants could be expected to resist zealously. In contrast, during the 1980s, especially during Mr. Sporkin's tenure as head of the Enforcement Division, the SEC regularly brought enforcement actions against the Big Five.

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

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

[62] A survey by *The Chicago Tribune* finds that the one-hundred largest corporations in the Chicago area (determined on the basis of market capitalization) paid consulting fees to their auditors that were on average over three times the audit fee paid the same auditor. *See* Janet Kidd Stewart & Andrew Countryman, *Local Audit Conflicts Add Up: Consulting*

potential in consulting than in auditing, but, during the 1990s, some also began to compete based on a strategy of "low balling" under which auditing services were offered at rates that were marginal to arguably below cost. The rationale for such a strategy was that the auditing function was essentially a loss leader by which more lucrative services could be marketed.

Although this argument that the provision of consulting services eroded auditor independence has considerable explanatory power, there is an obvious reply: those who defend the propriety of consulting services by auditors respond that the growth of consulting services made little real difference because the audit firm was already conflicted by the fact that the client paid its fees. Put as bluntly as possible, the audit partner of a major client (such as Enron) is always conflicted by the fact that such a partner has virtually a "one-client" practice. Whoever is the gatekeeper—attorney, auditor, or analyst—a "one client" practice compromises the agent. Should the partner lose that client for any reason, the partner will not easily find a replacement client and may need to find employment elsewhere. In short, both critics and defenders of the status quo tend to agree that the individual audit partner is already inevitably compromised by his or her desire to retain the client on whom partner's career depends. From this premise, a prophylactic rule prohibiting the firm's involvement in consulting might achieve little.

Even if true in part, this rebuttal nonetheless misses one key point: the difficulty faced by the client in firing the auditor in the real world. As discussed below, there are real costs associated with firing an auditor (but, in contrast, none to speak of in firing a consultant). Given this disparity, an unintended consequence of combining consulting services with auditing services in one firm is that the union of the two enables the client to more effectively threaten the auditing firm in a "low visibility" way. To illustrate this point, let us suppose, for example, that a client becomes dissatisfied with an auditor who refuses to endorse an aggressive accounting policy favored by its management. Today, the client cannot easily fire the auditor. Firing the auditor may result in public embarrassment, potential public disclosure of the reasons for the auditor's dismissal or resignation, or a probable SEC intervention.[63] However, if the auditor also becomes a consultant to the client, the client can then easily terminate the auditor as a consultant (or reduce its use of the firm's consulting services) in retaliation for the auditor's intransigence.

Deals, Hiring Practices In Question, CHI. TRIB., Feb. 24, 2002, at C1. The extreme example in this study was Motorola, which had over a 16:1 ratio between consulting fees and audit fees. *Id.*

[63] Item 4 ("Changes in Registrants Certifying Accountant") of Form 8-K requires a "reporting" company to file a Form 8-K within five days after the resignation or dismissal of the issuer's independent accountant or that of the independent accountant for a significant subsidiary of the issuer. The Form 8-K must then provide the elaborate disclosures mandated by Item 304 of Regulation S-K relating to any dispute or disagreement between the auditor and the accountant. *See* 17 C.F.R. § 229.304 (2003) ("Changes in and Disagreements With Accountants on Accounting and Financial Disclosure").

This low visibility response neither requires any disclosure nor invites any SEC oversight and yet incentivizes the audit firm to replace the intransigent audit partner. In effect, the client can bribe (or coerce) the auditor in its core professional role by increasing (or reducing) its use of consulting services.

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

2. The Market Bubble Story

Alternatively, the downfalls of Enron and Arthur Andersen, and the host of other sudden stock declines in 2001 to 2002, can be seen as the consequence of a classic bubble that overtook the equity markets in the late 1990s and produced a market euphoria.[65] But what exactly is the connection between a market bubble and gatekeeper failure? Here, a hypothesis needs to be advanced that cannot be rigorously proven, but that is consistent with modern behavioral economics: in a bubble, gatekeepers become less relevant and hence experience a decline in both their leverage over their client and the value of their reputational capital. That is, in an atmosphere of market euphoria,

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[64] *See* Richard Frankel et al., *The Relation Between Auditors' Fees for Nonaudit Services and Earnings Management*, 77 ACCT. REV. 71, 98-100 (Supp. 2002) (finding "a positive association between nonaudit fees and the likelihood of reporting small earnings surprise"). Firms purchasing more non-audit services were found more likely to just meet or beat analysts' forecasts, which is the standard profile of the firm playing "the numbers game." *Id.* at 89.

[65] The literature on bubbles is now burgeoning. Perhaps the best known scholar in this field was Charles Kindleberger, who viewed bubbles as "demand determined" and the product of irrational investors. *See* CHARLES P. KINDLEBERGER, MANIA, PANICS AND CRASHES: A HISTORY OF FINANCIAL CRISES 76-78 (2000). *See also* ANDREI SCHLEIFER, INEFFICIENT MARKETS 154 (2000) (discussing the phenomenon whereby certain traders "react to past price changes, as opposed to particular news," which leads to price bubbles); ROBERT J. SHILLER, IRRATIONAL EXUBERANCE 4-5 (2001) (noting that the extreme disparity between the increase in stock indexes during the mid-1990s—the Dow Jones Industrial Average tripling in five years, for example—and the comparatively modest performance of other economic indicators during the same period, likely indicated that the "period of high stock market pricing [would] . . . be followed by poor or negative performance"); Kenneth A. Froot & Maurice Obstfeld, *Intrinsic Bubbles: The Case of Stock Prices*, 81 AM. ECON. REV. 1189, 1208 (1991) (arguing that models that describe overreactions in stock prices to changes in fundamentals confirm the existence of a bubble). While most of these recent accounts focus on and assign causal responsibility to "noise traders," the account offered here focuses more on a behavioral phenomenon: "persistence bias" and the tendency of investors to expect recent exceptional returns to continue.

investors rely less on gatekeepers, and managements, in turn, regard them as more a formality than a necessity. Gatekeepers provide a critical service only when investors are cautious and skeptical and therefore rely on their services. In a market bubble, in contrast, caution and skepticism are by definition largely abandoned. In such an environment, auditors continue to be used more because SEC rules mandate their use (or because no individual firm wishes to call attention to itself by becoming the first to dispense with them) than because investors actually demand their use. As a result, because gatekeepers have reduced relevance, they also have reduced leverage with their clients. Thus, if we assume that the auditor will be largely ignored by euphoric investors, the rational auditor's best competitive strategy (at least for the short term) was to become as acquiescent and low cost as possible.

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

The key element in this story involves why investors cease to care about the gatekeeper's reputation. After all, the rise of auditing as a profession was the product of investors' own concerns about fraud and irregularity, not regulatory requirements. What then caused this concern to weaken? Here, behavioral economics supplies a plausible answer. Modern economics recognizes that individuals, including investors, have "bounded rationality" and do not pursue all information relevant to an optimal decision.[67] The Nobel Prize-winning research of Professors Kahneman and Tversky has in particular demonstrated that individuals typically make decisions by using heuristics—that is, rules of thumb—rather than by incorporating all obtainable information. A heuristic that they find to be pervasively used by individuals and that has particular relevance to the context of securities markets is the "availability heuristic."[68] It

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[66] Section 10A of the Securities Exchange Act of 1934 requires the auditor of a public company to notify the Commission where the auditor discovers an "illegal act [that] has a material effect on the financial statements of the issuer" and management and the board of the issuer have not taken "timely and appropriate remedial action" after notification by the auditor. *See* 15 U.S.C. § 78(j)(A) (2000). Since its adoption in 1995, this provision has been seldom, if ever, employed. *See infra* note 161 and accompanying text.

[67] For overviews of behavioral economics, see Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1473 (1998); Cass Sunstein, *Behavioral Analysis of Law*, 64 U. CHI. L. REV. 1175 (1997). The term "bounded rationality" was coined by Herbert Simon, a Nobel Prize winner, and is broadly accepted by most economists. *See* Herbert A. Simon, *Rationality as Process and as Product of Thought*, 68 AM. ECON. REV. 1, 10 (1978) (papers and proceedings).

[68] *See* Jolls et al., *supra* note 67, at 1477-78 (describing the availability heuristic as the process whereby individuals estimate the frequency of an event based on their ability to

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

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

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

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remember previous instances of the same or similar events); *see also* Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, *in* JUDGMENT UNDER UNCERTAINTY 3, 11 (Daniel Kahneman et al. eds., 1982) (giving the example of an individual assessing his risk of heart attack based on his recall of heart attacks striking his acquaintances).

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

[70] *See* Jolls et al., *supra* note 67, at 1524-25 (arguing that "[p]eople tend to think that bad events are far less likely to happen to them than to others"); *see also* Neil D. Weinstein, *Unrealistic Optimism About Future Life Events*, 39 J. PERSONALITY & SOC. PSYCHOL. 806 (1980).

