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Article: Beyond Liability: Rewarding Effective Gatekeepers

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SUMMARY:

... Scholars have contributed considerable analysis to the utility of positive incentives for corporate whistleblowers; a growing body of literature addresses paying rewards to effective capital market gatekeepers, with attention given to outside directors and lawyers. Previous literature on gatekeepers concentrated on designing a liability system to achieve optimal deterrence while relying largely on gatekeeper reputation as a self-enforcement device. ... Even so, professional aspirations suggest the importance of culture and norms in any analysis of reputation as a constraint on gatekeeper performance. ... The analysis concludes that diagnosis and reform invariably focus on negative threats associated with reputation and liability risk, but that considering positive incentive programs may lead to better results. ... The signaling power when an auditor fires a client arises because the enterprise must have an auditor while the auditor need not retain any given client. ... While all of the foregoing systemic factors contribute partial explanations for gatekeeper failure, associated analysis and reforms tend to revolve around the scholarly literature's enduring focus on reputation constraints plus liability risk. ... Professor Kraakman's original formulation of the gatekeeping model identifies effective gatekeepers as those with incentives that differ from clients in that they have "less to gain and more to lose" from granting capital market access to clients who misreport. ... They can protect reputation and reduce liability risk by increasing the effectiveness of their fellow gatekeepers. ...

TEXT:

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Corporate and securities law scholars increasingly investigate the role of rewards to promote desired behavior. n1 Scholars have contributed considerable analysis to the utility of positive incentives for corporate whistleblowers; n2 a growing body of literature addresses paying rewards to effective capital market gatekeepers, with attention given to outside directors n3 and lawyers. n4 Previous literature on gatekeepers concentrated on designing a liability system to achieve optimal deterrence while [*324] relying largely on gatekeeper reputation as a self-enforcement device. n5 This Article reviews the previous literature, noting inherent limitations of reputation and liability threats, including how the latter discourage gatekeepers from performing desirable services such as fraud detection. This Article then begins to explore how a rewards program might be designed to overcome some of those limitations and improve gatekeeper effectiveness.

The expanding interest in positive incentives for capital market gatekeepers dovetails with a broader and older trend in the regulation literature. This trend reflects a philosophical shift away from traditional deterrence-oriented strategies toward more cooperative and rewards-oriented systems to promote compliance. n6 This approach joins market and regulatory accountability mechanisms that are described using terms such as cooperative compliance, interactive compliance, responsive regulation, collaborative governance, and cooperative implementation. n7 Empirical psychological

evidence suggesting that positive incentives may be more likely to promote desired behavior than negative threats is an important inspiration for this shift. n8

This Article considers the context of financial reporting in connection with securities transactions. Complex forces of social norms and legal culture shape the character of financial reports. Forces operate at both the enterprise level and among [*325] third parties that enterprises enlist to assist in preparing disclosure, such as accountants and lawyers. While law can influence financial reporting quality through negative threats or positive incentives, lawyers and legal scholars focus nearly entirely on negative threats, designing liability regimes to induce fair reporting. n9 Laws impose duties on enterprises, individuals, outside accounting and law firms, and their individual professional employees. n10 The liability risks backing these regimes can be criminal or civil and include money damages, prison terms, fines, license revocations, and the like. n11 Layers of liability analysis result.

Yet law never supplies positive inducements (even lighter sanctions for conscientious enterprises or gatekeepers are weaker sticks, not carrots). True, traditional analysis also emphasizes reputation, but mainly because gatekeepers put it at risk when attesting to the veracity of an enterprise's assertions, meaning this operates more as a stick than as a carrot. One consequence of the existing regime's emphasis on liability threats is the generation of impressive professional resistance to undertaking a variety of potentially useful functions. For example, the auditing profession has long resisted any undertaking to detect for fraud in financial audits and the legal profession has long resisted any undertaking to conduct due diligence exercises in preparing public offerings of securities.

The prevailing regime's overwhelming emphasis on sticks offers limited assurance of success. That system failed during the late 1990s and early 2000s. Yet reforms concentrate on reconfiguring the type and combination of sticks in use. For example, many emphasize the reduced threat of auditor liability during that period and respond by prescribing enhanced penalties. n12 Others point to factors that reduce auditor investment in [*326] reputation, such as industry concentration, n13 differences between partner incentives and firm-level incentives, n14 and the proliferation of nonaudit services. n15

Law's preoccupation with liability design is understandable since lawyers have a comparative advantage in liability design. Designing reward systems may seem beyond law's scope or lawyers' competence. A lawyer might expect that if rewards programs are productive, then market participants would design and implement them. While this seems correct, two qualifications are relevant. First, nonmarket impediments can frustrate the implementation of good ideas. For example, gatekeepers fear that demonstrating the capability to perform a task will expose them to liability. Second, contemporary financial reporting occurs in a complex setting that combines free market innovation with considerable regulatory limitations. The combination may prevent otherwise appealing contractual innovations from gaining traction. If so, lawyers - and legal scholars - may have the capacity to spark ideas that markets can test and implement. It is in that spirit that this Article introduces the possibility of going beyond liability to designing rewards for effective gatekeepers.

Part I reviews the theory of capital market gatekeeping. It presents the conceptual underpinnings of the model and how a combination of reputation and liability risks sustains it. Part II analyzes recent experience that shows limitations on the theory in practice, including limitations that continue despite various reforms. From this fairly extensive review offered to provide context, a rewards program emerges as a way to meet some of [*327] these limitations. The analysis in each of these Parts highlights how the prevailing approach has the perverse effect of discouraging gatekeepers from performing vital functions.

Part III explores ways to design positive incentives to promote effective capital market gatekeeping. It draws on the intuition behind the evidence suggesting that positive incentives can be more effective than negative threats in promoting desired behavior. Positive incentives can induce gatekeepers to perform vital functions that the current regime discourages them from performing. While this Article cannot provide all the details of a comprehensive incentive program applicable for all gatekeepers in all circumstances, it contributes a general framework, model, and illustrations to the emerging literature taking the rewards approach.

I. THEORY

This Part reviews the well-known theory of capital market gatekeeping. Part I.A summarizes the standard model, distinguishing gatekeepers from whistleblowers and from various hybrid roles that professionals can assume. Part I.B focuses on the conditions necessary for effective gatekeeping (reputation and liability risk). Part I.C discusses costs of the standard model. The review invites inquiry into how adding explicit positive incentives can promote more effective gatekeeping.

A. Conceptions

Several varieties of third-party assistance in accessing capital markets exist. The following considers the attributes and distinctions among those usually described as "gatekeepers" and "whistleblowers" and then considers some that embody attributes of each (called hybrids below).

1. Gatekeepers

Gatekeepers work with an enterprise to correct misreporting before it occurs. n16 They do so by threatening to withhold support necessary to complete a report or consummate a transaction. n17 Gatekeepers can deny access to capital markets. n18 [*328] Thus gatekeepers are "intermediaries who provide verification and certification services to investors" by pledging their professional reputations n19 - and, by withholding such support, block admission through the gate. n20

Law's gatekeeper approach always imposes a monitoring duty but not necessarily a reporting duty: eventual discovery exposes the gatekeeper to liability for the primary violation, not merely a remedy for nonreporting. Even so, the gatekeeper approach is intended to give professionals regulatory incentives to prevent misreporting. n21 Most gatekeepers are paid for their services by the enterprises that retain them; all bear stated duties whose breach exposes them to legal liability.

Gatekeepers include auditors and attorneys, who work directly with and essentially inside the enterprise. Auditors attest to financial statement assertions under duties established by statute and articulated in professional codes of performance. n22 Lawyers advise on transaction design and disclosure. [*329] Lawyers often determine whether senior executives can sign disclosure documents and also provide written legal opinions or memoranda concerning the legality of transactions and their compliance with law. Duties of both auditors and lawyers arise initially from contract but include a regulatory overlay of professional standards.

Gatekeepers also include other transaction participants, such as investment banks and sometimes rating agencies, plus professionals working apart from transactions or outside the enterprise, such as securities analysts, and possibly stock exchanges and mutual funds. n23 Unlike auditors and lawyers, these gatekeepers do not typically act under any legal duty or vouch for statements that the enterprise makes about itself. Instead they provide their own statements, such as a securities rating or a buy-sell recommendation.

Professionals within this broad conception of gatekeepers thus differ significantly. n24 Roles vary with product or service type and the information the gatekeepers' buyers and users receive. Also varying are what professionals attest to or certify, such as fairness of financial statement assertions, legality of a securities issuance, and quality of a debt instrument. n25

Accordingly, all other public policy aspects of their respective performance vary, including requirements, expectations, capacities, incentives and appropriate legal liability for failure. n26 Indeed, auditors and attorneys reside at opposite ends of a gatekeeping spectrum: both put reputations and liability on the line but lawyers take leading roles in deal design and disclosure preparation. On the other hand, auditors take back-up roles in reviewing and testing disclosure. n27 Despite these differences, [*330] the term gatekeeper has assumed customary usage, not only in the academic literature but in official regulatory pronouncements. n28

2. Whistleblowers

Whistleblowers differ conceptually from gatekeepers. While gatekeepers generally work with enterprises to negotiate access to capital markets or deny it without further ado (keeping information confidential), whistleblowers report violations to the public or to authorities. n29 When gatekeepers determine that they cannot exercise internal influence to correct statements that require correcting, they may resign or otherwise withhold their services. This does not, however, involve blowing a whistle to any enforcement authority or the public. n30 The distinctive feature of the whistleblower, then, is that the third party discloses wrongdoing to authorities or third parties. n31

There are three recognized forms of whistleblowers. The first is the volunteer whose interest in whistleblowing is not based on any duty and does not lead to any reward. n32 The classic example is the enterprise employee who comes forward with evidence of wrongdoing. This employee is protected under various statutes against retaliation and is entitled to compensatory damages arising from costs of pursuing this redress. Notably, for employees, whistleblowing doctrines usually provide job security, and resist the enterprise's temptations toward retaliatory discharge. n33

[*331] The second form of whistleblower is the volunteer who shares in a bounty arising from blowing the whistle. Outside the securities context, the classic example is the *qui tam* action.ⁿ³⁴ The most prominent illustrations are cases under the False Claims Act.ⁿ³⁵ Private parties are vested with authority to prosecute claims of violations of laws and share in the recovery on behalf of government.ⁿ³⁶ Analogous bounty schemes appear, including, in the securities law context, the Securities and Exchange Commission's insider trading bounty programⁿ³⁷ and, in the tax context, the Internal Revenue Service's informant rewards system.ⁿ³⁸

The third form of whistleblower is the nonvolunteer, who has duties to come forward and publicly disclose discovered wrongdoing. This type of whistleblower is also primarily a gatekeeper but has specific additional whistleblowing duties. Consider, for example, auditors. The Private Securities Litigation Reform Act (PSLRA)ⁿ³⁹ expanded auditor whistleblowing obligations, requiring the reporting of illegal acts within an enterprise and to the SEC if satisfactory responses are not forthcoming from within the enterprise.ⁿ⁴⁰

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3. Hybrids

Despite conceptual distinctions, the categories of gatekeeper and whistleblower can sometimes overlap and give rise to hybrids. For example, auditors can perform roles that include both gatekeeper and whistleblower functions. Suppose an auditor determines that a client is committing illegal acts and the client refuses to redress the violations. The auditor must both resign from the engagement and disclose the illegal acts.ⁿ⁴¹ Thus, the auditor exercises both the gatekeeping function by refusing support and the whistleblowing by reporting the illegal acts to the authorities. Lawyers may be seen either as gatekeepers or whistleblowers in circumstances when their duty of client confidentiality comes into tension with their duty to avoid assisting in criminal or fraudulent activity.ⁿ⁴²

The SEC's struggle to formulate rules governing lawyer professionalism reveals the difficulty of classifying attorneys as either gatekeepers or whistleblowers.ⁿ⁴³ As adopted, SEC rules permit but do not require disclosing confidential information to prevent crime or fraud.ⁿ⁴⁴ That does not quite fit the typical whistleblower classification, the essence of which is reporting.ⁿ⁴⁵ The SEC proposed, but did not adopt, the so-called noisy withdrawal alternative, which contemplates a lawyer announcing publicly its resignation based on perceived client violations.ⁿ⁴⁶ [*333] This appears closer to the typical whistleblowing class,ⁿ⁴⁷ but is not quite whistleblowing due to limitations arising from the attorney-client privilege.ⁿ⁴⁸

Nor do SEC rules as adopted embrace the gatekeeping model. Under the rules, lawyers must report violations to designated internal officials within the enterprise ("up-the-ladder reporting") without necessarily reporting to outside authorities.ⁿ⁴⁹ But other elements of the gatekeeping model are missing: up-the-ladder reporting does not include the standard gatekeeping remedy of denying a client capital market access by withholding transactional support.ⁿ⁵⁰ So lawyers no doubt play a role in superintending capital market integrity, although it is not exactly clear whether they are gatekeepers or whistleblowers or something more of a hybrid.

B. Conditions

Law's whistleblowing model is simpler than its gatekeeping model. The former relies upon either payment or protection without venturing into the terms of the relationship between the actor and the wrongdoer. The gatekeeping model must not only design a relationship and specify duties, it must attend to the roles that reputation and liability play in its operation. Consequently, numerous conditions must be met for a gatekeeping model to succeed.

As a threshold matter, and in keeping with the metaphor, there must be a gate to keep. An enterprise has to traverse to access capital markets and there can be no other way through [*334] it - at least some gatekeeper must tend the gate. Likewise, the gate cannot be opened absent a keeper's volition. The metaphor attempts to capture initial offerings of securities as well as secondary market transactions and periodic reporting exercises.

More fundamentally, the keeper must be able to influence the petitioner, to groom it for admission. For example, the third party must be able to promote fair reporting. That implies a universe of participants connected to initial, periodic, or transactional reporting exercises. Federal securities laws have long imposed duties and associated liability risks on such persons and private and SEC enforcement actions make the risk real.ⁿ⁵¹ This approach can be justified by third parties' enjoyment of low-cost access to information and can provide a "private monitoring service on behalf of the capital markets."ⁿ⁵²

Gatekeepers must be independent and possess sufficient stakes in their reputations as keepers to insulate them from petitioner bribes. Legal theorists emphasize that keepers can be effective when many petitioners seek entrance so that no admission fee (or bribe) can outweigh the expected costs of admitting the inadmissible. n53 As Professor John C. Coffee, Jr. says, "At least in theory, a gatekeeper would not rationally sacrifice this reputational capital for a single client who accounts for only a small portion of its revenues." n54

Thus the third party must be an "outsider" in the sense that it commands assets apart from the enterprise and its individual members pursue careers apart from the enterprise. n55 This creates an incentive structure that differs from the enterprise and its employees. n56 As Professor Reinier H. Kraakman explained in his pioneering analysis, third parties "are likely to [*335] have less to gain and more to lose from [misleading reporting] than inside managers." n57 The stakes for these gatekeepers are influenced by both reputation and liability concerns, and gatekeepers' components can operate at the levels of individual actors, their firms, and entire professions.

1. Reputation

Enterprises accessing capital markets can use two reputations to signal reliability: their own reputations for candor and that of their gatekeepers for thoroughness and veracity. Enterprises seeking access, initially or as an ongoing matter, develop or have their own reputations for the quality of their disclosure, on the range from fair to misleading reporting. n58 Candid enterprises enjoy more investor trust. n59 The more valuable a reputation is, the greater is the cost of jeopardizing it through opportunistic abuse of that trust. n60

Enterprises can hire third parties to achieve similar purposes. The enterprise can hire attorneys, auditors, underwriters, and rating agencies to provide reports backed by their respective reputations for thoroughness and veracity. Thorough and honest gatekeepers enjoy more credibility, which is a valuable trait. The more valuable it is, the greater the risk of reputation loss so that, at some point, no additional incentives are necessary. n61

The more frequently firms are employed to serve as gatekeepers, and the larger the number of repeat occasions in which they expect to play these roles, the greater the value. n62 Enterprises pay fees for this credence. n63 Investors and other market participants appreciate these repeat engagements as [*336] valuable signals. n64 When operating effectively, they contribute to a market in which securities prices tend to converge accurately toward the fundamental value of the related enterprise. n65

Most gatekeepers are part of a profession that boasts its own reputation. An individual's or firm's membership in a profession creates an externality - each member of the profession exploits the profession's reputation. n66 An individual's or firm's investment in reputation should generate not only private benefits for them, but also wider benefits for the profession. Thus, firms and individuals can free ride on the investments of others. That result can have the effect of reducing incentives to invest. The effect is dramatized by the presence of so-called bucket shops, or securities firms that engage in small-scale deception while benefiting from the securities profession's broader reputation. n67 The problem can also creep into law and public accounting practices. n68

Professions address these externality and free-rider problems through various strategies. First, professional membership associations articulate professional codes of gatekeeper ethics or conduct. These codes effectively admonish that admitting the inadmissible is simply wrong. Indeed, to some extent, the professional identities of lawyers and accountants are based upon such codes. n69

Second, such associations may provide or promote licensing or disciplining schemes that implicitly vouch for each gatekeeper. n70 For example, there are the programs overseen by the American Institute of Certified Public Accountants (AICPA) n71 for auditors and the National Association of Securities Dealers [*337] (NASD) n72 for securities firms. Professional associations can police reputations of members and deny admission to unqualified applicants or expel noncompliant members. Resulting threats may improve a profession's return on investment in reputation by individuals and firms.

While profession-driven reputation protection can be critical, the professions have not proven particularly good at providing it. n73 This mixed success could be due, in part, to how the professions' toolboxes contain sticks and not carrots. True, licenses are carrots when first issued, as a badge of professional honor. n74 But the threat of revocation is more analogous to a stick; enforcement leads to suspensions or expulsions.

