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Article

Beyond Liability: Rewarding Effective Gatekeepers

Lawrence A. Cunningham *

Corporate and securities law scholars increasingly investigate the role of rewards to promote desired behavior.¹ Scholars have contributed considerable analysis to the utility of positive incentives for corporate whistleblowers;² a growing body of literature addresses paying rewards to effective capital market gatekeepers, with attention given to outside directors³ and lawyers.⁴ 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.⁵ 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. It then begins to explore how a rewards program might be designed to overcome some of those limitations and improve gatekeeper effectiveness.

* Professor of Law, George Washington University Law School. Thanks to John Coffee, Melvin Eisenberg, Claire Hill, Alan Palmiter and other participants in Columbia University Law School's conference, "Gatekeepers Today: The Professions after the Reforms" (Sept. 29, 2006), where I presented an early version of this Article, and to Assaf Hamdani.

¹ See 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).

² See, e.g., Pamela H. Bucy, "Carrots and Sticks:" *Post-Enron Regulatory Initiatives*, 8 BUFF. L. CRIM. L. REV. 277 (2004); Richard E. Moberly, *Sarbanes-Oxley's Structural Model to Encourage Corporate Whistleblowers*, 2006 B.Y.U. L. REV. 1107; Geoffrey Christopher Papps, *Beyond Protection: Invigorating Incentives for Sarbanes-Oxley Corporate and Securities Fraud Whistleblowers*, 87 BU L. REV. 91 (2007); David L. Schwarzkopf & Hugh M. Miller, *Early Evidence of How Sarbanes-Oxley Implementation Affects Individuals and their Workplace Relationships*, 110 BUS. & SOC'Y REV. 21 (2005).

³ 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 mis-reporting, by proving that they were non-negligent 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).

⁴ 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).

⁵ 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 discusses additional contributions to this literature.

The expanding interest in positive incentives for capital market gatekeepers dovetails with a broader and older trend in the regulation literature. This reflects a philosophical shift away from traditional deterrence-oriented strategies toward more cooperative and rewards-oriented systems to promote compliance.⁶ This approach joins market and regulatory accountability mechanisms that are described using various terms such as cooperative compliance, interactive compliance, responsive regulation, collaborative governance and cooperative implementation.⁷ An important inspiration for this shift is empirical psychological evidence suggesting that positive incentives may be more likely to promote desired behavior than negative threats.⁸

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 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. Law imposes duties on enterprises, individuals, outside accounting and law firms and their individual professional employees. The liability risks backing these regimes can be criminal or civil and include money damages, prison terms, fines, license revocations and the like. 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 likewise operates more as a stick than as a carrot. One consequence of the existing regime's emphasis on liability threats is to generate 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.

⁶ See, e.g., IAN AYRES & JOHN BRAITHWAITE, *RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE* (1992).

⁷ E.g., STEPHEN BREYER, *REGULATION AND ITS REFORM* (1982); JAY A. SIGLER & JOSEPH E. MURPHY, *INTERACTIVE CORPORATE COMPLIANCE* (1988); see Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L.Q. 487 (2003).

⁸ See AYRES & BRAITHWAITE, *RESPONSIVE REGULATION*, *supra* note 6, at 49–50 (“[P]sychological theories of minimal sufficiency and positive attribution demonstrate that long-term internalization of a commitment to compliance is more likely to occur when triggered by positive incentives rather than punishment”); see generally TOM R. TYLER, *WHY PEOPLE OBEY THE LAW* passim (1990).

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.⁹ Others point to factors that reduce auditor investment in reputation, such as industry concentration,¹⁰ differences between partner incentives and firm-level incentives,¹¹ and the proliferation of non-audit services.¹²

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, non-market impediments can frustrate implementing good ideas, as where 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 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 design 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

⁹ See, e.g., JOHN C. COFFEE, JR., GATEKEEPERS: THE ROLE OF THE PROFESSIONS IN CORPORATE GOVERNANCE 14–21 (2006); William W. Bratton, Jr., *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1350 (2002); William W. Bratton, Jr., *Shareholder Value and Auditor Independence*, 53 DUKE L.J. 439, 470 (2003); John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid"*, 57 BUS. LAW. 1403, 1403–05, 1409–10 (2002).

¹⁰ See, e.g., U.S. Gen. Accounting Office, Pub. No. GAO-03-864, *Public Accounting Firms: Mandated Study on Consolidation and Competition* 16, 20–22 (2003), <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 *infra* text accompanying notes 113–116.

¹¹ See, e.g., Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 CORNELL L. REV. 394, 407–08 (2004); Richard W. Painter, *Convergence and Competition in Rules Governing Lawyers and Auditors*, 29 IOWA J. CORP. L. 397, 412 (2004); Larry E. Ribstein, *Limited Liability of Professional Firms After Enron*, 29 IOWA J. CORP. L. 427, 447 (2004); see also Jonathan Macey & Hillary A. Sale, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 VILL. L. REV. 1167, 1173 (2003). See *infra* text accompanying notes 95–100.

¹² See e.g., Bratton, *Enron and the Dark Side of Shareholder Value*, *supra* note 9; Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, *supra* note 9; Prentice, *Inevitability of a Strong SEC*, *supra* note 10. See *infra* text accompanying notes 102–112.

extensive review offered to provide context, a rewards program emerges as a way to meet some of 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 the 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 contribute to the emerging literature taking the rewards approach.

I. THEORY

This Part reviews the well-known theory of capital market gatekeeping. Section A summarizes the standard model, distinguishing gatekeepers from whistleblowers and from various hybrid roles that professionals can assume. Section B focuses on the conditions necessary for effective gatekeeping (reputation and liability risk). Section C discusses costs of the standard model. The review entices 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 partake of attributes of each (called hybrids below).

1. Gatekeepers — Gatekeepers work with an enterprise to correct mis-reporting before it occurs.¹³ They do so by threatening to withhold support necessary to complete a report or consummate a transaction. Gatekeepers can deny access to capital markets.¹⁴ So gatekeepers are “intermediaries who provide verification and certification services to

¹³ 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.”).

¹⁴ See Peter C. Kostant, *Breeding Better Watchdogs: Multidisciplinary Partnerships in Corporate Legal Practice*, 84 MINN. L. REV. 1213, 1247 (2000).

investors” by pledging their professional reputations¹⁵—and, by withholding such support, block admission through the gate.¹⁶

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 non-reporting. Even so, the gatekeeper approach is intended to give professionals regulatory incentives to prevent mis-reporting.¹⁷ Most gatekeepers are paid for their services by the enterprises that retain them; all have 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.¹⁸ Lawyers advise on transaction design and disclosure. 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.¹⁹ 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

¹⁵ John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269, 279–280 (2004).

¹⁶ This reconciles what otherwise appear 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, n. 219 (2006) (identifying two strands of definition as those who: (a) certify as reputational intermediaries or (b) restrict access and endorse those admitted with their reputation for discretion); Peter Oh, *Gatekeeping*, 29 IOWA J. CORP. L. 735, 737 (2004) (noting conflation of reputational intermediary and professional capable of disrupting entry and exploring the distinction).

¹⁷ Editors, *Developments in the Law: Corporations and Society*, 117 HARV. L. REV. 2227, 2245 (2004).

¹⁸ See, e.g., Securities Exchange Act of 1934, 15 U.S.C. 78j-1 (statute stating audit requirements for detecting illegal acts); AICPA, Statement of Auditing Standards No. 54 (professional standards stating such requirements, later adopted by the PCAOB); SEC, Auditor Independence Requirements (Nov. 21, 2000) (regulations stating independence requirements); Statement of Auditing Standards No. 95 (professional statement of generally accepted auditing standards, later adopted by the PCAOB); Statement of Auditing Standards No. 99 (professional standards as to consideration of fraud in a financial statement audit, later adopted by the PCAOB). As to standards originally established by the AICPA adopted by the PCOAB, see SEC Order (April 25, 2003) (endorsing PCAOB adoption as interim standards those previously adopted by the AICPA).

¹⁹ See Lawrence A. Cunningham, *Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability*, 52 UCLA L. REV. 413, 417–18 n. 6 (2004)

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.²⁰ Roles vary with product or service type and the information its 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, quality of a debt instrument and so on.²¹

Accordingly, also varying are all other public policy aspects of their respective performance, including requirements, expectations, capacities, incentives and appropriate legal liability for failure.²² 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 while auditors take back-up roles in reviewing and testing disclosure.²³ Despite these differences, the term gatekeeper has assumed customary usage, not only in the academic literature but in official regulatory pronouncements.²⁴

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.²⁵ When gatekeepers determine that they cannot exercise internal influence to correct statements that require correcting, they may resign or otherwise withhold their services. However, this does not involve blowing a whistle to any enforcement authority or the public.²⁶ The distinctive feature of the whistleblower, then, is that the third party discloses wrongdoing to authorities or third parties.²⁷

²⁰ See John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 306 & 346–64 (stating that “all gatekeepers are not alike,” and developing proposals with entirely different content for auditors and for securities lawyers).

²¹ See also Arthur B. Laby, *Differentiating Gatekeepers*, 1 BROOKLYN J. CORP., FIN. & COMM. L. 119, 124–34 (distinguishing between independent and dependent gatekeepers) (2006).

²² See Cunningham, *Choosing Gatekeepers*, *supra* note 19, at n. 6.

²³ Coffee, *What Caused Enron*, *supra* note 15, at 279–80.

²⁴ See Coffee, *What Caused Enron*, *supra* note 15, at n. 35 (citing, for example, 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”)).

²⁵ See generally STEPHEN M. KOHN, *ET AL.*, WHISTLEBLOWER LAW: A GUIDE TO LEGAL PROTECTIONS FOR CORPORATE EMPLOYEES (2004).

²⁶ 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.”).

²⁷ See *Developments in the Law*, *supra* note 17, at 2245.

There are three recognized forms of whistleblowers. The first is the volunteer whose interest in whistle-blowing is not based on any duty and does not lead to any reward.²⁸ 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, whistle-blowing doctrines usually provide job security, resisting the enterprise's temptations toward retaliatory discharge.²⁹

The second 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.³⁰ The most prominent illustrations are cases under the False Claims Act.³¹ Private parties are vested with authority to prosecute claims of violations of laws and share in the recovery on behalf of government. Analogous bounty schemes appear, including, in the securities law context, the Securities and Exchange Commission's insider trading bounty program³² and, in the tax context, the Internal Revenue Service's informant rewards system.³³

The third form of whistleblower is the non-volunteer, one with duties to come forward and publicly disclose discovered wrongdoing. This type of whistleblower is also primarily a gatekeeper but has specific additional whistle blowing duties. Consider, for example, auditors. The Private Securities Litigation Reform Act (PSLRA)³⁴ expanded auditor whistle-blowing obligations, requiring the reporting of illegal acts within an enterprise and to the SEC if satisfactory responses are not forthcoming from within the enterprise.³⁵

²⁸ See Richard E. Moberly, *Sarbanes-Oxley's Structural Model To Encourage Corporate Whistleblowers*, 2006 BYU L. REV. 1108, 1126–31 (discussing the standard “anti-retaliation” model in general and its weaknesses in the particular context of capital market context).