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;[71] indeed, they 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. But as their salaries soared, analyst compensation came increasingly from the investment banking side of their firms. Hence, just as in the case of the auditor, the analyst's economic position became progressively dependent on promoting interests and services outside their profession (i.e., consulting income in the case of the auditor and the interests of investment bankers in the case of the analyst) who had little reason to respect or observe the standards or professional culture within the gatekeeper's profession.[72]

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

3. Allocating Responsibility Among Gatekeepers, Managers, and Investors

The foregoing explanations still do not fully explain the mechanisms by which reputational capital built up over decades might be sacrificed (or, more

[71] For the view that investment banking firms changed their competitive strategies in or around 1996 and thereafter sought the "popular, high-profile analyst" as a means of acquiring IPO clients, see Morgenson, *supra* note 49 (quoting chief investment officer at Trust Company of the West as indicating the ability of such analysts to "'grab[] a bigger share of those lucrative investment banking fees'").

[72] This idea that professional gatekeepers became dominated by persons outside their profession is at the heart of a recent lawsuit initiated by the New York Attorney General against five chief executive officers of major U.S. corporations. *See* Patrick McGeehan, *Spitzer Sues Executives of Telecom Companies Over 'Ill Gotten' Gains*, N.Y. TIMES, Oct. 1, 2002, at C1.

accurately, liquidated) once legal risks declined and/or a bubble developed. Because gatekeepers are agents who must compete in increasingly competitive markets to win and hold clients, changes that affect their principals will necessarily affect them as well. Whether we view the gatekeeper's principal as corporate management or as shareholders, the behavior and incentives of both changed during the 1990s and thereby placed gatekeepers, as their agents, under increased pressure.

a. *The Changing Motivations of Managers*

The pressure on gatekeepers to acquiesce in earnings management was not constant over time but rather accelerated during the 1990s as managerial incentives changed. Executive compensation shifted during the 1990s from being primarily cash-based to being primarily equity-based. By 2001, equity-based compensation constituted approximately two-thirds of the median annual compensation of chief executives of large public corporations, up from eight percent in 1990 and zero percent in 1984.[73] Another measure of this shift is the growth in stock options. Over the last decade, stock options rose from five percent of shares outstanding at major U.S. companies to fifteen percent—a three-hundred percent increase.[74] The value of these options rose by an even greater percentage and over a dramatically shorter period: from $50 billion in 1997, in the case of the two-thousand largest corporations to $162 billion in 2000—an over three-hundred percent rise in three years.[75] Stock options create an obvious and potentially perverse incentive to engage in short-run, rather than long-term, stock price maximization because executives can exercise their stock options and sell the underlying shares on the same day.[76]

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[73] *See* Brian J. Hall, *Six Challenges in Designing Equity-Based Pay*, J. APPLIED CORP. FIN., Spring 2003, at 23 fig.1.

[74] *See* Gretchen Morgenson, *Corporate Conduct: News Analysis; Bush Failed to Stress Need to Rein in Stock Options*, N.Y. TIMES, July 11, 2002, at C1 [hereinafter Morgenson, *Corporate Conduct*] ("Once a rarity, options are now ubiquitous at American companies; in the last 10 years, options have risen from 5 percent of shares outstanding at major companies to 15 percent."); *see also* Gretchen Morgenson, *Market Watch: Time For Accountability at the Corporate Candy Store*, N.Y. TIMES, Mar. 3, 2002, § 3, at 1 ("In the last decade, options have grown from 5 percent of shares outstanding at major companies to 15 percent.").

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

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

The key problem here is not that stock options provide excessive compensation but that they provide excessive liquidity.[77] This excess liquidity was, in turn, partially the product of deregulatory reform in the early 1990s, which relaxed the rules under section 16(b) of the Securities Exchange Act of 1934 to permit officers and directors to exercise stock options and sell the underlying shares without holding the shares for the previously required six-month period.[78] Thus, if executives inflate the stock price of their company through premature revenue recognition or other classic earnings management techniques, they could quickly bail out in the short term by exercising their options and selling, leaving shareholders to bear the cost of the stock decline when the inflated stock price could not be maintained over subsequent periods. Given these incentives, it became rational for corporate executives to use lucrative consulting contracts, or other positive and negative incentives, to induce gatekeepers to engage in conduct that assisted their short-term market manipulations. The bottom line is that the growth of stock options resulted in gatekeepers being placed under greater pressure to acquiesce in short-term oriented financial and accounting strategies.

b. *The Role of Investors*

Investors cannot fairly be presented as entirely innocent victims in the recent epidemic of financial irregularities. At a minimum, a bubble reflects investors' acquiescence in unrealistic valuations. More importantly, conflicts of interest on the part of gatekeepers that might alarm investors in other circumstances

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Curb, N.Y. TIMES, July 9, 2002, at A1.

[77] *See* Hall, *supra* note 73, at 24-29 (underscoring the temptation of executives to "artificially boost the stock price" and subsequently "cash out their equity holdings"). It should be noted here that other forms of equity compensation, such as restricted stock, do not give rise to this same level of conflict because management must either hold the stock longer or can only sell a modest percentage of it in any given year, thus precluding the possibility of a bail-out.

[78] Rule 16b-3(d) expressly permits an officer or director otherwise subject to the "short-swing" profit provisions of section 16(b) of the Securities Exchange Act of 1934 to exercise a qualified stock option and sell the underlying shares immediately "if at least six months elapse from the date of the acquisition of the derivative security to the date of disposition of the . . . underlying equity security." 17 C.F.R. § 240.16b-3(d). The SEC comprehensively revised its rules under section 16(b) in 1991, in part to facilitate the use of stock options as executive compensation and to "reduce the regulatory burden" under section 16(b). *See* Exchange Act Release No. 34-28869, 56 Fed. Reg. 7242, 7243, 7248 (Feb. 21, 1991) (remarking that the amendments "exempt . . . certain transactions . . . from the short-swing profit recovery provisions of Section 16" to "achieve greater clarity, enhance consistency with the statutory purpose, and improve compliance with the reporting provisions of the rules"). 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 with the stock's holding period, thereby enabling officers and directors to exercise options and sell on the same day (if the option had already been held six months).

may be accepted (or at least repressed) during a bubble. To be sure, many investors were likely misled by biased analyst research and overstated earnings, but this does not absolve the "buy side" of all responsibility. Particularly in the case of institutional investors, who account for over half the ownership and seventy-five percent of the trading in NYSE-listed equities,[79] financial intermediaries may have again failed. According to one estimate, at the peak of the market, sixty percent of Enron stock was held by large institutional investors.[80] Why didn't they see that Enron was overvalued, at least once alarm bells began to sound? A plausible explanation for the failure of institutional investors to respond to warning signals in the case of Enron starts from the premise that professional money managers are principally motivated by the desire to perform no worse than their major institutional rivals; this pressure quickly leads to herding behavior.[81] According to this analysis, fund managers attract investor funds and maximize their fees based on their "quarterly reported performance relative to comparable funds or indices."[82] Thus, if a fund manager discovers that Enron is overvalued and sells his firm's investment, the manager and the manager's clients do well—but only if the market agrees and Enron's stock price falls that quarter. If the market persists in overvaluing Enron or actually climbs based on biased "sell-side" research, the manager becomes an unfortunately premature prophet, and the manager's performance relative to his rivals falls. Precisely to the extent that this manager is accountable to the market, clients' funds flow out of this manager's account to those of rival fund managers, thereby collapsing like an accordion the funds under his management, so that this manager does not profit significantly even when Enron ultimately does collapse. In such an environment, there is little incentive to be ahead of the crowd and considerable incentive to ride the bubble to its top in order not to underperform rival investment managers. The result is behavior that economists call "herding" because, by following the herd, the fund manager will not underperform most of the manager's rivals. Put differently, the fund manager can survive mistakes that others also make but will be more severely injured by correct decisions that the market only belatedly recognizes. In turn, this may explain why institutions would herd and follow "sell-side" research that they know to

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

[80] *See* Healy & Palepu, *supra* note 39, at 22 (listing Enron's corporate investors, including Janus Capital Corp., Fidelity Management & Research, and Putnam Investment Management).

[81] The term "herding" was coined over a decade ago by Scharfstein and Stein. David S. Scharfstein & Jeremy Stein, *Herd Behavior and Investment*, 80 AM. ECON. REV. 465, 466 (1990); *see also* Healy & Palepu, *supra* note 39, at 26-27.

[82] Healy & Palepu, *supra* note 39, at 26 (claiming that "flows into and out of a fund each quarter" are rooted in comparisons to alternative funds or indices, which ultimately generates herding behavior).

be biased: that is, because they anticipated that others would follow it also, leaving them in the safe position of being part of the herd.

c. *The Role of Gatekeepers*

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

4. A Preliminary Evaluation

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

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[83] *See* Harrison Hong et al., *Security Analysts' Career Concerns and the Herding of Earnings Forecasts*, 31 RAND J. ECON. 121, 122-23 (2000) (concluding that analysts predicting bold, yet accurate, forecasts do not significantly improve their career prospects); *see also* Hong & Kubik, *supra* note 45, at 341-46 (finding systematic tendency towards overly optimistic advice based on careerist considerations).

[84] Federal Reserve Chairman Alan Greenspan has indeed suggested that market corrections will largely solve the problems uncovered in the wake of Enron. *See* Alan Greenspan, Corporate Governance, Address at the Stern School of Business, New York University (Mar. 26, 2002), *available at* http://www.federalreserve.gov/boarddocs/speeches/2002/200203262/default.htm (last accessed Mar. 12, 2004). In his view, earnings management came to dominate management's agenda. He says that, as a result,

> [i]t is not surprising that since 1998 earnings restatements have proliferated. This situation is a far cry from earlier decades when, if my recollection serves me correctly, firms competed on the basis of which one had the most conservative set of books. Short-term stock price values then seemed less of a focus than maintaining unquestioned credit worthiness.

