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Working Paper No. 214

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

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January 20, 2003

WHAT CAUSED ENRON?: A Capsule Social and Economic History of the 1990's

by John C. Coffee, Jr.[*]

The sudden explosion of corporate accounting scandals and related financial irregularities that burst over the financial markets between late 2001 and the first half of 2002 - - e.g. Enron, WorldCom, Tyco, Adelphia and others - - raises an obvious question: why now? What explains the concentration of financial scandals at this moment in time? Much commentary has rounded up the usual suspects and blamed the scandals on a decline in business morality, an increase in "infectious greed,"[1] or other similar subjective trends that cannot be reliably measured. While none of these possibilities can be safely dismissed, one still must be dissatisfied with approaches that simply reason backwards: that is, that proceed from the observation that there has been an increase in scandals to the conclusion that there must therefore have been a decline in business morality.

Alternatively, others have blamed these scandals either on a few "rogue" managers who somehow fooled the capital markets or on negligent, inattentive boards of directors that failed egregriously.[2] No doubt, there were some rogues. But the most reliable evidence, when properly

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

[2] Although it is not here denied that some boards did fail, this approach again seems intellectually disingenuous. Admittedly, a special committee of Enron's own board has concluded that the Enron board failed to monitor officers or conflicts of interest adequately. See William C. Powers, Jr. et al., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. (Feb. 1, 2002), 2002 WL 198018. A Senate Subcommittee has similarly assigned the principal blame to the Enron Board. See Report of the Permanent Subcommittee on Investigations of

read, suggests that Enron and related scandals were neither unique nor idiosyncratic; rather, pervasive problems arose that undercut existing systems of corporate governance. In any event, a focus on the deficiencies of any individual board of directors cannot explain this sudden surge of governance failures. Because no plausible theory suggests that board performance has generally deteriorated over recent years, one most look beyond the board, in particular to those who provide or control its informational inputs to explain this concentration of scandals.

Still another response to the concentration of recent scandals has been to posit that a wave of recriminations, soul-searching and scapegoating necessarily follows the collapse of any market bubble. Clearly, a large frothy bubble did burst in 2000.[3] As a historical matter, bubbles do tend to produce scandals and prophylactic legislation,[4] but this loose generalization leaves unanswered the critical questions: what caused this bubble and how does the growth of a bubble relate to the apparent breakdown of a once-confident system of corporate governance?

This article seeks to move beyond the "few bad apples" or "rogue managers"

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the Committee of Governmental Affairs, United States Senate, "The Role of the Board of Directors in Enron's Collapse," (Report 107-70) (July 8, 2001). Nonetheless, such studies beg the larger question: why did these boards fail now and not earlier?

[3] While this bubble initially burst in 2000, an additional sharp price decline occurred in the late Spring of 2002 as WorldCom and other crises appear to have further shaken market confidence. The S&P 500 index fell 26% between May 21 and July 23, 2002. See Christopher Nicholls, "The Outside Director: Policeman or 'Policebo'? (forthcoming 2002). Professor Nicholls, however, is skeptical that this market decline was caused by these corporate scandals. In his view, market downturns give rise to a "post-hoc fallacy" that the scandals revealed in the wake of a market downturn caused that downturn.

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

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

Above all, the fundamental developments that destabilized our contemporary corporate governance system were those ones that changed the incentives confronting both senior executives and the corporation's outside gatekeepers. In contrast, little reason exists to believe that the behavior of boards changed or deteriorated over recent decades (and indeed it probably improved). To this extent, blaming the board is a myopic theory of causation that leads nowhere, because it cannot explain the sudden surge in irregularities. Thus, a focus on gatekeepers and managers provides a better perspective for analyzing both what caused these scandals and the likely impact of the recent Congressional legislation in the United States (popularly known as the

Sarbanes-Oxley Act of 2002)[5] that was passed in their wake. Accordingly, this article will initially relate changes in managerial and gatekeeper compensation over the last two decades to the recent scandals. Yet, although the risk/reward ratios for managers and gatekeepers clearly changed over the 1990's because of exogenous changes in legal rules and market conditions, this is not the entire story. "Bubbles" - - hereinafter defined to mean a state of market euphoria in which investors lose their normal skepticism - - also change the behavior of gatekeepers, managers, and shareholders. To some degree, responsibility must be allocated among three different groups: (1) gatekeepers; (2) managers; and (3) shareholders, who in reality are principally composed of institutional investors. Initially, this article will focus on the special institution of corporate "gatekeepers" (on whom it argues modern corporate governance depends) and how their behavior may logically change during a bubble. Then, it will turn to managers and shareholders. This article's tentative conclusions have policy implications and in particular provide a perspective on the likely impact of Congress's efforts to address these recent scandals in the Sarbanes-Oxley Act.

I. The Prior Equilibrium: American Corporate Governance as of 1980

It is important to underscore how much and how quickly the world of corporate governance changed during the final two decades of the last century. If one turned back the clock twenty odd years to 1980, one would find that the dominant academic commentary on the corporation of that era articulated a "theory of managerial capitalism" that essentially saw the public corporation as a kind of bloated bureaucracy that maximized sales, growth and size, but

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[5] Technically, this statute was the "Public Company Accounting Reform and Investor Protection Act of 2002," 107 Pub. L. No. 204, 116 Stat. 745.

not profits or stock price.[6] Academic writers such as Robin Marris and William Baumol viewed the firms of that era as pursuing an empire-building policy, which "profit-satisficed," rather than profit maximized.[7] The interests of different constituencies were balanced by professional managers, and, at least in much of this literature, no special priority was assigned to the interests of shareholders. Such a management strategy was motivated in large part by the desire of the corporation's managers to increase their own security and perquisities. Conglomerate mergers, for example, achieved these self-interested ends by reducing the risk of insolvency, thereby protecting senior managers by providing them a diversified (but largely unrelated) portfolio of businesses that could cross-subsidize each other (and thereby mitigate the impact of the business cycle).[8] Also, with greater size came greater cash income to managers and a reduced risk of corporate control contests or shareholder activism.

Some academic writers in this era - - most notably Oliver Williamson - - did not view the conglomerate as necessarily inefficient; rather, Williamson argued that internal capital markets could be as efficient as external ones.[9] Still, both sides in this debate concurred that managers

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6 See, e.g., William Baumol, BUSINESS BEHAVIOR, VALUE AND GROWTH (1995); Robin Marris, THE ECONOMIC THEORY OF MANAGERIAL CAPITALISM (1969); see also Oliver Williamson, Managerial Discretion and Business Behavior, 53 Am. Econ. Rev. 1032 (1963).

7 See sources cited supra note 6.

8 See Amihud & Lev, Risk Reduction As a Managerial Motive for Conglomerate Mergers, 12 Bell J. Econ. 605 (1981); Marcus, Risk Sharing and the Theory of the Firm, 13 Bell J. Econ. 369 (1982); see also John C. Coffee, Jr., Shareholders Versus Managers: The Strain in the CorporateWeb, 85 Mich. L. Rev. 1 (1987).

9 See Oliver Williamson, MARKETS AND HIERARCHIES: Analysis and Antitrust Implications (1975); Oliver Williamson, The Modern Corporation: Origins, Evolution, Attributes, 19 J. Econ. Lit. 1537 (1981).

were effectively insulated from shareholder demands and could treat shareholders as just one of several constituencies whose interests were to be "balanced." Some criticized, while others defended, this lack of accountability, but few denied that managers possessed broad discretion in how they ran the business corporation.