Even so, professional aspirations suggest the importance of culture and norms in any analysis of reputation as a constraint on gatekeeper performance. This constraint entails an enormously complex set of factors that is difficult to untangle and exceedingly difficult for law to micromanage. n75 Laws can tinker with procedures and policies but these

changes must be tailored to the peculiar attributes of a profession and must be in tune with the idiosyncrasies of given firms and individuals. n76

There is debate about exactly what kind of reputation various gatekeepers seek to maintain. n77 For auditors, it is commonly said that an audit firm's most valuable asset is its reputation for honesty. n78 But as a matter of practice for effective auditing, [*338] an auditor's reputation for toughness is more important. n79 For lawyers, there is disagreement as to whether they seek to develop reputations with managers for complicity and empathy or with external investors for performing any kind of gatekeeping function. n80

2. Liability

An extensive body of literature dissects the components and effectiveness of first-party versus third-party liability enforcement strategies. First-party liability punishes the primary wrongdoer, and legal theory predicts a deterrent effect *ex ante* and a cost-internalization *ex post*. n81 Third-party liability supplements this device by addressing residual risks that the former fails to deter or internalize. n82 It occurs when a third party is able to deter or coerce cost-internalization. Law exploits this ability by imposing liability threats on gatekeepers based on primary violations of their clients.

Securities professionals are responsible for approving transactions, designing or opining on them or related disclosure, and providing assurance and attestation of financial statement assertions. Failure to perform these duties triggers liability under various state and federal claims, a panoply of SEC administrative sanctions, and criminal action. n83 In significant part, these doctrines are based on a theory of deterrence, a negative injunction to discourage misbehavior. n84 Scholars endlessly [*339] debate and policy analysts endlessly tinker with the numerous intricacies of this framework to seek its optimal structure. n85 The following briefly highlights several examples.

Some believe that the liability risk need not be as great as is traditional in the United States - a few high-damage lawsuits a decade are enough. n86 Others believe that even less liability risk is necessary for lawyers, because they are naturally cautious by training, represent clients with liability risk on the line, and protect their reputations by keeping their clients out of losing securities lawsuits. n87 Yet others cite the benefits of increasing liability with a hint of incontestability. Thus, "raising the penalties for both primary and third parties can be an effective way to make gatekeeping regimes work." n88 Professor Coffee states: "The more we suspect that attorneys will avert their gaze, the more we need to raise the penalties to deter them from so doing." n89

The shape of liability exposure can be altered, as by expanding the scope of gatekeeper duties or by broad interpretations of liability doctrines like "substantial assistance." n90 Or due diligence duties could be specified expansively. Third-party liability can be strict (under the doctrine of *respondeat superior*) or duty based (under the doctrines of *aiding-and-abetting* or *negligent nondetection*). n91

[*340] Some believe in the possibility of calibrating the duty to the penalties in optimal ways. This can be envisioned as a sliding scale on which, as liability standards move from negligence to strict liability, associated punishment can be relaxed accordingly. n92 Others contend that an optimal regime would allow gatekeepers to negotiate client contracts that state the levels of review and assurance to be provided, along with express terms of liability exposure tailored to that performance. n93

Scholars debate the method and effectiveness of alternative means of enforcement. They debate the scope of private rights of action under section 10(b) or argue that stepped-up public (SEC) enforcement is superior. n94 In this quest, the relative ability of enforcement authorities to learn of violations that warrant enforcement activity is also relevant. n95 Damages caps and safe harbors are likewise debated, along with the role of insurance. n96 To conclude this nonexhaustive highlight of the many contestable parameters of system design, scholars debate the merits of enterprise liability against individual liability. n97

Finally, some believe that the corollary of liability regulation works too. Consider the Federal Sentencing Guidelines which address corporate criminal liability. While increasing sanctions on the guilty, the guidelines also reduce sanctions for [*341] those who actively seek to deter, detect, and disrupt criminal activity. n98 As Professor Peter C. Kostant opines, "by greatly reducing the penalties for corporations that detect and disclose criminal activities, and requiring directors to cooperate in the prosecution of wrongdoers, the Federal Sentencing Guidelines offer a "legal bribe" to encourage gatekeeping." n99 These examples represent the progress achieved through incentive-based law, as compared to the *in terrorem* approach of liability threats.

C. Costs

The benefits of the third-party liability regime discussed in the preceding Section carry a number of costs. First, associated duties entail time, effort, training and other costs of precaution and implementation. Even the best-laid execution will not prevent misreporting. The fraud artists who pass through the gate undetected create additional costs in legal liability, borne either by the subject gatekeeper or by insurance. n100 Litigation and administration costs are considerable, and include costs associated with defending against nonmeritorious claims.

Second, in some contexts liability risk can overshoot the mark. The risk of error may create excessive risk aversion. n101 Costs of a gatekeeper liability regime increase otherwise unnecessary compliance burdens on those predisposed to report fairly. Further, third parties, reflecting their own liability risk, will charge a premium or require overinvestment in enterprise compliance and control infrastructure. Related costs can be passed on to enterprises, ultimately increasing their cost of capital; smaller businesses are invariably hurt disproportionately.

Third, and given scant attention in the literature, while liability risk may deter, it may also make gatekeepers unwilling to undertake functions that would otherwise be desirable for them to perform. For example, auditors have always resisted accepting any undertaking to detect fraud or opine on the reasonableness of management's accounting choices. n102 Similarly, [*342] lawyers resist the imposition of any obligations that even remotely threaten the jealously guarded attorney-client privilege and doctrines of confidentiality. n103

II. FAILURE

This Part reviews the literature that considers the episodes of financial misreporting of the early 2000s that illustrated the limitations on the traditional gatekeeping model. Part II.A discusses diminished reputation constraints that affected partners, firms, and professions as a whole. Part II.B considers how reduced liability risk may have magnified these limitations. Part II.C explores systemic features that pose inherent limitations for the traditional gatekeeping model. In each case, discussion indicates how these limitations endure despite various reforms that were made in response to the period's transgressions. The analysis concludes that diagnosis and reform invariably focus on negative threats associated with reputation and liability risk, but that considering positive incentive programs may lead to better results.

A. Diminished Reputation Constraints

The third-party model requires incentives for gatekeepers to turn away the inadmissible (or for whistleblowers to turn them in). As discussed below, a series of factors limiting the power of reputational constraints during the late 1990s and early 2000s may have impaired these incentives at various levels of partners, firms, and professions.

1. Partners

A common diagnosis of misaligned incentives considers the partner-level behavior of gatekeeper professionals. This consideration makes the conventional supposition that it is irrational for a large firm (such as Arthur Andersen LLP) to sacrifice its reputational capital for a single enterprise (such as Enron Corp.) but it may not be irrational for particular partners to do so. n104 This situation occurs when individual partners have only one client, making their career depend on pleasing its management.

According to this line of thought, "debacles like Enron's were inevitable in an environment that rewards audit partners [*343] who are captured by their client and punishes those who report negative information about their clients through the proper corporate channels." n105 This diagnosis underscores the value of rewarding those who disrupt misreporting.

A related diagnosis emphasizes how a firm that allows its partners' careers to depend on a single client commits colossal error, compounded when the firm relies solely on that partner - or a small coterie working with that partner - for information about the engagement. Such a practice can impair the condition of independence necessary for effective gatekeeping. n106 Enron dramatically illustrated this problem. n107 At minimum, these practices indicate inferior methods of internal assignment allocation.

For lawyers, the one-client problem is less obvious, as most law firm partners provide specialized services to a broad range of clients. n108 On the other hand, some evidence from the period indicated a decline in this constraint for other reasons, such as when lawyers' compensation was paid, in part, in equity in their client firms. n109 This problem could impair the reputational constraint at the partner level based on a desire to increase the value of that equity, either to increase personal or firm wealth.

2. Firms

For many decades, the reputational constraint, backstopped by a modest threat of legal liability, satisfied the gatekeeper model's requirements. n110 But during the 1990s, a pillar of the reputational constraint changed, especially for audit firms. During that period, the percentage of audit firm revenues from traditional auditing services shrank as revenues skyrocketed from consulting services (ranging from business [*344] strategy to technology management). n111 The significant cross-selling of consulting services to a firm's auditing clients meant that auditors would lose considerable consulting revenue if they were to sever clients or blow the whistle on them. n112

Cross-selling essentially eliminated one of the vital guarantors of auditor independence: the strong signal emitted when an auditor severs a client relationship. n113 The signaling power when an auditor fires a client arises because the enterprise must have an auditor while the auditor need not retain any given client. Enterprises thus lose much more than the auditor loses. They may be unable to find a replacement auditor at all after being severed. The auditor may even gain reputation value from this sternness, potentially enabling it to attract new clients. n114

Yet, during the 1990s, the incidence of auditor severing of clients declined due to shifts in power from auditors to clients. n115 According to this diagnosis, the existing auditing structure "will not function properly until a lead audit partner can confidently fire a dishonest client without jeopardizing his career." n116 In the period after the Sarbanes-Oxley Act became law, the number of audit firms that fired clients increased. n117

[*345] It is hard to determine exactly why auditors increasingly severed clients during this period. Some evidence indicates a tendency to sever smaller enterprises as opposed to larger ones, n118 even though all frauds that served as a catalyst for passage of the Sarbanes-Oxley Act involved large enterprises. n119 Moreover, Sarbanes-Oxley does not ban all nonaudit services, leaving a large exception for auditors to provide tax services to clients. n120 These services are lucrative, but may increase the acute risk of illegality and fraud. n121 Accordingly, while these reforms respond proportionately to a firm-level factor that reduced the reputational constraint's power, more policy levers may need plying.

3. Professions

Auditing industry concentration may lead to an increased erosion of audit quality. Mergers during the 1990s reduced the [*346] number of large audit firms from eight to five and the dissolution of Arthur Andersen reduced the number further to the current four. n122 These firms are massive compared to the next largest firms; annual revenue at the four largest firms is approximately \$ 20 billion compared to \$ 1 billion for the next largest firms. n123 This concentration in the industry's upper tier reduces the importance of product differentiation. n124 With a large number of firms, competition can concentrate on product differentiation, including investment in reputation; with so few firms, reduced competition diminishes incentives to invest in reputation and thus diminishes the power of the reputational constraint. n125

A final - and pervasive - limitation on gatekeeping efficacy is how the enterprise pays the gatekeeper. n126 That creates an inherent inclination for solicitude simply to retain business. Numerous solutions to this limitation have been proposed, including using insurance markets, n127 public funding, n128 stock exchange funding, n129 or voucher financing programs. n130

None of these has been adopted in the United States. Instead, the Sarbanes-Oxley Act adopts a more cautious approach. This reposes in an issuer's board audit committee the authority to determine auditor compensation (and other auditor [*347] oversight, including retention and dismissal). n131 One benefit of this approach is that audit committees can be conceptualized as gatekeepers, and there is some theoretical support for believing that having one gatekeeper pay another is an effective way to increase overall gatekeeping effectiveness. n132

B. Reduced Liability Risk

Several legal changes during the 1990s reduced the exposure of secondary actors to legal liability for failure to promote fair reporting. First, the PSLRA changed the liability regime from joint-and-several liability to proportionate liability so that gatekeepers no longer are liable for the entirety of damages but only for their share of culpability. n133 Second, the Supreme Court held that the antifraud provisions of the federal securities laws do not reach those who aid or abet others in misreporting. n134 While this did not prevent SEC actions under that theory, it significantly curtailed private actions. n135 Such changes reduced the legal liability threat, which could have been a factor in the declining propensity to protect reputations for integrity as gatekeepers (or whistleblowers). n136 When combined with the other factors noted above, incentives for quality gatekeeping declined. n137

[*348] A related diagnostic concerning audit firms is based on changing forms of liability structures. n138 Audit firms shifted from partnerships to limited liability entities. n139 This reduced incentives to maintain internal control, as litigation risk fell along with concern about steps that would reduce it. n140 At least in the case of Enron, this diagnosis concludes, "it seems doubtful that this situation would have existed if the firm had been operating under a legal regime in which partners were jointly and severally liable for negligence, audits were tied to reputation and not sold as commodities, and auditors were truly independent." n141

Much more could be said about the sources of litigation risk and how they change over time through doctrinal evolution or regulatory reform. As the discussion of liability risk in the previous Section attests, it is notoriously difficult to use alternative legal designs to achieve desired results. n142 It is particularly perplexing to meet the specific objective of setting an optimal level of deterrence. n143

That discussion also shows that it is fair to say that the role of liability risk is a dominant feature of the scholarly literature. Perhaps more litigation risk helps to reverse certain causes of gatekeeper failure. But further discussion of that strategy in this review will not advance that cause. Indeed, the following discussion identifies systemic factors that impair gatekeeper effectiveness, most of which are beyond the influence of liability threats.

C. Systemic Factors

Systemic features of the gatekeeping landscape can influence its effectiveness. During the late 1990s two broad forces appeared to operate when considerable limitations in the gatekeeper model appeared.

[*349] First, the era was characterized by financial euphoria. n144 A technological revolution occurred that altered means and methods of doing business and of many forms of human activity. In this and other such periods, a critical mass of persons throughout all sectors of society - including enterprises and investors and their professional advisors and gatekeepers - came to assume that a new era had emerged, for which the traditional norms of business and standards of accounting were less suited. n145 It becomes easy in such periods to suspend critical judgment, even with conventional matters of corporate governance and financial reporting. Any gatekeeping model will suffer serious stress in such periods. n146

Second, a systemic emphasis on gatekeepers can backfire. Gatekeepers stake reputations and liability only to the extent that there is at least a reasonable chance that misreporting will be uncovered in circumstances that damage reputation and create legal liability. But, especially during a euphoric period, and when gatekeepers are the centerpiece of a regime's integrity, professionals may believe that their transgressions can escape notice. If the system relies on gatekeepers to promote fair reporting, and gatekeepers know that, it is not irrational for gatekeepers to believe that they can conceal complicity.

For this reason, more elaborate gatekeeping theories emphasize using a multitude of gatekeepers as cross-checks, so that no one gatekeeper can ensure permanent concealment. n147 Alas, in euphoric periods, even a well-thatched mass of cross-checking gatekeepers may have limited effect. Collective suspension of objectivity can induce mutual myopia. For example, auditors may defer to lawyers who approve an approach to a reporting question while lawyers defer to the auditors who do so. n148

The bubble problem is recurring rather than continuing. Other cultural factors of a more enduring nature can impair gatekeeper effectiveness. It is critical to have individuals within professional firms capable of advancing and protecting the firm's reputation. This bonding is more likely in cultures where [*350] individuals enjoy and expect to have long term relationships with a single firm. In recent generations, however, cultural forces have led to far greater mobility among professionals, like auditors and lawyers. n149 They move from firm to firm more often than in previous generations. This mobility reduces the bonding between individuals and firms and related individual incentives to advance and protect firm reputations. n150

Bonding also was impaired when clients began to use different firms for different kinds of services more frequently; for example, when an enterprise that once used a single outside law firm for nearly all its legal needs increasingly began to use numerous different firms. n151 That, too, breaks long term bonds that promote the advancement of reputations for candor and integrity in securities disclosure. Likewise, more frequent mergers among professional service firms - now common among law firms - reduces bonding value. n152

Behavioral psychology contributes further explanations for why gatekeepers depart from the rationality-based assumptions of reputational constraints against misbehavior. First, gatekeepers may succumb to biases and use heuristics that prevent exercising best judgment. n153 Among numerous examples are the self-serving bias and the commitment

bias, which can afflict auditors, lawyers, and other gatekeepers. The first [*351] refers to a tendency to interpret data and assess uncertainty according to one's own self-interest. The second refers to a tendency to continue to believe positions one already has taken, which can induce continued confidence in mistaken beliefs instead of corrections using new information. n154

Structural devices can address such biases. For auditors, self-serving bias can be neutralized by reposing auditor supervision in audit committees and commitment bias by rotating audit partners through different auditing engagements. n155 It is harder to combat more general behavioral biases known as "backward recursion" and the "time delay trap." n156 These biases incline people to discount the significance of future events or circumstances, even those posing high-magnitude consequences, and to value instant gratification at higher levels than equal measures of deferred gratification. n157

While all of the foregoing systemic factors contribute partial explanations for gatekeeper failure, associated analysis and reforms tend to revolve around the scholarly literature's enduring focus on reputation constraints plus liability risk. n158 These systemic factors seem to explain why reputation assumes lesser importance in certain market environments. n159 Reforms tend to focus either on reinvestment in reputations or enhanced litigation threats. n160 An important oversight in such a framework is [*352] how liability risk can induce gatekeepers to invest, not in reputations for effectiveness, but in campaigns to limit or eliminate the scope and type of their undertakings.

Examples of how increased litigation risk results in gatekeeper pushback include (1) for auditors, resisting any undertaking to opine on the reasonableness of accounting principles that management selects or to detect fraud; and (2) for lawyers, resisting any duty to conduct due diligence or to opine on disclosure integrity to constituents other than a client's board of directors (or, in some circumstances, a securities underwriter). n161 In each case, a "Catch-22" appears: without litigation risk, gatekeepers acquiesce, but with it, they want limited responsibilities. While a system reliant on reputation and litigation risk cannot unwind this conundrum, adding a carrot-based merit component to the system might help.

III. INCENTIVE REWARDS

This Part explores how developing positive incentives or rewards can promote more effective capital market gatekeeping. Part III.A outlines the intuition and sketches a formal general model. Part III.B considers practical steps required to implement such rewards. This emphasizes and illustrates private arrangements that can be designed to adjust existing incentives. Part III.C turns to how public recognition can contribute additional incentives at very low cost.

A. General Model

This Section outlines a general model of incentives for gatekeepers. It begins with the intuitive motivation followed by an account of the model under assumptions of rationality and then under assumptions of behavioral economics.

1. Intuition

Popular corporate governance strategies include incentives designed to align principal-agent interests. n162 The most conspicuous [*353] of these are executive compensation packages tied to corporate performance. n163 Stock options are the most common form of these incentives. They epitomize the intuition behind any merit system: stock options give managers incentives to increase stock price. Critics debate the effectiveness of these devices, however, with some asserting that they overreach by tempting managers to provide misleading reporting to artificially inflate stock prices. n164

If the benefits of stock options are real, as devotees contend, similar benefits should accrue from awarding analogous options to gatekeepers. If the deleterious effects of stock options are real, as critics claim, an ideal response is to offer countervailing incentives to gatekeepers to neutralize those effects. If risk of misleading reporting increases in tandem with stock-based compensation, a precise antidote is merit-based gatekeeping to offset that increase.