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

5. An International Perspective

Although gatekeepers are universal and found in all systems of corporate governance, corporate governance itself varies widely around the world. In particular, the structure of share ownership is polarized between a system of dispersed ownership that prevails largely in the United States and the United Kingdom (and some other common law countries) and a system of concentrated ownership that is prevalent elsewhere.[85] In the dispersed ownership structure that characterizes the United States and the United Kingdom, controlling shareholders or controlling blocks are uncommon; managers have at least relatively greater autonomy as a result;[86] and dispersed shareholders must rely on indirect means, such as equity compensation, to align managers' self-interests with those of the shareholders. In contrast, in concentrated ownership systems, there is normally a controlling shareholder who can directly monitor the firm's management and who thus does not need to rely on indirect mechanisms, such as equity compensation, to incentivize management. As a result, Europe has made far less use of stock options and other forms of equity compensation than has the United States and the United Kingdom.

A further reason why European corporations have less incentive to manage for short-term profit maximization is that controlling shareholders seldom, if ever, sell their control blocks into the market; rather, they sell to an incoming controlling shareholder in privately negotiated transactions at a control

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Id. He goes on to predict 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 in yield spreads of corporate bonds" and that other signs of self-correction are discernible. *Id.*

[85] For an overview of the differences between dispersed and concentrated ownership systems, see Coffee, *supra* note 1, at 1. For empirical support, see Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471, 491-98 (1999) (establishing that the majority of the firms in the United Kingdom, the United States, and in Japan are considered to be widely held as distinguished from the remaining countries critiqued).

[86] This relative autonomy is evidenced by the enormous differential between chief executive compensation in the United States and that in other major economies. According to a study by Towers Perrin, a compensation consulting firm, chief executive compensation as a multiple of average employee compensation is 531 times greater in the United States, but the multiple is only 16 in France, 11 in Germany, 10 in Japan, and 21 in Canada. Even in Britain, which also has dispersed ownership and uses stock options, chief executive compensation is only 25 times average employee compensation. *See* Gretchen Morgenson, *Explaining (or Not) Why the Boss Is Paid So Much*, N.Y. TIMES, Jan. 25, 2004, § 3, at 1.

premium. As a result, they have less interest in the day-to-day stock price because it does not determine the price they will receive on such a sale (whereas managers in the United States and the United Kingdom do sell their shares at the market price and so are more concerned with maximizing it).

These factors probably explain why there was no corresponding wave of accounting irregularity cases in Europe when Enron, WorldCom and their progeny exploded across the American business scene in 2001 and 2002. Because European managers were less likely to be compensated with equity and European controlling shareholders had less reason to manage for the short term, they had far less incentive to "cook the books." To be sure, some accounting irregularity cases did arise in Europe, but they usually had an American dimension. Thus, Royal Ahold, the Dutch retailing firm, experienced a $1.2 billion fraud, but its accounting irregularities were largely localized within its U.S. Foodservice division.[87] Similar controversies arose at Skandia Insurance, a Swedish company, and at Vivendi Universal, a French company, but both had sought to convert themselves into American-style conglomerates that made frequent acquisitions and utilized equity compensation.[88] Most recently, problems (and whistleblowers) at the North American subsidiary of Adecco, a Swiss Company and the world's largest employment services company, have triggered another major financial scandal.[89] Given this American nexus, European commentators could continue to dismiss Enron and WorldCom as examples of American "greed," which would never arise in Europe.[90]

Then, the Parmalat scandal broke. At least $4.8 billion in cash simply disappeared from its balance sheet, and approximately $16 billion in net debt was hidden from the market according to PricewaterhouseCoopers.[91] Unlike American scandals, the evidence suggests that the fraud had continued for many years and had been assisted by Parmalat's bankers. The principal victims were Parmalat's creditors, not its shareholders (indeed, the controlling

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[87] *See* Landler, *supra* note 7 (highlighting that the Royal Ahold, Skandia Insurance, and Vivendi Universal scandals all possessed "strong American component[s]").

[88] *Id.*

[89] *See* Fionna Fleck, *Two Executives Resign at Adecco in Fallout Over Its Accounting*, INT'L HERALD TRIB., Jan. 17, 2004, at 9; Haig Simonsian, *Adecco's Problems are Shrouded in Mystery*, FIN. TIMES, Jan. 17, 2004, at 8.

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

[91] *See* Alessandra Galloni, *Scope of Parmalat's Problems Emerges*, WALL ST. J., Jan. 27, 2004, at A-3 (detailing the allegedly fraudulent accounting practices reported by PricewaterhouseCoopers after Parmalat filed for bankruptcy protection); Henry Sender & Michelle Pacelle, *Parmalat Probers Are Likely to Focus on Role of Banks*, WALL ST. J., Dec. 24, 2003, at C-1 (emphasizing the level of knowledge of the banks with which Parmalat engaged in business dealings and their role within the allegedly fraudulent accounting practices).

shareholders appear chiefly responsible for the fraud). Yet, while the end goal of the fraud was different from the typical American scandal, the means used were similar and involved use of some of the same exotic financial engineering that characterized Enron's failure.[92] Attorneys, auditors, and investment bankers have been similarly implicated. In short, gatekeeper failure is now a recognized problem on both sides of the Atlantic.[93]

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

II. THE NEAR FUTURE OF GATEKEEPERS: SARBANES-OXLEY AND THE LOOMING LITIGATION CRISIS

Historically, bubbles are followed by crashes, which, in turn, are followed by punitive legislation.[95] The 1999-2003 era is fully consistent with this pattern, and this section will focus on the likely impact of these reforms on gatekeepers. Still, because the problem of gatekeeper failure is not uniform, either in its character or intensity, it is important initially to outline the range of strategies that regulators could follow in response to corporate scandals and conflicts of interest.

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[92] *See* Sender & Pacelle, *supra* note 91.

[93] *See* John Plender, *Problems at Ahold, Parmalat and Now Adecco Raise New Questions About How Global Accounting Firms Should Work With Multinationals and Risk of Modern Investment Management Techniques*, FIN. TIMES, Jan. 22, 2004, at 15 (equating the Enron, Adecco, and Parmalat scandals, in that "all three raise questions once again about the quality of audits conducted by the global accounting and professional services firms").

[94] *See "Parma Splat—Europe's Corporate Governance"*, ECONOMIST, Jan. 17, 2004 (United States ed.) (noting that the Tanzi family held a majority of Parmalat's voting power and appears to have diverted assets to itself).

[95] For a discussion of this cycle over history, see Banner, *supra* note 6, at 850-51.

A. *A Typology of Conflict of Interest Reforms*

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

1. Structural Reform

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

Structural reforms can also change the obligations of private actors. For example, the law can create a new gatekeeper. In the 1930s, the federal securities laws and the SEC effectively made auditors into gatekeepers for the public (and not just for the clients who retained their services), and to a limited extent Sarbanes-Oxley has imposed new gatekeeping responsibilities on attorneys and securities analysts. Part III will suggest that these initial steps should be generalized.

2. Prophylactic Rules

Fiduciary law has long forbidden some forms of self-dealing between the fiduciary and the beneficiary. Thus, the trustee cannot transact business with the trust estate because such transactions are either void or voidable. Over the course of the twentieth century, American corporate law largely relaxed the prohibition on self-dealing provided that certain procedures were followed.[97] Offsetting this trend in state law, however, the federal securities laws introduced new prophylactic prohibitions, including a prohibition on a corporate officer or director retaining the proceeds of certain forms of short-term trading in his or her company's stock.[98] Sarbanes-Oxley has now

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[96] Title I of the Sarbanes-Oxley Act creates the PCAOB as a regulatory body subject to SEC oversight, and section 101(c) of the Act further directs the PCAOB to "establish or adopt . . . auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for" publicly held issuers. 15 U.S.C. § 7211(c) (2000).

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

[98] Section 16(b) of the Securities Exchange Act of 1934 mandates that senior officers, directors, and ten-percent shareholders of a publicly-held corporation must return to the corporation any profits they make, or losses they avert, on purchasing and selling the

introduced similar rules, most notably including a prohibition on a public company making or arranging for loans to its executives.[99]

3. Independence and Empowerment Rules

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

4. Liability Rules

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

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corporation's stock in any sequence within six months. This provision is a federal rule intended to discourage manipulation of the corporation's stock price by insiders. Securities Exchange Act of 1934 § 16(b), 15 U.S.C.S. § 78p(b) (2003).

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

[100] Section 301 of the Sarbanes-Oxley Act mandates that the audit committee "be directly responsible for the appointment, compensation, and oversight of the work" of the independent auditor. This provision has been codified as section 10A(m)(2) of the Securities Exchange Act of 1934. 15 U.S.C. § 10A(m)(2).

[101] *See* Joshua Ronen, *Post-Enron Reform: Financial Statement Insurance, and GAAP Re-Visited*, 8 STAN. J.L. BUS. & FIN. 39 (2002) (proposing that corporations be required to purchase financial statement insurance and that insurers select the firm's auditors).

