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# Partnoy's Complaint: A Response

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## INTRODUCTION

My article attempts to strike a balance and find a middle ground between the polar positions of those who favor strict liability (of whom Professor Partnoy is probably the most notable[1]) and recent critics who believe it would produce market failure.[2] Necessarily, those who take a middle position are exposed to fire from both sides. Although I admire Professor Partnoy's originality and incisive style, I do not believe that the market could easily survive his reforms and suspect that he has undervalued the hidden costs of strict liability. Deterrence is needed—but there can be too much of a good thing!

While many of the differences between Professor Frank Partnoy and myself are technical, second-tier, and even esoteric, one difference is not and needs to be underscored at the outset because it explains many other differences: under my proposal, the gatekeeper could be held liable even when the issuer is not.[3] This is deliberate, because otherwise we do not have a true system of strict liability, but only a rule of mandatory contribution. The case for severing the

[1] Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491 (2001).

[2] *See* Assaf Hamdani, *Gatekeeper Liability*, 77 S. CAL. L. REV. 53 (2003) (arguing against imposition of strict liability, and favoring only restoration of aiding and abetting liability); *see also* Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687, 689-91 (1997).

[3] Although Professor Partnoy would impose strict liability on gatekeepers, he has discussed only the primary market context and has not discussed liability under Rule 10b-5, which has a scienter standard. *See* Partnoy, *supra* note 1, at 540, 547 (proposing changes to the Securities Act of 1933, but failing to discuss the much more litigated context of Rule 10b-5). As next discussed, few would argue that the corporation should face strict liability in this context, where it is not issuing securities or trading in any way. Arguably, a liability rule could be crafted that imposed strict liability on the corporation in this context, but also placed some ceiling on the corporation's liability. My own preference would be to leave the corporation's liability largely unchanged but enhance the gatekeeper's liability.

liability of issuer and gatekeeper becomes clearest when we focus on the differences between primary market transactions (i.e., those in which the corporation is itself issuing securities) and secondary market transactions (i.e., transactions among shareholders with no trading by the corporation). Although Professor Partnoy has focused exclusively on the primary market context (where strict liability is already imposed on the issuer by virtue of Section 11 of the Securities Act of 1933[4]) in urging strict liability for gatekeepers, most securities class actions are brought instead with respect to the secondary market (where scienter must be proven before the issuer can be held liable under Rule 10b-5[5]). Imposing strict liability on the non-trading corporation in the latter secondary market context essentially imposes that liability on all shareholders who are not members of the plaintiff class. As a result, such litigation essentially effects a wealth transfer among shareholders, none of who are typically culpable.[6] Strict liability in turn would increase the volume of such wealth transfers.

Accordingly, the case for strict liability against the issuer in the secondary market context is at best problematic. But it still makes sense to impose such liability on the gatekeeper in order to maximize its incentive to take precautions. In turn, this means that the gatekeeper's liability should be independent of the client's, and this turn makes Professor Partnoy's percentage sharing approach unworkable.

Professor Partnoy addresses only the liability-enhancing proposals in my article, but within this limited range, he and I most disagree in the following three areas.

## I. THE CONTRACTARIAN FALLACY

Initially, Professor Partnoy insists that issuers and gatekeepers should contract over the percentage of total liability that gatekeepers would contribute. His contractarian bias here seems inconsistent with his willingness to insist on a mandatory system of strict liability. Presumably, he and I agree that mandatory legal norms, such as strict liability, are necessary because the

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[4] *See* 15 U.S.C. § 77(k) (2000).

[5] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976) (requiring proof of scienter under Rule 10b-5).

[6] In the typical Rule 10b-5 class action, a plaintiff class who bought the issuer's stock during a class period when the issuer's financial statements were allegedly inflated sues the corporation—and thus, indirectly, the other shareholders. Yet, because shareholders are largely diversified, they are likely to be in both classes much of the time. Today, with Corporation *X*, they will be on the plaintiff's side; tomorrow, with Corporation *Z*, on the defense side. Hence, the net result is to repeatedly shift funds from one shareholder pocket to another (minus of course the considerable charges skimmed from these transfers by the lawyers on both sides), thus arguably producing a net wealth loss for shareholders. Although there are also deterrent benefits from such liability, the costs to shareholders are high and the compensatory benefits uncertain. As a policy matter, re-focusing this liability on managers might better maximize the uncertain deterrent benefits of such litigation.

parties themselves will not likely negotiate the optimal contract. In turn, this is a concession that agency costs are high and that corporate managers will act in self-interested ways. If so, corporate managers have an incentive to permit the gatekeeper to escape significant liability, because the less threatened the gatekeeper is, the more that gatekeeper will be willing to acquiesce in managerial misconduct. If this is not true and if agency costs are not high, then mandatory reforms would not appear necessary in the first place. But let us not forget that in the post-Enron context, this is a hard premise to defend.