The intuition is akin to a hypothetical model of incentive compensation that Warren Buffett offered concerning investment banking services. At a symposium discussing how boards of directors assess mergers, Buffett considered the role that advisors play, especially investment bankers. n165 Many investment bankers charge contingent fees for merger transactions, giving them strong incentives to close a deal even if not in the client's interests.

[*354] To correct for this perversion, Buffett quipped as follows: "If I'm going to pay \$ 5 million to somebody if they give me the advice and the deal goes through, then I think I probably ought to pay \$ 5 million to somebody else

whose advice I listen to who gets paid the \$ 5 million only if the deal doesn't go through." n166 Similarly, if shareholders pay senior executives incentive compensation to achieve designated corporate performance measures, they should be willing to pay gatekeepers incentive compensation to assure those performance measures are achieved using fair reporting.

This intuition can be amplified by insights that Professor Richard W. Painter contributed concerning law firms in merger transactions. n167 Professor Painter noted that some law firms also use contingent compensation arrangements, sometimes with disastrous consequences for shareholders. Professor Painter offers the example of a \$ 35 million contingent fee that Time Warner Co. paid to a law firm upon the closing of its merger with America Online (AOL). n168 The price Time Warner paid for AOL in that merger was exorbitant and wound up costing its shareholders some \$ 200 billion in investment value. n169 As with Buffett's quip about bankers, Time Warner shareholders would likely have benefited if the company paid one law firm \$ 35 million if the deal closed and another firm \$ 35 million if it did not.

This example furnishes additional intuitive support favoring an incentives program for gatekeepers. Enterprises can promote effective gatekeeping by deploying two teams of lawyers rather than one. Moreover, to correct this problem, Professor Painter advocated banning lawyer contingent fees in corporate transactions. n170 This sensible proposal is akin to existing bans that prevent auditors from charging clients contingent fees. n171 The underlying rationale is to impair managerial power to bribe gatekeepers into complicity.

[*355] An additional step could strengthen gatekeeper effectiveness. Contingent fees could be provided to gatekeepers (auditors or lawyers) who discover and correct misreporting under circumstances when they otherwise have no legal obligation to do so. This would not require amending the ban on auditors charging contingent fees or interfere with imposing a similar ban on transactional lawyers. n172 Auditors (and lawyers) would still charge fees for professional services as under current practice. They would also earn additional fees upon discovery of errors or irregularities not otherwise within their existing responsibilities to uncover or disclose. n173

An incentives program can respond to some of the diagnoses of gatekeeper failure noted earlier in this Article. First, it generally is agreed that managers have considerable power over auditors who serve in a consulting capacity. n174 Firing an auditor for being tough is a red flag to the market, but firing an auditor from its nonaudit services is not. Thus, managers offered a carrot while holding out a stick: a favorable audit in exchange for lucrative consulting assignments. Auditors in the [*356] consulting business may have offered favorably lax audits to generate more assignments. n175 As Professor Coffee says, "the carrot works better than the stick, precisely because the threat to take the carrot away [can be] more credible." n176

This insight suggests inverting the policy experience. If auditors who are paid bonuses to do consulting work became more lax on audits, then paying them bonuses for fraud detection and discovery should improve audit effectiveness. During the 1990s, firms adopted the business model that rewarded audit partners for generating consulting work. It should be attractive to let firms adopt the business model that rewards audit partners for generating fraud-detection work. This would provide additional compensation for success in performing a watchdog function, and thereby supplement the existing regime that imposes liability risks.

Second, a common diagnosis of the reputational constraint failure considers how a firm's and a partner's incentives may differ. n177 Professor Coffee responds that, while plausible, this diagnosis is incomplete. If a firm really sought to protect its reputation, then it would control those persons through mandatory rotation of assignments or by imposing caps on nonaudit revenue they could earn. n178 This response, which seems correct, also contributes to the intuitive case for creating gatekeeper incentives. If firms wished to pursue the ends as Professor Coffee hypothesizes, then an internal merit system, such as awarding points or compensation for fraud detection, should be attractive.

Third, the standard conception of auditor reputation emphasizes investor assessment of auditor integrity - a conception that applies equally to other gatekeepers. n179 So viewed, carrots play no obvious role because integrity reflects a "disclose if detected" approach. But if one emphasizes a gatekeeper's reputation with management for toughness, carrots become more obvious tools. Given the inherent limits that gatekeepers face in testing the veracity of managerial assertions, reducing misreporting requires managers to believe that gatekeepers are ruthless. [*357] That reputation can be enhanced by rewarding them for successful detection and correction of misreporting.

Finally, some believe that lawyers who were paid with clients' equity securities suffered impaired judgment as a result. n180 This can be akin to the downside of compensating managers using stock options. While both tools can tend to align the interests of the gatekeepers/agents with those of the principal, they also can overreach and induce acquiescence

in misreporting. This likewise suggests inverting the experience. Instead of compensating gatekeepers in client equity securities, positive incentives should be offered in cash and paid as bonuses for discovering misreporting.

2. The Model Under Rationality Assumptions

A basic formal model of gatekeeper decision making compares the gains from acquiescence to the expected costs of inculcation. An incentives program adds gains from vetogating to the model, which must be sufficient to tip the balance for both firms and individuals. The following discussion presents a general model of this calculus, divided into three subparts: (1) a cost-benefit calculus; (2) the estimation of optimal gatekeeper payoffs; and (3) some alternative approaches and variations for specific situations. The discussion in this Section proceeds on the assumption of economic rationality among actors; the next Section considers the model under behavioral assumptions.

a. Cost-Benefit Calculus

Professor Kraakman's original formulation of the gatekeeping model identifies effective gatekeepers as those with incentives that differ from clients in that they have "less to gain and more to lose" from granting capital market access to clients who misreport. n181 Gatekeepers stand to gain the value of the bribe and stand to lose reputation value and liability costs. Neglected in this and kindred formulations is what gatekeepers have to gain from turning the petitioner away - true, they have to gain a good reputation with instrumental value. But just as the one side of the equation emphasizes "more to lose" in both reputation impairment and legal liability and the other side emphasizes "less to gain" from complicity, the formula should also emphasize "more to gain" from disruption.

[*358] A simple fact pattern illustrates this situation. In connection with a pending transaction, a corporate employee commits fraud (say booking false revenues). Gatekeepers participate in generating related documentation (say investment bankers draft, auditors certify, and lawyers finalize in disclosure documents). The gatekeepers have duties in respect of the transaction and also opportunities apart from those duties to become aware of the fraud. For each, gatekeepers must decide whether to perform their duties (and, if they discover anything, to correct, disclose, or withdraw) and whether to perform additional tasks, not otherwise required, that may uncover it (and then face the same set of alternative decisions).

In each case, a complex set of costs and benefits appear. Benefits of complicity at each step include fees from the pending transaction, the present value of probable future fees from other transactions, and any slice of the fraud such as bribes to acquiesce. Costs of complicity include the discounted probability of inculcation. Following most gatekeeper theory, the gatekeepers wish to preserve and promote a reputation for veracity and thoroughness and thus see complicity as a potential cost in reputation. In some cases, the gatekeeper may prefer a reputation for complicity and thus make the opposite calculation. n182 Setting those latter cases aside for the moment, the following formulation captures the elements of these decisions: n183

$$BF < > Pd * [(Pe * Ll) + Lr]$$

where:

[*359] BF = benefits from fraud (of complicity in misreporting)

Pd = probability of detection

Pe = probability of enforcement

Ll = legal liability

Lr = reputation damage

This formula expresses the relationship between the benefits of complicity on the left hand and the costs of inculcation on the right. It captures how rational actors will facilitate misreporting when the benefits from fraud, BF, exceed expected total costs. Expected total costs depend initially on the probability of detection, Pd. Assuming detection occurs, then expected legal liability is the product of the probability of successful enforcement, Pe, and associated legal liability, Ll. Expected total costs add reputation damage, Lr, to that result.

Recall how assessments in the literature, including diagnoses of the Enron era, highlight misaligned incentives and underdeterrence from inadequate liability risk. n184 The foregoing formula captures these, respectively, in the magnitude of the benefits from fraud (complicity in misreporting), BF, and the magnitude of legal liability, Ll. The misaligned

incentives thesis as applied to gatekeepers supposes that BF was too high compared to Lr and the legal liability thesis supposes that Ll was too low compared to the optimal level.

Recall also how the literature has said little about incentive compensation from disrupting misreporting. The literature concentrates almost entirely on the misaligned incentives and legal liability theses. If carrots were added, the gatekeeper's decision would include weighing the payoff that she would earn from disrupting misreporting. In the formula, this means adding a new variable to the right side to capture this gatekeeper payoff, as follows:

$$BF <> Pd * [(Pe * Ll) + Lr] + GP$$

where:

GP = gatekeeper payoff from effective gatekeeping (i.e., incentive payments received for disrupting misreporting)

[*360] For convenience, in the ensuing discussion, the components of this expanded formula will be referred to as follows: GP for these newly added gatekeeper payoffs, BF for the benefits of misreporting, and TC for the total expected costs of inculcation:

$$[Pd * [(Pe * Ll) + Lr]]$$

b. Optimal Gatekeeper Payoffs

The level of gatekeeper payoffs (GP) must be sufficient so that the benefits of misreporting are less than the sum of the total costs of inculcation plus gatekeeper payoffs from effective gatekeeping. In the formula's terms, GP must exceed BF - TC (so that $BF < TC + GP$).

The required gatekeeper payoff (the amount of GP) will vary with attributes of different professions, functions and environments. But to offer a sense of the parameters, it should be possible to hazard reasonable theoretical approximations of minimum and maximum levels. The minimum GP might be approximated by reference to a deciding agent's opportunity cost - a portion of BF. A maximum level might be approximated by reference to the next best deterrence strategy. Appreciating that these are analytical and illustrative rather than scientific or definitive, consider each in detail.

As to approximating the minimum gatekeeper payoff (GP), gatekeeping firms should compensate members to motivate them to build the firm's long term reputation but, for firms, retention requires meeting employee opportunity costs. n185 A professional's opportunity costs - gains available from the next best option - are determined largely by the managers with whom she regularly interacts, meaning clients, whose assessments of a professional's reputation is significant (for example, they will be asked to provide references should the professional later seek new employment). This can put her allegiances with those persons, not with her firm. This increases the firm's costs of monitoring her clients. To neutralize this, a minimum GP would be that amount necessary to bond the professional's interests to the firm's long term reputation. In this approximation, that is the amount of those opportunity costs.

In approximating the maximum gatekeeping payoff (GP), it must be no greater than the next best alternative strategy (if [*361] it were greater, then the alternative would be superior). For illustration, among candidates for the next best deterrence strategy is a legal regime that imposes vicarious personal liability on partners of the deciding actor's firm. Partner X is liable for violations of Partner Y. This increases Partner X's incentives to monitor Partner Y. But as Professor Larry E. Ribstein explains, "this liability may be ineffective because it places risk on those who are ill-situated to prevent harm." n186 Thus, such a system of negative threats may create excessive incentives for internal monitoring and yet remain ineffective.

As a next-best strategy, the alternative can be used to approximate a maximum level of gatekeeper payoff (GP). Using incentive contracts, Partner Y earns rewards that reduce the need for Partner X to monitor Partner Y. Rather than impose vicarious liability on Partner X for "wrongs" of Partner Y, the program awards Partner Y bonuses for "rights" that reduce Partner X's need to monitor Partner Y. The maximum GP, then, would be the cost to Partner X of engaging in such oversight (again, if GP were more than that, the vicarious deterrence alternative would be superior). n187

c. Other Approaches and Specifications

Other avenues for estimating the parameters or ranges of optimal gatekeeper payoffs (GP) are possible. I provide the foregoing examples to suggest the model's feasibility rather than to delineate it completely. In the same vein, it may be useful to consider alternatives to the existing stick-oriented gatekeeper regime and examples of specifications that may be useful in developing an incentives program.

As to approaches other than adding incentives for gatekeepers, some critics lament the limitations on the reputational constraint, which are manifested by the discrete and cumulative failures of private gatekeeping. They prescribe displacing it altogether in favor of an emboldened public enforcement program through a strengthened SEC. n188 This is extreme because it removes other benefits of the private gatekeeping model, which is far less intrusive than would be an SEC or other purely public model. n189 Perhaps it is a superior policy prescription. [*362] It is intended to increase the expected total costs of inculcation (TC) through regulatory empowerment. Yet it may be more prudent to continue to work with the existing model by adding gains from gatekeeping (GP) before taking such a radical move. It addresses the misaligned incentives problem by offering short-term personal gain not to be in on the fraud.

Another alternative to adding gatekeeper payoff incentives is to manipulate the expected total costs of inculcation (TC) using devices other than cash. Professor David McGowan proposed that securities lawyers who are first to disrupt misreporting be rewarded with transactional immunity from any related prosecution. n190 This is a valuable contribution to the literature. Yet it is a narrow change: it applies only to lawyers for a limited whistleblowing function and provides the carrot of lenity (which may be perceived as a lighter stick than a carrot). This Article is exploring a broader model for use by all gatekeepers and contemplates paying cash (and providing other forms of public recognition as noted in the next Section).

This exploration is thus more general, which means that the foregoing model requires specification for particular applications. First, it requires specification according to the professional identity of different gatekeepers. What works for auditors may not work for lawyers. An important issue is how to interpret the reputational constraint. For auditors, all seem to agree that enforcement and compelling disclosure increase reputation value whereas, for lawyers, scholars debate whether a reputation for complicity is more valuable than one for probity. n191 In the foregoing model, this difference between auditors and lawyers concerns whether to locate reputation, [r], on the left or right side of the formula. While [r]'s location influences the required amount of gatekeeper payoffs (GP), explicitly adding that variable to the calculus is useful under either assumption.

An incentives program requires specification for variations among gatekeepers and whistleblowers (and hybrids). As traditionally defined, gatekeepers are present to prevent access to capital markets or to correct misreporting before granting [*363] access. n192 They bear duties to do so and may be more often exposed to bribes for complicity. Whistleblowers traditionally report after a violation has occurred and a party has passed through the gate and accessed capital markets. n193 Whistleblowers often do not have duties to report so those engaged in misreporting may be less conscious of the value of offering bribes to them. Accordingly, relationships between benefits of complicity and costs of inculcation vary as between gatekeepers and whistleblowers (and hybrids). These differences do not alter the basic relationships between benefits and costs in the general model but would require specification for particular applications.

3. The Model Under Behavioral Assumptions

Turn from the rational cost-benefit calculus to some critiques from behavioral economics. Professor Robert Prentice identifies two important behavioral limitations on the reputational constraint: backward recursion and a time delay trap. Both limitations can be neutralized using the right positive incentives. n194

First, consider backward recursion, where short-term returns from dishonesty dwarf future benefits from honesty. n195 This problem is acute in certain settings, including end-game contexts (say, a person near retirement or a firm near dissolution), internal principal-agent contexts (where a firm's reputation counts but an individual member gets little benefit from it), or when gains to individuals exceed probable future losses or through misestimation of any of these and related penalties. n196

While an incentives program may not eliminate these biases - especially the risk of misestimation - it helps to counteract them. n197 It would increase the short-term returns from honesty. [*364] It can surgically respond to settings where risks of backward recursion are acute. For end-games, it increases retirement resources and firm solvency; it closes the reputation gap that arises from misaligned incentives. If gatekeeper payoffs (PF) are sufficiently large relative to the difference between benefits from complicity (BF) and expected costs of inculcation (TC), positive incentives can reduce the risk of misestimation.

Second, gatekeepers may suffer from a time-delay trap. n198 The trap arises when people over value instant gratification. n199 Gatekeepers may under appreciate the long term effects of building a reputation, which may take years, and thus delay gratification. n200 This condition manifests in improper activities promising immediate payoffs if either detection is unlikely in the long term or the long term is sufficiently distant to be discounted into immateriality. Self-serving bias can exacerbate this condition when people assess information supporting self-interest, as by rationalizing

fraudulent schemes. Carrots counteract these biases. Cash paid today offsets the discounting effect by providing gatekeepers immediate rewards. Cash compensates gatekeepers for not being in on a scheme, and thus reduces the likelihood that they will overlook the long term risks of liability.

Professor Painter notes that regulations do little to address cognitive biases gatekeepers may face. n201 For example, commitment bias can induce auditors to hide post-reporting discoveries or induce lawyers to adhere to previous assessments of the probability of litigation outcomes despite new information tending to contradict the assessment. n202 The resulting biased judgments can infect related disclosure. Possible solutions include the use of audit committees as auditor supervisors, as required by the Sarbanes-Oxley Act, or obtaining a second lawyer's opinion (an option but not a regulatory requirement). [*365] Neither solution is perfect or complete, but adding an incentives program can reduce the imperfections further. n203

B. Private Arrangements

If the intuition and formal general model are potentially appealing conceptually, it remains to consider practical steps necessary to implement it. The following discussion considers private arrangements for lawyers and auditors, surveying services that an incentive program might encompass and sketching some parameters of how private contractual arrangements can be designed to fund and execute them.