²⁹ See Papps, *supra* note 2, at 112-17 & 119-20.

³⁰ See generally Pamela H. Bucy, *Private Justice*, 76 S. CAL. L. REV. 1 (2002); Richard A. Bales, *A Constitutional Defense of Qui Tam*, 2001 WIS. L. REV. 381; Jill E. Fisch, *Class Action Reform, Qui Tam, and the Role of the Plaintiff*, 1997 LAW & CONTEMP. PROBS., 167.

³¹ 18 U.S.C. § 287 (2006).

³² 17 C.F.R. 201 (2006); see also Insider Trading and Securities Fraud Enforcement Act of 1988, 15 U.S.C. § 78u-1.

³³ See Internal Revenue Service, Pub. No. 733, *Rewards for Information Provided by Individuals to the Internal Revenue Service* (1997). 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.

³⁴ 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.

³⁵ See Kostant, *Breeding Better Watchdogs*, *supra* note 14, at 1246, n. 150. Notably, few reports have been made under this provision. See U.S. Gen. Accounting Office, *Securities Exchange Act: Review of*

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 partake of both a gatekeeper and a whistleblower function. Suppose an auditor determines that a client is committing illegal acts and the client refuses to redress the violations. It must both resign from the engagement and disclose the illegal acts.³⁶ That exercises both the gatekeeping function by refusing support and the whistle-blowing by reporting 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.³⁷

The SEC's struggle to formulate rules governing lawyer professionalism reveals the difficulty of classifying attorneys as either gatekeepers or whistleblowers.³⁸ As adopted, SEC rules permit but do not require disclosing confidential information to prevent crime or fraud.³⁹ That does not quite fit the typical whistleblower classification, the essence of which is reporting.⁴⁰ 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.⁴¹ This appears closer to the typical

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 either to few actual problems or rationalized self-interest. Another likely possibility is the chaperon thesis, in which auditors observing problems get them corrected so the client can be admitted, not bounced. That is, they perform their gatekeeping function first.

³⁶ Sec. & Exch. Comm., Reg. S-K, 17 C.F.R. § 229.304 (Item 304); Securities and Exchange Act of 1934 10A(b)(3), 15 U.S.C. 78h-1 (2007) (illegal acts); see Darin Bartholomew, *Is Silence Golden When It Comes to Auditing*, 36 J. MARSHALL L. REV. 57, 93–102 (2002); Kostant, *Breeding Better Watchdogs*, *supra* note 14, at 1245–46.

³⁷ See *United States v. Zolin*, 491 U.S. 553, 562–563 (1989) (construing and applying “crime-fraud exception to the attorney-client privilege”); Tamar R. Brickhead, *The Conviction of Lynne Stewart and the Uncertain Future of the Right to Defend*, 43 AM. CRIM. L. REV. 1, 5-10 (2006) (critical discussion of criminal conviction of criminal defense lawyer concerning activities arising out of the attorney-client relationship); Restatement (Third) of Law Governing Lawyers § 67 (2000); Model Rules of Prof'l Conduct R. 1.6(b) (2004); Model Rules of Prof'l Conduct R. 1.13(c); see also Richard W. Painter & Jennifer E. Duggan, *Lawyer Disclosure of Corporate Fraud: Establishing a Firm Foundation*, 50 SMU L. REV. 225 (1996) (exploring imposition of affirmative duties on auditors respecting steps to take when confronting corporate and exploring how one would adapt analogous provisions for the legal profession).

³⁸ See Roger C. Cramton, George M. Cohen & Susan P. Koniak, *Legal and Ethical Duties of Lawyers After Sarbanes-Oxley*, 49 VILL. L. REV. 725, 779–810 (2004) (extensive discussion and analysis of the “reporting out” concept).

³⁹ See 17 C.F.R. 205.3(d)(2) (2003), <http://www.sec.gov/rules/final/33-8185.htm>

⁴⁰ *Developments in the Law*, *supra* note 17, at 2245–46.

⁴¹ Cramton, Cohen & Koniak, *supra* note 38, at 810–813 (recapitulation of analysis of the proposed “noisy withdrawal” concept).

whistle-blowing class,⁴² but is not quite whistle-blowing due to limitations arising from the attorney-client privilege.⁴³

Nor do SEC rules as adopted embrace the gatekeeping model. Under the rules, lawyers must report violations to designated internal officials within the enterprise (called “up-the-ladder reporting”) without necessarily reporting to outside authorities.⁴⁴ 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.⁴⁵ So lawyers no doubt play a role in superintending capital market integrity, although it is not exactly clear whether they are gatekeepers or whistle-blowers or something more of a hybrid.

B. Conditions

Law’s whistle-blowing 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 obtain for a gatekeeping model to succeed.

As a threshold matter, and in keeping with the metaphor, there must be a gate to keep. It must be one that an enterprise has to traverse to access capital markets and there can be no other way through 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.

⁴² *Developments in the Law*, *supra* note 17, at 2246.

⁴³ M. Peter Moser & Stanley Keller, *Sarbanes-Oxley 307: Trusted Counselors or Informers?*, 49 VILL. L. REV. 833, 848–849 (2004) (summarizing grounds for objecting to the noisy withdrawal concept reflecting tensions with traditional values embedded in the attorney-client relationship).

⁴⁴ 17 C.F.R. 205.3(d)(2) (2003), <http://www.sec.gov/rules/final/33-8185.htm>.

⁴⁵ See Coffee, *The Attorney as Gatekeeper*, *supra* note 35, at 1301–1302 (distinguishing up-the-ladder reporting required from “other, potentially more extensive gatekeeping duties”). On these and other aspects of the SEC rulemaking in this context, see Stephen M. Bainbridge & Christina J. Johnson, *Managerialism, Legal Ethics, and Sarbanes-Oxley Section 307*, 2004 MICH. ST. L. REV. 299, [pin cite] (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 (Section 307 and the Part 205 Rules have flaws but bode well to improve normative self-conception of securities lawyers to assume 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 (failure to distinguish and give special dispensation to low level in-house counsel is defect in Part 205 Rules).

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.⁴⁶ This approach can be justified by how these third parties enjoy low-cost access to information and can provide a “private monitoring service on behalf of the capital markets.”⁴⁷

Gatekeepers must be independent and possess sufficient stakes in their reputations as keepers so that petitioner bribes cannot weaken their resolve. 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.⁴⁸ As Professor Coffee 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.”⁴⁹

So 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.⁵⁰ This creates an incentive structure that differs from the enterprise and its employees.⁵¹ As Professor Kraakman explained in his pioneering analysis, third parties usually “are likely to have less to gain and more to lose from [misleading reporting] than inside managers.”⁵² The stakes for these gatekeepers are influenced by both reputation and liability concerns, and their components can operate at the levels of individual actors, their firms and entire professions. Each influence is considered in turn.

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,

⁴⁶ Section 11 of the 1933 act and Section 10 of the 1934 Act 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. § 77(q)(a) (imposing on auditors the duties of inquiry and disclosure); 15 U.S.C. § 78r (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).

⁴⁷ *See* Kraakman, *Corporate Liability*, *supra* note 5, at 891.

⁴⁸ *See* Poonam Puri, *Taking Stock of Taking Stock*, 87 CORNELL L. REV. 99, 146 (2001).

⁴⁹ Coffee, *The Attorney as Gatekeeper*, *supra* note 35, at 1269.

⁵⁰ Kraakman, *Corporate Liability*, *supra* note 5, at 891.

⁵¹ Professor Kraakman’s chief insight is that “whenever potential offenders must employ incorruptible outsiders to gain legitimacy or expertise or to met [sic] a legal requirement, gatekeeper liability will thwart a class of offenses that are unreachable through enterprise-level or managerial sanctions.” *Id.*

⁵² *Id.*

develop or have their own reputations for the quality of their disclosure, on the range from fair to misleading reporting. Candid enterprises enjoy more investor trust.⁵³ The more valuable a reputation is, the greater is the cost of jeopardizing it through opportunistic abuse of that trust.⁵⁴

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, a valuable trait. The more valuable it is, the greater is the risk of reputation loss so that, at some point, no additional incentives are necessary.⁵⁵

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.⁵⁶ Enterprises pay fees for this credence. Investors and other market participants appreciate these as valuable signals.⁵⁷ When operating effectively, they contribute to a market in which securities prices tend to converge accurately toward the fundamental value of the related enterprise.⁵⁸

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.⁵⁹ An individual's or firm's investment in reputation should generate not only private benefits for them, but also wider benefits for the profession. If so, firms and individuals can free ride on the investments of others. That can have the effect of reducing incentives to invest. The effect is dramatized by the presence of so-called bucket shops, securities firms engaged in

⁵³ 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, 308–11.

⁵⁴ *See id.*

⁵⁵ *See* Victor P. Goldberg, *Accountable Accountants: Is Third-Party Liability Necessary?*, 17 J. LEG. STUD. 295, 312 (1988) (reputations of auditors sufficient so third-party liability not necessary).

⁵⁶ *See* David Charney, *Nonlegal Sanctions in Commercial Relationships*, 104 HARV. L. REV. 375, 408–25 (1990).

⁵⁷ Coffee, *What Caused Enron*, *supra* note 15, at 279–80 (2004) (“[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.”).

⁵⁸ *See* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 618–21 (1984) (investment bankers’ good reputations promote efficient markets).

⁵⁹ Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 787–88 (2001) [hereinafter Black, *Preconditions for Strong Securities Markets*].

small-scale deception while benefiting from the securities profession's broader reputation. The problem can creep into the practices of law and public accounting.⁶⁰

Professions address these externality and free rider problems using 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.⁶¹

Second, such associations may provide or promote licensing or disciplining schemes that implicitly vouch for each gatekeeper.⁶² Examples are the programs overseen by the American Institute of Certified Public Accountants (AICPA)⁶³ for auditors and the National Association of Securities Dealers (NASD)⁶⁴ for securities firms, including underwriters. Professional associations can police reputations of members and deny admission to unqualified applicants or expel non-compliant 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.⁶⁵ 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.⁶⁶ But the threat of revocation is more nearly 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 entails an enormously complex set of factors that it is difficult to untangle and exceedingly difficult for law to micro-manage.⁶⁷ Law can tinker with procedures and policies but these must

⁶⁰ *See id.*

⁶¹ *See* Pamela S. Karlan, *Contingent Fees and Criminal Cases*, 93 COLUM. L. REV. 595, 629-32 (1993) (lawyers as gatekeepers in respect to contingent fees in criminal cases); David B. Wilkins, *Who Should Regulate Lawyers?*, 105 HARV. L. REV. 801, 811 (1992) (noting that ABA ethics code "constitute[s] the most influential source[] of professional norms").

