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Merritt B. Fox
Columbia Law School

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GATEKEEPER FAILURES: WHY IMPORTANT, WHAT TO DO

*Merritt B. Fox**

GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE. By *John C. Coffee Jr.* Oxford and New York: Oxford University Press. 2006. Pp. vii, 389. \$45.

INTRODUCTION

The United States was hit by a wave of corporate scandals that crested between late 2001 and the end of 2002. Some were traditional scandals involving insiders looting company assets—the most prominent being Tyco, HealthSouth, and Adelphia. But most were what might be called “financial scandals”: attempts by an issuer to maximize the market price of its securities by creating misimpressions as to what its future cash flows were likely to be. Enron and WorldCom were the most spectacular examples of these financial scandals. In scores of additional cases, the companies involved and their executives were sued by the Securities and Exchange Commission (“SEC”), and, in a number, executives were criminally prosecuted (p. 15). Hundreds of issuers were forced to restate their financial statements (p. 15). Why did this rash of financial scandals occur and what lessons for reform can be learned from the explanation? These are the questions addressed by Professor John Coffee¹ in *Gatekeepers: The Professions and Corporate Governance*.

Coffee’s focus is on what he calls the “gatekeepers”: auditors, lawyers, securities analysts, and credit ratings agencies. Each of these professions can serve as a watchdog for the public. Each, at least in theory, has a particular position that allows for the acquisition of more information than the investing public has about an issuer’s prospects and that provides them an opportunity to warn the public when that information is different than the impression given by management in the issuer’s disclosures. In each of these financial scandals, the watchdogs failed to bark when the issuer’s disclosures obscured the less favorable underlying reality of its economic situation. Because of this *en masse* gatekeeper failure, Coffee contends, the “United States’ much vaunted system of corporate governance was suddenly compromised” (p. 15).

Coffee begins his book by demonstrating that gatekeeper failures played a large role in permitting the Enron and WorldCom disasters. He goes on to

* Michael E. Patterson Professor of Law, Columbia Law School. The author wishes to thank Spencer Marsden for his valuable research assistance.

1. Adolf A. Berle Professor of Law, Columbia Law School.

explain why such failures have occurred so frequently. For each gatekeeper, his discussion combines a fascinating consideration of its history with a realistic description of the current economic and political environment in which it operates. He concludes with recommendations for reforms, including a requirement that each issuer have its SEC periodic disclosure filings certified by outside counsel.

This is an excellent book. Its unusual combination of conceptual breadth and real-world, practical detail allows us to see what has been right in front of our faces but not fully appreciated. That gatekeeper failures substantially contributed to the Enron and WorldCom scandals is already well recognized.² Before this book, however, there was less awareness of the slowly accumulating changes in these professions and the environments in which they work that caused these failures. What awareness did exist was not accompanied by an adequate understanding of either the origins of these changes or their implications for our larger system of corporate governance. Coffee significantly advances this understanding and by so doing aids substantially in finding the most promising avenues for reform.

In this Review, I elaborate on Coffee's analysis in three regards. First, I highlight the links between the gatekeeper failures that Coffee identifies and defects in the U.S. system of corporate governance. Creating and maintaining institutional arrangements that reduce, or compensate for, the informational asymmetries that exist between management and investors is *the* central challenge for the market-centered, dispersed shareholder system of corporate governance that predominates in the United States. The core function of gatekeeping is the amelioration of these asymmetries. The gatekeeper failures that permitted the wave of financial scandals symbolized by Enron and WorldCom are symptomatic of profound changes in the gatekeeper professions and the environments in which they operate. These changes have had effects that go far beyond the losses incurred by shareholders of the particular companies involved when the truth came out and share price plummeted from the inflated levels prevailing when many shareholders bought. Poor gatekeeping undermines good corporate governance, which results in social-wealth-destroying suboptimal corporate decision making. While Coffee identifies the essential role gatekeepers play in ameliorating the informational asymmetries between dispersed investors and management, the primary corporate governance concern that he chooses to develop is the blind spots that gatekeeper failures create for outside directors. I broaden the inquiry to consider the full breadth of corporate governance problems that gatekeeper failure creates.