1. Services

Rewards concentrate on functions that would be productive for gatekeepers to perform, although not otherwise required by law. This category can be large and exists, in part, because of gatekeepers' reluctance to accept categorical exposure to liability for undertaking associated functions. The following illustrates some services that the program could encompass. It classifies them for convenience into two categories: investigation and certification. Examples of each are provided for both lawyers and auditors.

a. Investigation

For lawyers, a good illustration of investigation services concerns due diligence exercises. Laws permit, but do not require, lawyers to perform due diligence in numerous capital market transactions, from underwritten public offerings to change of control arrangements. Lawyers conduct due diligence because performance creates a defense against securities law liability. n204 Failure to perform, or failure to discover problems [*366] and disrupt access to capital markets, does not, ipso facto, expose lawyers to liability. n205 However, lawyers are component to perform the exercise and sometimes are expressly retained to do so, such as when an enterprise attempts to detect specific misconduct that has come to its board's attention. n206

For auditors, a good illustration of investigation services concerns fraud detection. Auditors conduct full-scale audits of clients but are not strictly obligated to search for fraud. n207 Failure to discover fraud does not, in itself, expose auditors to legal liability. Professional auditing standards articulate a modest measure of obligation to detect fraud, but its exact scope as a matter of law is contested and uncertain. n208 As a result, its execution in practice is limited. n209 Auditors prefer to deny having any duties that would flow from a broad interpretation of the [*367] standard. n210 Nevertheless, auditors sometimes assume express contractual duties to investigate for fraud, such as when they are engaged to conduct forensic audits. n211 Auditors actively promote the value of this service. n212 As with lawyers who undertake contractual duties to conduct due diligence, this signals that auditors command the professional skills and ingenuity required to perform this service.

b. Certification

Written legal opinions are examples of certification services that lawyers provide. Lawyers often provide these to clients for various securities-related matters and sometimes prepare them for others at a client's request. n213 A common example occurs when an underwriting agreement conditions the underwriter's duty on receiving an opinion from issuer's counsel concerning the legality of the transaction and compliance, as to form, with federal securities regulations.

Lawyers' opinions tend to be narrowly drawn and addressed. They invariably provide "negative assurance." n214 The opinion usually states that the firm conducted investigations it deemed necessary and that nothing came to its attention that would prevent it from opining that the transaction is lawful and that disclosure is in conformity with regulations. n215 Reliance is expressly limited to addressees, usually a client's [*368] board of directors (or, sometimes, an underwriting firm of a client's securities). Apart from contractual requirements and modest risk of liability such as neg-

ligent misrepresentation, failure to provide an opinion does not expose a firm to legal liability or even reputational damage. n216

Written comfort letters are examples of auditors' certification services. In securities underwriting, an underwriter's obligations are conditioned on receipt of a designated comfort letter from the issuer's auditors. As with lawyers' opinions, these provide negative assurance and do not require the auditor to conduct any particular investigation. n217 In present practice, evidence suggests that auditors expressly disclaim any specific responsibility for detecting fraud, echoing the profession's more general aversion to accepting such duties. n218

c. Why Law Does Not Mandate These Services

Law could require that gatekeepers render investigation and certification services of the kind just described. It could mandate that lawyers perform due diligence in securities transactions and provide formal written certifications to designated transaction participants, including investors. n219 It could require that those certifications state affirmatively that disclosure is fair and accurate in all material respects. Laws could clarify that auditors are responsible for detecting fraud and require that they provide specific positive assurance to underwriters or other transaction participants. But laws have not done so and probably for good reasons.

First, such blanket mandates may demand more than is necessary. Not all enterprises require comprehensive gatekeeper vetting. n220 Second, those mandates might demand more [*369] than is possible. Fraud and other sources of misreporting can be hidden in ways that no professional could discover. n221 Risks of error can be so high that the expected costs to the professionals exceed the price that they could charge for backstopping their opinions. As a result, the professions resist accepting such duties as a political matter. n222 This implies, however, that the threat of legal liability can backfire. Auditors and lawyers have a comparative advantage to investigate and certify yet, under the existing regime, these services may be rendered on suboptimal terms. n223 Designing a system in which auditors and lawyers would agree to perform these functions - without fear of legal liability - is thus appealing.

2. Contracts

Contracts are useful devices to induce gatekeepers to render investigation and certification services. The following discussion presents some requirements to promote contract effectiveness, evaluates possible contractual arrangements and incentives, and notes the risk of creating excess incentives.

a. Requirements

Effective contracting to make a positive incentives program useful probably requires at least the following attributes. First, the program's strength depends on generating and channeling sufficient funds to gatekeepers. n224 Compensation must be sufficient to fund an optimal level of gatekeeper payoffs (GP). The [*370] challenge is finding the funding. Ideally, funds would draw on resources that already exist in the capital formation process. One possibility, discussed below, is contractual reallocation of deal cash flows, chiefly from issuers and underwriters to auditors and lawyers.

Second, the program should satisfy the requirements of a signaling equilibrium. The strength depends, in part, on dissemination of information about it to capital market participants. n225 The contracts provide signals to market participants; enterprises giving gatekeepers incentives to disrupt misreporting should benefit from lower costs of capital compared to those unwilling to do so. n226 Signals work when the cost of signaling varies inversely with actual quality (i.e., it costs more for lower quality actors to signal; if it were cheaper to do so, everyone would signal and the value would plummet). n227 An incentives program would satisfy this condition because it would impose costs on low quality signalers that they would be unwilling to pay.

Third, all incentive-based exercises that gatekeepers undertake would be optional. Services that gatekeepers are otherwise legally required to perform are outside its scope. This triggers a related final requirement that judicial interpretation of resulting agreements should be strict. A law or auditing firm that expressly agrees to examine an enterprise to uncover misreporting, but fails to do so, should not face liability if the express terms of the contract do not carry any guarantee of performance. Litigation risk must not be so high that the expected liability costs of undertaking the optional functions exceeds the fair market contract price for undertaking them.

b. Modifying Present Practice

Modest modification to present practice would enable the implementation of positive gatekeeper incentives meeting the foregoing requirements. The following is intended to illustrate [*371] one context in which this could work - without meaning to be exhaustive. n228 Take the examples given in Part III.B.1 concerning lawyers' opinion letters and auditors' comfort letters. Both are products of underwriting agreements and reflect that those professionals conducted investigations they deemed necessary and that nothing came to their attention to prevent providing the certification. The professionals earn their fee as a result, in accordance with their retention or engagement agreements with issuers.

Under positive incentive contracts, in contrast, the professionals would agree with issuers to undertake the investigative functions and earn compensation to the extent, and only to the extent, that the investigation results in discoveries of misreporting. The important negotiated provisions would address compensation, delineate the activities or discoveries that generate it, and reference verification measures. In the best scenarios, those discoveries would result in correction and still enable the issuer to access capital markets; but the gatekeepers would also be paid in cases where their discoveries led to denying that access. All participants in the transaction - underwriters, issuers, auditors, and lawyers - have incentives to enter into these arrangements.

For underwriters, there are several incentives to modify existing arrangements in favor of this kind of program. First, the program need not replace the existing conditions set forth in underwriting agreements that generate negative assurance. Second, underwriters are gatekeepers too, and face reputation and liability constraints elaborated in the traditional gatekeeping [*372] model. They can protect reputation and reduce liability risk by increasing the effectiveness of their fellow gatekeepers. Current evidence indicates that underwriters are seeking to have auditors perform such functions but auditors are unwilling to do so. n229 An incentives program can break the resulting stalemate. Accordingly, it should be desirable, in principle, for underwriters to agree with issuers to create optional opportunities for their fellow gatekeepers to actively seek to discover and correct misreporting.

Most issuers should find this strategy attractive. True, enterprises that are institutionally dedicated to misreporting would find the proposal repellant. But the resulting differentiation among issuers creates the required signaling equilibrium to increase the program's strength. For investors, this would separate enterprises according to the relative probability that their reporting is fair compared to misleading. n230

Furthermore, while difficult to verify empirically, it does not seem common for entire enterprises to be institutionally dedicated to misreporting; more commonly, individual agents within an enterprise wish to misreport. In either case, the reforms made in the Sarbanes-Oxley Act create internal governance structures associated with boards of directors that can be useful. n231 Willingness to adopt arrangements to implement such a structure would likely have to originate with an issuer's board of directors, although it is not impossible to believe that senior executives would find it attractive, so long as they are not among an inner circle committed to deception. n232

Within issuers, audit committees should support and be able to develop gatekeeper incentives. Many believe that the [*373] most important of the changes in the Sarbanes-Oxley Act is the creation of audit committee power over auditors. n233 The law reposes in audit committees the power to select, compensate, supervise, and terminate auditors, as well as more power over the selection of appropriate accounting principles through a formal role in resolving disagreements between management and auditors and expressly empowering audit committees to retain independent counsel and other advisors. n234 Audit committees now wield considerable influence in the audit function and could easily develop incentive contracts and other programs to promote effective gatekeeping, by both auditors and lawyers.

For audit committees who believe that the rewards approach is conceptually appealing in principle, this aspiration can be stated expressly as part of the audit committee's charter. To the extent that the issuer assumes responsibility to fund bonus compensation that lawyers or auditors earn in the exercise, they should be able to command requisite resources internally from the enterprise under the Sarbanes-Oxley Act's provisions requiring that issuers give audit committees a sufficient budget. n235 Committees can argue, credibly, that associated costs will be vastly outweighed by saving the costs of later-discovered misreporting.

The issuer would not have to fund 100 percent of the awards. Award funding would be subject to negotiation between the issuer and underwriter. The issuer could agree to pay all bonus compensation or the issuer and underwriter could agree to share designated portions. Funding a portion of the payout will be appealing to the underwriter according to its calculations, under the traditional gatekeeping model, of reputation and liability costs that result from later-discovered misreporting.

Triggers for the awards would likewise be subject to negotiation. They would specify threshold levels necessary to earn compensation and specify kinds of error or irregularity that are included and excluded. Parameters would reflect

the difference between activities that a gatekeeper is otherwise obligated to perform under existing law and those that it is contractually [*374] undertaking to perform. In delineating these boundaries in the underwriting agreement, all participants - issuers and underwriters as well as auditors and lawyers - would contribute to negotiations.

Resulting incentives should make this approach enticing to auditors and lawyers. Auditing and law firms could increase its appeal and effectiveness by designing internal compensation systems through which the contingency payments for discovery are channeled to appropriate personnel. Among other contributions, this would facilitate the prescription, noted earlier, to create mechanisms that support channeling negative information through a chain of reporting. n236 The philosophical aspects of a positive incentives program could be reflected within such firms in compensation systems. At present, audit firm partner compensation is tied to generating revenues from consulting or auditing work and, since the Sarbanes-Oxley Act was passed, on designing and testing systems of internal control. The Public Company Accounting Oversight Board (PCAOB) encourages firms to allocate resources and compensation to functions designed to improve auditors' technical competence. n237 Without diminishing the importance of these ways of allocating resources, sufficient flexibility appears that would enable compensation systems to channel gains from effective gatekeeping to responsible partners. The same should be true of law firms.

c. Risk of Excess Incentives

Contracts designed to create incentives for effective gatekeeping require attention to the (ironic) risk that gatekeepers will fabricate misreporting to obtain additional compensation. As a theoretical matter, this risk also exists in the current reputation-and-liability model of gatekeeping. Auditor reputations increase in value by repeated demonstrations of integrity, whether this is achieved by detecting and correcting misreporting or by more public statements such as resigning from an engagement. That can create a strategic temptation to be too strict on clients.

Similar strategic misfires could arise under incentive programs. To police for such temptations in this context, contracts would specify not only the kinds of discoveries that generate [*375] compensation, but also provide for a verification procedure. For payments by issuers to gatekeepers, audit committees can perform this function; in the case of gatekeeper firm payments to internal personnel, verification committees could be established. In general, however, it should be easier to detect fraud about fraud than fraud itself.

3. Teams

To expand the specific illustrations just given of how contracts can be designed to create positive incentives, consider a broader framework involving the use of teams in the gatekeeping setting. Traditionally, enterprises retain one law firm and engage one auditing firm in securities transactions and often, especially for law firms, they dispatch a single team of experts who work together on the matter. Commonly, another enterprise participating in the transaction likewise hires and dispatches lawyers and auditors (as with counterparties in a business combination or financing arrangement).

These traditional approaches could be adjusted. For example, as Professor Coffee has explored heuristically, an enterprise could engage two separate teams of lawyers for a matter or retain a single law firm, but have it dispatch two separate teams. n238 This construct reflects the dual role that lawyers play in such contexts, serving as advocates and advisors to the enterprise on the one hand and also serving a public gatekeeping function on the other. Tensions result. Using two firms or teams can enable the segregation of these functions so that each team can discharge professional responsibilities without ethical dissonance. While deploying two teams can be expensive and redundant, the notion should not be dismissed.

First, auditors functionally deploy the equivalent of two teams to work on a single engagement. Audit firms dispatch engagement teams to work on particular audits, but these must report to and interact with partners and other teams in the firms' national offices. The national office is functionally equivalent to an incentives-driven supervisory team. Using incentives, either team would be more willing to deploy more rigorous auditing techniques, as where teams may elect to perform the more rigorous testing required in forensic audits than in traditional financial statement auditing.

[*376] This auditing practice of using an engagement team subject to national office supervision has a parallel in the organization of some large corporate law firms. They maintain internal policies that subject individual retentions to internal review. Examples include having a committee of partners review new clients and obtaining second-or third-partner review of firm opinions on certain matters before issuing them. The New York law firm of White & Case LLP famously implemented these structures in its agreement settling charges arising from its role in the notorious National Student Marketing fraud of the 1970s. n239

Second, among lawyers, there invariably are two teams on cooperative transactions - usually from different law firms. In securities offerings, both the underwriter's and the issuer's counsel participate in due diligence exercises designed to enable the preparation of fair disclosure in the prospectus. In business combinations, each side, buyer and seller, retains lawyers to negotiate the governing agreements, along with voluminous disclosure schedules, on the basis of respective due diligence investigations. Likewise, both sides' lawyers often prepare opinions in those transactions. While both sides seek to protect their own client's position, they are most effective when generating maximum gains from the transaction-creating value, not just claiming it. n240

In transactions with two teams, it should be possible to design assignment and compensation contracts that, while meeting professional responsibilities, also promote lawyers' role as gatekeepers. The ideal would be contracts in which one team is designated as the closing team whose mission is to accomplish the transaction. The other is the gatekeeping team whose assignment is to perform due diligence and certification functions. The closing team can be compensated conventionally, as based on billable hours, while the gatekeeping team can be compensated according to a base rate plus contingent bonuses for the discovery of misreporting (whether or not corrected). Addressing the specific professional responsibilities may be difficult, but the example suggests the vitality of Professor Coffee's heuristic.

[*377] Third, enlisting and designating two separate legal or audit teams for a transaction copes with increased complicity risks when individuals and teams within a gatekeeper or among different gatekeepers are capable of conspiring. This is an important insight accompanying Professor McGowan's proposal to offer immunity to lawyers who disrupt misreporting: creating incentives to do so weakens the capacity to conspire. n241 Effective deal making requires that participants cooperate to a large extent; this capacity must be preserved. A good way to do so is to dispatch two teams with designated assignments, each of which would be cooperative to the end of (1) closing a transaction while (2) using fair reporting. Each would have incentives that contribute to promoting that twin result.

The dual-team approach reflects the insights from Warren Buffett's and Professor Painter's bilateral professional service retention models. n242 Two teams facing different incentives will be inclined to exert pressure against each other. Misreporting temptations by the closing team are offset by opposite incentives of the gatekeeping team; temptations to overzealousness among the gatekeeping team are constrained by the closing team's contrary incentives. n243

C. Public Recognition

Apart from cash compensation channeled by contract to effective gatekeepers and team design, a broader range of public recognition could form part of a carrot system to supplement the traditional gatekeeping model. A proposal to provide public recognition raises and requires addressing several additional issues. These are cultural challenges to implementing the system; the relation of compensation to professional morality; and how public recognition can create excessive incentives among gatekeepers to exercise gatekeeping prerogatives.

1. Culture

Effective gatekeeping relies not only on the conditions of reputation and liability threats but on broader cultural foundations [*378] that make those stimuli function. n244 In contemporary culture, media, regulators, and scholars concentrate on persons who failed to perform their functions. These persons or firms are "shamed" in the press, face liability at the hands of authorities, and are given analytical attention by scholars inquiring into diagnostics that can yield normative policy implications. n245 Media, regulatory, or scholarly attention on those gatekeepers who perform their functions successfully is much rarer. For this reason alone, a merit system should have some appeal to highlight the degree to which gatekeeping is effective.

In contrast, such public recognition is showered on "heroes" who, after the fact, exercise authority to prosecute the villains. Consider Eliot Spitzer. As Attorney General of the State of New York, he earned public "hero" status for his enforcement of laws in a wide range of contexts in the postbubble fallout. n246 That status, in turn, played a significant role in his subsequent election as Governor of New York. True, private whistleblowers such as Sherron Watkins of Enron shared in some of the limelight, but even then received mixed reviews, in part for her emergence long after the scandal had incubated. n247 Hero status is not conferred on gatekeepers or others who disrupt misreporting and correct it because their effectiveness is not normally publicly disclosed.

[*379] Consider a more proactive strategy of public recognition. Unlike with gatekeeping contracts or team structure components of incentive programs, public recognition does not necessarily require cash (or at least not large amounts). n248 A good model of public recognition are the Malcolm Baldrige National Quality Awards, named for a United States Commerce Secretary and awarded annually since 1988 to United States innovators who demonstrate ex-

emplary leadership in designated performance categories. n249 For capital market gatekeeping, the SEC or PCAOB could adapt this honor to recognize an "Auditor of the Year" or "Lawyer of the Year" for successful disruption of misreporting. It is more socially valuable to make heroes out of auditors and securities lawyers ex ante than of prosecutors (or plaintiffs' lawyers) ex post.

The parameters of systematic formal public recognition must be drawn carefully. This is necessary to appreciate a more general potential obstacle to paying rewards to effective gatekeepers: a traditional cultural aversion to ratting in the United States. n250 This aversion arises from how competing values such as loyalty and trust are implicated. n251 These can be in tension with whistleblowing or gatekeeping, which are forms of ratting. The strength or frequency of the aversion is essentially impossible to estimate and can certainly be overstated. Yet the existence of governmental bounty programs (such as those of the IRS and SEC) and of qui tam actions suggest that inducements [*380] are necessary to entice United States persons to rat on fellow citizens. n252

On the other hand, for capital market gatekeepers, these tensions should be more attenuated than for other citizens. The professional status of most gatekeepers embraces probity and integrity more compatible with disrupting misreporting than with loyalty in acquiescing to it. This tendency is probably strongest for auditors, whose training and self-identification entails professional skepticism that is a cognate of ratting. n253 The common designation of the profession as a public watchdog bears this out.