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

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

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

Yet, if Enron and similar cases of accounting irregularities were more caused by the principal than the agent and were the product of the increased incentive of corporate executives to "cook the books" because of the temptations created by stock options, then Sarbanes-Oxley is less clearly responsive to these problems. Nor does it increase the deterrent threat facing gatekeepers to offset the predictably increased pressure from managements. For example, except in one minor respect, the Act does not seek to revise or reverse the PSLRA.[106] Finally, the Act never addresses stock options or

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[103] Section 101(c) of the Act enumerates broad powers, including the authority to "establish . . . auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers . . . ." 15 U.S.C. § 7211(c)(2).

[104] Section 201 of the Act, which is to be codified as section 10A(g) of the Securities Exchange Act of 1934, specifies eight types of professional services that the auditor of a public company may not perform for its audit client and also authorizes the PCAOB to prohibit additional services if it determines that they may compromise auditor independence. 15 U.S.C. § 78j-1(g).

[105] Section 301 of the Sarbanes-Oxley Act gives the audit committee full responsibility for supervision and compensation of the outside auditor. *See supra* note 100 and accompanying text. In addition, section 301 establishes minimum standards for audit committee members and bars them from accepting "any consulting, advisory or other compensatory fee from the issuer." *See* 15 U.S.C. § 10A(m)(3)(B).

[106] Section 804 of the Act does extend the statute of limitations for securities fraud suits, thereby reversing a 1991 Supreme Court decision that had shortened the time period. *See* Sarbanes-Oxley Act § 804, Pub. L. No. 107-204, 116 Stat. 745 (2002) (lengthening the statute of limitations for private claims against securities fraud to the earlier of two years after constructive notice of the violation through unearthing new facts, or five years after the violation occurred). For a discussion of the previous law thereby reversed, see *supra* note

executive compensation, except to the extent that it may require the forfeiture of such compensation to the corporation if the corporation later restates its earnings.[107] In short, while the potential benefits from acquiescing in accounting irregularities appear to have been reduced for auditors, the expected costs to them from such acquiescence also remain low because the level of deterrence that they once faced has not been restored.[108] Arguably then, the Sarbanes-Oxley Act represents an incomplete response—relevant in its desire to reduce agent conflicts of interest, but still not sufficient to the extent that underdeterrance remains the problem. But this assessment must be qualified to the extent that courts have begun to act on their own to fill this void.

C. *The Judicial Response*

Any assessment of gatekeeper liability that presupposes that their exposure to liability has remained constant is probably inaccurate. Although Congress has been cautious about changing the balance of advantage in civil litigation involving gatekeepers, a wave of post-Enron jurisprudence is sweeping across state and federal courts and has already shifted the balance of advantage in civil litigation significantly in the plaintiff's direction. The most obvious example of this shift is the decision in late 2002 in *In re Enron Corp. Securities, Derivative & ERISA Litigation*,[109] which seemingly has outflanked the Supreme Court's decision in *Central Bank of Denver*[110] and largely restored private "aiding and abetting" liability under a different name. In the *Enron* case, the district court denied the motions to dismiss filed by Enron's auditors, its principal outside law firm, and six major banks, all of whom asserted that they could not be deemed primary violators and so were immune from private suit under *Central Bank*. Adopting the position urged by the SEC in an amicus curiae brief,[111] the court ruled that primary liability could extend

52 and accompanying text.

[107] Section 304 of the Act requires the forfeiture of certain bonuses "or other incentive-based or equity-based compensation" and any stock trading profits received by a chief executive officer or chief financial officer of an issuer during the twelve-month period following the filing of an inflated earnings report that is later restated. 15 U.S.C. § 7243. This does cancel the incentive to inflate earnings and then bail out, but the enforcement methods applicable to this provision are unspecified and the provision applies only if the earnings restatement is the product of "misconduct." Ambiguities abound here.

[108] Prior to the 1990s, private litigation was a real (and arguably even excessive) constraining force on auditors, which required them to devote as much as fourteen percent of their revenues to litigation costs and expenses. *See supra* note 48 and accompanying text (discussing the potential exposure to loss of accounting firms resulting from securities fraud litigation costs).

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

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

[111] The SEC's amicus brief was largely modeled on a similar brief filed by the SEC (and initially adopted by the Third Circuit) in *Klein v. Boyd*, 1998 U.S. App. LEXIS 2004 (3d

to any person who contributes materially false or misleading information to persons who it understands to be preparing or drafting a report or press release to be filed with the SEC or disseminated to the investing public, even though this peripheral defendant neither solicited sales, participated in the actual drafting of the document, nor was otherwise identified in the document so filed or released.[112] The *Enron* decision not only rejected the majority rule in the federal courts, which seems to permit a private suit against the secondary participant only when the latter makes or authorizes an "attributed statement" that specifically identifies it and its conclusion,[113] but also went well beyond the few cases that have allowed primary liability to extend to persons who "substantially participate" in the drafting of an SEC document.[114] Under the *Enron* ruling, most who could formerly be reached under "aiding and abetting" liability now seemingly can be reached as a "maker" or "creator" of a public statement.[115]

Whether the *Enron* decision is correct can be (and is being hotly) debated. But the more relevant point for this article is that the decision seemingly signals a judicial shift—whether conscious or unconscious—toward imposing greater liability on gatekeepers. Symptomatically, *Enron* is not the only recent post-scandal decision to have expanded the scope of liability for secondary participants. In a series of decisions involving Lernout & Hauspie,[116] another federal court has refused to dismiss securities fraud allegations in private class actions against a variety of secondary defendants, including the firm's outside directors, auditors, stock analysts, and others. Unlike the *Enron* court, the

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Cir. Feb. 12, 1998), *vacated and reh'g en banc granted*, 1998 U.S. App. LEXIS 4121 (3d Cir. Mar. 9, 1998).

[112] *Enron*, 235 F. Supp. 2d at 582-91. Judge Harmon added that a defendant "can be a primary violator if he or she writes misrepresentations for inclusion in a document to be given to investors, even if the idea for those misrepresentations came from someone else." *Id.* at 693 (quoting the SEC's amicus brief).

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

[114] *In re* Software Toolworks Inc. Sec. Litig., 50 F.3d 615, 627 (9th Cir. 1994) (using "substantial participation" test).

[115] For this common assessment, see William Gleeson & Jesse Minier, *Financial Institutions and the Enron Whiplash: The Growing Pain of Rule 10b-5 Liability*, 22 BANKING & FINANCIAL SERVICES POLICY REPORT 1 (Feb. 2003). *See also* Anthony E. Davis, *Professional Responsibility—Who Should Regulate Lawyers?*, N.Y. L.J., Jan. 6, 2003, at 3; Kurt Eichenwald, *Ruling Leaves Most Players Exposed to Suits on Enron*, N.Y. TIMES, Dec. 21, 2002, at C3; Bart Schwartz & Jonathan Freedman, *Aiding and Abetting Liability and Enron*, N.Y. L.J., Jan. 23, 2003, at 5.

[116] *See In re* Lernout & Hauspie Sec. Litig., 286 B.R. 33 (D. Mass. 2002). *See also In re* Lernout & Hauspie Sec. Litig., 236 F. Supp. 2d 161 (D. Mass. 2003); Bomberg v. SG Cowen, 236 F. Supp. 2d 79 (D. Mass. 2002) (declining to dismiss action against security analyst who covered the issuer).

Lernout & Hauspie court did not need to focus on whether the defendant corporation's audit committee members had substantially participated in the drafting of SEC reports or press releases. Rather, because each director had signed the defendant's Form 10-K, the court found this fact alone sufficient to deem the audit committee members to have made a fraudulent statement.[117]

In an even more sweeping conclusion, the court further found that audit committee members could be held liable as "controlling persons" under section 20(a) of the Securities Exchange Act of 1934. Under long-established SEC rules, "control" "means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person."[118] Although the *Lernout & Hauspie* court acknowledged that outside directors were not inherently "control persons," it relied on an earlier decision to find that "an outside director and audit committee member who is in a position to approve a corporation's financial statements can be presumed to have the 'power to direct or cause the direction of the management and policies of' the corporation, at least insofar as the 'management and policies' referred to relate to ensuring a measure of accuracy in the content of company reports and SEC registrations that they actually sign."[119] Never discussed by the *Lernout & Hauspie* decision was the Sarbanes-Oxley Act, which, of course, could not apply retroactively to that case; still, that statute only reinforces this mode of analysis because it greatly enhances the powers of the audit committee, thus making its members look even more like "controlling persons." As a result, audit committee members would now seem significantly more exposed to personal liability. Finally, although a plaintiff is still required to plead facts raising a strong inference of fraud, the *Lernout & Hauspie* court found this last requirement satisfied by the fact that the audit committee members all allegedly had known that their corporation lacked an adequate system of internal controls and that its outside auditor had raised specific problems with its financial reporting.[120] Again, on this basis, many audit committee members could be held liable in the near future.

The net impact of these rulings is to substantially heighten the prospective liability of audit committee members. By signing a periodic report, by helping to draft such a report, or by acquiring knowledge of adverse facts as a "controlling person," such a person faces a non-trivial risk of personal liability. Already, there are signs that the major auditing firms recognize that they face increased liability and are beginning to internalize new controls and standards in light of it.[121]

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[117] *Lernout & Hauspie*, 286 B.R. at 38-40.