⁶² Black, *Preconditions for Strong Securities Markets*, *supra* note 59, at 788-89.

⁶³ *See* www.aicpa.org.

⁶⁴ *See* www.nasd.org.

⁶⁵ *See* Prentice, *Inevitability of a Strong SEC*, *supra* note 10, at 788-89 & 795-97 (as to NASD and New York Stock Exchange).

⁶⁶ Black, *Preconditions for Strong Securities Markets*, *supra* note 59, at 788-89.

⁶⁷ An abundant literature written 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); Lawrence E. Mitchell, *Understanding Norms*,

be tailored to the peculiar attributes of a profession and in tune with idiosyncrasies of given firms and individuals.⁶⁸

To highlight some of these complexities, there is debate about exactly what kind of reputation various gatekeepers seek to maintain.⁶⁹ For auditors, it commonly is said that their reputation for honesty is their most valuable asset.⁷⁰ But as a matter of practice for effective auditing, more important is a reputation with management for toughness.⁷¹ 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.⁷²

2. Liability — An extensive 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*.⁷³ Third-party liability supplements this device to address residual risks that the former fails to deter or so internalize.⁷⁴ It works 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 have duties: approving transactions, designing or opining on them or related disclosure, and providing assurance and attestation of financial statement assertions. Failure in these duties triggers liability under various state and federal claims, a panoply of SEC administrative sanctions, and criminal law.⁷⁵ In significant part, these doctrines are based on a theory of deterrence, a negative injunction

49 U. TORONTO L.J. 177 (1999); ERIC A. POSNER, *LAW AND SOCIAL NORMS* (2000); *see also* sources cited *infra* note 235.

⁶⁸ *See* Donald C. Langevoort, *Where Were the Lawyers? A Behavioral Inquiry Into Lawyers' Responsibility for Clients' Fraud*, 46 VAND. L. REV. 75, 115 (1993) [hereinafter Langevoort, *Where Were the Lawyers?*].

⁶⁹ *See* McGowan, *Why Not Try the Carrot?*, *supra* note 4, at 1828.

⁷⁰ *E.g.*, *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990) (Easterbrook, J.) (“An accountant’s greatest asset is its reputation for honesty, followed closely by its reputation for careful work”), *cert. denied* 498 U.S. 941 (1990).

⁷¹ *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).

⁷² *See* Langevoort, *Where Were the Lawyers?*, *supra* note 68, at 101–11; McGowan, *Why Not Try the Carrot?*, *supra* note 4, at 1833–34.

⁷³ *See* Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 NYU L. REV. 687, 701–05 (1997).

⁷⁴ Kraakman, *Corporate Liability*, *supra* note 5, at 701–05.

⁷⁵ *See* Puri, *supra* note 48, at 148–49 (reviewing all these liability risks).

to discourage misbehavior.⁷⁶ Scholars endlessly debate and policy analysts endlessly tinker with the numerous intricacies of this framework to seek its optimal structure.⁷⁷ 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.⁷⁸ 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.⁷⁹ Yet others cite the benefits of increasing liability with a hint of incontestability. Thus, “[r]aising the penalties for both primary and third parties can be an effective way to make gatekeeping regimes work.”⁸⁰ 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.”⁸¹

The shape of liability exposure can be altered, as by expanding the scope of duties or of doctrines such as broad interpretations of concepts like “substantial assistance” used to impose liability.⁸² Or due diligence duties could be specified expansively. Third-party liability can be strict (as under the doctrine of respondeat superior) or duty-based (as under the doctrines of aiding-and-abetting or negligent non-detection).⁸³

⁷⁶ 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, 676 (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).

⁷⁷ 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 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, 956-73 (2003) (showing 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 sub-group levels such as corporate culture and observing that additional incentives are supplied by private and regulatory enforcement).

⁷⁸ Black, *Preconditions for Strong Securities Markets*, *supra* note 59, at 794 (accountants) & 795 (bankers).

⁷⁹ *Id.* at 795 & 800.

⁸⁰ Kostant, *Breeding Better Watchdogs*, *supra* note 14, at 1248, n. 159.

⁸¹ Coffee, *The Attorney as Gatekeeper*, *supra* note 35, at 1306.

⁸² Langevoort, *Where Were the Lawyers?*, *supra* note 68, at 115.

⁸³ Compare Frank Partnoy, *Barbarians at the Gatekeepers*, 79 WASH. U. L. Q. 491, 540-46 (2001) (exploring strict liability for auditors) with John C. Coffee, Jr., *Gatekeeper Failure and Reform*, *supra* note 20, at 354 (evaluating relative strict liability for auditors such as a limitation on liability based on an affirmative defense requiring proof of non-negligence and good faith).

Some believe in the possibility of calibrating the duty to the penalties in optimal ways, as by a sliding scale on which, as liability standards move from negligence to strict liability, associated punishment for violations can be relaxed accordingly.⁸⁴ Others contend that an optimal regime would allow gatekeepers to negotiate contracts with clients stating the levels of review and assurance to be provided, along with express terms of liability exposure tailored to that performance.⁸⁵

Scholars debate the method and effectiveness of alternatives means of enforcement. They debate the scope of private rights of action under Section 10b or argue that stepped up public (SEC) enforcement is superior.⁸⁶ In this quest, also relevant is the relative ability of enforcement authorities to learn of violations that warrant enforcement activity.⁸⁷ Damages caps and safe harbors are likewise debated, along with the role of insurance.⁸⁸ To conclude this non-exhaustive highlight of the many contestable parameters of system design, scholars debate the merits of enterprise versus individual liability.⁸⁹

Finally, some believe that the corollary of liability regulation works too. Consider the Federal Sentencing Guidelines addressing corporate criminality. While increasing sanctions on the guilty, they also reduce sanctions for those who actively seek to deter, detect and disrupt.⁹⁰ As Professor 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

⁸⁴ E.g., Kostant, *Breeding Better Watchdogs*, *supra* note 14, at 1248.

⁸⁵ See Stephen Choi, *Market Lessons for Gatekeepers*, 92 NW. L. REV. 916, 951-58 (1998).

⁸⁶ For a well-known debate along these lines, see 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); 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).

⁸⁷ 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 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).

⁸⁸ Compare Donald C. Langevoort, *Capping Damages for Open Market Securities Frauds*, 38 ARIZ. L. REV. 639, 657-62 (1996) (exploring parameters of potentially appropriate liability caps for non-privy federal securities 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 integrity of securities markets by reducing managerial incentives to promote faithful financial reporting).

⁸⁹ See, e.g., Kraakman, *Corporate Liability*, *supra* note 5, at 867-68.

⁹⁰ Kostant, *Breeding Better Watchdogs*, *supra* note 14, at 1245, n. 146.

‘legal bribe’ to encourage gatekeeping.’⁹¹ These examples represent progress compared to the *in terrorum* approach of liability threats.

C. Costs

The benefits of a regime of third-party liability 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 mis-reporting. The fraud artists who pass through the gate undetected create additional costs in legal liability, borne either by the subject gatekeeper or by insurance. Litigation and administration costs are considerable, including costs associated with defending against non-meritorious claims.

Second, liability risk can overshoot the mark, at least in some contexts. The risk of error may create excessive risk-aversion.⁹² Costs of a gatekeeper liability regime are increased (and otherwise unnecessary) compliance burdens on those predisposed to report fairly. A related cost is how third-parties, reflecting their own liability risk, will charge a premium or require over-investment 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 always have resisted accepting any undertaking to detect for fraud or opine on the reasonableness of management’s accounting choices.⁹³ Lawyers likewise resist imposition of any obligations that even remotely threaten the jealously guarded attorney-client privilege and doctrines of confidentiality.⁹⁴

II. FAILURE

This Part reviews the literature diagnosing the episodes of financial mis-reporting of the early 2000s that showed limitations on the traditional gatekeeping model. Section A discusses diminished reputation constraints that affected partners, firms, and professions as a whole. Section B considers how reduced liability risk may have magnified these limitations. Section 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 made in response to the period’s

⁹¹ *Id.* at n. 164 (citing Kraakman, *Corporate Liability*, *supra* note 5, at 70–71) (discussing the use of legal bribes to promote effective gatekeeping).

⁹² *See* Choi, *supra* note 85, at 955

⁹³ *See* COFFEE, GATEKEEPERS, *supra* note 9, at 166-68]; *infra* text accompanying notes 197-202.

⁹⁴ *See* McGowan, *Why Not Try the Carrot?*, *supra* note 4, at 1846-54.

transgressions. The analysis concludes that diagnosis and reform invariably focus on negative threats associated with reputation and liability risk but that a more promising avenue is to consider positive incentive programs.

A. *Diminished Reputation Constraints*

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

1. Partners — A common diagnosis of mis-aligned incentives considers the partner-level behavior of gatekeeper professionals. It 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.⁹⁵ This 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 who are captured by their client and punishes those who report negative information about their clients through the proper corporate channels.”⁹⁶ This diagnosis underscores the value of rewarding those who disrupt mis-reporting.

A related diagnosis emphasizes how a firm that allows its partners’ careers to depend on single clients 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.⁹⁷ Yet it occurred at Enron and perhaps on other engagements.⁹⁸ At minimum, these errors indicate superior methods of internal assignment allocation.

For lawyers, the one-client problem was less obvious, as most law firm partners provide the specialized services to a broad range of clients.⁹⁹ On the other hand, some evidence from the period indicated a decline in this constraint for other reasons, chiefly when lawyers’ compensation was paid, in part, in equity in their client firms.¹⁰⁰ This

⁹⁵ See sources cited *supra* note 11.

⁹⁶ Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, *supra* note 11, at 407–08.

⁹⁷ See *supra* text accompanying notes 48-52.

⁹⁸ Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, *supra* note 11, at 410.

⁹⁹ See Coffee, *The Attorney as Gatekeeper*, *supra* note 35, at 1305–06 (noting that the one-client problem for audit partners can impair the reputational constraint at partner level but how this is not so at law firms).