Professor Partnoy apparently believes that the disclosure of the level of liability that the gatekeeper would assume would be far more material to the market than all the information that the market ignored (or recklessly believed) about Enron, WorldCom, and similar frauds. This is an empirical question, but some minimal support seems necessary from securities analysts or other market professionals before this even seems credible. Particularly during a bubble, investors want to believe the issuer as ardently as Boston Red Sox fans want to believe that next year their team will make it to the World Series. If investors tend to discount information about the downside during a bubble, the first item of information to be ignored will be that about the gatekeeper's prospective liability.

Nor will this information be simple and unequivocal in meaning. Rather than a simple competition among gatekeepers to see who will accept the largest percentage of liability, far more complicated rules would likely become standard.[7] My claim here is not that the race will be to the bottom, but rather that the gatekeepers will avoid any competition over the quality of their standards by, instead, converging on a single standard.[8]

Under Professor Partnoy's proposal, a gatekeeper is strictly liable for a percentage of the securities fraud damages *that the issuer pays.* But this apportionment system falls short of a true strict liability system. For example, the issuer might escape liability because the plaintiff cannot prove that it acted with scienter. Under such a legal regime, some incentive remains for the gatekeeper to acquiesce in fraud because its liability remains uncertain, even though the financial statements are materially overstated. Under a true strict liability system, the gatekeeper should be liable even if the issuer were not, so

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[7] If contracting over liability were really to occur between corporations and their auditors, the resulting contracts would not be as simple as Professor Partnoy presupposes. More likely would be a "declining percentage of the recovery" contract, under which the auditor would assume liability, for example, 5% of the first $10 million, 1% of the next $95 million and 0.1% of the balance, up to a possible ceiling on its liability. Such formulas are frequently negotiated by lawyers and clients in the contingent fee context. Once contracts become this complex, there is no clear, unequivocal signal. Moreover, it is in the interest of the Big Four to converge on such a pattern, noisy as the resulting signal thereby is.

[8] As Professor Partnoy has previously recognized, convergence by gatekeepers has always been the norm in the past. *See* Partnoy, *supra* note 1, at 541 (doubting that competition based on "quality of standards" has ever worked given tendency for gatekeepers to converge on a "single standard").

long as the decline in the issuer's stock price was caused by a material misrepresentation or omission for which the gatekeeper was responsible (i.e., a financial statement error in the case of the auditor). The rationale here is that the gatekeeper failed its responsibility to discover the irregularity and should not be absolved because the issuer's conduct was only negligent, rather than fraudulent. After all, investors suffer the same economic losses from negligence as from fraud. Although such "true" strict liability creates the optimal incentives for the gatekeeper to take precautions and monitor intensively, it both (1) undercuts the feasibility of private contracting because the issuer (and its managers) have little or no incentive to contract for liability on the part of the gatekeeper when the damages will not flow to them, and (2) necessitates a ceiling to preserve gatekeeper solvency. Hence, another metric must be used (such as a multiple of the gatekeeper's revenues from the client), because there is not necessarily any joint liability to allocate.

## II. DAMAGES UNDER STRICT LIABILITY

Professor Partnoy correctly observes that my revenues multiplier formula looks to private costs, not social costs, and thus might result in lesser deterrence. But this is deliberate, because even authorizing a greater penalty could cause the market for gatekeeper services to fail. Here, I am midway between his position and that of Assaf Hamdani, who argues, on economic grounds, that we should retain the current fault-based system because any system of stricter liability will deny deserving corporations access to the capital markets.[9] Although a revenues multiplier approach could result in either higher or lower damages than Professor Partnoy's approach, depending on the facts, it caps liability in a way that averts gatekeeper insolvency. At a time when only four major auditing firms remain, they are sadly "too big to fail," and it approaches the irresponsible not to consider the consequences if strict liability were to drive one of the Big Four into insolvency.