This equilibrium was profoundly destabilized, however, during the 1980's by the advent of the hostile takeover. While hostile takeovers predated the 1980's, it was only during that decade, beginning in 1983,[10] that they first began to be financed with junk bonds. Junk bond financing made the conglomerate corporate empires of the prior decade a vulnerable and tempting target for the financial bidder, who could reap high profits doing a "bust-up" takeover. In turn, this gave managements of potential targets a stronger interest in their firm's short-term stock price than they had in the past, because, even if takeover defensive tactics worked for a while, a target firm could not long remain independent if its market price fell significantly below its break-up value for a sustained period.

Less noticed at the time, but possibly even more significant from today's perspective, was the change in executive compensation. Leveraged buyout firms, such as Kohlberg Kravis Roberts, entered the takeover wars, seeking to buy undervalued companies, often in league with these firms' incumbent management. Alternatively, they sometimes installed new management teams to turn the company around. Either way, the goal of the LBO firms was to create strong

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[10] 1983 is the date identified by the Congressional Research Service as the first occasion on which "junk bonds" were used to finance hostile takeovers. See Congressional Research Service, 99th Cong., 1st Sess., THE ROLE OF HIGH YIELD BOND IN CAPITAL MARKETS AND CORPORATE TAKEOVERS: Public Policy Implications (1985).

incentives that would link management's interest to the firm's stock market value. Thus, they compensated senior managers with much greater ownership stakes that had customarily been awarded as stock options. Institutional investors also picked up this theme, encouraging greater use of stock options to compensate both managers and directors in order to increase their sensitivity to the market. Congress, itself, unintentionally hastened this process by placing a ceiling on the cash compensation that senior executives could be paid in connection with changes in corporate control.[11] Restricted in the cash compensation they could pay, corporate planners predictably shifted to greater use of equity compensation, which was less regulated. Although the shift towards equity compensation accelerated in the 1990's, it began in the 1980's and was a by-product of the takeover movement.

II. The Old Order Changeth: The New Governance Paradigm of the 1990's.

The two principal forces that initially changed American corporate governance over the

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[11] In 1984, concerned that target company executives were receiving unjustified "windfall" compensation in connection with "golden parachute" arrangements, Congress enacted the Deficit Reduction Act of 1984, which added Section 280G and Section 4999 to the Internal Revenue Code. The former section provided that no deduction was to be allowed the corporation for any "excess parachute payment," and the latter levied a 20% nondeductible excise tax on any executive who received an "excess parachute payment." Basically, "parachute payments" were defined to mean compensation contingent on a change in corporate control and "excess" payments were those that exceeded three times the executive's average taxable compensation from the corporation over the past five years. Hence, if the executive was paid an average compensation of $600,000 over that period, any payment in excess of $1,800,000 that was contingent on a change in control would be subject to this special excise tax. For a more detailed explanation of the mechanics of this tax, see Bruce A. Wolk, The Golden Parachute Provisions: Time for Repeal?, 21 Va. Tax Rev. 125, 129-134 (2001). Some place primary responsibility on the "excess parachute payment" provisions for the shift to equity compensation, whereas I see it as a secondary force, with management buyouts necessarily requiring extensive use of equity compensation in order to motivate managers. Either way, however, the outcome was the same.

1990's have already been identified: the takeover movement and the growing use of equity compensation. Other forces that crested during the 1990's - - including the heightened activism of institutional investors, a deregulatory movement that sought to dismantle arguably obsolete regulatory provisions, and the media's increasing fascination with the market as the 1990's progressed - - reinforced their impact, because in common all made managers more sensitive to their firm's market price. In so doing, however, these forces inclined managers to take greater risks to inflate that stock price. The dimensions of this transition are best revealed if we contrast data from the beginning and the end of the 1990's. As of 1990, equity-based compensation for chief executive officers of U.S. public corporations appears to have been only around five percent of their total annual compensation, but by 1999, this percentage had risen to an estimated sixty percent.[12] Although the current scale and significance of stock options as a motivator of management will be discussed later, the critical point here is that the 1990's was the decade in which senior executive compensation shifted from being primarily cash-based to being primarily stock-based. With this change, management became focused not simply on the relationship between market price and break-up value (which the advent of the bust-up takeover compelled them to watch), but on the likely future performance of their firm's stock over the short-run. Far more than the hostile takeover, equity compensation induced management to obsess over their firm's day-to-day share price.

Not only did market practices change during the 1990's, but legal developments

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[12] See Daniel Altman, "How to Tie Pay to Goals, Instead of the Stock Price," New York Times, September 8, 2002 at Section 3, p. 4 (citing data collected by Harvard Business School Professor Brian Hall).

facilitated both the use of equity compensation and (unintentionally) the ability of managers to bail out at an inflated stock price. Prior to 1991, a senior executive of a publicly held company who exercised a stock option was required to hold the underlying security for six months in order to satisfy the holding requirements of Section 16(b) of the Securities Exchange Act of 1934. Otherwise, he could be made to surrender any gain to the corporation as a "short swing" profit. In 1991, the SEC re-examined its rules under § 16(b) and broadly deregulated.[13] In particular, the SEC relaxed the holding period requirements under § 16(b) so that the senior executive could tack the holding period of the stock option to the holding period for the underlying shares. Thus, if the stock option had already been held six months or longer, the underlying shares could be sold immediately on exercise of the option. Because qualified stock options usually must be held several years before they become exercisable, this revision meant that most senior executives were free to sell the underlying stock on the same day they exercised the option. Very quickly, this became the prevailing pattern. Although it was not the intent of these reforms to authorize or encourage bailouts, they made it possible for senior executives with vested options to exploit a temporary price spike in their firm's shares by exercising their options and selling in a single day.

Even prior to the 1990's, earnings management was a pervasive and long-standing practice, but its goal had traditionally been to smooth out fluctuations in income in order to reduce the volatility of the firm's cash flows and present a simple, steadily ascending line from period to period. Thus, techniques such as "cookie jar" reserves were perfected to enable

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[13] See Securities Exchange Act Release No. 34-28869 (Feb. 8, 1991) (adopting revised Rule 16b-3(d), which permits an officer or director to tack the two holding periods).

management to save earnings for a "rainy day" by storing "excess" earnings in reserves. But, if one looks at the SEC's pronouncements on earnings management during the 1990's, the nature of this practice appears to have changed. Increasingly, managements appear to have shifted their focus from moderating earnings swings to advancing the moment of revenue recognition, and, commensurate with this shift toward premature recognition, accounting scandals rose.[14]

At least in part, the increased willingness of managements to recognize income prematurely (in effect, to misappropriate it from future periods) seems linked to another phenomenon: the need to satisfy the forecasts of security analysts covering the firm. By the mid-1990's, even a modest shortfall in earnings below the level forecasted could produce a dramatic market penalty, as dissatisfied investors dumped the firm's stock. But before one can rely on management's difficulty in satisfying the analyst's forecast to explain earnings management, a circularity problem must first be faced. At bottom, the security analyst's chief source of information about the company is its senior management. If management doubted its ability to meet the analyst's projection, why did it not encourage the analyst to make a less aggressive forecast in the first instance? The most logical answer again involves the growing importance of equity compensation. Aggressive forecasts drove the firm's stock price up and enabled management to sell at an inflated price. Premature revenue recognition then became a means by which managements satisfied aggressive forecasts and sustained high market valuations.

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[14] For a brief review of recent accounting scandals, which have been numerous, see Lawrence A. Cunningham, Sharing Accounting's Burden: Business Lawyers in Enron's Dark Shadow, 57 Bus. Law. 1421 (2002). For the assertion that management became obsessed with earnings, see Jeffrey N. Gordon, What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Relections, 69 U. Chi. L. Rev. 1233 (2002).