[118] *See* 17 C.F.R. § 240.12b-2 (2004) (defining term "control").

[119] *Lernout & Hauspie*, 286 B.R. at 39 (quoting *In re* Livent, Inc. Noteholders Sec. Litig., 151 F. Supp. 2d 371, 437 (S.D.N.Y. 2001)); *see also In re* Reliance Sec. Litig., 135 F. Supp. 2d 480, 518 (D. Del. 2001).

[120] *Lernout & Hauspie*, 286 B.R. at 37-38.

[121] *See* Jonathan Glater, *Pricewaterhouse Taking A Stand and A Big Risk*, N.Y. TIMES,

On the state level, some signs of a similar, if milder, shift toward imposing heightened responsibilities on directors are also evident in Delaware, where respected members of its judiciary have called for new legislation and an expanded meaning to be given to the critical Delaware concept of "good faith."[122] These comments have warned that a conflicted director may not be found to have acted in "good faith." "Good faith" is a key requirement under Delaware law because, in its absence, a Delaware corporation generally cannot indemnify an officer or director;[123] in addition, charter provisions eliminating monetary liability for breach of the duty of care (which most public companies in the United States now have) are ineffective if the director did not act in "good faith."[124] Following in the wake of these comments have come a flurry of recent Delaware decisions that have declined to dismiss derivative actions and that have otherwise raised the standards for both director independence and the duty of care.[125] Outside of Delaware, the trend has been the same, as plaintiffs have repeatedly won since *Enron*.[126] Although derivative actions are not the normal mechanism by which liability is asserted against gatekeepers,

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Jan. 1, 2003, at C1 (noting pledge of PricewaterhouseCoopers to resign as auditors "in any case where we cannot resolve concerns about the quality of the information we are receiving or about the integrity of the management teams with whom we are working"). Of course, from a distance, it is impossible to determine if such assurances are largely self-promotional or whether they reflect a real change in behavior.

[122] *See* William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. (forthcoming 2003). Mr. Chandler is the Chancellor and Mr. Strine a Vice Chancellor of the Delaware Chancery Court. *See also* Tom Becker, *Delaware Judge Warns Boards of Liability for Executive Pay*, WALL ST. J., Jan. 6, 2003, at A-14.

[123] *See* DEL. CODE ANN. tit. 8, § 145(a) (2004) (Delaware corporation has the power to indemnify any person who "acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation.").

[124] *See id.* § 102(b)(7) (permitting charter provision to eliminate due care liability if director acted in "good faith").

[125] *See, e.g., In re* Oracle Corp. Derivative Litig., 824 A.2d 917 (Del. Ch. 2003) (deeming directors not to be independent of an academic colleague or a university contributor); *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275 (Del. Ch. 2003) (deeming allegations sufficient to assert cause of action that board's action in approving compensation and non-fault termination of Michael Ovitz, a senior officer, was not taken in good faith); *In re* HealthSouth Corp. S'holders Litig., 2003 WL 22769045 (Del. Ch. Nov. 24, 2003) (refusing to dismiss or stay derivative raising insider trading claims); *In re* Pure Resources, Inc. S'holders Litig., 808 A.2d 421 (Del. Ch. 2002) (finding tender by controlling shareholder to be coercive).

[126] *See, e.g., In re* Abbott Lab. Derivative S'holders Litig., 325 F.3d 795, 809 (7th Cir. 2003) (derivative action for "conscious inaction" in face of potentially illegal corporate activities reinstated and demand futility test simplified); McCall v. Scott, 239 F.3d 808, 817-19 (6th Cir. 2001) (derivative action reinstated where plaintiffs had sufficiently alleged a sustained failure by board to exercise appropriate attention).

both the holdings and dicta in these recent cases have upgraded the level of care and attention that courts are expecting all corporate fiduciaries to exercise. In short, all the judicial straws in the wind point towards a higher risk of liability, although, for the present, the principal target of this new litigation appears to be directors, rather than gatekeepers.

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

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

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

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

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[127] *See* PRICEWATERHOUSECOOPERS, LLP, *supra* note 56, at 2.

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

[129] In compiling this list, I have relied on data made available to me by the firm of Milberg, Weiss, Bershad, Hynes & Lerach, for whom I served as an expert witness during the Rite Aid litigation. The principal cases on this list are, however, a matter of public record. *See In re* Cendant Corp. Litig., 264 F. 3d 286, 294 (3d Cir. 2001) (approving $335 million settlement by Ernst & Young and $2.85 billion settlement by Cendant); *In re* Rite Aid Corp. Sec. Litig., 269 F. Supp. 2d 603, 611 (E.D. Pa. 2003) (approving $125 million settlement by KPMG); *News in Brief: $300 Million Oxford Settlement Approved*, N.Y. L.J., June 19, 2003, at 1 (noting that Oxford Health would pay $225 million and KPMG $75 million). Arthur Andersen's involvement in the *Waste Management*, *Sunbeam*, and *Baptist Foundation of America* litigation is all concisely summarized in *In re* Enron Corp. Sec. Litig., 235 F. Supp. 2d 549, 675-76 n.109-11 (S.D. Tex. 2002) (noting that Andersen paid $110 million to settle in the *Sunbeam* class action in 2001 and $217 million to settle the *Baptist Foundation* litigation in 2002).

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

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

Although auditors continue to be sued only in the minority of securities class actions, the number of securities class actions naming auditors as defendants has also recently risen, climbing to 34 cases in 2002 (up 21% over the 1998-2001 period and up 89% over 2001).[130] For the future, the most ominous fact may be that accounting irregularities tend increasingly to be the primary focus of securities class actions.[131] The more actions filed against auditors, the greater the chance of a catastrophic judgment.

D. *The Prospective Litigation Impact of Reform*

Little agreement exists about the overall impact of the Sarbanes-Oxley Act on civil litigation. Some critics have viewed it as more rhetoric than serious reform;[132] others contend that it is a sweeping intrusion into the existing U.S. system of corporate governance. Both perspectives miss, however, what it most important: Sarbanes-Oxley ushers in and accelerates a major and probably inevitable transition, which will move us from a rules-based system of financial disclosure to a principles-based system. In contrast to Europe, the United States has long relied on a rules-based system in which generally accepted accounting principles (or "GAAP") were precise, technical, and

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[130] *See* PRICEWATERHOUSECOOPERS, LLP, *supra* note 56, at 7-8. This represented 34 out of 217 total securities class actions filed in that year (or 16%). *Id.* at 8. In contrast, the number of securities class actions brought against auditors declined from 1998 to 2001. *See id.* at 7. Still, the highest number of such actions against auditors over the past five years was 39 in 1998. *Id.* at 8.

[131] Over 50% of the securities class actions settled between the passage of the PSLRA and December 31, 2002 appear to have involved accounting irregularities and over 60% involved a restatement of financials. *See* LAURA E. SIMMONS & ELLEN M. RYAN, CORNERSTONE RESEARCH, POST-REFORM ACT SECURITIES LAWSUITS: SETTLEMENTS REPORTED THROUGH DECEMBER 2002 at 9 (2003), *available at* http://www.cornerstone.com/fram_res.html (last accessed Mar. 12, 2004).

[132] *See* Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (and It Might Just Work)*, 35 CONN. L. REV. 915 (2003).

limited. Typically, these narrow rules afforded safe harbors from liability for issuers and gatekeepers. In contrast, European accounting principles were broader, more generalized, and sometimes indefinite to the point of being ineffable. As discussed below, Europe could live with this imprecision because Europe is characterized by a relatively low rate of litigation, and thus its issuers did not need to fear American-style entrepreneurial litigation.

Precisely for this reason, however, a shift to a principles-based system exposes American issuers and their gatekeepers to a substantially heightened threat of liability. At the core of a principles-based system is the notion that the issuer must not only comply with GAAP, but must make a "fair presentation" that provides a full, fair, and holistic picture of the issuer's financial condition and results of operations. In sections 302 and 906 of the Sarbanes-Oxley Act, Congress directed the chief executive officer and chief financial officer of every publicly held company to certify in every periodic report filed with the SEC "that information contained in the periodic report 'fairly presents,' in all material respects, the financial condition and results of operations of the issuer."[133] This concept of "fair presentation" is not limited by any reference to GAAP, and compliance with GAAP is clearly not dispositive of whether the issuer has provided a "fair presentation." Instead, the standard seems to intend that the issuer provide full and fair disclosure in the form of a holistic picture of the company that reveals all material financial weaknesses, even if their disclosure were not required by GAAP.

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

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[133] The quoted language is from section 906 of the Sarbanes-Oxley Act, a penal code provision. Pub. L. No. 107-204 § 906, 116 Stat. 745, 806 (2002) (codified at 18 U.S.C. § 1350). Section 302 of Sarbanes-Oxley Act uses slightly different language: "the financial statements, and other financial information included in the report, fairly presents in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report." Pub. L. No. 107-204 § 302, 116 Stat. 745, 777 (codified at 15 U.S.C. § 7241). No difference in scope or meaning seems intended by this slight difference in phrasing.