2. See John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid"*, 57 BUS. LAW. 1403 (2002); Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 CORNELL L. REV. 394, 405–10 (2004); Jonathan Macey & Hillary A. Sale, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 VILL. L. REV. 1167, 1167 (2003); WILLIAM C. POWERS, JR. ET AL., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. 5, 17, 24–26 (2002), available at <http://news.findlaw.com/hdocs/docs/enron/sicreport/sicreport020102.pdf>.

Second, I informally model Coffee's discussion of the changes in the professions that led to the wave of financial scandals and consider the implications of this analysis for determining what factors were the primary causes of gatekeeper failure. This exercise reinforces Coffee's fundamental conclusion that reform is needed—and that the reform must be something beyond just changing the rules by which existing gatekeepers operate and the applicable liabilities when the rules are violated.

Third, I discuss what this fundamental reform should be. Coffee correctly argues for the need to improve the quality of periodic disclosures filed with the SEC. He would do so by requiring each issuer to have an outside disclosure counsel certify these filings. In my view, certifying counsel is the wrong player to bring this improvement about. A certifying investment bank that faces measured liability in the event it fails to engage in adequate due diligence is a better alternative.

I. THE LARGER IMPORTANCE OF GATEKEEPER FAILURE

Professor Coffee defines a "gatekeeper" in functional terms, as a "reputational intermediary to assure investors as to the quality of the 'signal' sent by the corporate issuer" (p. 2). The gatekeeper is a repeat player who has over time developed "reputational capital" by verifying only the statements of corporate issuers that the gatekeeper reasonably believes are accurate (p. 9). Once a gatekeeper develops this reputational capital, its verification of a corporation's statement, by pledging this capital, makes the statement more believable. Thus, an auditor's certification of an issuer's financial statement, an investment bank's willingness to take an IPO to market, a lawyer's "Rule 10b-5" opinion that nothing suggests that a prospectus contains misstatements, a rating agency's credit rating, and a "sell side" analyst's "buy" recommendation all share this verifying pledge of reputation feature.

A gatekeeper failure occurs when the gatekeeper verifies an issuer statement that it knows, or through reasonable effort could know, is false or misleading. But what are the corporate governance effects of these failures and why are they important?

A. *Leaving Independent Directors in the Dark*

Professor Coffee identifies the core contribution of gatekeepers to corporate governance to be their capacity to reduce information asymmetries between investors and managers. In terms of the corporate governance consequences of gatekeeper failure, however, his primary focus is on its disabling effect on the outside members of the corporation's board of directors. On the book's very first page, Coffee states: "[A]ll boards of directors are prisoners of their gatekeepers. No board of directors—no matter how able and well-intentioned its members—can outperform its professional advisors. Only if the board's agents properly advise and warn it, can the board function effectively" (p. 1).

The “monitoring board,” as the corporate board is typically conceived in modern corporate law commentary,³ is an important institution in helping to align managerial decision making with what is in the best interests of shareholders. Coffee correctly believes that too much emphasis has been put on the need to reform the board itself, rather than the informational environment in which the board operates (p. 7). He observes that “the sudden outburst of financial irregularity that surfaced in 2001 to 2003” cannot be due to an increase in board failure “because boards have only improved over the interval from 1980 to 2000” (p. 8). Coffee’s concern is that when an issuer makes a misstatement, outside directors are often as fooled as outside investors. This is a key element in his argument that more attention should be paid to gatekeeper failure.

Coffee’s decision to focus on outside board members should not, however, obscure the fact that gatekeeper failure has a variety of other important corporate governance consequences as well. There is, in fact, some tension between any suggestion that outside directors’ lack of information is at the core of gatekeeper failure’s impact on corporate governance and Coffee’s own analysis of the origins of gatekeeper failure and the reforms that are needed. While diffuse investors should in theory be the gatekeepers’ principals, they are too disorganized to play this role effectively. Managers have filled the void. Because managers hire and fire most gatekeepers, managers have become gatekeepers’ real principals. As a result, the watchdogs have become the pets of those who feed them (p. 335). If outside director lack of information were the core of the corporate governance problem generated by gatekeeper failures, the solution would be straightforward. An issuer’s outside directors, unlike its shareholders, are a discrete group, easily capable of coordinated action. Outside directors could substitute for management as the gatekeepers’ effective principal to fill the void created by shareholder diffusion. Indeed, this is the focus some of the reforms already adopted.⁴ As Coffee’s own recommendations show, however, reform needs to go well beyond simply enhancing the relationship between gatekeepers and independent directors.