High market valuations were not, however, simply the product of aggressive forecasting. Beginning around 1994 and continuing until 2000, the stock market in the United States entered the longest, most sustained bull market in U.S. history. In such an excited environment, aggressive forecasting produces an assured market reaction. Moreover, the market euphoria that a sustained bull market generates may cause investors, analysts, auditors, and other "gatekeepers" to suspend their usual skepticism.

Accounting scandals have had a long history over the last half century, [15] and, viewed from a distance, Enron and the related scandals of 2001-2002 are probably most comparable to the Savings and Loan crisis of the late 1980's (which episode similarly resulted in Draconian legislation[16]). Both episodes reveal perverse managerial incentives that appear to have been the driving force leading managers to accept high risk (which risk they did not fully bear themselves). After the S&L crisis, a classic "moral hazard" problem was quickly identified under which bank promoters possessed the ability to leverage their firms excessively because the government guaranteed their bank's financial obligations to depositors. In the case of the Enron-era scandals, the impact of stock compensation may have played a similar explanatory role. This leads to a tentative generalization: perverse incentives, not declines in ethics, cause scandals.[17]

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[15] For a review of recent accounting scandals, see Cunningham, supra note 14.

[16] The S&L crisis led directly to the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"), Pub. L. No. 101-73, 103 Stat. 183 (1989), which imposes high fiduciary standards on directors of thrift and savings and loan institutions. Much as Sarbanes-Oxley has, FIRREA also created a new regulatory body: namely, the Resolution Trust Corporation.

[17] Alternatively, one could argue that there was a "decline in ethics" (at least within the S&L industry) during the 1980's. But at this point, the concept of "decline in ethics" becomes so overused that it loses its meaning and appears to be more of a post hoc rationalization.

Still, an alternative hypothesis also remains plausible: namely, that a market bubble explains (or at least contributes significantly to our understanding of) the failure of those monitors who should have restrained management. Because multiple explanations can account for the pervasive gatekeeper failure that has accompanied the recent financial and accounting scandals, a synthesis seems necessary. But this first requires us to focus more closely on what defines and motivates the professional gatekeeper.

III. The Changing Position of the Gatekeeper During the 1990's.

Although the term "gatekeeper" is commonly used,[18] its meaning is not self evident. As used in this article, gatekeepers are reputational intermediaries who provide verification and certification services to investors.[19] These services can consist of verifying a company's financial statements (as the independent auditor does), evaluating the creditworthiness of the company (as the debt rating agency does), assessing the company's business and financial prospects vis-a-viz its rivals (as the securities analyst does), or appraising the fairness of a specific transaction (as the investment banker does in delivering a fairness opinion). Attorneys can also be gatekeepers when they pledge their professional reputations to a transaction (as counsel for the issuer typically does in an initial public offering). Still, as later discussed, the more typical role of attorneys serving public corporations is that of the transaction engineer, rather than that of a

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[18] The term "gatekeeper" is not simply an academic concept. In Securities Act Release No. 7870 (June 30, 2000), the SEC recently noted that "the federal laws .. make independent auditors 'gatekeepers' to the public securities markets." 2000 SEC LEXIS 1389 *

[19] For a fuller, more theoretical consideration of the concept of the gatekeeper, see R. Kraakman, Corporate Liability Strategies and the Costs of Legal Controls, 93 Yale L.J. 857 (1984); R. Kraakman, Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy, 2. J.L., Econ. & Org. 53 (1986); S. Choi, Market Lessons for Gatekeepers, 92 Nw. U.L. Rev. 116 (1998).

reputational intermediary. The auditor and the attorney are then located at the opposite poles of a continuum; each can be a reputational intermediary or a transaction engineer, but the attorney tends more often to function as the engineer and the auditor more often as the certifier or reputational intermediary.

Characteristically, the professional gatekeeper essentially assesses or vouches for the corporate client's own statements about itself or a specific transaction. This duplication is necessary 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. To be sure, the gatekeeper as watchdog is arguably compromised 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 is in effect pledging a reputational capital that it has built up over many years of performing similar services for numerous clients. In theory, such reputational capital would not be sacrificed 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, experience over the 1990's suggests that professional gatekeepers do acquiesce in managerial fraud, even though the apparent reputational losses seem to dwarf the gains to be made from the individual client.[20] The deep question about Enron and related scandals is then not: why did some managements engage in fraud? Rather it is: why did the gatekeepers let them?

Initially, obvious reasons can be advanced why gatekeepers should resist fraud and not acquiesce in accounting irregularities. In theory, a gatekeeper has many clients, each of whom

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

pay it a fee that is modest in proportion to the firm's overall revenues. Arthur Andersen had, for example, 2,300 audit clients.[21] On this basis, the firm seemingly had little incentive to risk its considerable reputational capital for any one client. During the 1990's, many courts bought this logic hook, line and sinker. For example, in DiLeo v. Ernst & Young,[22] 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]."[23]

Of course, the modest fees in some of these cases (for example, the audit fee was only $90,000 in Robin v. Arthur Young & Co.)[24] were well less than the $100 million in prospective annual fees from Enron that Arthur Andersen & Co. explicitly foresaw. But does this difference really explain Arthur Andersen's downward spiral? 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).[25] Hence, a fuller explanation seems necessary.

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

22 901 F.2d 624 (7th Cir. 1990); see also Melder v. Morris, 27 F.3d 1097, 1103 (5th Cir. 1994); Robin v. Arthur Young & Co., 915 F.2d 1120, 1127 (7th Cir. 1990) (mere $90,000 annual audit fee would have been an irrational motive for fraud).

23 Id. at 629.

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

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

A. The Auditing Profession During the 1990's

Once among the most respected of all professionals 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 characterize the recent corporate scandals as simply the work of a "few bad applies" may wish to present Arthur Andersen as an outlier, in effect an "outlaw" firm that masqueraded as honest. This theory, however, simply does not hold water. The available evidence in fact suggests that Andersen was not significantly different from its peers and experienced the same (or lesser) rate of earnings restatements.[26] 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 1990's.

Indeed, this is the area where the data is the clearest. During the 1990's, earnings

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presumably also increase.

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

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.[27] A later, fuller study conducted by the United States General Accounting Office in October, 2002, examined all financial statement restatements (not just earnings restatements) and also found a similarly sharp, discontinuous spike in 1999 that has continued through 2002.[28] The GAO Study's data shows the following trend line:[29]

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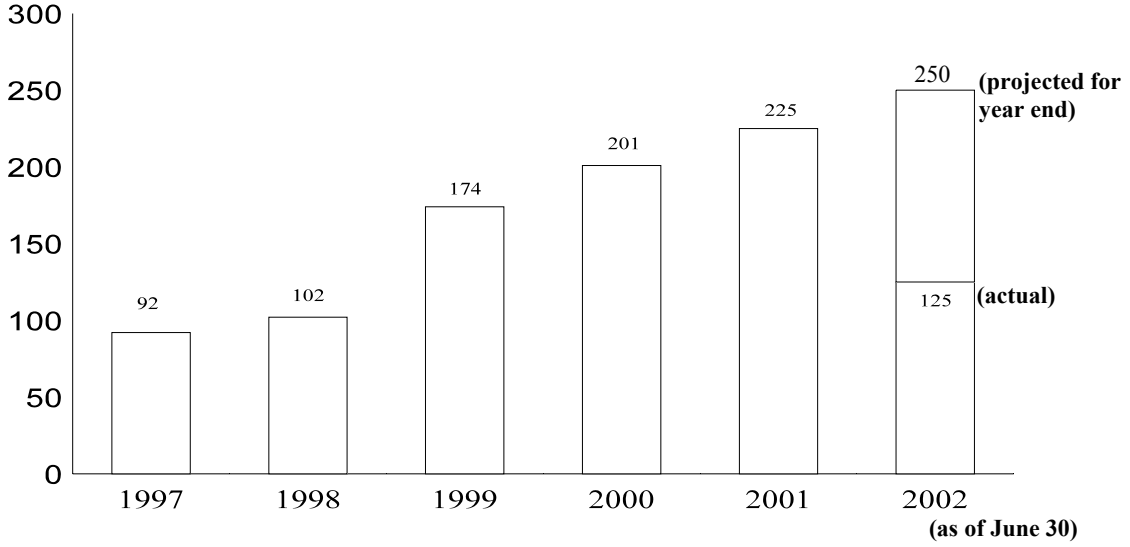
[27] See Moriarty and Livingston, Quantitative Measures of the Quality of Financial Reporting, 17 Financial Executive 53, at 54 (July/August 2001).