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

[135] I have been unable to find any circuit court decision in the past twenty years that cites the *Simon* case in a decision upholding civil or criminal liability for securities fraud. The decision has, however, been cited by dissenting judges who believed that a case should not have been dismissed or overturned. *See, e.g.*, *In re* K-Tel Int'l Sec. Litig., 300 F.3d 881, 906 (8th Cir. 2002). The last published decision citing it in a decision favoring private plaintiffs or the SEC appears to have been *SEC v. Seaboard Corp.*, 677 F.2d 1301, 1313 (9th Cir. 1982).

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

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

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

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[136] *See* SEC Certification of Disclosure in Companies' Quarterly and Annual Reports, Exchange Act Release No. 33-8124, 67 Fed. Reg. 57,276, 57,279 n.55 (Sept. 9, 2002).

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

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

III. THE FUTURE GATEKEEPER: REMEDIES FOR GATEKEEPER FAILURE

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

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

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

[138] *See* Private Securities Litigation Reform Act, Pub. L. No. 104-67, § 21D(b)(2), 109 Stat. 737 (1995) (codified at 15 U.S.C. § 78u-4(b)(2) (2000)) (requiring complaint to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind").

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

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

Third, public policy must also strike an acceptable balance between the obligation of client loyalty and the role of protecting the integrity of the market. This is the unique problem associated with asserting that securities attorneys owe gatekeeper obligations—either legal or ethical—to investors, as well as to their clients. Defenders of the traditional advocacy role of the lawyer find this conflict unbridgeable and argue that imposing gatekeeper obligations on attorneys will simply "dry up" the free flow of information between attorney and client, thus possibly resulting in greater illegality. This section finds this claim to be unsupportable. Rather, it concludes that the primary consequence of imposing gatekeeper obligations on attorneys will be to increase their leverage over their clients.

A. *Striking the Balance on Liability*

Recent commentators have divided over whether gatekeepers should be held strictly liable for client misconduct.[142] Both sides in this debate recognize the

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[139] For an overview of asserted "expectations gap," see Carl Pacini et al., *At the Interface of Law and Accounting: An Examination of a Trend Toward a Reduction In the Scope of Auditor Liability to Third Parties in the Common Law Countries*, 37 AM. BUS. L.J. 171, 215-17 (2000) (discussing the "expectations gap"); *see also* Brenda Porter, *An Empirical Study of the Audit Expectation-Performance Gap*, 24 ACCT. & BUS. RESEARCH 49 (1993).

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

[141] *See* Ronen, *supra* note 101, at 41. Professor Ronen objects that generally accepted accounting principles ("GAAP") contain many elements that are "simply not auditable." *Id.* Applying an undiluted regime of strict liability to such principles would be of little value, but would risk market failure.

[142] Professor Partnoy has proposed such a strict liability regime for underwriters, auditors, and attorneys in light of Enron. *See* Partnoy, *supra* note 9, at 492. To the contrary,

advantages of strict liability over negligence liability: (1) strict liability gives the gatekeeper greater incentive to take precautions and exercise due diligence; (2) strict liability induces the gatekeeper to limit its level of activity, for example, by rejecting overly risky corporations as clients; and (3) strict liability spares both courts and regulators the need to descend into the Serbonian bog of defining precise standards of care, thereby reducing transaction costs and increasing predictability.[143] Obviously, under a strict liability system, gatekeepers would raise their fees to cover their increased liability, but even this increase can be presented as one of the attractions of this approach because it forces the client to bear a higher fee precisely to the extent that it cannot convince its auditor that it presents a low risk of fraud or irregularity. In a perfect market, the issuer would thus bear the expected social cost of the fraud, which would, in turn, imply that the only issuers that could access the market would be "those for whom the value of the public financing exceeds the harm caused by fraud."[144] Put more simply, very high audit fees should tend to deter the fraudulent actor.

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

Moreover, the increase in audit fees might have to be enormous in order to enable auditors to survive under a regime of strict liability. During the collapse of the high tech bubble in 2000 and 2001, the market value of publicly held firms audited by the then Big Five fell by over $1 trillion.[146] Under a

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Assaf Hamdani, has argued that strict liability would be excessive. *See* Hamdani, *supra* note 10, at 114.

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

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

[145] This "adverse selection" problem can result in a "lemons market" that causes the honest company to leave the market. *See* George Akerlot, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 496-97 (1970).

[146] One survey of thirty-three public firms that restated their earnings finds that companies audited by the Big Five fell in value by roughly $1.3 trillion. *See* Stephen Taub,

strict liability regime, the auditor would be jointly and severally liable for this amount with the issuer, at least if a material misrepresentation or omission and loss causation were shown. To protect itself against such exposure, the auditor would need to charge a fee that funded its expected liability costs—which loss could potentially reach multi-billion dollar sums.[147] Not only would corporate clients be unable to pay such an amount, but they would predictably oppose such a fee increase with sufficient vigor as to make the adoption of strict liability politically infeasible.

Given the risk of being rendered insolvent by a single client, some auditors also might simply cease to offer auditing services, concentrating instead on consulting services or simply on providing bookkeeping services without the provision of any certification. If some firms were to exit, replacements might well enter. But in all likelihood, new entrants would be smaller, risk-preferring "fly-by-night" firms that might seek to charge very high fees for the short term and then liquidate on an adverse judicial determination. Increasingly, audit firms would seek to protect their partners' assets by minimizing their capital investments in their firms and by use of limited liability organizational forms, such as the limited liability company or limited partnership. Even if auditor exit from the market were deemed a remote risk, it is a virtual certainty that heightened liability would cause existing auditors to be far more selective in the public companies that they would accept as clients. Although this might desirably result in some "lawless" corporation being denied access to public markets, auditors lack the ability to distinguish ex ante the "law-abiding" client from the "lawless" one; hence, some "law-abiding" firms would be denied access to the market with a resulting social loss. Some recent evidence suggests that this screening process may already have intensified[148] and that

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Big Five Get Low Grades For Performance (July 12, 2002), *at* http://www.cfo.com/Article?article=7445 (last accessed Mar. 12, 2004) (noting fall from $1.8 trillion to only $527 billion in market capitalization).

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

[148] In 2003, over 1460 public companies changed auditors, which was the highest number in at least five years. Although such switches could be because the client was dissatisfied with the auditor, many were because the auditor considered the client too risky—or because the auditor raised its fees in light of that increased risk. This phenomenon of auditor switching affected over one-third of the firms in the Russell 3000, which covers most smaller market capitalization firms. *See* Matt Krantz, *More Firms Part Way With Auditors: Shuffling Expected to Pick Up, Casting Doubt on Accounting*, USA TODAY, Feb. 9, 2004, at 1B. By itself, this evidence may not prove that auditors are becoming significantly more selective with regard to clients, but it is at least consistent with

audit fees are rising dramatically.[149]

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

B. *Designing a "Stricter" Liability Approach: A Proposal*

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

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such a hypothesis.

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

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

[151] Professor Joshua Ronen has offered a somewhat similar idea that does not combine the two roles of auditor and insurer but does integrate them. Under his proposal, public firms would purchase financial statement insurance from insurers, who would then select the auditors. *See* Ronen, *supra* note 101, at 48. Among the problems with this proposal is the danger that the insurer might prefer that the auditor hide, rather than reveal, accounting irregularities discovered after the insurance policy was issued, if their revelation would trigger its obligation to pay under its policy. Still, Professor Ronen has properly recognized the close connection between auditing and insurance.

Under this approach, for example, if the corporate client were found liable for $100 million, then the auditor would have to contribute toward that liability up to the amount of its policy. The one mandatory element in this proposal would be a minimum floor on the gatekeeper's insurance policy that would have to equal some adequate multiple of the highest annual revenues received by the gatekeeper from its client over the last several years. For purposes only of illustration, let us assume a multiplier of ten. Now, on the facts of the Enron case, where it has been widely reported that Arthur Andersen received roughly $52 million from Enron in its final year, Andersen's liability would be not less than $520 million (i.e., $52 million times ten). This is a large number, but it does not approach the roughly $80 billion loss in market capitalization that Enron experienced and for which Andersen conceivably could be held liable under a strict liability regime. In a more typical case, where the auditor receives only a $2 million audit fee from the client, the damages would be reduced to only $20 million. Hence, the market for gatekeeping services could easily function under this proposal. It can be debated whether the auditor should be able to purchase insurance to cover this exposure, but to the extent it is permitted to pass along this added insurance cost on to its clients, it would automatically increase the minimum required floor on its policy under the above mandatory 10:1 ratio between minimum liability and revenues from the client.

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

Essentially three practical differences distinguish these two similar proposals: (1) Professor Partnoy's system is essentially contractual, while this proposal is essentially regulatory; (2) Professor Partnoy uses a percentage of the total damages as his minimum floor, while this proposal uses a multiple of the gatekeeper's highest annual revenues from the client; and (3) while the potential damages, as calculated under Professor Partnoy's proposal, could

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[152] *See* Partnoy, *supra* note 9, at 540-46 (offering a modified strict liability proposal as an improvement over current due diligence-based approaches); *see also* Stephen Choi, *Market Lessons for Gatekeepers*, 92 NW. U. L. REV. 916, 951-59 (1998). Professor Choi appears to have been the first to suggest that the issuer and the gatekeeper should contract over the share of the gatekeeper's liability for the losses experienced by the issuer's investors.