¹⁰⁰ See Puri, *supra* note 48; 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

problem could impair the reputational constraint at the partner level by 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.¹⁰¹ 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 strategy to technology management).¹⁰² 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.¹⁰³

Cross-selling essentially eliminated one of the vital guarantors of auditor independence: the strong signal emitted when an auditor severs a client relationship.¹⁰⁴ 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 that auditors fire thus lose much more than the auditor loses. They may be unable to find any auditor at all after being severed. The auditor may even gain reputation value from this sternness and this could enable it to attract new clients.¹⁰⁵

Yet, during the 1990s, the incidence of auditor vetogating declined due to shifts in power from auditors to clients.¹⁰⁶ According to this diagnosis, the existing auditing

traditional gatekeeper liability theory and noting controversy as to 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 (2005).

¹⁰¹ See Bratton, *Enron and the Dark Side of Shareholder Value*, *supra* note 9, at 1350.

¹⁰² Prentice, *Inevitability of a Strong SEC*, *supra* note 10, at 786 (“[C]onsulting fees rose from seventeen percent of audit fees in 1990 to sixty-seven percent in 1999”) (citing Richard M. Frankel et al., *The Relation Between Auditors’ Fees for Non-Audit Services and Earnings Management*, 77 ACCT. REV. (Supp.) 71, 89 (2002)); Bratton, *Enron and the Dark Side of Shareholder Value*, *supra* note 9, at 1350 (describing how fees from audit clients for non-audit services rose from 13% of revenues in the 1970s to 50% of revenues in the 1990s).

¹⁰³ Professor Prentice documents factors that had the same weakening effect at all other gatekeepers, including lawyers, analysts, rating agencies, bankers, mutual funds and stock exchanges. See Prentice, *Inevitability of a Strong SEC*, *supra* note 10, at 786–98.

¹⁰⁴ 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) (most important guarantor of auditor independence is 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 give auditor incentives not to sever clients).

¹⁰⁵ The danger in this structure—also true of a rewards program—is auditor strategic behavior, in which they fire entirely responsible clients to shine their image and attract other shinier clients. See, e.g., Macey & Sale, *Observations on the Role of Commodification*, *supra* note 11, at 1176. The effect, in any event, is a kind of balance of power between enterprises and auditors, one of “mutual reputation enhancement.” *Id.*

¹⁰⁶ Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, *supra* note 11, at 409.

structure “will not function properly until a lead audit partner can confidently fire a dishonest client without jeopardizing his career.”¹⁰⁷ In the period after the Sarbanes-Oxley Act became law, the number of audit firms firing clients increased dramatically.¹⁰⁸

It is hard to determine exactly why auditors increasingly severed clients during this period. Some evidence indicates a tendency to sever smaller enterprises not larger ones,¹⁰⁹ even though all frauds leading to the Sarbanes-Oxley Act involved large enterprises.¹¹⁰ Moreover, Sarbanes-Oxley does not ban all non-audit services, leaving a large exception for tax services to clients.¹¹¹ This is both lucrative and a context in which acute risk of illegality and fraud appear.¹¹² 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 have increased erosion of audit quality. Mergers during the 1990s reduced the number of large audit firms from

¹⁰⁷ *Id.*

¹⁰⁸ See Coffee, *Gatekeeper Failure and Reform*, *supra* note 20, at 348, 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.”).

¹⁰⁹ An extensive contemporary and historical literature investigates the multiple aspects of auditor switching. Among recent contributions suggesting that increased switching after Sarbanes-Oxley is not strictly due to those reforms but at least potentially related to client size, see Michael Ettredge, Chan Li & Susan Scholz, *Audit Fees and Auditor Realignment in the Sarbanes-Oxley Era*, U. Kansas Working Paper (Nov. 2005) (“[A]uditors tend to resign from companies that pay relatively lower fees [and those] whose auditors resign also are characterized by smaller size, negative income (losses), and prior receipt of going concern audit reports”); see also Wayne R. Landsman, Karen K. Nelson & Brian R. Rountree, *An Empirical Analysis of Big N Auditor Switches* (2005) (detailing pre-SOX study of switches during 1993 to 2001 showing that resignations of large audit firms commonly result in the client engaging another large audit firm).

¹¹⁰ 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 SOX 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).

¹¹¹ 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).

¹¹² See *United States v. Stein*, 2006 U.S. Dist. LEXIS 42915, [pin cite] (S.D.N.Y. June 26, 2006); *United States v. KPMG LLP*, 316 F. Supp. 2d 30, [pin cite] (D.D.C. 2004) (facts at preliminary stage of Internal Revenue Service and Department of Justice investigations into criminal conduct at KPMG, which eventually led to the firm’s narrowly escaping a criminal indictment); see also Sheldon D. Pollack & Jay A. Soled, *Tax Professionals Behaving Badly*, 105 TAX NOTES 201, 210 (2004).

eight to five and the dissolution of Arthur Andersen reduced it further to the current four.¹¹³ These firms are massive compared to the next largest firms, with annual revenue at the four large firms reaching \$20 billion compared to \$1 billion for the next largest firms.¹¹⁴ This concentration in the industry's upper tier reduces the importance of product differentiation.¹¹⁵ 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.¹¹⁶

A final—and pervasive—limitation on gatekeeping efficacy is how the enterprise pays the gatekeeper.¹¹⁷ That creates an inherent inclination for solicitude, simply to retain business. Numerous solutions to this limitation have been proposed, some applied to auditors and some to other intermediaries. Examples include using insurance markets,¹¹⁸ public funding,¹¹⁹ funding through stock exchanges¹²⁰ or voucher financing programs.¹²¹

None of these has been adopted in the United States. Instead, the Sarbanes-Oxley Act adopts a more cautious ground. This reposes in an issuer's board audit committee the authority to determine auditor compensation (and other auditor oversight, including

¹¹³ See U.S. Gen. Accounting Office, *Public Accounting Firms: Mandated Study on Consolidation and Competition*, *supra* note 10, at 16, 20–22.

¹¹⁴ See *id.*

¹¹⁵ 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); Eric L. Talley, *Cataclysmic Liability Risk among Big-Four Auditors*, 106 COLUM. L. REV. 1641, [pin cite] (2006).

¹¹⁶ O'Connor, *Be Careful What you Wish For*, *supra* note 10, at 787–88; Prentice, *Inevitability of a Strong SEC*, *supra* note 10, at 786.

¹¹⁷ Coffee, *What Caused Enron?*, *supra* note 15, at 279–80 (noting that gatekeeper utility is limited because paid by party to be monitored).

¹¹⁸ Cunningham, *Choosing Gatekeepers*, *supra* note 19, at 427–41 (instead of having companies pay auditors, authorizing them to buy insurance and having insurers hire and pay auditors).

¹¹⁹ Steven L. Schwarcz, *Rethinking the Disclosure Paradigm in a World of Complexity*, 2004 U. ILL. L. REV. 1, 29, n. 180 (suggesting but discounting possibility of having gatekeepers such as auditors paid through public funding).

¹²⁰ 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 (having the stock exchanges coordinate and compensate auditors)).

¹²¹ 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).

retention and dismissal).¹²² One benefit of this approach is that audit committees can be conceptualized as gatekeepers, of a fashion, and there is some theoretical support for believing that having one gatekeeper pay another is an effective way to increase overall gatekeeping effectiveness.¹²³

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 Private Securities Litigation Reform Act (PSLRA) changed the liability regime from joint-and-several liability to proportionate so that gatekeepers no longer are liable for the entirety of damages but only for their share of culpability.¹²⁴ Second, the Supreme Court held that the anti-fraud provisions of the federal securities laws do not reach those who aid or abet others in mis-reporting.¹²⁵ While this did not prevent SEC actions under that theory, it significantly curtailed private actions.¹²⁶ Such changes reduced the legal liability threat, which could have been a factor in declining propensity to protect reputations for integrity as gatekeepers (or whistleblowers).¹²⁷ When combined with the other factors noted above, incentives for quality gatekeeping declined.¹²⁸

A related diagnostic concerning audit firms is based on changing forms of liability structures.¹²⁹ Audit firms shifted from partnerships to limited liability entities.¹³⁰ This

¹²² Sarbanes-Oxley Act of 2002, § 301, codified in 15 U.S.C. § ____.

¹²³ COFFEE, GATEKEEPERS, *supra* note 9, at 166-68; *see infra* text accompanying note 219 (one feature of the rewards system is the possibility of securities underwriters paying bonuses to auditors).

¹²⁴ 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.

¹²⁵ *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 177 (1994). In May 2007, the Supreme Court granted *certiorari* in *Stoneridge Investments v. Scientific Atlanta*, to be heard in the 2007-08 Term, giving the Court an opportunity to elucidate this body of law.

¹²⁶ *See* Talley, *Cataclysmic Liability Risk*, *supra* note 115, at 1650-51 & 1656-57 (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).

¹²⁷ Bratton, *Enron and the Dark Side of Shareholder Value*, *supra* note 9, 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).

¹²⁸ *See* COFFEE, GATEKEEPERS, *supra* note 9, at 152-56; Bratton, *Shareholder Value and Auditor Independence*, *supra* note 9, at 470 (attributing 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).

¹²⁹ Macey & Sale, *Observations on the Role of Commodification*, *supra* note 11, at 1180.

¹³⁰ Ribstein, *supra* note 11, at 447.

reduced incentives to maintain internal control, as litigation risk fell along with concern with steps that would reduce it.¹³¹ At least in the case of Enron, this diagnosis concludes, “[i]t 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.”¹³²

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.¹³³ It is particularly perplexing to meet the specific objective of setting an optimal level of deterrence.¹³⁴

That discussion also shows how fair it is 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 reach of any liability threats to control.

C. Systemic Factors

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

First, the era was characterized by financial euphoria.¹³⁵ 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.¹³⁶ It becomes easy in such periods to suspend critical judgment, including as to conventional matters of

¹³¹ *Id.*

¹³² Macey & Sale, *Observations on the Role of Commodification*, *supra* note 11, at 1181.

¹³³ *See supra* text accompanying notes 73-91; *see also* John Siliciano, *Negligent Accounting and the Limits of Institutional Tort Reform*, 86 MICH. L. REV. 1929, [pin cite] (1988).

¹³⁴ *See* COFFEE, GATEKEEPERS, *supra* note 9, at 61 (discussing the decline of deterrence).

¹³⁵ *See* ROBERT SHILLER, *IRRATIONAL EXUBERANCE* passim (2d ed. 2005).