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

[29] Id. at 15.

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



If the GAO Study's projection of 250 financial statement restatements for 2002 proves roughly correct, it will mean that the number of restatements increased by approximately 270% over the five years ending in 2002.

Not all restatements, however, are equal. Some may involve small, infrequently traded companies or involve only trivial changes or trigger only modest stock price reactions, while others may be on a scale with Enron or WorldCom. Therefore, it is necessary to focus more precisely on financial statement restatements by companies listed on the NYSE, Amex, and Nasdaq, thereby excluding smaller companies that trade only on regional exchanges or over the counter. On this basis, between 1997 and 2001, the proportion of listed companies on the NYSE, Amex and Nasdaq that restated their financial statement approximately tripled, increasing from less than 0.89 percent in 1997 to approximately 2.5 percent in 2001, and the

GAO Study further predicted that this percentage would reach nearly 3 percent in 2002.[30] Overall, the GAO Study found that from January 1997 to June 2002, approximately "10 percent of all listed companies announced at least one restatement."[31] Also noteworthy was the fact that the size (in terms of market capitalization) of the typical restating company rose rapidly over this period,[32] and in 2002, companies listed on the NYSE or Nasdaq accounted for over 85 percent of all restatements identified in that year.[33]

What drove this sudden spike in restatements? Clearly, restatements are resisted internally because public corporations fear the stock price drops, securities class actions, and SEC investigations that follow in the wake of financial statement restatements. Indeed, the GAO Study found that stock prices of restating companies over the 1997 to 2001 period suffered an immediate market-adjusted decline of almost 10 percent on average, measured on the basis of the stock's three day price movement from the trading day before the announcement through the trading day after the announcement.[34] During 1997 to 2002, restating firms lost over $100 billion in market capitalization just over this three trading day period surrounding a restatement announcement.[35] Given these significant and adverse stock price effects, it is implausible to read the sharp increase in restatements at the end of the 1990's as the product of any new tolerance

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30 Id. at 4.

31 Id.

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

33 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.

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

35 Id. at 28.

for, or indifference to, restatements. Perhaps (as some audit firms have argued), some portion of the change might be attributed to a new SEC activism about "earnings management,"[36] which became an SEC priority in 1998.[37] But this explanation does not take us very far. Corporate issuers will not voluntarily expose themselves to large stock price declines and potential securities fraud liability simply to please the SEC.

Interestingly, not only did the number of earnings restatements increase over this period, but so also did the magnitude of the restatements involved.[38] This suggests that managers became progressively willing over this period to take greater risks. Moreover, as the decade of the 1990's 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

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[36] 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 1990's. This explanation is not very convincing, in part because the principal SEC statement that tightened the definition of materiality - - Staff Accounting Bulletin No. 99 - - was issued in mid-1999, after the number of restatements had already begun to soar in 1998. Also, SAB No. 99 did not truly mandate restatements, but only advised that any rule of thumb employed by auditors and issuers that assumed that amounts under 5% were inherently immaterial could not be applied reflexively. See Staff Accounting Bulletin No. 99, 64 F.R. 45150 (August 19, 1999).

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

[38] According to Moriarty and Livingston, supra note 27, companies that restated earnings suffered market losses of $17.7 billion in 1998, $24.2 billion in 1999, and $31.2 billion in 2000. Id. at 55. Expressed as a percentage of the overall capitalization of the market (which was ascendingly hyperbolically over this period), these losses for 1998 through 2000 came to 0.13%, 0.14% and 0.19%, respectively, of market capitalization. In short, however expressed, the losses increased over this period.

be more inexperienced or rash. Managerial behavior within the largest firms then seems to have changed over this period.

The GAO Study's data supports this interpretation that managerial behavior changed. Although there are many reasons why a company may restate its financial statements (e.g., to adjust costs or expenses or to recognize liabilities), one particular reason dominated during the period from 1997 to 2002. The GAO study found that issues involving revenue recognition accounted for almost 39 percent of the 919 announced restatements that it identified over the 1997 to 2002 period.[39] In effect, attempts by management to prematurely recognize income appear to have been the most common cause of restatements. Where, earlier in the decade, managements may have 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, by the end of the decade 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.[40] Seemingly, the market feared such restatements more than others because of the apparent signal they carried that reported earnings could not be trusted; yet, they remained the most common restatement. All in all, the interests of management and shareholders appear not to have been well aligned, and gatekeepers appear to have been progressively caught in the middle.

B. Security Analysts During the 1990's

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[39] See GAO Study, supra note 28, at 5. Revenue recognition was also the leading reason for restatements in each individual year over this period. Id.

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

Before any attempt is made to explain what motivations led managements to pressure their auditors for premature revenue recognition, it is useful to recognize that this pattern of increased acquiescence by the gatekeeper to its clients' demands during the 1990's was not limited to the auditing profession. The best example of a profession equally or more conflicted than auditors is that of securities analysts. Much of the evidence here is anecdotal, but striking. As late as October 2001, shortly before Enron's bankruptcy,16 out of the 17 securities analysts covering Enron maintained "buy" or "strong buy" recommendations on its stock.[41] Yet, months earlier as of December 31, 2000, Enron already had a stock price that was 70 times earnings and six times its book value, and had earned an 89% return for the year (despite a 9% decrease over the same period for the S&P 500 index).[42] Such a profile should have seemingly alerted any analyst who was even half awake to the possibility that Enron was seriously overvalued. 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.[43] Prudential was also believed to have the highest proportion of sell ratings among the stocks it evaluated.[44] Perhaps, Prudential

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

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

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

44 Id.

also woke up late, but it is revealing that the least conflicted were the first to awake.

How close then are the similarities between analysts and auditors? Much like auditors, analysts are also "reputational intermediaries," whose 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 been as high as 100 to 1.[45] 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.[46] Yet, a related statistic may be more revealing because it underscores the apparent transition that took place in the 1990's and parallels the earlier noted increase in accounting restatements during the 1990's. According to a study by Thomson Financial, the ratio of "buy" to "sell" recommendations increased from 6 to 1

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

[46] "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 less than 1%) 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 easily be liquidated.

in 1991 to 100 to 1 by 2000.[47] Again, it appears that something happened in the 1990's that compromised the independence and objectivity of the gatekeepers on whom our private system of corporate governance depends.[48] Even before Enron, there is considerable evidence that the most sophisticated market participants had understood the extent of these conflicts and had ceased to rely on "sell side" analysts.[49]

IV. Explaining Gatekeeper Failure

It is now time to consider generalizations. A good starting point is supplied by the fact that none of the watchdogs that should have detected Enron's collapse - - auditors, analysts or debt rating agencies - - did so before the penultimate moment. This is the true common denominator not only in the case of Enron, but also in the other "accounting irregularity" cases of 2001-2002. What plausible hypothesis can explain the collective failure of the gatekeepers? Why did the watchdogs not bark in the night when it now appears in hindsight that a massive fraud took place? Here, two quite different, although complementary, stories can be told. The first will be called the "general deterrence" story; and the second, the "bubble" story. The first is essentially economic in its premises; and the second, psychological.