Coffee is undoubtedly aware that the corporate governance consequences of gatekeeper failure go beyond independent directors being left in the dark. Much of the book is about investors being left in the dark, which by itself is self-evidently a bad thing. One can only do so much in one book. Below, I take the next step to give the reader a better sense of the full range of consequences for corporate decision making when gatekeeper failure

3. 1 AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE § 3.01 (1994); MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 162–68 (1976).

4. See, e.g., Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 201–301, 116 Stat. 745, 771–77 (codified in scattered sections of 15 & 18 U.S.C.) (requiring that auditors report to an audit committee of the board of directors with enhanced independence from management, rather than to the issuer’s chief financial officer, as was traditionally typical); Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. pt. 205 (2007) (requiring attorneys representing public corporations to report evidence of “material violations” of the securities laws to the audit committee or the independent directors under some circumstances).

leaves investors in the dark. Taking this next step suggests just how large the stakes for reform really are.

B. *Gatekeepers and Good Corporate Governance in Broader Context*

There has been a growing consensus among commentators over the last few decades that the principal corporate governance problem for the U.S.-style dispersed shareholder corporation is minimizing the “agency costs of management.”⁵ It is in the best interests of shareholders that management makes decisions in a way that maximizes share value. Management decisions meeting this criterion maximize overall social wealth as well—at least when corporations operate in competitive markets and are properly regulated to account for externalities. At the margin, the corporation’s payments for its inputs equal the value of what it takes from society. The payments the corporation receives for its output, meanwhile, equal the value of what it gives back. Thus decisions that maximize the difference between the two—the net cash flows generated by the corporation over its life discounted to present value—maximize its contribution to society. These are also the decisions that maximize share value. The “agency problem” is that the decisions that maximize share value are not necessarily the decisions that maximize the utility of the managers. The central task of corporate governance in the United States is to construct for managers a structure of incentives—carrots and sticks—that, in a cost-effective manner, minimizes the deviation between the decisions that maximize managerial utility and the ones that maximize share value. Thus, addressing the agency costs of management is the central challenge of creating good corporate governance in this country, and good corporate governance contributes in important ways to improving the country’s economic well-being.

A number of institutions, when properly designed and regulated, reduce managerial agency costs: a board of directors elected by shareholders and subject to litigation-backed fiduciary duties, the threat of hostile takeover, and share-price-based managerial compensation. More accurate share prices and better information in the hands of investors enhance the ability of each of these institutions to reduce the agency costs of management. Gatekeeper failure reduces share price accuracy and the quality of information possessed by investors. It thus undermines the effectiveness of these institutions in reducing managerial agency costs. This damages corporate governance and lessens overall social wealth.

C. *The Full Consequences of Gatekeeper Failure*

When gatekeepers fail, they undermine their capacity to reduce information asymmetries that otherwise inevitably exist between issuer managers

5. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); see also FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 10 (1991).

and the outside world. Failure thus reduces the quality and quantity of information concerning an issuer available to persons outside management. This reduction, and the accompanying decline in the accuracy of the issuer's share price as a predictor of future cash flows, undermine the effectiveness of the whole panoply of devices that create the structure of incentives that encourages managers to make share-value-maximizing decisions.

1. *Legally Based Pressures for Capable, Motivated Boards*

For a board to promote share value maximization, it needs more than information. It must be capable and motivated. Two practices based in corporate law are relevant here: the shareholder franchise to elect directors and vote on certain constitutive decisions and the fiduciary duties of directors. Reducing the information asymmetry between management and the outside world enhances the effectiveness of each.

Less information asymmetry can enhance the effective exercise of the shareholder franchise because a better-informed shareholder is more likely to vote for directors who will maximize share value. Previously, this observation might have sounded quaintly romantic. Sophisticated realists assumed that shareholders would vote the way management suggested regardless of what information was available to the public. Unhappy shareholders would simply follow the "Wall Street rule" and sell. But for the substantial portion of larger, established U.S. corporations that lack a controlling shareholder, the shareholder franchise has taken on new importance in recent years.