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

often bankrupt the gatekeeper, bankruptcy would rarely follow when a multiple of the revenues from the client generated the required minimum floor on the gatekeeper's insurance obligation. Thus, on reflection, the relevant profession might actually support this proposal, once it recognized that its existing exposure to liability was even higher. The proposal thus falls (if only barely) within the range of political feasibility.

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

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

If one believes that auditors have not been aware of their clients' stretching of "generally accepted accounting principles" and have been more negligent than willful, then higher penalties approaching the total social loss caused by the auditors' conduct (and not merely exceeding the expected gain to them) could be justified. This might lead one to prefer Professor Partnoy's proposal, which is at least related to the total social loss. Ironically, the more one believes that gatekeeper failure was the product of negligence rather than fraud, the stronger the case becomes for harsher penalties. At least politically, however, this is a hard argument to make because greater penalties are being visited upon the less culpable.

In any event, my intuition is that, at least in the leading recent scandals, the auditors have been sufficiently aware of the ongoing risks posed by their clients that penalties focused simply on canceling any expected gain to the auditor from its involvement with the clients would suffice. But even if one disagrees and believes that typically the auditor did not know, there is a further problem with Professor Partnoy's proposal: many aspects of GAAP principles may simply not be "auditable."[155] If so, additional deterrence is excessive because it cannot reduce the overall social loss.

Obviously, this article's proposal of stricter liability with a lower ceiling based on a multiple of the revenues from the client will typically (but not inevitably) result in lesser liability than under the Partnoy proposal.[156] Yet, it still eliminates any intentional incentive to acquiesce in fraud and gives the gatekeeper considerable incentive to utilize all monitoring controls (including closer monitoring of its own agents) that are reasonably likely to reduce the prospect of fraud or earnings manipulation. Above all, this approach prevents

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[154] *See generally* Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968) (utilizing economic theories to develop optimal approaches to combating illegal behavior).

[155] *See* Ronen, *supra* note 101, at 41 (postulating that financial statement elements should be separated into two groups: those that are auditable, and those that are not).

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

the market for gatekeeping services from unraveling.

How strict need a stricter system of liability be? Here, we enter the thicket of political realism. Pure strict liability might be the best rule, but it is probably not politically acceptable to auditors, who represent a powerful political lobby. Nor does it seem politically defensible to favor the imposition of a significantly higher standard of liability on the auditor than on its client, the issuer. In this light, the highest standard of liability that might be politically attainable in the case of auditors would likely be that set forth already for auditors in section 11 of the Securities Act of 1933, which requires the auditor as an expert to prove as an affirmative defense that the auditor "had, after reasonable investigation, reasonable ground to believe and did believe" that its statement were true.[157] In effect, the burden would be shifted to the auditor in all Rule 10b-5 actions to prove its non-negligence and good faith belief in its statements.

C. *Implementing the Gatekeeper Role of Attorneys*

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

The case of the attorney forces us to focus on still other differences. First, functionally, attorneys act only occasionally as gatekeepers, certifying or verifying information for investors, while auditors perform this function primarily (and increasingly exclusively). Second, the role of gatekeeper arguably conflicts with the more typical roles performed by attorneys as either advocates or transaction engineers for their clients. Third, asking attorneys to serve as gatekeepers may dry up the flow of confidential information between attorney and client, thereby jeopardizing the ability of the attorney to serve the client. Based on these premises, the bar (and its academic defenders) have vehemently argued that, if the attorney were compelled to serve as a watchdog

[157] Securities Act of 1933, § 11(b)(3)(B), 15 U.S.C. § 77k(b)(3)(B) (2000).

instead of as an advocate or transaction engineer for the client, the client could no longer depend on the attorney as a zealous advocate or transaction engineer.[158]

Although this debate has generated much heat, little empirical light has been focused on just what could be reasonably expected if attorneys were subjected to a "noisy withdrawal" standard. Yet, one natural experiment exists that does shed useful light on this question. In 1995, as part of the PSLRA, Congress added section 10A to the Securities Exchange Act of 1934, which requires auditors to report to the SEC likely illegal acts that have a material impact on the issuer's financial statement that an auditor discovers during the course of an audit unless the issuer takes appropriate remedial action to remedy them.[159] This is the functional equivalent of the noisy withdrawal requirement that the SEC has proposed (but not adopted) for securities attorneys.[160] The existence of this provision raises the obvious question: what has been the experience under it? The short answer is that not much has happened. A 2003 report by the GAO finds that over the period between when section 10A became effective for fiscal years beginning after January 1, 1996 through May 15, 2003, the SEC received a grand total of twenty-nine section 10A reports from auditors.[161] Yet, section 10A's enactment was not resisted by the auditing profession, which instead viewed the section as part of a highly desirable political compromise that would secure it litigation protection through the enactment of other provisions of the PSLRA.

From such evidence, it seems a fair inference that attorneys would be even less likely to report misconduct to the SEC under an SEC rule requiring "noisy withdrawal." After all, auditors are expected to audit and report damaging information, while such reporting runs counter to the professional culture of attorneys. This conclusion does not mean that attorneys should not be asked to perform a gatekeeping role but rather that, to be effective, such an obligation must be placed in a context whereby the attorney is playing a clearly defined

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[158] For a detailed exposition of the argument that the roles of the attorney and the gatekeeper are essentially inconsistent and that attorneys make poor informational and reputational intermediaries, see Jill E. Fisch & Kenneth M. Rosen, *Is There a Role for Lawyers in Preventing Future Enrons?*, 48 VILL. L. REV. 1097, 1097 (2003) (arguing that requiring the attorney to act as corporate gatekeeper is not the best way to solve corporate governance problems).

[159] *See* 15 U.S.C. § 78j (2000).

[160] *See* Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No. 33-8186, 68 Fed. Reg. 6324 (proposed Feb. 6, 2003).

[161] *See* U.S. GEN. ACCOUNTING OFFICE, SECURITIES EXCHANGE ACT: REVIEW OF REPORTING UNDER SECTION 10A at 1 (Sept. 3, 2003), *available at* http://www.house.gov/commerce_democrats/press/gao92303.pdf (last accessed Mar. 12, 2004). The SEC has also brought seven enforcement actions over this same interval against auditors for violations of section 10A. *Id.* This may also suggest that the SEC is slow to bring enforcement proceedings against professional firms (and would remain similarly reluctant to enforce a "noisy withdrawal" rule against attorneys).

professional role that the client has invited. Otherwise, the attorney is risking professional disaster and will predictably resist.

A serious strategy for converting the attorney into a gatekeeper must also address the tension between the roles of gatekeeper and advocate, possibly by separating the two roles and encouraging firms to employ multiple counsel. That is, the corporation could use different law firms, one to plan and structure a transaction and the other to supervise disclosure. Obviously, this would involve increased costs because duplicative work would be performed. Yet, this is essentially what Sarbanes-Oxley did to the accountant, divorcing the roles of auditor and consultant because of the clear conflict of interest. In any event, such a separation need not be legally mandated in the case of the attorney because it could be left to the corporation to decide if it felt sufficiently threatened by an attorney who was under a legal obligation to perform a gatekeeping function that it wished to hire multiple counsel. Firms would not need to specialize in one or the other role, but ideally, a law firm would not serve in both capacities to the same client.

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

On the premise that securities attorneys should serve as gatekeepers for investors, this article will make three specific proposals. First, the SEC should adopt a limited certification requirement mandating that a securities attorney acknowledge that it has reviewed the non-financial disclosure in publicly filed reports; second, it should establish independence standards for securities attorneys performing certain tasks that require them to be independent of management, such as the conduct of internal corporate investigations for

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[162] *See* Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 33-8185, 68 Fed. Reg. 6296 (Jan. 29, 2003) (codified at 17 C.F.R. pt. 205) (adopting final rule requiring "up the ladder" reporting by securities attorneys, but not imposing additional steps, such as "noisy withdrawal").

publicly held firms; and third, the SEC should deem negligence by attorneys in the preparation of SEC disclosure documents to amount to unprofessional conduct for which attorneys could be disciplined under the SEC's Rules of Practice (just as auditors can be disciplined today).[163] Uniting these proposals is the idea that the attorney should perform a due diligence investigation of the corporation's non-financial disclosures that roughly corresponds to the auditor's role with respect to financial disclosures.

1. A Negative Assurance Certification

A certification requirement applicable to attorneys can be justified simply on the grounds of consistency. Today, a publicly-held corporation's CEO and CFO must certify that each periodic report "fairly presents in all material respects" the issuer's "financial condition and results of operations."[164] Similarly, the securities analyst must also today certify that the analyst truly agrees with his or her research advice to investors.[165] Thus, managers, auditors, and analysts all certify their work, but the corporation's principal counsel does not. Arguably, the attorney should not be able to escape a corresponding obligation, particularly because the auditor takes no responsibility for the textual portion of the disclosure document, which is independent of the financial statements that the auditor certifies. In effect, attorney certification mandates a parallel expert to review the non-financial disclosures of the public corporation, but the attorney, as gatekeeper, would not be asked to perform an audit or check facts in the manner that an auditor does.