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47 See Opening Statement of Congressman Paul E. Kanjorski, supra note 45, at 1. (citing study by First Call).

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

49 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 and K. Womack, Conflict of Interest and the Credibility of Underwriter Analyst Recommendations, 12 Review of Financial Studies 653 (1999).

A. The Deterrence Explanation: The Underdeterred Gatekeeper

The general deterrence story focuses on the decline in the expected liability costs arising out of acquiescence by auditors in aggressive accounting policies favored by managements. It postulates that, during the 1990's, 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 1990's, auditors faced a very real risk of civil liability, principally from class action litigation.[50] Why did the legal risks go down during the 1990's? The obvious list of reasons would include:

(1) the Supreme Court's Lampf, Pleva decision, which in 1991 significantly shortened the statute of limitations applicable to securities fraud;[51]

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[50] As of 1992, Congress was advised that the securities fraud litigation costs for just the six largest accounting firms (then the "Big Six") accounted for $783 million, or more than 14% of their audit revenues. Potential exposure to loss was in the billions. See Private Litigation Under the Federal Securities Laws: Hearings Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 103rd Cong., lst Sess. No.103-431 (1993) (statement of Jake L. Netterville), reprinted in Fed. Sec. L. Rep. (CCH) No. 1696, (January 10, 1996). One major auditing firm, Laventhol & Horwath, did fail and entered bankruptcy as a result of litigation and associated scandals growing out of the savings and loan scandals of the 1980's. See "What Role Should CPA's be Playing in Audit Reform?," Partner's Report for CPA Firm Owners, April, 2002 (discussing experience of Laventhol & Horwath). The accounting profession's bitter experience with class litigation in the 1980's and 1990's probably explains why it became the strongest and most organized champion of the Private Securities Litigation Reform Act of 1995.

[51] Lampf, Pleva, Lipkind & Petigrow v. Gilbertston, 501 U.S. 350, 359-61 (1991) (creating a federal rule requiring plaintiffs to file within one year of when they should have known of the violation underlying their action, but in no event more than three years after the violation). This one to three year period was typically shorter than the previously applicable limitations periods which were determined

(2) the Supreme Court's Central Bank of Denver decision,[52] which in 1994 eliminated private "aiding and abetting" liability in securities fraud cases;

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

(4) the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), which abolished state court class actions alleging securities fraud.[53]

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 1980's until the late 1990's, the SEC shifted its enforcement focus away from actions against the Big Five accounting firms towards other priorities.[54] In any event, the point here is not that

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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.

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

53 See Pub. L. No. 105-353, 112 Stat. 3227 (codified in scattered sections of 15 U.S.C.). For an analysis and critique of this statute, see Richard Painter, Responding to A False Alarm: Federal Preemption of State Securities Fraud Causes of Action, 84 Cornell L. Rev. 1 (1998).

54 This point has been orally made to me by several former SEC officials, including Stanley Sporkin, the long-time former head of the Commission's Division of Enforcement. They believe that the SEC's enforcement action against Arthur Andersen, which was resolved in June, 2001, was one of the very few (and perhaps the only) enforcement action brought against a Big Five accounting firm on fraud grounds during the 1990's. See Securities and Exchange Commission v. Arthur Andersen LLP, SEC Litigation Release No. 17039, 2001 SEC LEXIS

any of these changes were necessarily unjustified or excessive,[55] 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.[56] 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 1990's 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-1990's, the provision of consulting services to audit clients was infrequent and insubstantial in the aggregate.[57] Yet, according to one recent survey, the typical large public corporation now pays

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1159 (June 19, 2001). Although the Commission did bring charges during the 1990's 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 1980's, especially during Mr. Sporkin's tenure as head of the Enforcement Division, the SEC regularly brought enforcement actions against the Big Five.

55 Indeed, this author would continue to support proportionate liability for auditors on fairness grounds and sees no problem with the PSLRA's heightened pleading standards, as they have been interpreted by some courts. See, e.g., Novak v. Kasaks, 216 F.3d 300 (2d Cir.), cert. denied 531 U.S. 1012 (2000).

56 At a minimum, plaintiffs today must plead with particularity facts giving rise to a "strong inference of fraud." See, e.g., Novak v. Kasaks, supra note 55. At the outset of a case, it may be possible to plead such facts with respect to the management of the corporate defendant (for example, based on insider sales by such persons prior to the public disclosure of the adverse information that caused the stock drop), but it is rarely possible to plead such information with respect to the auditors (who by law cannot own stock in their client). In short, the plaintiff faces a "Catch 22" dilemma in suing the auditor: it cannot plead fraud with particularity until its obtains discovery, and it cannot obtain discovery under the PSLRA until it pleads fraud with particularity.

57 Consulting fees paid by audit clients exploded during the 1990's. According to the Panel on Audit Effectiveness, who was appointed in 1999 by the Public Oversight Board at the request of the SEC to study audit practices, "audit firms'

its auditor for consulting services three times what it pays the same auditor for auditing services.[58] Not only did auditing firms see more profit potential in consulting than in auditing, but they also began during the 1990's 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.

Appealing as this argument may seem that the provision of consulting services eroded auditor independence may seem, it is potentially subject to at least one important rebuttal. 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 is already conflicted by the fact that the client pays its fees.[59] Put as bluntly as possible, the audit partner of a major client

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fees from consulting services for their SEC clients increased from 17% ... of audit fees in 1990 to 67% . . . in 1999." See the Panel on Audit Effectiveness, REPORT AND RECOMMENDATIONS (Exposure Draft 2000) at p. 102. In 1990, the Panel found that 80% of the Big Five firms' SEC clients received no consulting services from their auditors, and only 1% of those SEC clients paid consulting fees exceeding their auditing fees to the Big Five. Id. at 102. While the Panel found only marginal changes during the 1990's, later studies have found that consulting fees have become a multiple of the audit fee for large public corporations. See text and note infra at note 58.

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

[59] For the academic view that "auditor independence" is an impossible quest, in large part because the client pays the auditor's fees, see Sean O'Conner The Inevitability of Enron And the Impossibility of 'Auditor Independence Under the Current Audit System, (forthcoming in 2002).

(such as Enron) is always conflicted by the fact that such a partner has virtually a "one-client" practice. Should the partner lose that client for any reason, the partner will likely need to find employment elsewhere. In short, both critics and defenders of the status quo tend to agree that the audit partner is already inevitably compromised by the desire to hold the client. From this premise, a prophylactic rule prohibiting the firm's involvement in consulting would seemingly achieve little.

Even if true in part, this analysis nonetheless misses a key point: namely, the difficulty faced by the client in firing the auditor in the real world. Because of this difficulty, the 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 the aggressive accounting policy favored by its management. Today, the client cannot easily fire the auditor. Firing the auditor is a costly step, inviting potential public embarrassment, public disclosure of the reasons for the auditor's dismissal or resignation, and potential SEC intervention.[60] However, if the auditor also becomes a consultant to the client, the client can then easily terminate the auditor as a consultant (or reduce its use of the firm's consulting services) in retaliation for the auditor's intransigence. This low visibility response requires no disclosure, invites no SEC oversight, and yet incentivizes the

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

audit firm to replace the intransigent audit partner. In effect, the client can bribe (or coerce) the auditor in its core professional role by raising (or reducing) its use of consulting of 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.[61]