In contrast, lawyers face conflicting values. Enlisting lawyers as capital market watchdogs confronts the profession's traditional advocacy model and resulting principles of confidentiality epitomized in the attorney-client privilege. n254 Lawyers have not historically assumed a watchdog identity comparable to that of auditors. Despite that history, some sense of a watchdog function has animated at least part of the professional identity of the securities lawyer - as it has for other private lawyers who play a quasi-public role. n255 For securities lawyers willing to accept this somewhat complex identity, a carrot system can ease resulting tensions.

Either way, however, public recognition for such activities must be carefully drawn to be in tune with the public's general aversion to ratting. The "heroes" must be portrayed in much the way that Elliott Spitzer was presented. They must be seen as dedicated, public-minded professionals, perhaps seeking to advance their own careers - as Spitzer certainly did - but only in a way that is consistent with the public interest - likewise, as Spitzer did. n256

[*381]

2. Functions

The prevailing lack of public recognition for successful gatekeeping may also be due to the historical emphasis on gatekeeping functions as opposed to whistleblower functions. That is, gatekeeper models are designed to act internally within an enterprise rather than to shine the public spotlight on it. But public recognition for successful gatekeeping obviously would alter that.

A good example occurred in the 1970s when the auditing firm of Arthur Young blew the whistle on, and withheld support from, Lockheed Corporation amid the foreign government bribery scandals of that era. n257 Lockheed and its top managers had much to gain from concealing the scheme - it was criminal. But Arthur Young disrupted their ability to do so by disrupting Lockheed's access to capital markets. As theory would predict and explain, in Professor Kraakman's terms, Arthur Young had little to gain and much to lose from complicity. n258 And Arthur Young received considerable public recognition for its refusal in the contemporary press. n259

In contrast, today's sensibilities shower less praise on effective gatekeepers and instead tend to diagnose pathological cases for lessons about what went wrong and then generalize from these for systemic reform. n260 With that orientation, it is unsurprising that policymakers and scholars incline toward refashioning [*382] the duties and liability strategies in search of optimal deterrence. An alternative, less common approach would examine how and why things go well. Reputation and liability risks may influence a professional's decision making, but more fundamental norms drive professional behavior too. n261 Many professionals who perform effectively do so to obtain satisfaction from a job well done - not for fear of liability or damaging reputation. What should the consequences be of doing a good job?

For many critics, it appears that doing a required job is simply the norm and doing it well deserves no special praise. But if one condemns those who fail in their job, why not be willing to recognize those who perform their jobs well? A more general and affirming response to good work is recognition. This can assume many forms, from a simple expression of gratitude (like a supervisor's pat on the back or handwritten note) n262 to a more forthright public expres-

sion of appreciation. A carrot system could envision that kind of public recognition for disrupting misreporting (in addition to the form of cash incentive programs discussed in the preceding Section).

This may raise an objection. It may appear redundant to pay gatekeepers extra for doing what they ought to do - whether required by law or by professional or other nonlegal commands. n263 As to legal requirements, the proposal preempts this objection to avoid problems of contract law's preexisting duty rule. n264 The proposal envisions a program that pays compensation or recognition for performing functions that are not otherwise legally required. As to professional or other nonlegal commands, the objection is harder to meet, for it is valiant to emphasize such commands and project ethical appeals to induce superior gatekeeping. Yet it seems more realistic to appreciate [*383] how cash and public recognition can contribute to achieving those aspirations.

Perhaps paradoxically, cash and recognition may even be edifying vehicles to reinforce professional principles. Consider how structural forces catalogued earlier may have reduced gatekeeper incentives to invest in reputational capital. n265 Among audit firms, the phenomenon of cross-selling (bundling consulting assignments to auditing engagements) changed auditing culture from professionalism to commercialism. Since reversing culture is difficult, n266 tools that work within existing culture are more promising than those alien to it. A carrot system works within existing commercial culture by paying people bonuses when successful as detectives. That should induce investment in reputation despite contrary forces and that, in turn, would promote an ethical sense of probity and integrity among those so compensated.

3. Effects

In the years after the Sarbanes-Oxley Act passed, critics complained of what they saw as a decline in United States' competitiveness in global capital markets. They cited a decrease in the frequency and size of initial public offerings in New York compared to London, and a decline in the number of public companies listed in the United States. n267 Implicitly, these critics essentially argue that gatekeeping can be too effective. A carrot system, in this view, is the last thing these markets need. This critique invites brief remarks on the parallel but different system of gatekeeping that appears in the legislative process.

Certain theories of the legislative process emphasize the presence of multiple "vetogates." n268 These refer to choke points [*384] in the legislative process that enable participants to obstruct the passage of legislation. n269 Examples include congressional bicameralism, presidential presentment, supermajority voting (as with overriding a presidential veto), formal standing rules, senatorial rules concerning filibusters and cloture, the committee and conference reporting systems, and even informal legislative mores. n270 Numerous gatekeepers participate in activating these vetogates, including the President, as well as committee chairs, senior Senators and House members and, especially, lobbyists. n271 The result is that the vast majority of bills do not become law, a deliberate strategy designed to minimize the risk of suboptimal lawmaking as well as to promote confidence that law is supported by consensus. n272

Compared to the legislative process, the capital formation process is modestly parallel yet radically different. The parallel concerns how system design contains numerous vetogates. Consider the many opportunities to activate vetogates in a typical securities transaction, say a public offering: hiring an underwriter to sell it; attracting securities analysts to follow it; retaining lawyers to negotiate and document the terms and furnish legal opinions; engaging auditors to audit financial statements (and internal controls) and offer related comfort letters; for debt, getting a rating agency to rate it; requesting that the SEC declare the related registration statement effective; and closing the transaction. Without being scientific about it, there appear to be as many vetogates in capital market transactions as there are in the legislative process.

The radical differences between vetogates in legislative processes compared to capital market transactions concern the purpose of these devices and the orientation of participants. Vetogates in legislative processes are intended to reduce the probability [*385] of passing legislation and this is seen as necessary to promote the appearance and achievement of consensus and the effectiveness of laws. n273 For securities transactions, the cultural milieu is nearly exactly the opposite. Participants want to facilitate the deal, enable the financing, and form or transfer capital.

Some vocal critics of the Sarbanes-Oxley Act imply that more capital market transactions are better and more public companies are better - they criticize the Act's fallout by showing proportionately fewer public offerings made in New York compared to London and a falling number of public companies in the United States. n274 But becoming and staying a public company historically were - and probably should be - badges of honor. To sustain that designation, it should not necessarily be easier to become or continue as a public company than it is for a bill to become law.

It is unlikely that vetogating in capital markets would or should ever be more common than vetogating in legislative processes. Capital market vetogates are not discretionary in the same way they can be in the legislative process. Rather, the system installs additional cross-checks designed to counterbalance competing incentives. Managers who are inclined to misreport when doing so earns lucrative gains from stock options currently face gatekeepers whose compensation is not tied to reporting accuracy, except through vague reputation constraints and liability risks. Tying gatekeeper compensation to the disruption of misreporting would neutralize contrary incentives. The potential risk the system raises of excessive vetogating is further reduced by the continuing presence of participants with strong incentives to get deals or audits done.

CONCLUSION

Regulatory reform and scholarly literature concerning capital market gatekeepers have historically concentrated on penalties [*386] for failing to meet legal duties or structures to promote investment in reputations. Imposing penalties to deter acquiescence is a natural response, in part because acquiescent gatekeepers assume a vivid public posture amid publicized fraud, and in part because lawyers and law naturally look to liability design to influence behavior. Penalties may be necessary to achieve optimal deterrence. Promoting investment in reputations for integrity likewise produces a valuable contribution to capital market integrity.

A new line of inquiry is developing that focuses on rewarding gatekeepers. This innovation should have considerable purchase when one considers how the reputational constraint and liability threats were insufficient to deter widespread ineffective gatekeeping during the late 1990s and early 2000s. We have learned in recent decades that positive incentives may be more likely than negative threats to promote desired behavior. That insight can and should be adapted to promote effective capital market gatekeeping. The examples provided in this Article of how to redesign contractual cash flows and deploy professional teams, as well as increase public recognition for gatekeeping success, are intended to advance that discussion.

Legal Topics:

For related research and practice materials, see the following legal topics:

Banking Law
Bank Activities
Securities
Retail Repurchase Agreements
Labor & Employment Law
Employer Liability-
False Claims Act
General Overview
Labor & Employment Law
Wrongful Termination
Remedies
Compensatory Damages

FOOTNOTES:

n1. Tamar Frankel, Using the Sarbanes-Oxley Act to Reward Honest Corporations, *62 Bus. Law.* 161, 171-73, 189-91 (2006) (offering "honest corporations" exemptions from certain provisions of the Sarbanes-Oxley Act).

n2. See, e.g., Pamela H. Bucy, "Carrots and Sticks": Post-Enron Regulatory Initiatives, *8 Buff. Crim. L. Rev.* 277, 318-22 (2004); Richard E. Moberly, Sarbanes-Oxley's Structural Model to Encourage Corporate Whistleblowers, *2006 BYU L. Rev.* 1107, 1133-38; Geoffrey Christopher Rapp, Beyond Protection: Invigorating Incentives for Sarbanes-Oxley Corporate and Securities Fraud Whistleblowers, *87 B.U. L. Rev.* 91, 111-14 (2007).

n3. See Assaf Hamdani & Reinier Kraakman, Rewarding Outside Directors, *105 Mich. L. Rev.* 1677, 1691-93, 1703-07 (2007) (proposing a hypothetical reverse negligence regime in which directors can sue to recover rewards following a triggering event, such as misreporting, by proving that they were nonnegligent in performing their duties or otherwise exceeded designated standards, and also suggesting two more modest alternatives that reward directors who resign in certain circumstances and authorize board "leadership awards" to pay bonuses to outside directors for taking designated actions).

n4. See David McGowan, Why Not Try the Carrot? A Modest Proposal for Granting Immunity to Lawyers Who Disclose Client Financial Misconduct, *92 Cal. L. Rev.* 1825, 1837-38, 1840 (2004) (offering transactional immunity to securities lawyers who first report violations of law to authorities).

n5. The seminal contributions to the theory of capital market gatekeeping are Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 *Yale L.J.* 857 (1984) [hereinafter Kraakman, *Corporate Liability*] and Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 *J.L. Econ. & Org.* 53 (1986) [hereinafter Kraakman, *Gatekeepers*]. The ensuing discussion notes additional contributions to this literature.

n6. See, e.g., Ian Ayres & John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* 3-7 (1992).

n7. See Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 *Wash. U. L.Q.* 487, 487-91 (2003) (discussing both the rise of "negotiated governance" models and the limitations of such models). See generally Stephen Breyer, *Regulation and Its Reform* (1982) (introducing a framework for analyzing regulatory programs); Jay A. Sigler & Joseph E. Murphy, *Interactive Corporate Compliance* (1988) (proposing "interactive compliance" as a process through which business and government might work toward a more beneficial and more cooperative relationship).

n8. See Ayres & Braithwaite, *supra* note 6, at 49 ("As opposed to the maximal-operant principle, a great deal of empirical evidence supports a minimal-sufficiency principle: the less salient and powerful the control technique used to secure compliance, the more likely that internalization will result."). See generally Tom R. Tyler, *Why People Obey the Law* (1990) (creating a framework for analyzing which factors maximize compliance with the law).

n9. See, e.g., Kraakman, *Corporate Liability*, *supra* note 5, at 897-98.

n10. See Bucy, *supra* note 2, at 279-92 (discussing duties imposed upon lawyers and corporate officials to deter financial fraud).

n11. See *id.* (discussing criminal sanctions for certain offenses related to financial fraud).

n12. See, e.g., John C. Coffee, Jr., *Gatekeepers: The Professions and Corporate Governance* 152-56 (2006) [hereinafter Coffee, *Gatekeepers*]; William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 *Tul. L. Rev.* 1275, 1350 (2002) [hereinafter Bratton, *Shareholder Value*]; William W. Bratton, *Shareholder Value and Auditor Independence*, 53 *Duke L.J.* 439, 470 (2003) [hereinafter Bratton, *Auditor Independence*]; John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 *Bus. Law.* 1403, 1409-10 (2002).

n13. See, e.g., U.S. Gen. Accounting Office, Rep. No. GAO-03-864, *Public Accounting Firms Mandated Study on Consolidation and Competition* 16, 20-22 (2003), available at <http://www.gao.gov/new.items/d03864.pdf>; Sean M. O'Connor, *Be Careful What You Wish for: How Accountants and Congress Created the Problem of Auditor Independence*, 45 *B.C. L. Rev.* 741, 787-88 (2004); Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 *Cornell L. Rev.* 775, 786 (2006); see also *infra* notes 122-25 and accompanying text.

n14. See, e.g., Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 *Cornell L. Rev.* 394, 407-08 (2004) [hereinafter Macey, *Efficient Capital Markets*]; Jonathan Macey & Hillary A. Sale, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 *Vill. L. Rev.* 1167, 1176 (2003); Richard W. Painter, *Convergence and Competition in Rules Governing Lawyers and Auditors*, 29 *J. Corp. L.* 397, 412 (2004); Larry E. Ribstein, *Limited Liability of Professional Firms After Enron*, 29 *J. Corp. L.* 427, 447 (2004); see also *infra* notes 104-09 and accompanying text.

n15. See, e.g., Bratton, Shareholder Value, *supra* note 12, at 1350; Prentice, *supra* note 13, at 786-87; see also *infra* notes 111-21 and accompanying text.

n16. See Ronald J. Gilson, The Devolution of the Legal Profession: A Demand Side Perspective, *49 Md. L. Rev.* 869, 883 (1990) ("A well-functioning gatekeeper regime is an elegant enforcement strategy. Wrongdoing is prevented, rather than punished after the fact, without the substantial administrative costs of a formal enforcement proceeding.").

n17. *Id.*

n18. See Peter C. Kostant, Breeding Better Watchdogs: Multidisciplinary Partnerships in Corporate Legal Practice, *84 Minn. L. Rev.* 1213, 1246-47 (2000).

n19. John C. Coffee, Jr., What Caused Enron? A Capsule Social and Economic History of the 1990s, *89 Cornell L. Rev.* 269, 279-80 (2004).

n20. This reconciles what otherwise appears to be two distinct definitional conceptions of gatekeepers that appear in the literature. See Erik F. Gerding, The Next Epidemic: Bubbles and the Growth and Decay of Securities Regulation, *38 Conn. L. Rev.* 393, 426 n.219 (2006) (identifying two strands of definition as those who (1) certify as reputational intermediaries or (2) restrict access and endorse those admitted with their reputation for discretion); Peter B. Oh, Gatekeeping, *29 J. Corp. L.* 735, 740-42 (2004) (noting conflation of the reputational intermediary and the professional capable of disrupting entry and exploring the distinction).

n21. See Developments in the Law: Corporations and Society, *117 Harv. L. Rev.* 2169, 2227, 2245 (2004).

n22. See, e.g., Securities Exchange Act of 1934, *15 U.S.C. § 78j-1* (2000 & Supp. IV 2006) (delineating audit requirements for detecting illegal acts); *Revision of the Commission's Auditor Independence Requirement's, Securities Act Release No. 33-7919, 73 SEC Docket 2591* (Nov. 21 2001) (delineating regulations stating independence requirements); Codification of Accounting Standards and Procedures, Statement of Auditing Standards No. 99 (Am. Inst. of Certified Pub. Accountants 2002) (delineating professional standards as to consideration of fraud in a financial statement audit, later adopted by the Public Company Accounting Operating Board (PCAOB)); Codification of Accounting Standards and Procedures, Statement of Auditing Standards No. 95 (Am. Inst. of Certified Pub. Accountants 2001) (setting forth a professional statement of generally accepted auditing standards, later adopted by the PCAOB); Codification of Accounting Standards and Procedures, Statement of Auditing Standards No. 54 (Am. Inst. of Certified Pub. Accountants 1988) (setting forth professional standards stating such requirements, later adopted by the PCAOB). As for standards originally established by the AICPA adopted by the PCOAB, see Order Regarding Section 103(a)(3)(B) of the *Sarbanes-Oxley Act of 2002, Securities Exchange Act Release No. 47,745, 80 SEC Docket 181* (Apr. 25, 2003) (endorsing PCAOB adoption as interim standards of those previously adopted by the AICPA).

n23. See Lawrence A. Cunningham, Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability, *52 UCLA L. Rev.* 413, 417-18 n.6 (2004).

n24. See John C. Coffee, Jr., Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms, *84 B.U. L. Rev.* 301, 306-07, 346-64 (2004) (stating that "all gatekeepers are not alike," and developing proposals with entirely different content for auditors and for securities lawyers).

n25. See Arthur B. Laby, Differentiating Gatekeepers, *1 Brook. J. Corp., Fin. & Com. L.* 119, 124-34 (2006) (distinguishing between independent and dependent gatekeepers).

n26. See Cunningham, *supra* note 23, at 417-18 n.6.

n27. Coffee, *supra* note 19, at 279-80.

n28. See *id.* at 279 n.35 (citing Revision of the Commission's Auditor Independence Requirements, Exchange Act Release No. 33-7870, 65 *Fed. Reg.* 43,148, 43,150 (July 12, 2000) (codified at 17 C.F.R. pts. 210, 240) ("The federal securities laws ... make independent auditors 'gatekeepers' to the public securities markets.")).

n29. See generally Stephen M. Kohn et al., *Whistleblower Law: A Guide to Legal Protections for Corporate Employees* (2004) (discussing federal protections for whistleblowers who expose fraud).

n30. See Howell E. Jackson, Reflections on Kaye, Scholer: Enlisting Lawyers to Improve the Regulation of Financial Institutions, 66 *S. Cal. L. Rev.* 1019, 1028 n.30 (1993) ("While disaffirmance or resignation may have informational content in some cases, it is distinct from a pure whistleblowing obligation.").

n31. See Developments in the Law, *supra* note 21, at 2245.