¹³⁶ Cunningham, *The Sarbanes-Oxley Yawn*, *supra* note 110, at [pin cite].

corporate governance and financial reporting. Any gatekeeping model will suffer serious stress in such periods.¹³⁷

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 mis-reporting 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.¹³⁸ Alas, in euphoric periods, even a well-thatched mass of cross-checking gatekeepers can be of limited effect. Collective suspension of objectivity can induce mutual myopia, as when auditors defer to lawyers who approve an approach to a reporting question while lawyers defer to the auditors who do so.¹³⁹

The bubble problem is recurring rather than continuing. Other cultural factors of a more enduring nature can impair gatekeeper effectiveness. Critical to success is having individuals within professional firms capable of advancing and protecting the firm's reputation. This bonding is more likely in cultures where 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, such as auditors and lawyers.¹⁴⁰ They move from firm to firm more often than in previous generations. This reduces the bonding between individuals and firms and related individual incentives to advance and protect firm reputations.¹⁴¹

¹³⁷ See Bratton, *Shareholder Value and Auditor Independence*, *supra* note 9, at 470; Gerding, *The Next Epidemic*, *supra* note 16, at 426–28.

¹³⁸ COFFEE, GATEKEEPERS, *supra* note 9, at [pin cite].

¹³⁹ See Lawrence A. Cunningham, *Sharing Accounting's Burden: Business Lawyers in Enron's Dark Shadows*, 57 BUS. LAW. 1421, 1454 (2002).

¹⁴⁰ See Frederick W. Lambert, *A Preliminary Inquiry into the Transcendence of Value Creation*, 74 OR. REV. 121, 143–44 (1995) (noting practice beginning in 1970s of law firms recruiting associates laterally from other firms, the emergence of partner “books of business” that were portable to other firms, 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 role of lateral movement among law firm associates)

¹⁴¹

Bonding also was impaired when clients began more frequently to use different firms for different kinds of services; 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.¹⁴² That too breaks long-term bonds that concentrate on advancing and protecting reputations for candor and integrity in securities disclosure. Likewise, more frequent mergers among professional service firms—now common among law firms—reduces bonding value.¹⁴³

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.¹⁴⁴ Among numerous examples are the self-serving bias and the commitment bias, which can afflict auditors, lawyers and other gatekeepers.¹⁴⁵ The first 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 correcting them using new information.

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.¹⁴⁶ Harder to combat are more general behavioral biases known as “backward recursion” and the “time delay trap.”¹⁴⁷ These biases incline people to discount the significance of future events or

¹⁴² See Kraakman, *Corporate Liability*, *supra* note 5, at n. 106 (citing Ronald C. Gilson & Robert H. Mnookin, *Sharing Among the Human Capitalist: An Economic Inquiry into the Corporate Law Firm and How Partners Spilt Profits*, 37 STAN. L. REV. 313 (1985) as “examining relation between structure of law firms and nature of client loyalty to individual partners” and “describing law firm’s reputation as firm-specific capital which attracts clients and permits firm to serve as reputational intermediary on behalf of clients”).

¹⁴³ 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. 2005 Supp.).

¹⁴⁴ Prentice, *Inevitability of a Strong SEC*, *supra* note 10, 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)).

¹⁴⁵ 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 (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 (1977); Simon Lorne, *The Corporate and Securities Adviser, the Public Interest, and Professional Ethics*, 76 MICH. L. REV. 423, 445-65 (1978).

¹⁴⁶ Donald C. Langevoort, *Seeking Sunlight in Santa Fe’s Shadow: The SEC’s Pursuit of Managerial Accountability*, 79 WASH. U. L. Q. 449, 485 (2001).

¹⁴⁷ See Prentice *Inevitability of a Strong SEC*, *supra* note 10, at 797-99.

circumstances, even those posing high magnitude consequences, and to value instant gratification at higher levels than equal measures of deferred gratification.¹⁴⁸

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.¹⁴⁹ These systemic factors are taken to explain why reputation assumes lesser importance in certain market environments.¹⁵⁰ Reforms tend to focus either on reinvestment in reputations or enhanced litigation threats. An important oversight in such a framework is 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 (a) for auditors, resisting any undertaking to opine on the reasonableness of accounting principles that management selects or to detect for fraud; and (b) 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).¹⁵¹ 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. Section A outlines the intuition and sketches a formal general model. Section B considers practical steps required to implement such rewards. This emphasizes and illustrates private arrangements that can be designed to adjust existing incentives. Section C turns to how public recognition can contribute additional incentives at very low cost.

A. *General Model*

¹⁴⁸ *Id.*

¹⁴⁹ See, e.g., COFFEE, GATEKEEPERS, *supra* note 9, at 5 (“both strategies (*i.e.*, both legal remedies and reputational intermediaries” are important) (emphasis added); see also *id.* at 318 (“gatekeeper’s willingness to resist pressure [from managers] will still depend on” litigation risk and reputation loss).

¹⁵⁰ See COFFEE, GATEKEEPERS, *supra* note 9, at 67, 318–324.

¹⁵¹ 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 violations of law. See Lawrence A. Cunningham, *Catastrophe Bond Securitizations for Audit Failure Instead of Damages Caps*, 49 WM. & MARY L. REV. ____ (forthcoming 2007); *supra* note 88 (citing debate between Professors Langevoort and Goldschmid on the merits of such efforts).

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.¹⁵² The most conspicuous of these are executive compensation packages tied to corporate performance.¹⁵³ 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 inflate stock price artificially.¹⁵⁴

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, Mr. Buffett considered the role that advisors play, especially investment bankers.¹⁵⁵ 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.

To correct for this perversion, Mr. 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

¹⁵² 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 (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 (1990); compare Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q.J. ECON. 653 (1998) (challenging the Jensen-Murphy thesis).

¹⁵³ See, e.g., Brian J. Hall & Kevin J. Murphy, *Stock Options for Undiversified Executives*, 33 J. ACCT. & ECON. 3 (2002); Kevin Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847 (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 Corporate Governance Inst., Finance Working Paper No. 44/2004 (2004) <http://ssrn.com/abstract=561305>.

¹⁵⁴ See, e.g., WARREN E. BUFFETT & LAWRENCE A. CUNNINGHAM, *THE ESSAYS OF WARREN BUFFETT: LESSONS FOR CORPORATE AMERICA* 54–61 (2nd ed. 2001); see also John Cassidy, *How the Financial System Encouraged Corporations to Go Crazy*, THE NEW YORKER (Sept. 23, 2002)..

¹⁵⁵ Lawrence A. Cunningham, ed., *Conversations from the Warren Buffett Symposium*, 19 CARDOZO L. REV. 719, 767 (1997).

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."¹⁵⁶ 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 that achieving them is done using fair reporting.

This intuition can be amplified by insights that Professor Painter contributed concerning law firms in merger transactions.¹⁵⁷ Some law firms also use contingent compensation arrangements, sometimes with disastrous consequences for shareholders of their clients. Professor Painter instances a \$35 million contingent fee that Time-Warner Co. paid to a law firm upon the closing of its merger with America-On-Line (AOL).¹⁵⁸ The price Time-Warner paid for AOL in that merger was exorbitant and wound up costing its shareholders some \$200 billion in investment value.¹⁵⁹ As with Mr. 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.¹⁶⁰ This sensible proposal is akin to existing bans against auditors from charging clients contingent fees.¹⁶¹ The rationale is to impair managerial power to bribe gatekeepers into complicity.

An additional step could strengthen gatekeeper effectiveness. It would provide for contingent fees for gatekeepers (auditors or lawyers) who discover and correct misreporting under circumstances when they otherwise had no legal obligation to do so. This would not require amending the ban on auditors charging contingent fees or interfere with imposing one on transactional lawyers.¹⁶² Auditors (and lawyers) would

¹⁵⁶ *Id.*

¹⁵⁷ Painter, *Convergence and Competition*, *supra* note 11, at 412.

¹⁵⁸ *Id.*

¹⁵⁹ See Matthew T. Bodie, *AOL Time Warner and the False God of Shareholder Primacy*, 31 IOWA J. CORP. L. 975, 982-94 (2006) (in a comprehensive diagnosis of the transaction and background norms, noting that, in the two months following closing of the transaction, shareholders in the enterprise suffered losses of some \$200 billion in market value plus several billion more in civil liability costs).

¹⁶⁰ Painter, *Convergence and Competition*, *supra* note 11, at 412.

¹⁶¹ *Id.* at 410 (citing AICPA, Code of Prof'l Ethics, 302, R. 302.01).

¹⁶² See AICPA, Code of Prof'l Ethics, 302, R. 302.01. 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." See Sankar De & Pradyot K. Sen, *Is Auditor Moral Hazard the*

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.¹⁶³

An incentives program can respond to some of the diagnoses of gatekeeper failure noted earlier in this Article. First, it generally is agreed that wide-scale marketing of consulting services by auditors gives managers considerable power over them.¹⁶⁴ Firing an auditor for being tough is a red flag to the market, but firing an auditor from its non-audit services is not. Managers offered a carrot while holding out a stick: a favorable audit in exchange for lucrative consulting assignments. Auditors in the consulting business may have offered favorably lax audits to generate more assignments.¹⁶⁵ As Professor Coffee says, “the carrot works better than the stick, precisely because the threat to take the carrot away [can be] more credible.”¹⁶⁶

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 in addition to the existing regime that imposes liability risks.

Only Reason to Ban Contingent Fees for Audit Services?, 1 INT. J. AUDIT. 175, [pin cite] (1997); Ronald A. Dye *et al.*, *Contingent Fees for Audit Firms*, 28 J. ACCT. RES. 239, [pin cite] (1990).

¹⁶³ Professor Painter signals desire for reform using compensation systems, which is the basis for the mechanics of any merit system. *See* Painter, *Convergence and Competition*, *supra* note 11, at 412 (problems associated with mis-aligned 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).”).

¹⁶⁴ *See supra* text accompanying notes 101-112; COFFEE, GATEKEEPERS, *supra* note 9, at 64 ff. Legal scholars have expressed or implied a substantial consensus that auditors rendering non-audit 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., Zoe-Vonna Palmrose & Susan Scholz, *Auditor Independence, Non-Audit Services and Restatements: Was the US Government Right?*, 42 J. ACCT. RES. 561, [pin cite] (2004); *see also* Jayanthi Krishnan, Heibatollah Sami & Yinqi Zhang, *Does the Provision of Nonaudit Services Affect Investor Perceptions of Auditor Independence?*, 24 AUDITING: J. PRAC. & THEORY 111, [pin cite] (2005) (noting mixed results of empirical research on the effect of non-auditing services on auditor independence and investigating whether investors perceive such an effect—and interpreting the results affirmatively).

¹⁶⁵ *See* COFFEE, GATEKEEPERS, *supra* note 9, at 64–65.

¹⁶⁶ *Id.* at 159; *see also id.* at 65 (“Bribes work better than threats for a variety of reasons . . .”).

Second, a common diagnosis of the reputational constraint failure is how a firm's and a partner's incentives may differ.¹⁶⁷ 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 non-audit revenue they could earn.¹⁶⁸ 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.¹⁶⁹ So viewed, carrots play no obvious role—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 mis-reporting requires *managers to believe* that gatekeepers are ruthless. *That* reputation can be enhanced by rewarding them for successful detection and correction of mis-reporting.