Specifically, the attorney principally responsible for preparing a document or report filed with the SEC should certify: (1) that such attorney believes the statements made in the document or report to be true and correct in all material respects, and (2) that such attorney is not aware of any additional material information whose disclosure is necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.[166] The real thrust of this proposal is to require the issuer to subject its principal disclosure documents to the scrutiny of an attorney who would be

[163] *See* Rule 102(e)(1)(iv) of the SEC Rules of Practice, 17 C.F.R. § 201.102(e)(1)(iv) (2004) (authorizing SEC to suspend or censure an accountant for "a single instance of highly unreasonable conduct . . . [or] . . . [r]epeated instances of unreasonable conduct").

[164] *See supra* notes 125-129 and accompanying text (discussing certification requirements under sections 302 and 906 of Sarbanes-Oxley).

[165] *See* Regulation Analyst Certification, Securities Act Release No. 33-8193, 68 Fed. Reg. 9482 (Apr. 14, 2003) (codified at 17 C.F.R. pt. 242) (adopting Regulation AC, which requires a research analyst employed by a broker or dealer to certify that the views expressed in the research report accurately reflect his or her personal views).

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

under a professional obligation to exercise a reasonable level of "due diligence" in his or her review.[167] Today, there is no barrier to the preparation and filing of such non-financial documents entirely by non-professionals.

At first glance, this proposed certification simply tracks the language of Rule 10b-5. Yet, the bar will object that by subjecting the attorney to the requirement that the attorney exercise reasonable care, the attorney is being subjected to unreasonable liability. In truth, however, this proposed obligation would only generalize existing practices in the market because today, in most public underwritten offerings, issuer's counsel does deliver an opinion to the underwriters stating that it is not "aware" of any material information required to be disclosed that has not been disclosed.[168] SEC rules would therefore simply be requiring for 1934 Act periodic filings what is already done in the primary market for 1933 Act disclosure documents; the real difference is that, in the case of periodic filings under the Securities Exchange Act, there is no analogue to the underwriter to demand such an opinion or certification from the attorney. Thus, SEC action would fill this void. In addition, such a requirement would have a profound symbolic and psychological effect on the bar because it would recognize the attorney's obligations as a gatekeeper.

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[167] An additional question is whether such review should be by an attorney "independent" of management—a term that additional SEC rules could define. Although the case for requiring an "independent" attorney is obvious, even if the corporation's general counsel were permitted to provide this certification, there would still be value to this proposal because the obligation to certify might offset other pressures on such counsel.

[168] For a description of this standard opinion in registered public offerings, see Richard R. Howe, *The Duties and Liabilities of Attorneys in Rendering Legal Opinions*, 1989 COLUM. BUS. L. REV. 283, 287. The author of the article, a partner at the New York firm of Sullivan & Cromwell, properly observes, "such opinions are not really 'legal opinions' at all in that they do not state any legal conclusion but only say that the attorney believes certain facts to be true." *Id.* Precisely for this reason, such an opinion is more a pledge of the law firm's reputational capital, which the underwriters demand. The counsel giving such opinion does not purport to conclude that all information required to be disclosed has been disclosed (as an auditor might by analogy), but only that it lacks personal knowledge or belief as to any such failure. *See* Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 291 (1984) (also describing such opinions); Richard W. Painter, *Toward A Market for Lawyer Disclosure Services: In Search of Optimal Whistleblowing Rules*, 63 GEO. WASH. L. REV. 221, 226-27 & n.19 (1995) (discussing judicial interpretation of such opinions). The American Bar Association has characterized this type of opinion as a "negative assurance" and finds such opinions to be "unique to securities offerings." *See* ABA Comm. on Legal Opinions, *Third-Party Legal Opinion Report, Including the Legal Opinion Accord of the Section of Business Law, American Bar Association*, 47 BUS. LAW. 167, 228 (1991). Although the ABA considers it generally inappropriate for attorneys to request such "negative assurance" opinions from other attorneys, the special context of securities offerings is exempted, reflecting the fact that underwriters consider such an assurance to be necessary to them. That the ABA, as the representative of the bar, "disfavors" such opinions, because of the demands they place on the attorney, probably only underscores the value of such a reform.

Ideally, the SEC should go even further and require the attorney to certify that the attorney so believed "after making such inquiry that the attorney reasonably believed appropriate in the circumstances"; this would establish at least a minimal due diligence obligation. To be sure, this is a far cry from the strict liability that the auditor would face, but it is a meaningful enhancement designed to elicit greater precaution from, and investigation by, attorneys. Indeed, law firms would likely agree to provide such certification only if they could maintain a continuing oversight of the firm; one-time-only certifications would be a service that few firms would dare, or be economically motivated, to provide.

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

2. Independence

Auditors, of course, must be independent of their client, and SEC rules have long defined tests for auditor independence. Increasingly, a new literature has warned that attorneys are becoming too economically interconnected with their client to exercise independent judgment as the result, in part, of the increasing practice of law firms taking (and even demanding) equity stakes in the client in return for professional services.[170] If some level of independence is necessary for an attorney to function as a gatekeeper, SEC rules of professional conduct could define these limits. To illustrate, a law firm that holds in its portfolio ten percent of the corporate client's equity (or, alternatively, equity in the client equal to ten percent of its own net asset value) will probably be a poor, or at least a biased, monitor.

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

[170] *See* Royce De R. Barondes, *Professionalism Consequences of Law Firm Investments In Clients: An Empirical Assessment*, 39 AM. BUS. L.J. 379 (2002) (hypothesizing that law firms that invest in their clients create conflicts of interest); John S. Dzienkowski & Robert J. Peroni, *The Decline in Lawyer Independence: Lawyer Equity Investments in Clients*, 81 TEX. L. REV. 405 (2002) (critiquing the practice of accepting equity in exchange for legal services).

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

3. The Due Diligence Obligation

Certification is only a first step. The next logical step would be to mandate due diligence by the attorney in preparing or reviewing SEC filings as a minimum standard of professional conduct. Here, Sarbanes-Oxley changes the picture significantly because section 307 of Sarbanes-Oxley authorizes the SEC to establish "minimum standards of professional conduct for attorneys appearing and practicing before the Commission . . . ." This reference to "professional conduct" would certainly seem to empower the SEC to adopt rules requiring the attorney both to conduct a minimal due diligence review before the attorney files a document or report with the SEC and to certify its good faith belief in the accuracy of the statements made therein. Indeed, in its existing Rules of Practice, the SEC already holds auditors to precisely such a standard and asserts the power to suspend or disbar them for merely negligent conduct.[171] If this can be done without special statutory authority, then it seems to follow a fortiori, after the enactment of section 307, that the SEC could require attorneys to take reasonable steps to investigate the accuracy of statements made in documents that they prepare.[172]

The bottom line then is that the SEC is today empowered to adopt rules that could suspend or disbar an attorney for negligence as a form of professional misconduct. Negligence would clearly not support a private cause of action under Rule 10b-5, but it may be the appropriate standard for the imposition of

[171] *See* 17 C.F.R. § 201.102(e)(iv) (2004) (specifying that two forms of "negligent conduct"—either "[a] single instance of highly unreasonable conduct" or "[r]epeated instances of unreasonable conduct"—could trigger sanctions under Rule 102(e)).

[172] The attorney would, of course, be entitled to rely on the auditor with respect to financial information certified by the auditor, as in the case of the "reliance on an expert" defense under section 11(b)(3)(c) of the Securities Act of 1933. *See* 15 U.S.C. § 77(k)(b)(3)(C) (2000).

sanctions under section 307.[173] Such a tradeoff—i.e., public liability but not private liability for negligence—again seems desirable in that it enhances deterrence without threatening insolvency for law firms.

D. *Accessing Counter-Arguments: Can Attorneys Be Gatekeepers?*

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

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[173] Historically, the SEC did once hold attorneys liable for professional negligence in "aiding and abetting" cases. *See* SEC v. Spectrum Ltd., 489 F.2d 535, 536, 542 (2d Cir. 1973). This is no longer possible after the Supreme Court mandated a scienter standard in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), but sanctions for professional misconduct could look to a similar standard.

[174] Evans A. Davis, *The Meaning of Professional Independence*, 103 COLUM. L. REV. 1281, 1289 (2003) (arguing that the SEC's up-the-ladder reporting rules inhibit professional independence).

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

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

Id. at 618-19.

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

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

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

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

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

[176] *See id.* at 618-19.

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

and others as transactional engineers.

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

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

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

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[178] *See* Louis Kaplow & Steven Shavell, *Legal Advice About Information to Present in Litigation: Its Effects and Social Desirability*, 102 HARV. L. REV. 565, 597 (1989) (describing ex ante legal advice as a socially beneficial tool); *see also* Richard A. Posner, *An Economic Approach to the Law of Evidence*, 51 STAN. L. REV. 1477, 1531-33 (1999).

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

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

CONCLUSION

The diagnosis of "gatekeeper failure" made in Part I of this article leads naturally to a multi-part prescription for law compliance: the law should create, empower, and deter gatekeepers. Deterrence is easy, but it can be overdone. Thus, although this article has favored a shift towards stricter liability, it has coupled this recommendation with a proposed ceiling on liability set at the level necessary to deter the gatekeeper. This proposal may subordinate compensation to deterrence—but only with regard to litigation against gatekeepers, who are seldom in any event in a position to fund full compensation to the investor class.

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

Gatekeeper empowerment necessarily requires intruding upon our existing guild-like structure of private self-regulation of the professions. Sarbanes-

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