n32. See Richard E. Moberly, Sarbanes-Oxley's Structural Model to Encourage Corporate Whistleblowers, 2006 *BYU L. Rev.* 1107, 1126-31 (discussing the standard 'anti retaliation' model in general and its weaknesses in the particular context of capital market context).

n33. See Rapp, *supra* note 2, at 112-16, 119-20.

n34. See Richard A. Bales, A Constitutional Defense of Qui Tam, 2001 *Wis. L. Rev.* 381, 381-85; Pamela H. Bucy, Private Justice, 76 *S. Cal. L. Rev.* 1, 43-45 (2002); Jill E. Fisch, Class Action Reform, Qui Tam, and the Role of the Plaintiff, 1997 *Law & Contemp. Probs.*, 167, 167-70.

n35. 18 *U.S.C.* § 287 (2000).

n36. *Id.*

n37. 17 *C.F.R.* § 201.61 (2006); see Insider Trading and Securities Fraud Enforcement Act of 1988, 15 *U.S.C.* § 78u-1 (2000 & Supp. IV 2006).

n38. See I.R.S. Pub. No. 733, Rewards for Information Provided by Individuals to the Internal Revenue Service (rev. 2004), available at <http://www.irs.gov/pub/irs-pdf/p733.pdf>. For analysis of these and several other federal bounty programs, see Marsha J. Ferziger & Daniel G. Currell, Snitching for Dollars: The Economics and Public Policy of Federal Civil Bounty Programs, 1999 *U. Ill. L. Rev.* 1141.

n39. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 *Stat.* 737 (codified as amended at 15 *U.S.C.* § 78u-4 (2000 & Supp. IV 2006)).

n40. See Kostant, *supra* note 18, at 1246. Notably, few reports have been made under this provision. See U.S. Gen. Accounting Office, GAO-03-982R, Securities Exchange Act: Review of Reporting Under Section 10A, at 2 (2003), available at <http://www.gao.gov/new.items/d03982r.pdf>; John C. Coffee, Jr., The Attorney as Gatekeeper: An Agenda for the SEC, 103 *Colum. L. Rev.* 1293, 1306 n.39 (2003) (citing SEC reports). Professor Coffee attributes this to either few actual problems or rationalized self interest. *Id.* at 1306-07. Another likely

possibility is the chaperon thesis, in which auditors observing problems get the problems corrected so the client can be admitted, not bounced. That is, the auditors perform their gatekeeping function first. See Kraakman, Gatekeepers, *supra* note 5, at 62-66 (discussing "chaperoning" and "bouncing").

n41. Sec. & Exch. Comm., Reg. S-K, 17 *C.F.R.* § 229.304 (2006); Securities and Exchange Act of 1934, 15 *U.S.C.* § 78h-1 (2000 & Supp. IV 2006); see Darin Bartholomew, Is Silence Golden When It Comes to Auditing?, 36 *J. Marshall L. Rev.* 57, 93-105 (2002); Kostant, *supra* note 18, at 1245-46.

n42. See *United States v. Zolin*, 491 *U.S.* 554, 562-63 (1989) (construing and applying the "crime-fraud exception to the attorney-client privilege"); Model Rules of Prof'l Conduct R. 1.6(b) (2006); *id.* R. 1.13 (2006); *Restatement (Third) of Law Governing Lawyers* § 67 (2000); Tamar R. Birckhead, The Conviction of Lynne Stewart and the Uncertain Future of the Right to Defend, 43 *Am. Crim. L. Rev.* 1, 5-12 (2006) (discussing critically the criminal conviction of a criminal defense lawyer concerning activities arising out of the attorney-client relationship); see also Richard W. Painter et al., Lawyer Disclosure of Corporate Fraud: Establishing a Firm Foundation, 50 *SMU L. Rev.* 225, 236-44 (1996) (exploring the imposition of affirmative duties on auditors respecting steps to take when confronting corporate fraud and exploring how one would adapt analogous provisions for the legal profession).

n43. See Roger C. Cramton et al., Legal and Ethical Duties of Lawyers After Sarbanes-Oxley, 49 *Vill. L. Rev.* 725, 779-810 (2004) (discussing and analyzing the "reporting out" concept).

n44. See 17 *C.F.R.* § 205.3 (2006).

n45. See Developments in the Law, *supra* note 21, at 2245-46.

n46. Cramton et al., *supra* note 43, at 810-14 (recapitulating the analysis of the proposed noisy withdrawal concept).

n47. See Developments in the Law, *supra* note 21, at 2246.

n48. M. Peter Moser et al., Sarbanes-Oxley 307: Trusted Counselors or Informers?, 49 *Vill. L. Rev.* 833, 848-49 (2004) (summarizing the grounds for objecting to the noisy withdrawal concept and reflecting on tensions with traditional values embedded in the attorney-client relationship).

n49. 17 *C.F.R.* § 205.3.

n50. See Coffee, *supra* note 40, at 1301-02 (distinguishing required up-the-ladder reporting from "other, potentially more extensive gatekeeping duties"); see also Stephen M. Bainbridge et al., Managerialism, Legal Ethics, and Sarbanes-Oxley Section 307, 2004 *Mich. St. L. Rev.* 299, 315 (asserting that section 307 and the part 205 rules give lawyers many ways to avoid reporting, so incentives have not changed much); Peter C. Kostant, Sarbanes-Oxley and Changing the Norms of Corporate Lawyering, 2004 *Mich. St. L. Rev.* 541, 550-58 (arguing that section 307 and the part 205 rules have flaws but bode well to improve normative self-conception of securities lawyers to assume the gatekeeper function); Lisa H. Nicholson, SarbOx 307's Impact on Subordinate In-House Counsel: Between a Rock and a Hard Place, 2004 *Mich. St. L. Rev.* 559, 603-13 (arguing that the failure to distinguish and give special dispensation to low level in-house counsel is a defect in the part 205 rules).

n51. Section 11 of the Securities Act of 1933 and section 10 of the Securities Exchange Act of 1934 impose these duties and risks. Securities Act of 1933, 15 *U.S.C.* § 77k; Securities Exchange Act of 1934, 15 *U.S.C.* § 78j; see also 15 *U.S.C.* § 77q(a) (providing a basis for auditors' duties of inquiry and disclosure); 15 *U.S.C.* § 78r

(2000) (creating private rights of action against persons, including accountants, who "make or cause to be made" materially misleading statements in reports or other documents filed with the SEC).

n52. Kraakman, *Corporate Liability*, *supra* note 5, at 891.

n53. See Poonam Puri, *Taking Stock of Taking Stock*, 87 *Cornell L. Rev.* 99, 146 (2001).

n54. Coffee, *supra* note 40, at 1297-98.

n55. Kraakman, *Corporate Liability*, *supra* note 5, at 891.

n56. Professor Kraakman's chief insight is that "whenever potential offenders must employ incorruptible outsiders to gain legitimacy or expertise or to meet a legal requirement, gatekeeper liability will thwart a class of offenses that are unreachable through enterprise-level or managerial sanctions." *Id.*

n57. *Id.*

n58. See Joseph A. Franco, *Why Antifraud Prohibitions Are Not Enough: The Significance of Opportunism, Candor and Signaling in the Economic Case for Mandatory Securities Disclosure*, 2002 *Colum. Bus. L. Rev.* 223, 307-08.

n59. *Id.*

n60. See *id.*

n61. See Victor P. Goldberg, *Accountable Accountants: Is Third-Party Liability Necessary?*, 17 *J. Legal Stud.* 295, 312 (1988) (arguing that reputations of auditors are sufficient so third-party liability is not necessary).

n62. See David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 *Harv. L. Rev.* 375, 408-25 (1990).

n63. Coffee, *supra* note 19, at 280 ("The market recognizes that the gatekeeper has less incentive to deceive than does its client and thus regards the gatekeeper's assurance or evaluation as more credible than the client's statements.").

n64. See *id.*

n65. See Ronald J. Gilson et al., *The Mechanisms of Market Efficiency*, 70 *Va. L. Rev.* 549, 618-21 (1984) (stating that investment bankers' good reputations promote efficient markets).

n66. Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 *UCLA L. Rev.* 781, 787-88 (2001).

n67. See *id.*

n68. See *id.*

n69. See Pamela S. Karlan, Contingent Fees and Criminal Cases, *93 Colum. L. Rev.* 595, 629-32 (1993) (discussing lawyers as gatekeepers with respect to contingent fees in criminal cases); David B. Wilkins, Who Should Regulate Lawyers?, *105 Harv. L. Rev.* 801, 810 (1992) (noting that the ABA ethics code "constitutes the most influential source[] of professional norms").

n70. Black, *supra* note 66, at 788-89.

n71. See generally American Institute of Certified Public Accountants, <http://www.aicpa.org> (last visited Nov. 5, 2007).

n72. In July 2007 a new body, the Financial Industry Regulation Authority (FINRA), was formed to perform similar functions. See generally Financial Industry Regulation Authority Home Page, <http://www.finra.org> (last visited Nov. 3, 2007).

n73. See Prentice, *supra* note 13, at 788-89, 795-97 (discussing the National Association of Securities Dealers (NASD) and the New York Stock Exchange as examples).

n74. See Black, *supra* note 66, at 788-89.

n75. An abundant literature in recent decades explores the relationship of norms to law, how norms are formed, and their role in influencing compliance with law. See, e.g., Robert C. Ellickson, *Order Without Law: How Neighbors Settle Disputes* (1991); Eric A. Posner, *Law and Social Norms* (2000); Lawrence E. Mitchell, *Understanding Norms*, *49 U. Toronto L.J.* 177 (1999); see also *infra* note 235.

n76. See Donald C. Langevoort, Where Were the Lawyers? A Behavioral Inquiry Into Lawyers' Responsibility for Clients' Fraud, *46 Vand. L. Rev.* 75, 115-16 (1993).

n77. See McGowan, *supra* note 4, at 1828.

n78. See, e.g., *DiLeo v. Ernst & Young*, *901 F.2d* 624, 629 (7th Cir. 1990) ("An accountant's greatest asset is its reputation for honesty, followed closely by its reputation for careful work.").

n79. See Lawrence A. Cunningham, Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before It Unravels, *106 Colum. L. Rev.* 1698, 1726-27 (2006).

n80. See Langevoort, *supra* note 76, at 101-11 ("In a representational setting, a lawyer's ability to detect client fraud is diminished by cognitive bias [Since] gatekeeper liability structures ... generally are justified on the assumption that they provide incentives to careful client monitoring[,] lawyers with a diminished cognitive capacity for monitoring may not be the best candidates for that role."); McGowan, *supra* note 4, at 1833-34.

n81. See Jennifer Arlen & Reinier Kraakman, Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes, *72 NYU L. Rev.* 687, 701-05 (1997).

n82. *Id.*

n83. See Puri, *supra* note 53, at 148-52 (reviewing all these liability risks).

n84. See Michael A. Perino, *Enron's Legislative Aftermath: Some Reflections on the Deterrence Aspects of the Sarbanes-Oxley Act of 2002*, 76 *St. John's L. Rev.* 671, 674-76 (2002). See generally Gary S. Becker, *Crime and Punishment: An Economic Approach*, in *Essays in the Economics of Crime and Punishment 1* (Gary S. Becker & William M. Landes eds., 1974) (introducing an economic analysis of the optimal level of punishment necessary to deter crime).

n85. See, e.g., Timothy F. Malloy, *Regulation, Compliance and the Firm*, 76 *Temp. L. Rev.* 451, 497-523 (2003) (conceiving regulatory compliance as another routine for an organization to be pursued the way other routines are, to supplement typical profit-maximizing and law-abiding images for a realistic appraisal); Geraldine Szott Moohr, *An Enron Lesson: The Modest Role of Criminal Law in Preventing Corporate Crime*, 55 *Fla. L. Rev.* 937, 956-75 (2003) (showing the limitations of rational choice and unconscious instinct models of obedience, the former due to biased judgment risk impairing calculability and the latter offset by competing social forces at subgroup levels such as corporate culture, and observing that additional incentives are supplied by private and regulatory enforcement).

n86. Black, *supra* note 66, at 794-95 (making this argument for both accountants and bankers).

n87. *Id.* at 795, 800.

n88. Kostant, *supra* note 18, at 1248 n.159.

n89. Coffee, *supra* note 40, at 1306.

n90. Langevoort, *supra* note 76, at 115.

n91. Compare Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 *Wash. U. L.Q.* 491, 540-46 (2001) (exploring a modified strict liability regime for auditors), with Coffee, *supra* note 24, at 349-54 (evaluating relative strict liability for auditors such as a limitation on liability based on an affirmative defense requiring proof of nonnegligence and good faith).

n92. See, e.g., Kostant, *supra* note 18, at 1248.

n93. See Stephen Choi, *Market Lessons for Gatekeepers*, 92 *Nw. U. L. Rev.* 916, 951-58 (1998).

n94. For a well-known debate along these lines, see generally Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 *Harv. L. Rev.* 963 (1994); Joseph A. Grundfest, *Why Disimply?*, 108 *Harv. L. Rev.* 727 (1995); and Joel Seligman, *A Comment on Professor Grundfest's "Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority,"* 108 *Harv. L. Rev.* 438 (1994).

n95. Assaf Hamdani, *Gatekeeper Liability*, 77 *S. Cal. L. Rev.* 53, 102-08 (2003) (providing a framework for choosing strict versus duty-or knowledge-based liability according to how well-equipped enforcement authorities are to enforce violations - the less equipped, the greater the need for strict liability, and vice versa - and locating auditor performance under the knowledge-based end).

n96. Compare Donald C. Langevoort, *Capping Damages for Open Market Securities Fraud*, 38 *Ariz. L. Rev.* 639, 657-62 (1996) (exploring parameters of potentially appropriate liability caps for nonprivity federal securi-

ties fraud cases), with Harvey J. Goldschmid, Capping Securities Fraud Damages: An Unwise Proposal in an Imperfect World, *38 Ariz. L. Rev.* 665, 666-67 (1996) (commenting on the foregoing article by Professor Langevoort and objecting to damages caps as risking the integrity of securities markets by reducing managerial incentives to promote faithful financial reporting).

n97. See, e.g., Kraakman, *Corporate Liability*, supra note 5, at 867-68.

n98. Kostant, supra note 18, at 1245 n.146.

n99. Id. at 1248 n.164 (discussing the use of legal bribes to promote effective gatekeeping).

n100. See Kraakman, *Corporate Liability*, supra note 5, at 867-68.

n101. See Choi, supra note 93, at 955.

n102. See Coffee, *Gatekeepers*, supra note 12, at 168; infra text accompanying notes 197-202 (discussing the uncertain scope of an accountant's obligation to discover fraud).

n103. See McGowan, supra note 4, at 1846-54.

n104. See supra note 14.

n105. Macey, supra note 14, at 407-08.

n106. Id.

n107. Id. at 410.

n108. See Coffee, supra note 40, at 1305-06 (noting that the one-client problem for audit partners can impair the reputational constraint at the partner level but also how this is not so at law firms).

n109. See Puri, supra note 53, at 146; see also John S. Dzienkowski & Robert J. Peroni, The Decline in Lawyer Independence: Lawyer Equity Investments in Clients, *81 Tex. L. Rev.* 405, 481-85 (2002) (discussing traditional gatekeeper liability theory and noting the controversy as to the suitability of lawyers to perform the function); Christine Hurt, Counselor, Gatekeeper, Shareholder, Thief: Why Attorneys Who Invest in their Clients in a Post-Enron World Are "Selling Out," Not "Buying In," *64 Ohio St. L.J.* 897, 935-38 (2003).

n110. See Bratton, *Shareholder Value*, supra note 12, at 1350.

n111. Panel on Audit Effectiveness, *Report and Recommendations 112* (2000), available at <http://www.pobauditpanel.org/downloads/chapter5.pdf> (showing a shift in the revenue mix of the five largest auditing firms from traditional auditing services to consulting services); Bratton, *Shareholder Value*, supra note 12, at 1350 (describing how fees from audit clients for nonaudit services rose from 13% of revenues in the 1970s to 50% of revenues in the 1990s).

n112. Professor Prentice documents factors that had the same weakening effect on other gatekeepers, including lawyers, analysts, rating agencies, bankers, mutual funds, and stock exchanges. See Prentice, *supra* note 13, at 786-98.

n113. See Jeffrey N. Gordon, What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections, *69 U. Chi. L. Rev.* 1233, 1237 (2002) (suggesting that the most important guarantor of auditor independence is the saliency of auditor terminations, a material event that must promptly be disclosed, but the value of which drops dramatically when audit firms cross-sell consulting services, which gives auditors incentives not to sever clients).

n114. The danger in this structure - also true of a rewards program - is auditor strategic behavior, in which auditors fire entirely responsible clients to shine their image and attract other shinier clients. See, e.g., Macey & Sale, *supra* note 14, at 1173. The effect, in any event, is a kind of balance of power between enterprises and auditors, one of "mutual reputation enhancement." *Id.*

n115. Macey, Efficient Capital Markets, *supra* note 14, at 409.

n116. *Id.* at 410.

n117. See Coffee, *supra* note 24, at 348-49 n.148 ("In 2003, over 1460 public companies changed auditors, which was the highest number in at least five years. Although such switches could be because the client was dissatisfied with the auditor, many were because the auditor considered the client too risky - or because the auditor raised its fees in light of that increased risk... . By itself, this evidence may not prove that auditors are becoming significantly more selective with regard to clients, but it is at least consistent with such a hypothesis.").

n118. An extensive contemporary and historical literature investigates the multiple aspects of auditor switching. For a recent contribution suggesting that increased switching after Sarbanes-Oxley is not strictly due to those reforms but at least potentially related to client size, and detailing a pre-Sarbanes-Oxley study of switches during 1993 to 2001 showing that resignations of large audit firms commonly result in the client engaging another large audit firm, see Wayne R. Landsman, et al., An Empirical Analysis of Big N Auditor Switches (Apr. 2006) (unpublished manuscript, available at <http://ssrn.com/abstract=899544>).