Finally, some believe that lawyers who were paid in equity securities of clients suffered impaired judgment as a result.¹⁷⁰ 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 mis-reporting. 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 mis-reporting.

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 sub-parts: (a) a cost-benefit calculus; (b) estimating optimal gatekeeper payoffs; and (c) 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.

¹⁶⁷ See *supra* text accompanying notes 95-98.

¹⁶⁸ COFFEE, GATEKEEPERS, *supra* note 9, at 318.

¹⁶⁹ See *supra* note 70 (quoting Judge Easterbrook's opinion in *DeLio*).

¹⁷⁰ See *supra* text accompanying note 100.

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 mis-report.¹⁷¹ Gatekeepers stand to 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.

A simple fact pattern illustrates. 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 conform 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 posing a potential cost in reputation. In some cases, the gatekeeper may prefer a reputation for complicity and thus make the opposite calculation.¹⁷² Setting those latter cases aside for the moment, the following formulation captures the elements of these decisions:¹⁷³

$$BF <> P[d] * \{ (P[e] * L[l]) + L[r] \}$$

¹⁷¹ Kraakman, *Corporate Liability*, *supra* note 5, at 891 (emphasis added).

¹⁷² It is possible for reputation effects of effective gatekeeping to be a negative. See McGowan, *Why Not Try the Carrot?*, *supra* note 4, at 1828 (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 McGowan assumes that clients dislike whistle-blowing lawyers because it increases transaction costs. 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. But this hypothesis seems to overlook how whistle-blowing is an ex post action whereas gatekeeping is an ex ante action. From this distinction, one might infer from relatively low levels of observed whistle-blowing that high levels of effective gatekeeping exist.

¹⁷³ Gerding, *The Next Epidemic*, *supra* note 16, at 426–28.

where:

BF = benefits from fraud (of complicity in mis-reporting)

$P[d]$ = probability of detection

$P[e]$ = probability of enforcement

$L[l]$ = legal liability

$L[r]$ = 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 mis-reporting when the benefits from fraud, BF , exceed expected total costs. Expected total costs depend initially on the probability of detection, $P[d]$. Assuming detection occurs, then expected legal liability is the product of the probability of successful enforcement, $P[e]$, and associated legal liability if so, $L[l]$. Expected total costs add reputation damage, $L[r]$, to that result.

Recall how assessments in the literature, including diagnoses of the Enron era, highlight mis-aligned incentives and under-deterrence from inadequate liability risk.¹⁷⁴ The foregoing formula captures these, respectively, in the magnitude of the benefits from fraud (complicity in mis-reporting), BF , and the magnitude of legal liability, $L[l]$. The mis-aligned incentives thesis as applied to gatekeepers supposes that BF was too high compared to $L[r]$ and the legal liability thesis supposes that $L[l]$ was too low compared to the optimal level.

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

$$BF <> P[d] * \{(P[e] * L[l]) + L[r]\} + GP$$

where

GP = gatekeeper payoff from effective gatekeeping (*i.e.*, incentive payments received for disrupting mis-reporting).

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 mis-reporting and TC for the total expected costs of inculcation [$P[d] * \{(P[e] * L[l]) + L[r]\}$].

¹⁷⁴ See *supra* text accompanying notes 95-134.

b. Optimal Gatekeeper Payoffs.

The level of gatekeeper payoffs (*GP*) must be sufficient so that the benefits of mis-reporting 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.¹⁷⁵ 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.

As to approximating the maximum gatekeeping payoff (*GP*), it must be no greater than the next best alternative strategy (if 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 incentives that Partner X has to monitor Partner Y. But as Professor Ribstein explains, "this liability may be ineffective because it places risk on those who are ill-situated to prevent harm."¹⁷⁶ 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,

¹⁷⁵ Ribstein, *supra* note 120, at 288–289.

¹⁷⁶ Ribstein, *Limited Liability of Professional Firms*, *supra* note 11, at 447.

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).¹⁷⁷

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—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.¹⁷⁸ 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.¹⁷⁹ Perhaps it is a superior policy prescription. 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 McGowan proposed that securities lawyers who are first to disrupt mis-reporting be rewarded with transactional immunity from any related prosecution.¹⁸⁰ This is a valuable contribution to the literature. Yet it is a narrow change: it applies only to lawyers for a limited whistle-blowing 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 identify of different gatekeepers. What works for auditors may not work for lawyers. An important issue is how to interpret the reputational constraint. For

¹⁷⁷ Again, these are approximations of parameters, intended to support a view of the model as reasonable, not scientific determinations.

¹⁷⁸ See Prentice, *The Inevitability of a Strong SEC*, *supra* note 10, at ____.

¹⁷⁹ Regulators are not generally seen as gatekeepers. See Oh, *supra* note 16.

¹⁸⁰ McGowan, *Why Not Try the Carrot?*, *supra* note 4, at 1837-38 & 1840 (proposing transactional immunity to the first securities lawyer to blow the whistle about an unlawful transaction).

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.¹⁸¹ 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 mis-reporting before granting access.¹⁸² 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.¹⁸³ Whistle-blowers often do not have duties to report so those engaged in mis-reporting 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 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.¹⁸⁴

First, consider backward recursion, where short-term returns from dishonesty dwarf future benefits from honesty.¹⁸⁵ 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 mis-estimation of any of these and related penalties.¹⁸⁶

¹⁸¹ See *supra* text accompanying notes 69-72.

¹⁸² See *supra* text accompanying notes 13-24.

¹⁸³ See *supra* text accompanying notes 25-35.

¹⁸⁴ See Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for Its Future*, 51 DUKE L.J. 1397, 1427, 1429-34 (2002) (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 (2002).

¹⁸⁵ Prentice, *The Inevitability of a Strong SEC*, *supra* note 10, at 798, n. 142.

¹⁸⁶ *Id.*

While an incentives program may not eliminate these biases—especially the risk of mis-estimation—it help to counteract them.¹⁸⁷ It would increase the short-term returns from honesty. 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 mis-aligned 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 mis-estimation.

Second, gatekeepers may suffer from a time-delay trap.¹⁸⁸ The trap arises when people over-value instant gratification.¹⁸⁹ Gatekeepers may under-appreciate the long-term effects of building a reputation, which may take years, delaying gratification.¹⁹⁰ 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 offset the discounting effect by providing gatekeepers immediate rewards. Cash compensates gatekeepers for *not* being in on a scheme, reducing 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.¹⁹¹ As examples, 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.¹⁹² The resulting biased judgments can infect related disclosure. Among solutions to such problems are to use audit committees as auditor supervisors, as required by the Sarbanes-Oxley Act, or to obtain a second lawyers' opinion (an option but not a regulatory requirement). Neither solution is perfect or complete—adding an incentives program can reduce the imperfections further.¹⁹³

¹⁸⁷ Biases may complicate estimating the optimal gatekeeper payoff (*GP*), but that is also true of estimating other components of the model under rationality assumptions.

¹⁸⁸ Prentice, *The Inevitability of a Strong SEC*, *supra* note 10, at 798, n. 148; *see also* Manuel A. Utset, *Model of Time-Inconsistent Misconduct: The Case of Lawyer Misconduct*, 74 *FORDHAM L. REV.* 1319 (2005).

¹⁸⁹ Prentice, *The Inevitability of a Strong SEC*, *supra* note 10, at 798, n. 149.

¹⁹⁰ *Id.* at 798, n. 148.

¹⁹¹ Painter, *Convergence and Competition*, *supra* note 11, at 415.

¹⁹² *Id.* at 414.

¹⁹³ 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* text accompanying notes 135-137. 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 generally* Stuart Banner, *What Causes New Securities Regulation?* 300

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. Law permits, but does 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.¹⁹⁴ Failure to perform, or failure to discover problems and disrupt access to capital markets, does not, ipso facto, expose lawyers to liability.¹⁹⁵ However, lawyers are component to perform the exercise and sometimes are expressly retained to do so, as where an enterprise detects for specific misconduct that has come to its board's attention.¹⁹⁶

For auditors, a good illustration of investigation services concerns fraud detection. Auditors conduct full-scale audits of clients but are not strictly obligated to detect for

Years of Evidence, 75 WASH. U. L.Q. 849 (1997); Larry E. Ribstein, *Bubble Laws*, 40 HOUS. L. REV. 77 (2003).

¹⁹⁴ See LOUIS LOSS, JOEL SELIGMAN & TROY A. PAREDES, *SECURITIES REGULATION*, at [5246, n. 151] (3d ed. 1998) (noting that the so-called due diligence “duty” is not an affirmative duty but a defense).

¹⁹⁵ See Ben D. Orlanski, *Whose Representations Are They 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”).

¹⁹⁶ 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 Corp.'s board of directors retained the Washington, D.C. law firm of Wilmer, Cutler & Pickering to conduct internal investigation growing out of the foreign bribery scandals of the 1970s). See generally Arthur F. Mathews, *Internal Corporate Investigations*, 45 OHIO ST. L. J. 655, 666–678 (1984) (providing numerous illustrations of the practice and its origins as well as assessing benefits and costs).

fraud.¹⁹⁷ Failure to discover fraud does not, in itself, expose auditors to legal liability. Professional auditing standards articulate a modest measure of obligation to detect for fraud, but its exact scope as a matter of law is contested and uncertain.¹⁹⁸ As a result, its execution in practice is limited.¹⁹⁹ Auditors prefer to deny having any duties that would flow from a broad interpretation of the standard.²⁰⁰ Nevertheless, auditors sometimes assume express contractual duties to investigate for fraud, such as when they are engaged to conduct forensic audits.²⁰¹ Auditors actively promote the value of this service.²⁰² 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.²⁰³ A common context occurs when an underwriting agreement conditions the underwriter's duty on receiving an

¹⁹⁷ 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 imposition of legal liability for non-detection of fraud).

¹⁹⁸ Reflecting both the stakes and the controversy, accounting standard-setters have rewritten the applicable auditing standards on numerous occasions. See AM. INST. CERT. PUB. ACCT., STATEMENT OF AUDITING STANDARD NO. 99, CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT (2002) (version currently in effect). The current standard mainly elaborates on the difficulties auditors face in detecting fraud rather than specifying anything resembling a duty to investigate or pro-actively to detect for it. 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, at [pin cite] (1997).

¹⁹⁹ See Sean M. O'Connor, *Strengthening Auditor Independence: Reestablishing Audits as Control and Premium Signaling Mechanisms*, 81 WASH. L. REV. 525, 582–583 (2006) (in support of prescription to replace the US mandatory statutory audit with a shareholder-driven audit, arguing that the “general purpose audit” is “not a very effective device” particularly compared to a forensic audit).