This increased importance of the shareholder franchise arises from the increased activity of larger shareholders—institutions or wealthy individuals each holding between a fraction of one percent and a few percent of the issuer's outstanding shares. These larger non-control shareholders, in aggregate, hold a sufficiently large portion of the issuer's total outstanding shares to play a potentially critical role in voting.⁶ Unlike the typical small individual shareholder, larger shareholders have a big enough stake to make information concerning the corporation, if freely available, worth learning. Thus a reduction in information asymmetries can genuinely enhance the effectiveness of their votes. There is substantial evidence that votes by larger shareholders using firm-specific information have become more important.

6. See Jay C. Hartzell & Laura T. Starks, *Institutional Investors and Executive Compensation*, 58 J. FIN. 2351, 2356 (2003) (showing that the firms in the S&P 500 Index, the S&P Midcap Index, and the S&P Smallcap Index had average aggregate institutional holdings of 53.1% of shares outstanding, and the average holdings of the top five institutional investors in a firm were 22% of the outstanding shares and 44% of the aggregate institutional holdings); Marcia Millon Cornett et al., *The Impact of Institutional Ownership on Corporate Operating Performance* 14 (N.Y. Univ. Stern Sch. Of Bus., Finance Working Paper No. 03-033, 2003), available at <http://ssrn.com/abstract=468800> (indicating that a sample of the firms in the S&P 100 had 59.3% of shares outstanding owned by institutions, and the average total holdings of the top five institutional investors in a firm was 20.1% of the outstanding shares).

Activist hedge funds, for example, have been able to target individual firms⁷ and, by orchestrating other larger, non-control shareholders to join them in voting against management (or at least threatening to orchestrate such votes), have accomplished changes in management, managerial policy, and corporate governance in ways that appear to enhance share value.⁸ More generally, in recent years there has been a substantial movement seeking to enlarge the shareholder role in selecting directors.⁹

As for fiduciary duties, reducing information asymmetries not only increases the likelihood that outside board members will play their proper role in assuring management's compliance with its fiduciary duties, it also improves shareholders' ability to use the threat of litigation to police management and board violations of these duties. Before an issuer can enter into a material transaction in which a manager or director has an interest, corporate law requires management either to show that the transaction's authorization followed specified procedures designed to remove the taint of the conflict, or to establish affirmatively that the terms of the transaction are fair to the issuer.¹⁰ If management does not expect that the transaction and the conflict will become known outside the firm, the likelihood increases sharply that the corporation will enter into transactions that have not been authorized by these special authorization procedures and are not demonstrably fair to the issuer.

2. *The Market for Corporate Control*

Consider a potential acquirer and a target that the acquirer feels is mis-managed. In order to decide whether it is worth paying what would need to be paid in order to acquire the target, the potential acquirer's management

7. See Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021 (2007).

8. William W. Bratton, *Hedge Funds and Governance Targets* (Georgetown Univ. Law Ctr. & European Corporate Governance Inst., Working Paper No. 80, 2007), available at http://ssrn.com/abstract_id=928689 (indicating that hedge funds have a high record of success in using the proxy system to achieve corporate change); Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance* (European Corp. Governance Inst., Finance Working Paper No. 139/2006 & Vanderbilt Law and Economics Research Paper No. 07-8, 2006), available at <http://ssrn.com/abstract=948907> (indicating that activists are at least partially successful at achieving corporate change two-thirds of the time, and there are statistically significant positive abnormal returns in the range of five to seven percent with the announcement that a hedge fund has targeted a particular issuer, suggesting that the market anticipated an increase in share value due to the changes the hedge fund was demanding).

9. See, e.g., Security Holder Director Nominations, 68 Fed. Reg. 60,784, 60,785-92 (proposed Oct. 23, 2003) (to be codified at 17 C.F.R. pts. 240, 249, 247) (proposing Exchange Act Rule 14a-11, which would require several "triggering events" to occur before shareholders have access to the company proxy such as (i) a company's failure to act on a shareholder proposal that received a majority of votes and (ii) an election where a director candidate received a significant number of abstention or "withhold" votes); Internet Availability of Proxy Materials, Exchange Act Release No. 52,926, Investment Company Act Release No. 27,182, 70 Fed. Reg. 74,598 (proposed Dec. 15, 2005) (to be codified at 17 C.F.R. pts. 240, 249, 274).