B. The Irrational Market Story

Alternatively, Enron's and Arthur Andersen's downfalls, and the host of other sudden stock declines in 2001 to 2002, can be seen as the consequence of a classic bubble that overtook the equity markets in the late 1990's and produced a market euphoria. But what exactly is the connection between a market bubble and gatekeeper failure? Here, a hypothesis needs to be advanced that cannot be rigorously proven, but that is consistent with modern behavioral economics: in a bubble, gatekeepers become less relevant and hence experience a decline in both their leverage over their client and the value of their reputational capital. That is, in an atmosphere of market euphoria, investors rely less on gatekeepers, and managements in turn regard them as more a formality than a necessity. Gatekeepers provide a critical service only when investors are cautious and skeptical and therefore rely on their services. Conversely, in a

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

market bubble, caution and skepticism are by definition largely abandoned. In such an environment, auditors continue to be used more because SEC rules mandate their use (or because no individual firm wishes to call attention to itself by becoming the first to dispense with them) than because investors actually demand their use. As a result, because gatekeepers have reduced relevance in such a environment, they also have reduced leverage with their clients. Thus, if we assume that the auditor will be largely ignored by euphoric investors, the rational auditor's best 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, withdrawing its certificate on a later discovery of the fraud, or notifying the SEC.[62]

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

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

not pursue all information relevant to an optimal decision.[63] 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."[64] It asserts that individuals estimate the frequency of an event by recalling recent instances of its occurring (even if these instances are normally rare or infrequent, when viewed from a longer term perspective). Hence, if the stock market has recently experienced extraordinary returns for several years, it becomes predictable that individuals will overestimate the likelihood of such extraordinary gains continuing.[65] 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-1990's, investors, operating on heuristics, came to assume that this pattern would continue.

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

64 See Jolis, Sunstein and Thaler, supra note 63, at 1477-78. See also, Amos Tversky and Daniel Kahneman, "Judgment Under Uncertainty: Heuristics and Biases" in JUDGMENT UNDER UNCERTAINTY 3 (Daniel Kahneman, Paul Slovic, and Amos Tversky eds. 1982).

65 This is by no means the only way to explain bubbles without resorting to claims of mass delusion. An alternative theory is that institutional money managers have rational incentives to engage in "herding behavior," preferring a common wrong decision to a risky correct one. See text and notes infra at notes 74 to 76.

Further aggravating this tendency is the deep-seated bias displayed by many individuals toward optimism in predicting future events.[66]

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 are cautious and prudent will be outperformed by those who recklessly predict extraordinary returns. Hence, in a bubble, extreme optimism for analysts becomes less a heuristic bias than a competitive necessity. Put more bluntly, it is dangerous to be sane in an insane world. As a result, the securities analyst who prudently predicted reasonable growth and stock appreciation during the 1990's was increasingly left in the dust by the investment guru who prophecized a new investment paradigm in which revenues and costs were less important than the number of "hits" on a website.

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[66] See Jolis, Sunstein and Thaler, supra note 63, at 1524-25; see also Neil D. Weinstein, Unrealistic Optimism About Future Life Events, 39 J. Personality & Soc. Psychology 806 (1980).

Institutional factors compounded this problem. As the initial public offering (or "IPO") market soared in the 1990's, securities analysts became celebrities and valuable assets to their firms;[67] 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 thus soared, analyst compensation came increasingly from the investment banking side of their firms. Hence, just as in the case of the auditor, the analyst's economic position became progressively dependent on favoring the interests of persons outside their profession (i.e., consultants in the case of the auditor and investment bankers in the case of the analyst) who had little reason to respect or observe the standards or professional culture within the gatekeeper's profession.[68]

One common denominator linking these examples is that, as auditors increasingly sought consulting income and as analysts became more dependent on an investment banking subsidy, these gatekeepers' normal desire to preserve their reputational capital for the long run become subordinated to their desire to obtain extraordinary returns in the short run by risking that reputational capital. Alternatively, the value of gatekeepers' reputational capital may have simply declined in a bubble, because investors in such an environment rationally reduce their reliance on gatekeeping services based on their false belief that extraordinary returns will persist.

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[67] For the view that investment banking firms changed their competitive strategies on or around 1996 and thereafter sought the "popular, high-profile analyst" as a means of acquiring IPO clients, see Morgenson, supra note 48 at Section 3-1 (quoting chief investment officer at Trust Company of the West).

[68] This idea that professional gatekeepers became dominated by persons outside their profession is at the heart of a recent lawsuit initiated by the New York Attorney General against five chief executive officers of major U.S. corporations. See Patrick McGeehan, "Spitzer Sues Executives of Telecom Companies Over 'Ill Gotten' Gains," New York Times, October 1, 2002, at C-1. on September 30, 2002.

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 1990's, 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.

C. Allocating Responsibility Among Gatekeepers, Managers and Investors

The foregoing explanations still do not fully explain the mechanisms by which reputational capital built up over decades might be sacrificed (or, more accurately, liquidated) once legal risks declined and/or a bubble developed. Here, an allocation of responsibility must be made among the various participants in corporate governance: managers, gatekeepers, and investors.

1. The Role of Managers. The pressure on gatekeepers to acquiesce in earnings management was not constant over time, but rather accelerated during the 1990's as managerial incentives changed. As noted earlier, executive compensation shifted during the 1990's from being primarily cash based to being primarily equity based. The clearest measure of this change is the growth in stock options. Over the last decade, stock options rose from five percent of shares outstanding at major U.S. companies to fifteen percent - - a three hundred percent increase.[69] The value of these options rose by an even greater percentage and over a

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

dramatically shorter period: from $50 billion in 1997 in the case of the 2,000 largest corporations to $162 billion in 2000 - - an over three hundred percent rise in three years.[70] 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.[71] Interestingly, this ability was, itself, the product of deregulatory reform in the early 1990's, 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.[72] Thus, if executives inflate the stock price of their company through premature revenue

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[70] See Morgenson, "Corporate Conduct," supra note 69, at C-1 (citing study by Sanford C. Bernstein & Co.). Thus, if $162 billion is the value of all options in these 2,000 companies, aggressive accounting policies that temporarily raise stock prices by as little as ten percent create a potential gain for executives of over $16 billion - - a substantial incentive.

[71] This point has now been made by a variety of commentators who have called for minimum holding periods or other curbs on stock options. These include Henry M. Paulson, Jr., chief executive of Goldman, Sachs, and Senator John McCain of Arizona. See David Leonhardt, "Corporate Conduct: Compensation: Anger At Executives' Profits Fuels Support for Stock Curb," New York Times, July 9, 2002, at A-1.

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

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 at least became rational for corporate executives to use lucrative consulting contracts, or other positive and negative incentives, to induce gatekeepers to engage in conduct that assisted their short-term market manipulations. The bottom line is then that the growth of stock options resulted in gatekeepers being placed under greater pressure to acquiesce in short-term oriented financial and accounting strategies.

2. The Role of Investors. Investors cannot be fairly presented as entirely innocent victims in the recent epidemic of financial irregularities. At a minimum, a bubble reflects investors' acquiescence in unrealistic valuations. More importantly, conflicts of interest on the part of gatekeepers that might alarm investors in other circumstances may be accepted (or at least repressed) during a bubble. To be sure, many investors were likely misled by biased analyst research and overstated earnings, but this does not absolve the "buy side" of all responsibilities. 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,[73] financial intermediaries may again have failed. According to one estimate, at the peak of the market, sixty percent of Enron stock was held by large institutional investors.[74] 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

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

[74] See Healy and Palepu, supra note 42, at 22.