Central to my position and little examined by Professor Partnoy is the "adverse selection" problem. If gatekeepers cannot distinguish ex ante the "honest" from the "dishonest" issuer, a lemons market developed under strict liability should logically drive the honest client from the market. Apparently, Professor Partnoy's answer is that catastrophic recoveries are simply unlikely, even in today's climate. (He apparently does not know the trial lawyers I know.[10]) Here, I present considerable data that average recoveries are

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[9] *See* Hamdani, *supra* note 2, at 71-80.

[10] As a reality check, I predict that the Enron litigation will eventually produce an aggregate settlement in excess of $5 billion, even though both Enron and Arthur Andersen have disappeared from the scene. This liability will fall almost exclusively upon defendants who can be characterized as gatekeepers, such as investment banks and law firms, and thus shows the potential impact of a more liberalized standard of strict liability. If the total liability proves to be under $1 billion, I will concede that Professor Partnoy appraised the legal environment better than I. If it falls between $1 and $5 billion, the issue will remain

climbing, particularly against auditors, that audit fees are rising, and that auditors are already screening out higher-risk clients (typically smaller companies). He disagrees, relying on his own data. Better data about average settlement size cannot ultimately resolve this dispute because, ultimately, the destabilizing factor that seems most likely to cause market failure is the risk of catastrophic loss—that is, a loss well above the average level that cannot be insured or recovered through higher fees. Nor are gatekeepers a realistic source of insurance against such losses. While he argues that public corporations and their investors would want the insurance that gatekeepers would provide issuers under his proposal, I doubt this. Professional service firms make poor insurers because they are owned not by diversified shareholders, but rather by very undiversified owner-managers whose human capital is at risk. Cheaper insurance would thus be available in the market.

Finally, existing data can never tell us what would be the outcomes under a new legal regime. Today, we do not have strict liability, at least in the secondary market context. Moving to a system of strict liability makes the data on existing settlements under a fault-based system largely irrelevant. Put simply, settlements occur because the parties bargain in the shadow of the law. If the law were to provide for strict liability, existing settlement data become irrelevant, and recoveries would go up—dramatically.[11]

## III. ATTORNEYS AS GATEKEEPERS

Professor Partnoy expresses some parenthetical dismay that I let attorneys off lightly, not subjecting them to strict liability. But strict liability makes sense precisely to the extent that we believe the gatekeeper can prevent fraud or misconduct. Here, my simple premise is that auditors are better at discovering fraud than attorneys. Auditors are better positioned and logistically equipped to review all aspects of the issuer's business; attorneys can conduct due diligence, but the value of these efforts has never been truly established. Indeed, in adopting shelf registration some twenty years ago, the SEC largely eliminated due diligence from the context of seasoned public offerings by accelerating the offering's timetable—and nothing of great consequence appears to have happened.[12] The point of imposing strict (or at

open (but I will admit my surprise).

[11] This problem might be less severe under his proposal if, and to the extent that, the issuer's liability in the secondary market context would remain fault-based (he has taken no definitive position on this question). But, as noted earlier, this would leave the gatekeeper under his system with inadequate incentive to monitor intensively, so long as it escapes liability if the issuer does.

[12] At the time, this change evoked major controversy and criticism from respected corporate law academics that saw it as undercutting the gatekeeper's role. *See* Merritt B. Fox, *Shelf Registration, Integrated Disclosure, and Underwriter Due Diligence: An Economic Analysis*, 70 VA. L. REV. 1005 (1985). Arguably, Enron and WorldCom may be attributable in part to these deregulatory changes, but the lag time is sufficiently long to

least stricter) liability on the gatekeeper is not to convert it into an insurer, because professional service firms are not the lowest cost providers of insurance, but to minimize the likelihood of fraud or irregularity. If heavy penalties were to be imposed without the risk of fraud and irregularity being significantly reduced, the result would be an inefficient system.

## CONCLUSION

Change, if it comes at all, will come incrementally and only in a form that is politically acceptable to powerful political interests. Imposing strict liability without some ceiling on the potential damages will not only galvanize gatekeepers into resistance, but also the corporate clients who will bear the higher fees that come with strict liability. In contrast, strict liability coupled with a ceiling can produce adequate deterrence without necessarily exceeding the boundaries of political feasibility. In this light, Professor Partnoy's innovative work stops short of asking the essential question from a legal perspective: how do we translate theory into practice? Academic lawyers, in particular, have a duty to face this question because we are ultimately applied scientists of legal engineering.

make any such conclusion highly speculative.