10. See DEL. CODE ANN. tit. 8, § 144(a); *Fliegler v. Lawrence*, 361 A.2d 218 (Del. 1976); ROBERT C. CLARK, *CORPORATE LAW* 169 (1986).

must assess what the target would be worth in the acquirer's hands. This assessment is inherently risky, but reduced information asymmetry lowers the risk. This reduction in risk means that a smaller apparent deviation between incumbent management decision making and the decisions that would maximize share value will impel the potential acquirer into action. Thus, with reduced information asymmetries, incumbent managers will be less tempted to operate existing projects in ways that sacrifice profits to satisfy their personal aims, to implement negative net-present-value projects in order to maintain or enlarge their empires, or to hold onto assets that would be more valuable in the hands of another firm. And those managers who nevertheless do these things are more likely to be replaced.

3. *Share-Price-Based Managerial Compensation*

Share-price-based compensation, such as grants of stock options or restricted stock, has long been heralded as a way to better align the interests of management with those of shareholders.¹¹ Compared to straight salary with the same expected value, the problem for a manager with share-price-based compensation is the undiversifiable unsystematic risk it imposes. Reduced information asymmetry makes share prices more accurate and reduces this unsystematic risk. As a result, a manager offered a total compensation package with a given expected value will be willing to take a larger portion in share-price-based form. With a larger portion of compensation in share-price-based form, incumbent managers will have reduced incentives to make decisions that sacrifice profits to satisfy their personal aims.

There is some irony, however, in the observation that reduced gatekeeper failure would lead to an economic-efficiency-inducing increase in the use of share-price-based compensation. One of Coffee's major theses is that the shift in the 1990s in executive compensation toward a greater share price basis, by creating incentives to manipulate earnings and to pressure gatekeepers to accept these manipulated figures, substantially contributed to the financial scandals of the early 2000s (pp. 55–56, 62–64). It might appear that share-price-based compensation may be more effective at promoting misleading disclosure than at promoting good management.

These problems, however, arose in part from the particular design of the compensation packages involved. The packages had insufficient emphasis on long-run share-price performance. Long-run share prices are much harder to influence through earnings manipulation than short-run share prices.¹² Even more to the point, though, this experience simply shows the

11. *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, 141.

12. The most common ways of inflating current earnings are to recognize revenues prematurely, to postpone recognition of expenses, or to capitalize expenditures that will not in fact contribute to future profitability and hence are properly categorized as expenses. Each of these acts will reduce earnings in the future and therefore have a depressing effect on future share price. Coffee in fact implicitly recognizes that the problem was the short-term emphasis of the compensation packages, when he refers to changes that "made corporate managers far more interested in

importance of gatekeeper reform itself, without which share-price-based compensation's socially useful, high-powered managerial incentives for genuinely good corporate performance will not work. Indeed, one reason for the recent wave of conversions of companies from a dispersed public ownership structure to a private equity one—despite private equity's disadvantages of reduced investor liquidity and ease of diversification—may be the substantial risk of gatekeeper failure. Without a reduction in this risk, private equity may appear to be the only way to provide incentives that reliably promote good performance.

II. THE ORIGINS OF GATEKEEPER FAILURE

Coffee suggests that the key feature that makes an entity a gatekeeper is that it verifies corporate issuer statements. Coffee sees the gatekeeper as a repeat player that acquires reputational capital by verifying only corporate issuer statements it reasonably believes are accurate (p. 9). Verification by a gatekeeper with substantial reputational capital makes a corporate issuer's statement more believable because, compared to the issuer, the gatekeeper has more to lose and less to gain if the issuer's statement ultimately turns out to be false or misleading. Coffee's point is that gatekeeping can sometimes break down, however. A systemic breakdown, starting perhaps in the 1990s, appears to have permitted the rash of financial scandals of the early 2000s. Coffee suggests four problems as the likely causes of this systemic breakdown: agency problems within the gatekeeper firms themselves, imperfect competition within the gatekeeper industry, a decline in the value of reputational capital that made it less worth protecting, and reduced exposure to litigation (p. 10).