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.[75] 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."[76] Thus, if a fund manager discovers that Enron is overvalued and sells his firm's investment, the manager and the managers clients do well - - but only if the market agrees and Enron's stock price falls that quarter. If the market persists in overvaluing Enron or actually climbs based on biased "sell-side" research, the manager becomes an unfortunately premature prophet, and the manager's performance relative to his rivals falls. Precisely to the extent that this manager is accountable to the market, clients' funds flow out of their manager's account to those of rival fund managers, thereby collapsing like an accordion the funds under his management, so that this manager does not profit significantly even when Enron ultimately does collapse. In such an environment, there is little incentive to be ahead of the crowd and considerable incentive to ride the bubble to its top in order not to underperform rival investment managers who do. The result is "herding" because, by following the herd, the fund manager will not underperform most of the manager's rivals. Put differently, the fund manager can survive mistakes that others also make, but may be more injured by correct decisions that the market only belatedly recognizes. In turn, this may explain why institutions would follow "sell-side" research that they knew to be biased: that is, because they anticipated that others would follow it also, leaving them in the safe position of being part of the herd.

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[75] Id. at 26-27.

[76] Id. at 26.

3. 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. Earlier, this article has argued that gatekeepers performed poorly in the 1990's (at least in the case of auditors and analysts) because they faced reduced costs and increased benefits from acquiescing in managerial misbehavior. But there are further nuances to this story:

a. The absence of competition. The Big Five accounting firms obviously dominated a very concentrated market for auditing services. As a result, smaller competitors could not expect to develop the international scale or marketable brand names that the Big Five possessed simply by quoting a cheaper price. Thus, there were high barriers to entry into this market More importantly, in a market this concentrated, implicit collusion develops easily. Each of the Big Five could develop and follow a common competitive strategy in parallel without fear of being undercut by a major competitor. In particular, under these conditions, each of the Big Five might prefer a strategy under which it acquiesced to clients at cost of an occasional litigation loss and some public humiliation. Yet, it would be more costly to observe such a policy if the market were less concentrated so that a disciplined firm stood out and looked appreciably less trustworthy than its peers. But in a very concentrated market, it becomes more likely that every firm will bear some litigation scars from highly public scandals and insolvencies. Also, in such an environment, it is less likely that one competitor will seek to stand out and distinguish itself through its greater reputation for integrity. Formal collusion is not necessary in a concentrated market, but only the expectation that one's competitors would also be rationally willing to accept litigation losses and occasional public humiliation as a cost of obtaining consulting revenues.

Put differently, either in a less concentrated market where several dozen firms competed or in a market with low barriers to entry, it would be predictable that some dissident firm would seek to market itself as distinctive for its integrity. But in a market of five firms (and only four for the future), this is less likely.

b. Principal/Agent Problems. Auditing firms have always known that an individual partner could be dominated by, and might defer excessively to, a large client in a manner that could inflict liability on the firm. Thus, early on, they developed systems of internal monitoring that were far more elaborate than anything that law firms have yet attempted. But within the auditing firm, this internal monitoring function is not all powerful. After all, it is not itself a profit center. With the addition of consulting services as a major profit center, a natural coalition developed between the individual audit partner and the consulting divisions; each had a common interest in checking and overruling the firm's internal audit division when the latter's prudential decisions would prove costly to them. Cementing this marriage was the use of incentive fees. If those providing software consulting services for an audit firm were willing to offer the principal audit partner for a client a fee of 1% (or so) of any contract sold to the partner's audit client, few others within the firm might see any reason to object. If software consulting contracts (hypothetically, for $50 million) were then sold to the client, the audit partner might now receive more compensation from incentive fees for cross-selling than from auditing and thus have greater reason to value the client's satisfaction above his interest in the firm's reputational capital. More importantly, the audit partner now also has an ally in the consultants, who similarly would want to keep their mutual client satisfied, and together they would form a coalition potentially able to override the protests of their firm's internal audit unit (if the latter felt that an overly aggressive policy were being followed). While case histories exactly

matching this pattern cannot yet be identified, abundant evidence does exist for the thesis that incentive fees can bias audit decision-making.[77] Interestingly, Enron itself presents a fact pattern in which the audit firm's on-the-scene quality control officer was overruled and replaced.[78]

V. Implications: Evaluating Congress's Response

Does it matter much 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 or desirable. To the extent one accepts the deterrence story, we may need legal changes aimed at restoring an adequate legal threat. In principle, these changes could either raise the costs or lower the benefits of acquiescence to auditors (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.[79] Also, not all gatekeepers are alike. It may be

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[77] One of the most famous recent accounting scandals involved the Phar-Mor chain of retail stores. There, after the audit partner for Coopers & LyBrand was denied participation in profit sharing because he had insufficiently cross-sold the firm's services, he sold $900,000 worth of business in the next year (most of it to Phar-Mar and its affiliates), but then failed to detect $985 million in inflated earnings by Phar-Mor over the following three years. See Prentice, supra note 20, at 184; Max Bazerman et. al., The Impossibility of Auditor Independence, Sloan Management Review (Summer 1997) at 89.

[78] Carl E. Bass, an internal audit partner, warned other Andersen partners in 1999 that Enron's accounting practices were dangerous. David Duncan and Enron executives are alleged to have had Mr. Bass removed from the Enron account within a few weeks after his protest. See Robert Manor and Jon Yates, "Faceless Andersen partner in spotlight's glare; David Duncan vital to federal probe after plea," Chicago Tribune, April 14, 2002, at p. C-1. If nothing else, this evidence suggests that the internal audit function within one Big Five firm could be overcome when the prospective consulting fees were high enough.

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

that the deterrence story works better for auditors than analysts, while in the latter case, structural reforms aimed at increasing the independence of the gatekeeper will outperform litigation remedies.

Viewed historically, the Enron crisis is only one of several modern "accounting crises," extending from Penn Central crisis in the 1970's to the S&L crisis in the 1980's.[80] But the distinctive difference between the Enron crisis and the crises of the 1970's and the 1980's is that management in the past only had a strong incentive to "cook the books" as their corporation approached insolvency. Only insolvency in an earlier era threatened management with ouster. Today, as the mechanisms of corporate accountability (e.g., takeovers, control contests, institutional activism, and more aggressive boards) have shortened managements' margin for error, the incentive to engage in earnings management and accounting irregularities is more widespread. Not only is management survival more in question in an increasingly competitive business environment, but the instant wealth promised by stock options can give rise to an incentive to cheat, even when management's survival is not in question.

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

[80] For an overview of these crises, see Cunningham, supra note 14.

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

Passed almost without dissent, the "Public Company Accounting Reform and Investor Protection Act of 2002" (popularly known as the Sarbanes-Oxley Act) essentially addresses the problem of accounting irregularities by shifting control of the accounting profession from the profession to a new body: the Public Company Accounting Oversight Board (the "Board"), which is authorized to regulate the profession, establish auditing standards and impose professional discipline.[81] Conceptually, this is not a new approach, as the Board'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 bars auditors from providing a number of categories of professional services to their audit clients and further authorizes the Board to prohibit additional categories.[82] Thus, if conflicts of interest compromised auditors, the Act responds with an appropriate answer.

But if accounting irregularities were more the product of a lack of general deterrence or the increased incentive of corporate executives to "cook the books" because of the temptations created by stock options, the Act is less clearly responsive to these problems. For example, except in a minor way, the Act does not seek to revise or reverse the PSLRA;[83] nor does it make

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[81] 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...."

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

[83] Section 804 of the Act does extend the statute of limitation for securities fraud suits, thereby reversing a 1991 Supreme Court decision that had shortened the

gatekeepers liable in private litigation to investors where the gatekeeper knowingly aided and abetted a securities fraud. Finally, the Act never addresses stock options or executive compensation, except to the extent that it may require the forfeiture of such compensation to the corporation if the corporation later restates its earnings.[84] In short, while the potential benefits from acquiescing in accounting irregularities appear to have been reduced for auditors, the expected costs to them from gatekeeper failure also remain low because the level of deterrence that they once faced has not been restored.[85]

Thus, from this article's perspective, a public policy agenda should have three goals that Sarbanes-Oxley never addressed: (1) increasing civil liability for acquiescence in managerial fraud; (2) reducing the perverse incentives caused by stock options; (3) addressing the structural conflicts that cause "herding behavior" and analyst bias.