n119. See Lawrence A. Cunningham, The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Might Just Work), *35 Conn. L. Rev.* 915, 923-28 (2003) (chronicling the road to Sarbanes-Oxley from the implosion of the "Big Four Frauds," referring to Qwest Communications, Inc.; WorldCom, Inc.; Global Crossing, Ltd.; and Enron Corp., and noting that the statute takes the unusual step, for legislation, of mentioning the latter two by name).

n120. See Matthew J. Barrett, "Tax Services" as a Trojan Horse in the Auditor Independence Provisions of Sarbanes-Oxley, *2004 Mich. St. L. Rev.* 463, 485-502 (noting continuing auditor dependence on clients to whom they render tax services which are still allowed).

n121. See *United States v. Stein*, 435 F. Supp. 2d 330, 336-50 (S.D.N.Y. 2006); *United States v. KPMG LLP*, 316 F. Supp. 2d 30, 31-34 (D.D.C. 2004) (discussing facts at the preliminary stage of Internal Revenue Service and Department of Justice investigations into criminal conduct at KPMG, which eventually led to the firm narrowly escaping a criminal indictment); see also Sheldon D. Pollack & Jay A. Soled, Tax Professionals Behaving Badly, *105 Tax Notes* 201, 210 (2004).

n122. See U.S. Gen. Accounting Office, *supra* note 13, at 16, 20-22.

n123. See *id.*

n124. See Theodore Eisenberg & Jonathan R. Macey, Was Arthur Andersen Different? An Empirical Examination of Major Accounting Firm Audits of Large Clients, 1 *J. Empirical Legal Stud.* 263, 297-98 (2004).

n125. O'Connor, *supra* note 13, at 787-88; Prentice, *supra* note 13, at 786.

n126. Coffee, *supra* note 19, at 279-80 (noting that gatekeeper utility is limited since gatekeepers are paid by the party to be monitored).

n127. Cunningham, *supra* note 23, at 427-41 (discussing a proposed alternative approach of authorizing companies to buy insurance and having insurers hire and pay auditors rather than having companies hire and pay auditors directly).

n128. Steven L. Schwarcz, Rethinking the Disclosure Paradigm in a World of Complexity, 2004 *U. Ill. L. Rev.* 1, 29 n.180 (suggesting but discounting the possibility of having gatekeepers such as auditors paid through public funding).

n129. Larry E. Ribstein, SarbOx: The Road to Nirvana, 2004 *Mich. St. L. Rev.* 279, 289 (citing Paul M. Healy & Krishna G. Palepu, How the Quest for Efficiency Corroded the Market, *Harv. Bus. Rev.*, July 2003, at 76, 82-83 (proposing the idea of having the stock exchanges coordinate and compensate auditors)).

n130. Stephen J. Choi & Jill E. Fisch, How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries, 113 *Yale L.J.* 269, 314-28 (2003).

n131. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 *Stat.* 745, 775-77 (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

n132. Coffee, Gatekeepers, *supra* note 12, at 166-68; see *infra* text accompanying note 228 (noting that one feature of the rewards system is the possibility of securities underwriters paying bonuses to auditors).

n133. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 *Stat.* 737, 758 (codified as amended at 15 *U.S.C.* § 78u-4 (2000)).

n134. *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 *U.S.* 164, 177 (1994). In March 2007, the Supreme Court granted certiorari in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 127 *S. Ct.* 1873 (2007), and heard oral arguments in October 2007, giving the Court an opportunity to elucidate this body of law. See Linda Greenhouse, Sceptically Court Hears Fraud Case, *N.Y. Times*, Oct. 10, 2007, § C.

n135. See Eric L. Talley, Cataclysmic Liability Risk Among Big Four Auditors, 106 *Colum. L. Rev.* 1641, 1650-51, 1656-57 (2006) (noting that the percentage of federal securities fraud class actions naming auditors as defendants decreased considerably since the Supreme Court announced that federal securities laws do not authorize private securities fraud actions against those aiding and abetting securities fraud).

n136. Bratton, Shareholder Value, *supra* note 12, at 1350 (noting that during the 1990s, the legal liability threat to auditors declined and this, coupled with other factors, contributed to a greater willingness to risk the firms' reputational capital).

n137. See Coffee, *Gatekeepers*, supra note 12, at 152-56; Bratton, *Auditor Independence*, supra note 12, at 470 (attributing the source of audit gatekeeping deterioration to reduced liability risk and concomitant decline in auditors' traditional modes of independence and conservatism, plus the transformation of their consulting work into a high-return premium business carrying a suitably high risk for the auditor's reputational capital).

n138. Macey & Sale, supra note 14, at 1180.

n139. Ribstein, supra note 14, at 447.

n140. Id.

n141. Macey & Sale, supra note 14, at 1181.

n142. See supra text accompanying notes 73-91.

n143. See Coffee, *Gatekeepers*, supra note 12, at 60-61 (discussing the decline of deterrence).

n144. See Robert Shiller, *Irrational Exuberance* passim (2d ed. 2005).

n145. Cunningham, supra note 119, at 923-28.

n146. See Bratton, *Shareholder Value*, supra note 12, at 470-71; Gerding, supra note 20, at 426-28.

n147. Coffee, *Gatekeepers*, supra note 12, at 333-61.

n148. See Lawrence A. Cunningham, *Sharing Accounting's Burden: Business Lawyers in Enron's Dark Shadows*, 57 *Bus. Law.* 1421, 1454 (2002).

n149. See Frederick W. Lambert, *A Preliminary Inquiry into the Transcendence of Value Creation*, 74 *Or. L. Rev.* 121, 143-44 (1995) (noting the practice, beginning in the 1970s, of law firms recruiting associates laterally from other firms, the emergence of partner "books of business" that were portable to other firms, and the rise of placement services, a trade press, and financial pressures); David B. Wilkins & G. Mitu Gulati, *Reconceiving the Tournament of Lawyers: Tracking, Seeding, and Information Control in the Internal Labor Markets of Elite Law Firms*, 84 *Va. L. Rev.* 1581, 1624-25 (1998) (theorizing on the role of lateral movement among law firm associates).

n150. See Wilkins & Gulati, supra note 149, at 1625-27, 1638-41.

n151. See Kraakman, *Corporate Liability*, supra note 5, at 893 nn.106-07 (citing Ronald J. Gilson & Robert H. Mnookin, *Sharing Among the Human Capitalists: An Economic Inquiry into the Corporate Law Firm and How Partners Split Profits*, 37 *Stan. L. Rev.* 313, 351-71 (1985), as "examining relations between structure of law firms and nature of client loyalty to individual partners" and "describing [a] law firm's reputation as firm-specific capital which attracts clients and permits [a] firm to serve as [a] reputational intermediaries on behalf of clients").

n152. See Robert W. Hillman, *Hillman on Lawyer Mobility: The Law and Ethics of Partner Withdrawals and Law Firm Breakups* § 2.7.5, at 2:132 (2d ed. Supp. 2005).

n153. Prentice, *supra* note 13, at 786 (citing Brian W. Mayhew et al., *The Effect of Accounting Uncertainty and Auditor Reputation on Auditor Objectivity*, 20 *Auditing*, Sept. 2001, at 49, 66).

n154. See Donald C. Langevoort & Robert K. Rasmussen, *Skewing the Results: The Role of Lawyers in Transmitting Legal Rules*, 5 *S. Cal. Interdisc. L.J.* 375, 410-11 (1997) (evaluating lawyer motivations); Donald C. Langevoort, *The Epistemology of Corporate-Securities Lawyering: Beliefs, Biases and Organizational Behavior*, 63 *Brook. L. Rev.* 629, 654-56 (1997); see also John C. Coffee, Jr., *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 *Va. L. Rev.* 1099, 1157-61 (1977) (describing gatekeeper malfeasance and legal theories available in response); Simon M. Lorne, *The Corporate and Securities Adviser, the Public Interest, and Professional Ethics*, 76 *Mich. L. Rev.* 423, 445-65 (1978) (debating lawyers' duties as gatekeepers in their capacity as corporate advisers).

n155. Donald C. Langevoort, *Seeking Sunlight in Santa Fe's Shadow: The SEC's Pursuit of Managerial Accountability*, 79 *Wash. U. L.Q.* 449, 485-86 (2001).

n156. See Prentice, *supra* note 13, at 797-99.

n157. *Id.*

n158. See, e.g., Coffee, *Gatekeepers*, *supra* note 12, at 9 (explaining that "both strategies (i.e. both legal remedies and reputational intermediaries)" are important) (emphasis added); see also *id.* at 318 (contending that a "gatekeeper's willingness to resist pressure [from managers] will still depend on" litigation risk and reputation loss).

n159. See *id.* at 67-68, 318-24.

n160. *Id.* at 318-24.

n161. Increased litigation risk also emboldens gatekeepers to lobby for other kinds of reforms, including, most commonly, calls to cap liability for damages arising from their own legal violations. See Lawrence A. Cunningham, *Securitizing Audit Failure Risk: An Alternative to Caps on Damages*, 49 *Wm. & Mary L. Rev.* (forthcoming Dec. 2007) (manuscript at 2-3, on file with author); *supra* note 96 (citing debate between Professors Langevoort and Goldschmid on the merits of liability caps).

n162. See, e.g., Michael C. Jensen & Kevin J. Murphy, *CEO Incentives - It's Not How Much You Pay, But How*, *Harv. Bus. Rev.*, May-June 1990, at 138, 138-44 (complaining that managerial pay was geared more towards organizational size than to performance, and urging more incentive-based compensation); Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 *J. Pol. Econ.* 225, 227-42 (1990). *Contra* Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 *Q.J. Econ.* 653, 653-56 (1998) (challenging the Jensen-Murphy thesis).

n163. See, e.g., Brian J. Hall & Kevin J. Murphy, *Stock Options for Undiversified Executives*, 33 *J. Acct. & Econ.* 3, 3-13 (2002); Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 *U. Chi. L. Rev.* 847, 862-69 (2002); Michael C. Jensen & Kevin J. Murphy, *Remuneration: Where We've Been, How We Got to Here, What Are the Problems, and How to Fix Them*, (European Corp. Governance Inst., Finance Working Paper No. 44/2004, 2004), available at <http://ssrn.com/abstract=561305>.

n164. See, e.g., Warren E. Buffett, *The Essays of Warren Buffett: Lessons for Corporate America* 54-61 (2001); see also John Cassidy, *The Greed Cycle: How the Financial System Encouraged Corporations to Go Crazy*, *New Yorker*, Sept. 23, 2002, at 64, 64-73 (detailing the negative effects of executive stock options).

n165. *Conversations from the Warren Buffett Symposium*, *19 Cardozo L. Rev.* 719, 766-68 (1997).

n166. *Id.* at 767.

n167. Painter, *supra* note 14, at 412.

n168. *Id.*

n169. See Matthew T. Bodie, *AOL Time Warner and the False God of Shareholder Primacy*, *31 J. Corp. L.* 975, 982-94 (2006) (noting, in a comprehensive diagnosis of the transaction and background norms, that in the two months following the closing of the transaction, shareholders in the enterprise suffered losses of some \$ 200 billion in market value plus several billion dollars more in civil liability costs).

n170. Painter, *supra* note 14, at 412.

n171. *Id.* at 411.

n172. See Code of Prof'l Ethics § 302, R. 302.01 (2006). This provision defines a contingent fee as "a fee established for the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such service." *Id.*; see Sankar De & Pradyot K. Sen, *Is Auditor Moral Hazard the Only Reason to Ban Contingent Fees for Audit Services?*, *1 Int'l J. Auditing* 175, 180-83 (1997); Ronald A. Dye et al., *Contingent Fees for Audit Firms*, *28 J. Acct. Res.* 239, 239-40 (1990).

n173. Professor Painter signals desire for reform using compensation systems, which is the basis for the mechanics of any merit system. See Painter, *supra* note 14, at 411 (explaining that problems associated with misaligned incentives between firms and partners "can only be corrected through structural changes within the gatekeeper firms themselves (e.g., risk management departments in audit firms, ethics committees in law firms, and reforms to compensation systems)").

n174. Coffee, *Gatekeepers*, *supra* note 12, at 64; see *supra* notes 110-14 and accompanying text. Legal scholars have expressed or implied a substantial consensus that auditors rendering nonaudit services for clients impaired gatekeeping effectiveness. Notably, however, a few studies by accounting scholars raise some uncertainty about how confidently this conclusion should be held. E.g., William R. Kinney, Jr. et al., *Auditor Independence, Non-Audit Services, and Restatements: Was the US Government Right?*, *42 J. Acct. Res.* 561, 565-66 (2004); see also Jayanthi Krishnan, et al., *Does the Provision of Nonaudit Services Affect Investor Perceptions of Auditor Independence?*, *24 Auditing: J. Prac. & Theory* 111, 111-13, 130-31 (2005) (noting mixed results of empirical research on the effect of nonauditing services on auditor independence and investigating whether investors perceive such an effect, as well as interpreting the results affirmatively).

n175. See Coffee, *Gatekeepers*, *supra* note 12, at 64-65.

n176. See *id.* at 65 ("Bribes work better than threats for a variety of reasons ...").

n177. See supra notes 104-07 and accompanying text.

n178. Coffee, Gatekeepers, supra note 12, at 318.

n179. See supra note 78 (quoting Judge Easterbrook's opinion in *DeLio v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990)).

n180. See supra note 109 and accompanying text.

n181. Kraakman, Corporate Liability, supra note 5, at 891 (emphasis added).

n182. It is possible for reputation effects of effective gatekeeping to be a negative. See McGowan, supra note 4, at 1828, 1833 (contending that reputation effects of effective gatekeeping by lawyers can either be a benefit (if clients like reputable gatekeepers) or a cost (if clients like compliant gatekeepers)). If so, this makes for a difficult theoretical case about the possibility that lawyers can be gatekeepers. It runs counter to the basic theory of gatekeeping. Professor David McGowan assumes that clients dislike whistleblowing lawyers because it increases transaction costs. See *id.* at 1833. While acknowledging the possibility that such action benefits clients by signaling to third parties a trustworthy client, Professor McGowan believes that if this were so, one would observe more whistle-blowing than we actually observe. See *id.* But this hypothesis seems to overlook how whistle-blowing is an ex post action whereas gatekeeping is an ex ante action. See supra text accompanying notes 16 & 29. From this distinction, one might infer from relatively low levels of observed whistleblowing that high levels of effective gatekeeping exist.

n183. Gerding, supra note 20, at 426-28.

n184. See supra notes 104-43 and accompanying text.

n185. Ribstein, supra note 129, at 288-89.

n186. Ribstein, supra note 14, at 429.

n187. Again, these are approximations of parameters, intended to support a view of the model as reasonable, not scientific determinations.

n188. See Prentice, supra note 13, at 797-800.

n189. Regulators are not generally seen as private gatekeepers. See Oh, supra note 20, at 755-66, 796-98 (discussing how public corporate gatekeepers such as the SEC can engage in more intense corrective efforts).

n190. McGowan, supra note 4, at 1837-38, 1840 (proposing transactional immunity to the first securities lawyer to blow the whistle about an unlawful transaction).

n191. See supra notes 77-80 and accompanying text.

n192. See supra notes 16-28 and accompanying text.

n193. See supra notes 29-40 and accompanying text.

n194. See Robert Prentice, Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for Its Future, *51 Duke L.J.* 1397, 1427-34 (2002) (offering a critique of reputational constraint based on six countervailing factors); see also Lawrence A. Cunningham, Behavioral Finance and Investor Governance, *59 Wash. & Lee L. Rev.* 767, 786-806 (2002) (discussing responses to cognitive biases in investor behavior).

n195. Oliver Marnet, Behavior and Rationality in Corporate Governance, *39 J. Econ. Issues* 613, 625 (2005).

n196. Id.

n197. Biases may complicate estimating the optimal gatekeeper payoff (GP), but that is also true of estimating other components of the model under rationality assumptions.

n198. See Prentice, *supra* note 13, at 798.

n199. See *id.*; see also Manuel A. Utset, Model of Time-Inconsistent Misconduct: The Case of Lawyer Misconduct, *74 Fordham L. Rev.* 1319, 1343-48 (2005) (arguing that lawyers engage in repeated misconduct because they value immediate gratification).

n200. See Prentice, *supra* note 13, at 798.

n201. Painter, *supra* note 14, at 413-15.

n202. Id. at 414.

n203. It is foolish to conjecture how a carrot-based merit system would influence collective behavior during a market bubble such as that fueled by technological change during the late 1990s and 2000s. See *supra* notes 144-46 and accompanying text. Given how episodes of financial euphoria recur, it seems doubtful that any system design feature can mediate them (yet regulatory change in response to fallouts from financial euphoria likewise recurs). See Stuart Banner, What Causes New Securities Regulation? 300 Years of Evidence, *75 Wash. U. L.Q.* 849, 850-51 (1997) (noting that new securities regulation tends to follow crashes); Larry E. Ribstein, Bubble Laws, *40 Hous. L. Rev.* 77, 83-96 (2003) (discussing securities regulation enacted following the market crashes of 2002, 1929, and the South Sea Bubble).

n204. See 9 Louis Loss & Joel Seligman, *Securities Regulation* 4259 n.151 (3d ed. 2004) (noting that the so-called due diligence obligation is not an affirmative duty but a defense).

n205. See Ben D. Orlanski, Whose Representations Are These Anyway? Attorney Prospectus Liability After Central Bank, *42 UCLA L. Rev.* 885, 904-05 (1995) (noting incorrect but common judicial rhetoric characterizing the due diligence defense as somehow involving an "affirmative duty").

n206. See, e.g., *Auerbach v. Bennett*, 393 N.E.2d 994, 996, 1003 (N.Y. 1979) (noting how the audit committee of General Telephone & Electronics Corporation's board of directors retained the Washington, D.C. law firm of Wilmer, Cutler & Pickering to conduct an internal investigation growing out of the foreign bribery scandals of the 1970s); see also Arthur F. Mathews, Internal Corporate Investigations, *45 Ohio St. L.J.* 655, 666-78 (1984) (providing numerous illustrations of self-investigation and its origins as well as assessing its benefits and costs).