²⁰⁰ See COFFEE, GATEKEEPERS, *supra* note 9, 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.”).

²⁰¹ See Vinita Ramaswamy, *Corporate Governance and the Forensic Accountant*, CPA J. (March 2005), <http://www.nysscpa.org/cpajournal/2005/305/essentials/p68.htm>.

²⁰² See Samuel A. DiPiazza *et al.*, *Global Capital Markets And The Global Economy: A Vision From The CEOs Of The International Audit Networks* 10 (2006), http://www.globalpublicpolicysymposium.com/CEO_Vision.pdf (noting report of large audit firms advocating mandatory forensic audits or all public companies on random or periodic basis).

²⁰³ See Jonathan M. Barnett, *Degenerate Certification: The Opinion Puzzle and Other Transactional Curiosities*, ___ J. CORP. L. ___ (forthcoming Nov. 2007); SCOTT T. FITZGIBBON & DONALD W. GLAZER, FITZGIBBON AND GLAZER ON LEGAL OPINIONS: WHAT OPINIONS IN FINANCIAL TRANSACTIONS SAY AND WHAT THEY MEAN [pin cite] (1992).

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."²⁰⁴ The opinion 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 disclosure in conformity with regulations.²⁰⁵ Reliance is expressly limited to addressees, usually a client's board of directors (or, sometimes, an underwriting firm of a client's securities). Apart from contractual requirements and modest risk of liability such as negligent misrepresentation, failure to provide an opinion does not expose a firm to legal liability or even reputational damage.²⁰⁶

Written comfort letters are examples of certification services that auditors provide. 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.²⁰⁷ 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.²⁰⁸

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.²⁰⁹ It could require that those certifications state

²⁰⁴ See Special Report of the Task Force on Securities Law Opinions, Negative Assurance in Securities Offerings (Joint Effect of the ABA Committee on Legal Opinions and Subcommittee on Securities Law Opinions of the ABA Federal Regulation of Securities Law Committee), 59 BUS. LAW. 1513 passum (2004).

²⁰⁵ *Id.*

²⁰⁶ 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* (The Legal Opinion Committee Workshop), PLI Order No. 6232 (March 2005).

²⁰⁷ Auditing regulations govern the preparation, scope and delivery of comfort letters. See AM. INST. CERT. PUB. ACCT., STATEMENT OF AUDITING STANDARDS NO. 72 (SAS 72); AU § 634, Letters for Underwriters and Certain Other Requesting Parties (adopted as an Interim Standard by PCAOB); see also William J. Whelan, III, *Accountant's Due Diligence and Comfort Letters*, PLI Order No. 10,852 (April 2007) (providing practice perspective on auditors' comfort letters).

²⁰⁸ COFFEE, GATEKEEPERS, *supra* note 9, at 166 & 168 (discussing how the auditing profession is "refusing to discuss the prospect for fraud or illegality with other gatekeepers.").

²⁰⁹ Coffee, *The Attorney as Gatekeeper*, *supra* note 35, at 1311 & 1313–15, n. 57.

affirmatively that disclosure is fair and accurate in all material respects. Law could clarify that auditors are responsible for detecting fraud and require that they provide specific positive assurance to underwriters or other transaction participants. But law has 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.²¹⁰ Second, that might demand more than is possible. Fraud and other sources of mis-reporting can be hidden in ways that no professional could discover.²¹¹ 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.²¹² 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 sub-optimal terms.²¹³ 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.²¹⁴ Compensation must be sufficient to fund an optimal level of gatekeeper payoffs (*GP*). The challenge is finding the funding. Ideally, funds would draw on resources that already exist in the capital

²¹⁰ See Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1065 (1993).

²¹¹ See, e.g., Alexander Dyck, Adair Morse & Luigi Zingales, *Who Blows the Whistle on Corporate Fraud?*, NBER Working Paper No. 12,882 (Feb. 2007) (empirical study of fraud detection covering 1994 to 2004 finds multiple sources of discovery, including internal and external sources and finding 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”).

²¹² COFFEE, GATEKEEPERS, *supra* note 9, at 166, 168.

²¹³ 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 with using incentive devices is favorable, it could be possible to substitute that approach for existing mandatory duties backed by liability imposition.

²¹⁴ COFFEE, GATEKEEPERS, *supra* note 9, at 369–70 (observing that “[c]arrots, as well as sticks, then must be used” and a challenge is to find “funding . . . to subsidize” these incentives).

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.²¹⁵ The contracts provide signals to market participants; enterprises giving gatekeepers incentives to disrupt mis-reporting should benefit from lower costs of capital compared to those unwilling to do so.²¹⁶ 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).²¹⁷ 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 mis-reporting 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 implementing positive gatekeeper incentives meeting the foregoing requirements. The following is intended to illustrate one context in which this could work—without meaning to be exhaustive.²¹⁸

²¹⁵ Confidential incentive contracts could result in more effective gatekeeping (through discovery and correction of mis-reporting) but their value should increase if they are widely-publicized..

²¹⁶ *Cf.* Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, *supra* note 11, at 410 (noting how the pension funds in New York and North Carolina award brokerage business only to firms having adopted internal mechanisms to reduce conflicts of interest).

²¹⁷ See Michael Spence, *Job Market Signaling*, 87 Q. J. ECON. 355 (1973); Michael Spence, *Signaling in Retrospect and the Informational Structure of Markets*, 82 AM. ECON. REV. 434, (2002).

²¹⁸ 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 1702–05. 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 mis-reporting. 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 mis-reporting by showing that they were not responsible for it. *Id.* at 1711. These examples, as with those in the text, are naturally non-exhaustive, 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 regimes with a full set of possible legal

Take the examples given in Section 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 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 mis-reporting. The important negotiated provisions would address compensation, delineate the activities or discoveries that generate it, and 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 in these arrangements.

For underwriters, 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 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.²¹⁹ 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 mis-reporting.

Most issuers should find this strategy attractive. True, enterprises that are institutionally dedicated to mis-reporting 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.²²⁰

Furthermore, while difficult to verify empirically, it does not seem common for entire enterprises to be institutionally dedicated to mis-reporting; more commonly, individual agents within an enterprise wish to mis-report. In either case, the reforms made in the Sarbanes-Oxley Act create internal governance structures associated with boards of

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.”).

²¹⁹ See *supra* note ____.

²²⁰ See George A. Akerlof, *The Market for “Lemons:” Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488, 488–89 (1970).

directors that can be useful.²²¹ Willingness to adapt arrangements to implement one likely would 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.²²²

Within issuers, audit committees should support gatekeeper incentives and be able to develop them. Many believe that the most important of the changes in the Sarbanes-Oxley Act is audit committee power over auditors.²²³ The law reposes in audit committees the power to select, compensate, supervise and terminate auditors, as well 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.²²⁴ Audit committees now wield considerable influence in the audit function and easily could 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.²²⁵ Committees can argue, credibly, that associated costs will be vastly outweighed by saving the costs of later-discovered mis-reporting.

The issuer would not have to fund 100% 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

²²¹ These include requirements imposed respecting the composition and duties of board audit committees. See Sarbanes Oxley Act of 2002, §§ 301, 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 NYSE Listed Company Manual 303.01(B)(2)(a) and 303.01(B)(2)(b)-(c); NASD By-Laws, Art. 9, Sec. 5; NASD Marketplace Rules, Sec. 4350(d)(1)-(2).

²²² See James Fanto, *Whistleblowing and the Public Director: Countering Corporate Inner Circles*, 83 OR. L. REV. 435, [in cite] (2004).

²²³ COFFEE, GATEKEEPERS, *supra* note 9, at 367; ; William W. Bratton, *Enron, Sarbanes-Oxley and Accounting: Rules versus Principles versus Rents*, 48 VILL. L. REV. 1023, 1034-36 (2003)..

²²⁴ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 301, 116 Stat. 745, 775-77; see William W. Bratton, *Enron, Sarbanes-Oxley and Accounting: Rules versus Principles versus Rents*, 48 VILL. L. REV. 1023, 1034-36 (2003).

²²⁵ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 301, 116 Stat. 745, 775-77.

to its calculations, under the traditional gatekeeping model, of reputation and liability costs that result from later-discovered mis-reporting.

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 voluntarily undertaking to perform contractually. In delineating these boundaries in the underwriting agreement, all participants would contribute to negotiations—issuers and underwriters as well as auditors and lawyers.

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.²²⁶

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.²²⁷ 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 mis-reporting 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 mis-reporting or more public statements such as resigning from an engagement. That can create a strategic temptation to be too strict on clients.

Similar strategic mis-fires could arise under incentive programs. To police for such temptations in this context, contracts would specify not only the kinds of discoveries that generate compensation, but also provide for a verification procedure. For payments

²²⁶ See *supra* text accompanying notes ___–__.

²²⁷ Remarks of Mr. Daniel Goelzer, Board Member, PCAOB, Columbia University Law School's conference, "Gatekeepers Today: The Professions after the Reforms" (Sept. 29, 2006).

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.²²⁸ This construct reflects the dual role that lawyers play in such contexts, serving as both advocates and advisors to the enterprise on the one hand and a public gatekeeping function on the other. Tensions result. Using two firms or teams can enable segregating these functions so that each can discharge professional responsibilities without ethical dissonance. While so 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.

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 famously implemented these structures in its agreement settling charges arising from its role in the notorious National Student Marketing fraud of the 1970s.²²⁹

Second, among lawyers, there invariably are two teams on cooperative transactions—usually from different law firms. In securities offerings, both underwriter's

²²⁸ COFFEE, GATEKEEPERS, *supra* note 9, at ____.

²²⁹ See *SEC v. National Student Marketing Corp.*, Fed. Sec. L. Rep. (CCH) ¶ 96,027 (D.D.C. 1977).

and issuer's counsel participate in due diligence exercises designed to enable preparing 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.²³⁰

In transactions with two teams, it should be possible to design assignment and compensation contracts that, while facilitating meeting professional responsibilities, also enable promoting 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 and 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 in respect of discovered mis-reporting (whether or not corrected). Addressing the specific professional responsibilities may be difficult, but the example suggests the vitality of Professor Coffee's heuristic.

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 mis-reporting: creating incentives to do so weakens the capacity to conspire.²³¹ 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 (a) closing a transaction while (b) using fair reporting. Each would have incentives that contribute to promoting that twin result.

The dual-team approach reflects the insights from Mr. Buffett's and Professor Painter's bilateral professional service retention models.²³² Two teams facing different incentives will be inclined to exert pressure against each other. Mis-reporting temptations by the closing team are offset by opposite incentives of the gatekeeping team; temptations to overzealousness among the gatekeeping team are constrained by contrary incentives of the closing team.²³³

²³⁰ See DALE A. OESTERLE, *THE LAW OF MERGERS AND ACQUISITIONS* 19–21 (2nd ed. 2002) (excerpting DAVID A. LAX & JAMES K. SEBENIUS, *THE MANAGER AS NEGOTIATOR* 29–30, 33–35 (1986)).