B. Prospects for the Future

Some critics have regarded the Sarbanes-Oxley Act as more rhetoric than serious reform;[86] others (probably more) view it as a sweeping intrusion into our existing system of corporate governance. This essay's view is roughly intermediate: the Act is a reasonable, but

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time period. See supra note 51.

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

85 Prior to the 1990's, private litigation was a real (and arguably even excessive) constraining force on auditors. See text and note supra at note 50.

86 See Lawrence A. Cunningham, The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (and It Might Just Work), 36 U. Conn. L. Rev. __ (forthcoming in 2003).

incomplete, response to serious problems, but with some rough edges that were probably inevitable, given the speed with which it passed and the number of floor amendments. Sarbanes-Oxley may curtail the conflicts of interest affecting auditors, but, absent stronger legal threats, little reason exists to believe that it alone will cause accounting firms to take sufficient steps to monitor and control their individual partners, who usually have more than sufficient incentives to defer to their dominant clients. Nor are the misincentives of executives and fund managers addressed in any serious way by the Act. Perhaps, alternatives to litigation, such as the mandatory rotation of audit firms, would also work, but the Act stopped short of legislating these remedies as well.[87] Market corrections may mitigate the rate of accounting scandals for the near future, but, given the regularity of accounting scandals over U.S. financial history, it would be rash to predict their disappearance because of Sarbanes-Oxley.

Finally, should the rest of the world expect to catch this American disease of accounting irregularities? Or, does their relative immunity to it show the superiority of their own systems of accounting?[88] The best answer here is that the frequency of American accounting scandals has little to do with substantive accounting rules or philosophies and more to do with the structure of share ownership. Dispersed ownership in the U.S. contrasts with concentrated ownership in Europe and elsewhere. In concentrated ownership systems, a controlling shareholder monitors

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[87] Section 204 of the Act does require rotation of the lead partner, at least every five years, but not the audit firm itself. Mandatory rotation may also not work well in a highly concentrated industry of only four large firms, as it will likely lead to only reciprocal swaps of clients among auditing firms.

[88] Before it is assumed that Europe is immune to accounting scandals, it should be noted that the Neuer Markt, the high-tech German market for young companies, will be closed in 2003 after a series of financial and accounting scandals tarnished its reputation. See Mark Landler, "German Technology Stock Market to Be Dissolved," NY Times, September 27, 2002, at W-1. It was, however, an uncharacteristic European market.

management and has little incentive to create short-term price spikes or to engage in aggressive earnings management (in part because a controlling shareholder will only sell in a control transaction at a control premium and cannot bail out into the market). Conversely, in dispersed ownership systems, strong executives may be only weakly monitored by their board and so have the incentive to cause price spikes into which they bail out. As a result, even if European accounting systems were seriously inferior, we would still witness less accounting scandals abroad.

What specific reforms might follow from this article's analysis? Essentially, the risks described in this article are that corporate mangers, motivated by stock options, will inflate earnings, and the usual monitors - - securities analysts and investment fund managers - - will often turn a blind eye to such financial chicanery because of their own misincentives. Accordingly, if one were to indulge for a moment in the luxury of "thinking outside the box," the following reforms suggest themselves:

1. Relaxing the prohibition on short-selling. If stock prices tend to be recurrently inflated and if fund managers are reluctant to combat such inflation, a different champion must be found to bring the market back into equilibrium. In an unregulated market, that natural champion would be the short seller. But under U.S. securities law, the short seller is disfavored

and heavily regulated.[89] Relaxing these regulations, while not politically popular, would be one way of creating a countervailing force to those that inflate stock prices.

2. Retention ratios and mandatory holding periods. If stock options can create perverse incentives for managers, this does not mean that their use should be discouraged. After all, any wholesale return to cash compensation would only take us back to the era of the 1960's with its bloated conglomerates. Rather, the more tailored, nuanced answer is to require managers to hold shares for a longer period[90] and to impose some minimum retention level (say 66⅔) to restrict management bailouts. Obviously, these reforms would be controversial, and the devil is in their details. Still, they respond more directly to the underlying problems than do many of the prophylactic rules in Sarbanes-Oxley.

3. Gatekeeper rotation. The idea of mandatory rotation has been proposed for auditors, but works less well in this context because of the concentrated character of the market for

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[89] Increasing economic evidence suggests that short sale constraints can cause stocks to be overvalued. See Charles M. Jones and Owen A. Lamont, Short-Sale Constraints and Stock Returns, 66 J. Fin. Econ. 207 (2002). Best known of the legal constraints that restrict short selling is the "up-tick" rule, which permits short sales only at a price higher than the previous price (an "up-tick") or at the previous price if the last different price was lower. See 17 CFR Section 240.10a-1. The purposes of the rule are outlined in Securities Exchange Act Release No. 13091 (Dec. 21, 1976). Today, the impact of the "up-tick" rules has been weakened by the advent of decimalization of securities prices. Still, recent commentators have argued that the primary constraints on short selling are imposed by the tax laws. See Michael Powers, David Schizer and Martin Shubik, Market Bubbles, Wasteful Avoidance, and Tax and Regulatory Constraints on Short Sales (Working Paper 2003) (detailing both tax and regulatory constraints). In recommending some relaxation of these constraints, this author does not mean to suggest that the prohibition against market manipulation should be relaxed, but only the more prophylactic rules, such as the "up tick" rule.

[90] Prior to 1991, a minimum six month holding period (after the exercise of the options) was required by virtue of Section 16(b) of the Securities Exchange Act of 1934. See text and note supra at note 72.

auditing services (where today four firms share the vast majority of the market in the case of publicly held companies). In such an environment, mandatory rotation may lead only to reciprocal client swaps among auditors. Yet, the idea may have greater value in other markets for professional services that are less concentrated. To be sure, there is an efficiency loss because of duplicative overlap when a firm must use multiple advisors, but this loss could well be counterbalanced by the gain in independence.

CONCLUSION

This article has reviewed several different explanations for the surge in financial irregularities in the late 1990's. Chief among these are:

1. The Gatekeeper Story: Professional "reputational intermediaries" faced less legal risk and had more reason to defer to their clients as the 1990's wore on. This combination of increased market incentives and legal deregulation can explain why auditors acquiesced and analysts became more biased, but it cannot stand alone as a comprehensive explanation. Some further explanation of why managers and underwriters became more interested in "bribing" their gatekeepers than in the past is needed.

2. The Misaligned Incentives Story. As executive compensation changed during the 1990's, it created an increased incentive for managers to inflate earnings, even if the resulting stock prices were not sustainable, because management could bail out ahead of their shareholders. This explanation can fill the gap and account for the increased incentive on the part of managers to induce gatekeepers to acquiesce in aggressive accounting. In particular, the

fact that the plurality of restatements in the late 1990's involved income recognition issues supports this explanation.[91]

3. Herding and Persistence Bias Stories. There explanation can account for the market myopia underlying a bubble, but they lack quantitative support. While it can be asserted that individual investors expect extraordinary returns to persist, this hypothesis is less credible when applied to institutions. Yet, fund managers do have reasons to herd and may more fear being prematurely prophetic than being collectively wrong. As a result, the market did not respond to available evidence of overvaluation.

If weight is accorded to any of these explanations, then it becomes clear that the Sarbanes-Oxley Act, while useful, still addresses only one aspect of the first explanation: namely, the ability of managers to seduce auditors with consulting income. To conclude, one can only paraphrase Santayana: those who ignore conflicts of interest are destined to repeat history, cycle after cycle.

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[91] See text and notes supra at notes 39 to 40.