n207. See Gideon Mark, Accounting Fraud: Pleading Scienter of Auditors Under the PSLRA, 39 *Conn. L. Rev.* 1097, 1147-50, 1155 (2007) (elaborating upon ways that professional auditing standards prevent the imposition of legal liability for the nondetection of fraud).

n208. Reflecting both the stakes and the controversy, accounting standard-setters have rewritten the applicable auditing standards on numerous occasions. See Codification of Accounting Standards and Procedures, Statement on Auditing Standards No. 99 (Am. Inst. of Certified Public Accountants 2002). The current standard mainly elaborates on the difficulties auditors face in detecting fraud rather than specifying anything resembling a duty to investigate or proactively detect it. See *id.* P P 5-12. For analysis of predecessor formulations, see Mark F. Zimbelman, The Effects of SAS No. 82 on Auditors' Attention to Fraud Risk Factors and Audit Planning Decisions, 35 *J. Acct. Res.* 75, 86-94 (1997) (concluding that despite increased attention toward fraud risk, auditors will not change their audit plans to effectively detect fraud).

n209. See Sean M. O'Connor, Strengthening Auditor Independence: Reestablishing Audits as Control and Premium Signaling Mechanisms, 81 *Wash. L. Rev.* 525, 582-83 (2006) (arguing in support of prescription to replace the United States mandatory statutory audit with a shareholder-driven audit, and arguing that the "general purpose audit" is "not a very effective device," particularly compared to a forensic audit).

n210. See Coffee, Gatekeepers, *supra* note 12, at 138-46 ("The battle lines seem to have been drawn: the profession is content with an emphasis on internal controls, while reformers want enhanced standards requiring the auditor to recognize a responsibility to detect material fraud. For the profession, this latter priority carries the prospect of greater litigation exposure.").

n211. See Vinita Ramaswamy, Corporate Governance and the Forensic Accountant, *CPA J.*, Mar. 2005, at 68, available at <http://www.nysscpa.org/cpajournal/2005/305/essentials/p68.htm>.

n212. See Samuel A. DiPiazza et al., Global Capital Markets and the Global Economy: A Vision from the CEOs of the International Audit Networks 13 (2006), http://www.globalpublicpolicysymposium.com/CEO_Vision.pdf (noting the proposal of large audit firms advocating mandatory forensic audits of all public companies on a random or periodic basis).

n213. See Scott Fitzgibbon & Donald W. Glazer, Fitzgibbon and Glazer on Legal Opinions: What Opinions in Financial Transactions Say and What They Mean 1-4 (1992); Jonathan M. Barnett, Degenerate Certification: The Opinion Puzzle and Other Transactional Curiosities, *J. Corp. L.* (forthcoming Nov. 2007).

n214. See Special Report of the Task Force on Securities Law Opinions, ABA Section of Business Law, Negative Assurance in Securities Offerings, 59 *Bus. Law.* 1513 *passim* (2004).

n215. *Id.*

n216. For a primer on the subject of lawyers' legal opinions (i.e., addressing contexts beyond that of capital market gatekeeping), see Jeffrey Smith, A Legal Opinion Malpractice Primer, in *The Legal Opinion Committee Workshop 2005*, at 165 (2005).

n217. Auditing regulations govern the preparation, scope, and delivery of comfort letters. See Codification of Accounting Standards and Procedures, Statement on Auditing Standards No. 72 (Am. Inst. Certified Pub. Accountants 1993); see also William J. Whelan, III, Accountant Due Diligence and Comfort Letters, in *Securi-*

ties Offerings 2007: Operating Under the New Rules 403 (2007) (providing practice perspective on auditors' comfort letters).

n218. Coffee, *Gatekeepers*, supra note 12, at 166, 168 (discussing how the auditing profession is "refusing to discuss the prospect for fraud or illegality with other gatekeepers").

n219. Coffee, supra note 40, at 1310-11, 1313 n.57.

n220. See Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 *Geo. Wash. L. Rev.* 1034, 1065 (1993).

n221. See, e.g., Alexander Dyck et al., *Who Blows the Whistle on Corporate Fraud?* (Nat'l Bureau of Econ. Research, Working Paper No. 12882, 2007), available at <http://www.nber.org/papers/w12882.pdf> (presenting an empirical study of fraud detection covering 1994 to 2004, finding multiple sources of discovery, including internal and external sources, and concluding that "monetary incentives for detection in frauds against the government influence detection without increasing frivolous suits, suggesting gains from extending such incentives to corporate fraud more generally").

n222. See Coffee, *Gatekeepers*, supra note 12, at 166, 168.

n223. The greater the professional resistance to a broad mandate, the more likely it is suited to an incentives program. Performing the function successfully yields bonus payments, whereas either not performing the function or doing so unsuccessfully does not expose the gatekeeper to legal liability or even reputational harm. If experience using incentive devices is favorable, it could be possible to substitute that approach for existing mandatory duties backed by liability imposition.

n224. Coffee, *Gatekeepers*, supra note 12, at 369-70 (observing that "carrots, as well as sticks, then must be used" and that a challenge is to find "funding ... to subsidize" these incentives).

n225. Confidential incentive contracts could result in more effective gatekeeping (through discovery and correction of misreporting), but their value should increase if they are widely publicized.

n226. Cf. Macey, *Efficient Capital Markets*, supra note 14, at 410 (noting a proposal by the pension funds in New York and North Carolina to award brokerage business only to firms having adopted internal mechanisms to reduce conflicts of interest).

n227. See Michael Spence, *Job Market Signaling*, 87 *Q.J. Econ.* 355 (1973); Michael Spence, *Signaling in Retrospect and the Informational Structure of Markets*, 92 *Am. Econ. Rev.* 434, 448 (2002).

n228. Professors Hamdani and Kraakman's analysis of rewards for outside directors suggests additional alternatives that could be adapted to other gatekeepers. For example, they propose to reward directors who resign under protest when legitimately objecting to corporate wrongdoing. See Hamdani & Kraakman, supra note 3, at 1703-05. That could be adapted to reward auditors who resign from an engagement under stated circumstances. As another example, they propose a rule of reverse negligence that rewards directors who show that they discharged their duties despite a triggering event such as misreporting. See *id.* at 1691-93. They note that this could be adapted for auditors into a reverse strict liability rule under which auditors would be entitled to recover rewards despite misreporting by showing that they were not responsible for it. See *id.* at 1711. These examples, as with those in the text, are naturally nonexhaustive, as this literature is just emerging. See *id.* ("We list these possibilities not because we endorse them, but because they demonstrate that augmenting the traditional liability re-

gimes with a full set of possible legal sanctions, both negative and positive, can provide potentially valuable tools for fixing the incentives of gatekeepers that have not yet been analyzed - or even imagined.").

n229. See *supra* note 102 and accompanying text.

n230. See George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. Econ. 488, 488-89 (1970).

n231. These include requirements imposed respecting the composition and duties of board audit committees. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, *116 Stat. 745, 775-77* (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.). Governance requirements previously established by stock exchanges concerning audit committee composition, charters, and duties enhance the capabilities of audit committees to pursue a carrot system to promote gatekeeping effectiveness. See NASD, Inc., *By-Laws, Article IX, § 5* (2001); NASD, Inc. *Manual R., 4350(d)(1)-(2)* (2002); NYSE, Inc., *Listed Company Manual §§303.01(B)(2)(a), 303.01(B)(2)-(c)* (2007).

n232. See James Fanto, *Whistleblowing and the Public Director: Countering Corporate Inner Circles*, 83 *Or. L. Rev.* 435, 538-39 (2004) (discussing the group psychology of corporate inner circles that often opposes whistleblowing activities).

n233. Coffee, *Gatekeepers*, *supra* note 12, at 367; William W. Bratton, *Enron, Sarbanes-Oxley and Accounting: Rules Versus Principles Versus Rents*, 48 *Vill. L. Rev.* 1023, 1033 (2003).

n234. Sarbanes-Oxley Act of 2002, § 301; see Bratton, *supra* note 233, at 1035.

n235. Sarbanes-Oxley Act of 2002 § 301.

n236. See *supra* note 105 and accompanying text.

n237. Daniel Goelzer, Board Member, PCAOB, *Remarks at Columbia University Law School Conference, Gatekeepers Today: The Professions After the Reforms* (Sept. 29, 2006).

n238. Coffee, *Gatekeepers*, *supra* note 12, at 318-30.

n239. See *SEC v. Nat'l Student Mktg. Corp.*, *Fed. Sec. L. Rep. (CCH) P 95,912* (D.D.C. Jan. 18, 1977).

n240. See David A. Lax & James K. Sebenius, *The Manager as Negotiator* 29-30 (1986), reprinted in Dale A. Oesterle, *The Law of Mergers and Acquisitions* 19-21 (2d ed. 2002).

n241. See McGowan, *supra* note 4, at 1825-26.

n242. See *supra* notes 165-71 and accompanying text.

n243. Other gatekeepers use separate teams from multiple firms or use multiple teams within a single firm, including co-lead managers in underwriting transactions, lead banks in bank lending syndicates, and risk and rating teams within rating agencies.

n244. Cf. Frankel, *supra* note 1, at 162-65 (arguing that organization culture is the key to corporate honesty or rehabilitation); Jonathan R. Macey, A Pox on Both Your Houses: Enron, Sarbanes-Oxley and the Debate Concerning the Relative Efficacy of Mandatory Versus Enabling Rules, *81 Wash. U. L.Q.* 329, 333-35 (2003) (noting that factors other than corporate governance and securities laws bear on the honesty of actors within those systems, including "religiously, culturally, and sociologically induced incentive structures").

n245. See Gregory Mitchell, Case Studies, Counterfactuals, and Causal Explanation, *152 U. Pa. L. Rev.* 1517, 1518-20 (2004) (noting the prodigious volume of scholarship devoted to the Enron debacle and its implications for normative policy); David A. Skeel, Jr., Shaming in Corporate Law, *149 U. Pa. L. Rev.* 1811, 1814, 1841-50 (2001).

n246. Jonathan R. Macey, Wall Street in Turmoil: State-Federal Relations Post-Eliot Spitzer, *70 Brook. L. Rev.* 117, 120-22 (2004) (noting that Time Magazine named Spitzer the "crusader of the year"); Kulbir Walha & Edward E. Filusch, Eliot Spitzer: A Crusader Against Corporate Malfeasance or a Politically Ambitious Spotlight Hound? A Case Study of Eliot Spitzer and Marsh & McLennan, *18 Geo. J. Legal Ethics* 1111, 1111-15 (2005).

n247. E.g., Robert Salladay, "Snitch' Bill Passed by State Senate, S.F. Chron., June 21, 2002, at A1 ("Enron Vice President Sharon Watkins, hailed as a whistle-blower hero, had never informed the public or government about alleged wrongdoing but simply wrote a skeptical memo to the company chairman.").

n248. Creative public funding devices may nevertheless be possible, with funds generated from such sources as the Fair Funds for Investors provisions of the Sarbanes-Oxley Act, PCAOB's budget generated from public company accounting support fees, royalties on sales of FASB products, fines imposed by PCAOB on audit firms, and profit disgorgement remedies the SEC obtains, whether under the Sarbanes-Oxley Act or otherwise. One reason to prefer private arrangements to such public devices is the risk that the government agencies will not actually pay. See Ferziger & Currell, *supra* note 38, at 1155 (noting congressional testimony of Duke Law Professor James Cox stating that "that the biggest problem with a proposed insider trading bounty program would be the SEC's likely unwillingness to actually give out any rewards").

n249. See Malcolm Baldrige National Quality Improvement Act of 1987, Pub. L. No. 100-107, *101 Stat.* 724; Nat'l Inst. of Standards and Tech., Baldrige National Quality Program, [http://www.quality.nist.gov/PDFfiles/Improvement Act.pdf](http://www.quality.nist.gov/PDFfiles/Improvement%20Act.pdf) (last visited Nov. 5, 2007).

n250. See generally Robert M. Bloom, *Rattling: The Use and Abuse of Informants in the American Justice System* (2002) (exploring the cultural anxieties of ratting and betrayal).

n251. Cf. Margaret M. Blair & Lynn A. Stout, Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law, *149 U. Pa. L. Rev.* 1735 (2001) (inquiring into the roles of trust and loyalty in corporate relationships).

n252. See *supra* notes 34-38 and accompanying text.

n253. See Codification of Auditing Standards and Procedures, Statement on Auditing Standards No. 57, § 324.04 (Am. Inst. of Certified Pub. Accountants 2004); Codification of Auditing Standards and Procedures, Statement on Auditing Standards No. 82, (Am. Inst. of Certified Pub. Accountants 1997) ("Due professional care requires the auditor to exercise professional skepticism. Professional skepticism is an attitude that includes a questioning mind and critical assessment of audit evidence.").

n254. See Deborah L. Rhode, *In the Interests of Justice: Reforming the Legal Profession* 15 (2000) (observing the close and often conflicting connection between confidentiality and zealous advocacy).

n255. See Anthony T. Kronman, *The Lost Lawyer: Failing Ideals of the Legal Profession* 3-17 (1993) (meditating upon moral character and the ideal of the lawyer as "statesman").

n256. See Walha & Filusch, *supra* note 246, at 1131 ("Spitzer has been described as an ambitious political figure ... [and yet] many Americans view Spitzer as someone who personifies integrity and trust, view these complaints as Wall Street trying to protect itself, and most importantly, view Spitzer as someone who has fought against corporate greed on their behalf.").

n257. See John Braithwaite, *On Speaking Softly and Carrying Big Sticks: Neglected Dimensions of a Republican Separation of Powers*, 47 *U. Toronto L.J.* 305, 334-35 (1997) (discussing how Arthur Young, auditors of Lockheed, "put their responsible corporate self forward by refusing to certify the Lockheed Annual Report," prompting managers to respond, deliberate, and reform, and amid the resulting "domino-effect of public-regarding deliberation," Lockheed became "a born again corporation" (attributing this latter phrase to David Boulton, *The Grease Machine* 276 (1978), and noting that additional details appear in Brent Fisse & John Braithwaite, *The Impact of Publicity on Corporate Offenders* 144 (1983)).

n258. See *supra* text accompanying note 181.

n259. E.g. William A. Shumann, *Lockheed Agrees to End Payouts Abroad*, *Aviation Week & Space Tech.*, Sept. 1, 1975, at 19, 21; Robert M. Smith, *Japan Rightist Got \$ 7 Million from Lockheed*, *N.Y. Times*, Feb. 5, 1976, at 1; Robert M. Smith, *Lockheed Sought to Give Costly Boat as Impetus to Sale*, *N.Y. Times*, Sept. 1, 1975, at 1.

n260. See Mitchell, *supra* note 245, at 1518-25 (observing the "dizzying array" of scholarship mining the Enron collapse for policy implications).

n261. Cf. Jeffrey Pfeffer, *The Human Equation: Building Profits by Putting People First* 131-35 (1998) (indicating how norms and attitudes fundamentally shape company conduct, even to the financial and productive detriment of organizations).

n262. See Paul Strebler, *Why Do Employees Resist Change?*, *Harv. Bus. Rev.*, May-June 1996, at 86, 88 (observing that employee loyalty and commitment are connected to managerial recognition of a job well done).

n263. See Frankel, *supra* note 1, at 172 ("A direct monetary reward for honesty is unseemly. Honesty should be considered the rule and not the exception A monetary reward undermines the values of self-limitation and self-control in the face of temptation.").

n264. Cf. *Taft v. Hyatt*, 180 P. 213 (Kan. 1919) (holding that a police officer is ineligible for a contractual reward for apprehending an alleged criminal given his pre-existing duty to do so).

n265. Coffee, *Gatekeepers*, *supra* note 12, at 329-30; see *supra* text accompanying notes 104-61.

n266. See Robert A. Prentice, *Sarbanes-Oxley: The Evidence Regarding the Impact of Section 404*, 29 *Cardozo L. Rev.* (forthcoming 2007) (manuscript at 49-53, available at <http://ssrn.com/abstract=991295>) (discussing difficulties and prospects of how legal changes concerning the testing of internal controls may influence corporate culture).

n267. See Comm. on Capital Markets Regulation, Interim Report 2-3, 26-29, 39-44 (2006); McKinsey & Co., Sustaining New York's and the US' Global Financial Services Leadership 9 (2007) (referencing data concentrating on the relative number of initial public offerings made in New York and London in the periods before and after adoption of the Sarbanes-Oxley Act).

n268. See William N. Eskridge et al., *Cases and Materials on Legislation: Statutes and the Creation of Public Policy* 66-67 (3d ed. 2001).

n269. *Id.* at 66.

n270. See *id.* at 24, 66.

n271. *Id.* at 74-76; Coffee, *Gatekeepers*, *supra* note 12, at 10 n.1 ("Political scientists regard congressional committees as the gatekeepers of the legislative process."); Kay Lehman Schlozman & John T. Tierney, *Organized Interests and American Democracy* 317, 395-96 (1986) (observing that interest groups are more successful at preventing than facilitating legislation because "there are so many opportunities for throwing up roadblocks to unwanted action").

n272. The concept of vetogates has been adapted to other collective decision-making processes, such as generating the Federal Rules of Civil Procedure. See Catherine T. Struve, *The Paradox of Delegation: Interpreting the Federal Rules of Civil Procedure*, 150 *U. Pa. L. Rev.* 1099, 1129 (2002).

n273. See Eskiridge et al., *supra* note 268, at 65-71.

n274. See Henry N. Butler & Larry E. Ribstein, *The Sarbanes-Oxley Debacle: What We've Learned, How to Fix It* 71-73 (2006); William J. Carney, *The Costs of Being Public After Sarbanes-Oxley: The Irony of "Going Private,"* 55 *Emory L.J.* 141, 141-43 (2006); see also Ehud Kamar et al., *Going-Private Decisions and the Sarbanes-Oxley Act of 2002: A Cross-Country Analysis* 1-2 (U.S.C. Ctr. in Law, Econ. & Org., Research Paper No. C06-5, 2006), available at <http://ssrn.com/abstract=901769>; Christian Leuz et al., *Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistration* 1-4, 22-23 (European Corporate Governance Inst., Working Paper No. 155/2007, 2006), available at <http://www.ssrn.com/abstract=592421>.