In this Part, I informally model parts of Coffee's discussion in order to consider what can be said about the relative contributions of each of his four causes of gatekeeper breakdown. The approach is as follows. Assume for a moment that the expected longer run losses attributable to verifying an issuer statement that the gatekeeper knows, or through reasonable effort could know, is materially false or misleading, discounted to present value, exceed the extra fees the gatekeeper could earn from making such verification. Assume also that the gatekeeper firm is a rational maximizer of its own value. Under these assumptions, gatekeeper failure would never occur because expected cost would exceed expected benefit. Gatekeeper failure, however, does occur. By asking the question in what way have one or both of these assumptions not been met, we can usefully explore the causes of the gatekeeper failures that permitted the financial scandals of the early 2000s.

maximizing their firm's short-term stock market price—even if the resulting stock price spike could not be sustained for long." P. 55.

A. Agency Problems

1. *The Increasing Nature of Gatekeepers' Agency Problems*

A gatekeeper firm is an organizational entity that can only act through its individual agents. Just as the incentives of corporate managers may not align perfectly with the corporate goal of share value maximization, the incentives of a gatekeeper firm's agent may not align perfectly with the goal of maximizing the value of the firm. In fact, setting up a structure of incentives that aligns the interests of the gatekeeper firm's agent who makes the actual day-to-day verification decisions with the interests of his firm is particularly tricky. On the one hand, the firm prospers when an agent generates a large amount of fees. So, all else equal, rewarding the billing of fees helps align the agent's incentives with the gatekeeper firm's goals. On the other hand, one way for the agent to attract and retain clients that generate large billings is to verify statements that make the client corporation look good but that the agent knows, or with reasonable effort could know, are false or misleading. The cost of such a practice—the risk of loss to the gatekeeper's reputational capital—is borne in the first instance by the gatekeeper firm. The agent will bear at most a fraction of this loss, and then only if he has some kind of equity interest in the gatekeeper firm. Moreover, the larger the firm is, the smaller the fraction of the loss borne by an agent—even by an agent that does have an equity interest—is, and hence the more serious the firm's potential agency problem. Since accounting and law firms have grown substantially in recent decades, their agency problems have inherently increased. Devices to fight these problems would have needed to be strengthened just to hold even the incidence of agent damage to reputational capital.

2. *The Weakening of Agent Self-Policing*

Two influences—identification with the public purposes of the profession and identification with the firm—naturally help align agent decision making with the gatekeeper entity's need to protect its reputational capital. These influences, which I call "agent self-policing," have weakened in recent decades, at least in law and accounting.

a. *Professionalism*

A person who identifies strongly with the professed public purposes of her profession is more likely to resist verifying questionable issuer statements because, whatever the rewards of doing so, it will reduce her self respect. An important source of an individual agent's sense of professionalism is her sense of participating in some larger social practice that places

value on these public purposes.¹³ Each accounting and law firm benefits from the reputation-protecting consequences of its individual agents' identification with these public purposes of the profession.

The increased general orientation of accounting and law firms toward generating high incomes¹⁴ inevitably crowds out, at least to some extent, the more publicly oriented concerns of the typical member of the profession. Thus the social practice of placing value on the public purposes of the profession has become less widespread and intense. Whether a particular firm follows this trend or not, the reduced presence of the social practice provides each of the firm's agents with less with which to identify—lessening their resistance to verifying questionable issuer statements.

In essence, the firm reputation protection that arises from the social practice is a public good. A public good is underproduced because the person creating it incurs all the costs but receives only a small portion of the benefits, which are spread over some larger population. Each gatekeeping firm bears the full cost (through lost monetary income) of its contribution to the public purposes of the profession. It receives, however, only a small portion of the benefits, since the identification-enhancing effect of the increase in the social practice arising from the particular firm's contribution is spread over all the agents working in the entire gatekeeper industry. Hence all the firms enjoy the contribution's reputation-protecting benefits.¹⁵

b. Identification with the Firm

Another agent self-policing mechanism that traditionally kept an agent acting in ways that would respect the gatekeeping firm's need to protect its reputational capital was the agent's identification with his employer. When such identification is strong, hurting the firm feels like hurting oneself. But the forces encouraging identification with the firm have been weakening.