²³¹ See McGowan, *Why Not Try the Carrot?*, *supra* note 4, at 1833–36.

²³² See *supra* text accompanying notes 155–61.

²³³ 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.

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 the potential that public recognition could 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 that make those stimuli function.²³⁴ 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.²³⁵ Much rarer are media, regulatory or scholarly attention on those gatekeepers who perform their functions successfully. 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 Elliot 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 post-bubble fallout.²³⁶ That status, in turn, played a significant role in his subsequent election as Governor of that State. True, private whistleblowers such as Sharron Watkins of Enron shared in some of the limelight, but even then received mixed reviews, in part for emerging long after the scandal had incubated.²³⁷ Hero status is not conferred on gatekeepers or others who disrupt misreporting and correct it because their effectiveness is not normally publicly disclosed.

²³⁴ Cf. Macey, *A Pox*, *supra* note 11, at 331 (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”); Frankel, *supra* note 1, at 165–73 (elaborating on concept of corporate culture and challenges involved in influencing it over time).

²³⁵ See Melvin Aron Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1255 (1999); Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1011 (1997); David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811, 1912–13 (2001).

²³⁶ 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” and offering an interpretation for federalism of his stated-based enforcement campaign); Kulbir Walha & Edward E. Filusch, *Eliot Spitzer: A Crusader Against Corporate Malfeasance or a Politically Ambitious Spotlight Hound?*, 18 GEO. J. LEGAL ETHICS 1111, 1112–15 (2005).

²³⁷ E.g., Robert Salladay, “Snitch” Bill Passed by State Senate, S.F. CHRON. (June 21, 2002) (“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”).

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).²³⁸ A good model of public recognition are the Malcom Baldrige National Quality Awards, named for a US Commerce Secretary and awarded annually since 1988 to US innovators who demonstrate exemplary leadership in designated performance categories.²³⁹ 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 mis-reporting. 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.²⁴⁰ This aversion arises from how competing values such as loyalty and trust are implicated.²⁴¹ These can be in tension with whistle-blowing 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 tem* actions suggest that inducements are necessary to entice US persons to rat on fellow citizens.²⁴²

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 mis-reporting than with loyalty in acquiescing to it. This tendency is probably strongest for auditors, whose training and

²³⁸ 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 33, at 1155 (noting Congressional testimony of Duke Law Professor James Cox "that the biggest problem with a proposed insider trading bounty program would be the SEC's likely unwillingness to actually give out any rewards").

²³⁹ *See* National Institute of Standards and Technology, *Baldrige National Quality Program*, <http://www.quality.nist.gov/>.

²⁴⁰ *See generally* ROBERT M. BLOOM, *RATTING: THE USE AND ABUSE OF INFORMANTS IN THE AMERICAN JUSTICE SYSTEM* (2002) (comprehensive exploration revealing the cultural anxieties of ratting).

²⁴¹ *Cf.* Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735 (2001) (general inquiry into the roles of trust and loyalty in corporate relationships).

²⁴² *See supra* text accompanying notes 30-33.

self-identification entails professional skepticism that is a cognate of rattling.²⁴³ 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.²⁴⁴ 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 quai-public role.²⁴⁵ For securities lawyers willing to accept this somewhat complex identify, 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 rattling. 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.²⁴⁶

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 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.²⁴⁷ Lockheed and its top managers had much to

²⁴³ See Codification of Statements on Auditing Standards, Standards of Field Work § 342, ¶ 4 (Am. Inst. Certified Pub. Accountants 2003); Consideration of Fraud in a Financial Statement Audit, Statement of Fin. Accounting Standards No. 82 (Fin. Accounting Standards Bd. 1997) ("Due professional care requires the auditor to exercise professional skepticism—that is, an attitude that includes a questioning mind and critical assessment of audit evidence.").

²⁴⁴ See DEBORAH L. RHODE, *IN THE INTERESTS OF JUSTICE: REFORMING THE LEGAL PROFESSION* 15 (2000) (rigorous critique that includes observations concerning the close connection between confidentiality and model of zealous advocacy).

²⁴⁵ See ANTHONY T. KRONMAN, *THE LOST LAWYER: FAILING IDEALS OF THE LEGAL PROFESSION* 3-17 (1993) (aspirational meditation upon moral character and the ideal of the lawyer as "statesman").

²⁴⁶ See Walha & Filusch, *supra* note 236, at 1131 (concluding a careful evaluation of Spitzer's actions in light of principles of legal ethics by noting that "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.").

²⁴⁷ 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,

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.²⁴⁸ And Arthur Young received considerable public recognition for its refusal in the contemporary press.²⁴⁹

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.²⁵⁰ With that orientation, it is unsurprising that policymakers and scholars incline toward refashioning 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.²⁵¹ 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)²⁵² to a more forthright public expression of appreciation. A carrot system could envision that kind of public recognition for disrupting mis-reporting (in addition to the form of cash incentive programs discussed in the preceding section).

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)).

²⁴⁸ See *supra* text accompanying note 171.

²⁴⁹ E.g., *Lockheed’s Bribes Backfire*, *BUS. WK.* (Feb. 23, 1976); William A. Shumann, *Lockheed Agrees to End Payouts Abroad*, *AVIATION WEEK & SPACE TECH.* (Sept. 1, 1975); Robert M. Smith, *Information Bank Abstracts*, *N.Y. TIMES* (Feb. 5, 1976; Feb. 8, 1976; Sept. 1, 1975).

²⁵⁰ See Gregory Mitchell, *Case Studies, Counterfactuals and Causal Explanations*, 152 *U. PA. L. REV.* 1517, 1521-25 (2004) (challenging tendency of legal scholars diagnosing Enron failure to narrate causal stories from selected facts and then draw normative implications from them).

²⁵¹ See JEFFREY PFEFFER, *THE HUMAN EQUATION: BUILDING PROFITS BY PUTTING PEOPLE FIRST* [pin cite] (1998).

²⁵² See Paul Strebel, *Why Do Employees Resist Change?*, 74 *HARV. BUS. REV.* 86, [pin cite] (1996).

This may raise an objection. It may appear that paying gatekeepers extra for doing what they ought to do—whether required by law or by professional or other non-legal commands.²⁵³ As to legal requirements, the proposal preempts this objection to avoid problems of contract law’s pre-existing duty rule.²⁵⁴ The proposal envisions a program that pays compensation or recognition for performing functions not otherwise legally required. As to professional or other non-legal 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 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.²⁵⁵ 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,²⁵⁶ 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 US 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 US.²⁵⁷ Implicitly, these critics essentially argue that gatekeeping can be too effective. A carrot system, in

²⁵³ 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.”).

²⁵⁴ *Cf. Taft v. Hyatt*, 180 P. 213 (Kan. 1919) (police officer ineligible for contractual reward for apprehending alleged criminal given pre-existing duty to do so).

²⁵⁵ COFFEE, GATEKEEPERS, *supra* note 9, at 330; *see supra* text accompanying notes 95-151.

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²⁵⁷ See, e.g., REPORT OF THE COMMITTEE ON US COMPETITIVENESS (Nov. 2006) (report of group of interested parties formed at the behest of US Treasury Secretary Henry Paulson and referred to as the “Paulson Committee”); MCKINSEY FINANCIAL SERVICES, SUSTAINING NEW YORK’S AND THE US’ GLOBAL FINANCIAL LEADERSHIP (2006) (report by consulting firm commissioned by the Mayor of the City of New York and the Senior United States Senator from New York, 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); *see also* Lawrence A. Cunningham, *The Paulson Committee’s Muddle on Rules-Principles*, NAT’L L.J. (April 16, 2007) (critique of portion of Paulson Committee Report addressing optimal combination of rules and principles in corporate regulation).

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.²⁵⁸

Certain theories of the legislative process emphasize the presence of multiple “vetogates.” These refer to choke points in the legislative process that enable participants to obstruct the passage of legislation.²⁵⁹ 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.²⁶⁰ Numerous gatekeepers participate in activating these vetogates, including the President, as well as committee chairs, senior Senators and House members and, especially, lobbyists.²⁶¹ The result is that the vast majority of bills do not become law, a deliberate strategy designed to minimize the risk of sub-optimal lawmaking as well as to promote confidence that law is supported by consensus.²⁶²

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 transactions, 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 of passing legislation and this is seen as necessary to promote the appearance and

²⁵⁸ See William N. Eskridge, Jr., *Norms, Empiricism, and Canons in Statutory Interpretation*, 66 U. CHI. L. REV. 671, 677 (1999); WILLIAM N. ESKRIDGE, JR., PHILIP P. FRICKEY & ELIZABETH GARRETT, *CASES AND MATERIALS ON LEGISLATION: STATUTES AND THE CREATION OF PUBLIC POLICY* 66–67 (3rd ed. 2001).

²⁵⁹ See ESKRIDGE, FRICKEY & GARRETT, *supra* note 258, at 2–3, 17.

²⁶⁰ *Id.*

²⁶¹ *Id.* at 72–76 (discussing how senior members long have enjoyed a norm of influence through deference under traditional legislative folkways); COFFEE, *GATEKEEPERS*, *supra* note 9, at 10, n.1 (“Political scientists regard congressional committees as the gatekeepers of the legislative process”); KAY SCHLOZMAN & JOHN TIERNEY, *ORGANIZED INTERESTS AND AMERICAN DEMOCRACY* 317, 395–96 (1986) (interest groups are more successful at preventing than facilitating legislation because “there are so many opportunities for throwing up roadblocks to unwanted action”).

²⁶² 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).

achievement of consensus and the effectiveness of laws.²⁶³ For securities transactions, the cultural milieu is nearly exactly the opposite. Participants want to facilitate the deal, to enable the financing, to 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 US.²⁶⁴ 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 mis-report 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 disrupting mis-reporting 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 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 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

²⁶³ See ESKIRIDGE, FRICKEY & GARRETT, *supra* note 258, at [2–3, 17].

²⁶⁴ See *supra* note 257 (Paulson Committee Report and McKinsey Report); 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, [pin cite] (2006); see also Ehud Kamar *et al.*, *Going-Private Decisions and the Sarbanes-Oxley Act of 2002: A Cross-Country Analysis* (U.S.C. Ctr. in Law, Econ. & Org., Research Paper No. C06-5, 2006), www.ssrn.com/abstract=901769; Christian Leuz *et al.*, *Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations* (Am. Fin. Ass'n 2006 Boston Meetings Paper), www.ssrn.com/abstract=592421.

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.