13. See Eliot Freidson, *The Theory of Professions: State of the Art*, in *THE SOCIOLOGY OF THE PROFESSIONS* 19 (Robert Dingwall & Philip Lewis, eds., 1983) (noting that an ideological orientation to the public interest is one of the most fundamental traits of a profession); see also ROSCOE POUND, *THE LAWYER FROM ANTIQUITY TO MODERN TIMES* 5 (1953) (defining a profession as a group of individuals "pursuing a learned art as a common calling in the spirit of a public service").

14. MARK PERLMUTTER, *WHY LAWYERS (AND THE REST OF US) LIE AND ENGAGE IN OTHER REPUGNANT BEHAVIOR* 71–75 (1998) (discussing the rise in a profit-maximizing orientation in law firms and lawyers). See generally BARBARA L. TOFFLER WITH JENNIFER REINGOLD, *FINAL ACCOUNTING: AMBITION, GREED, AND THE FALL OF ARTHUR ANDERSEN* 6 (2003) (describing the culture of Arthur Anderson as degenerating into a "mad scramble for fees"); Ianthe Dugan, *Before Enron, Greed Helped Sink the Respectability of Accounting*, *WALL ST. J.*, Mar. 14, 2002, at A1.

15. Firm value includes not only the monetary income that the firm generates, but also any utility that the firm's participants gain from the sense of rectitude associated with the firm participating in a social practice that places value on the public purposes of the profession. Thus sacrificing current monetary income to contribute to this social practice can be perfectly consistent with the rational maximizing of firm value, even if the sacrifice of current income is not made up for by a higher level of future income. The public goods point being made here is that there are benefits other than this sense of rectitude that arise from a firm's decision to participate more fully in the social practice. The other benefit is the ability of other firms to rely more on their own agents' self-policing to control agency problems, which adds to the monetary value of the other firms. The firm making the contribution does not capture this other benefit.

One weakening force has been the increase in firm size. When firms were smaller, partners knew each other well. Strong identifications with the firm were more likely to develop because they grew out of personal loyalties.¹⁶ Thus, the large increase in size over the last few decades in the firms that have provided the bulk of accounting and law gatekeeping services not only increases agency problems. By reducing the individual agent's pro rata economic stake in the fortunes of the firm, it also weakens the individual agent's identification with the firm and hence its effectiveness as a device for fighting these agency problems.¹⁷

Another weakening force has been the increase in agent mobility among firms.¹⁸ Compared to an agent who expects to stay at the same gatekeeping firm for the rest of her career, one who anticipates a shorter tenure will not identify as strongly with the firm.

3. *Other Ways to Control Gatekeeper Agency Problems*

A variety of forces have led the accounting and legal professions to their increased high-income orientation and to the increase in firm size and inter-firm personnel mobility. Whether socially desirable or not, these forces are probably here to stay. Coffee's skepticism concerning the effectiveness of calls for a reinvigoration of the public purpose spirit of the professions certainly suggests that he thinks so.¹⁹ Given the consequent weakening of agent self-policing, other kinds of devices to control the agency problems of gatekeeping firms are needed to fill the gap.

Firms have three ways of controlling agency problems that do not rely on agent self-policing. One way is to reduce the risk of damage to its reputational capital by devoting resources to finding among the candidates for promotion those who have best internalized the need to avoid damage to the

16. CARROLL SERON, *THE BUSINESS OF PRACTICING LAW: THE WORK LIVES OF SOLO AND SMALL-FIRM ATTORNEYS* 68 (1996) (concluding, based upon a survey of small law firms and solo practitioners in New York, that "[a]t its core a small law firm rests on a tight, closed, personal, and fraternal bond").

17. It could be argued, of course, that firm size could stimulate rather than diminish agent identification with the firm because larger firms typically have more prestige. While it is true that some of the largest law and accounting firms have the greatest prestige, this prestige is in important part a reflection of the success over time that led to these firms' growth relative to other firms, not a reflection of the absolute size of the organization itself.

An agent's identification with a smaller firm may also have different implications in terms of generating the agent self-policing that protects a firm's reputation. Hurting the firm is likely to be more painful to the agent of a smaller firm because much or all of the harm is done to persons whom the agent knows personally.

18. Geoffrey Miller, *From Club to Market: The Evolving Role of Business Lawyers*, 74 *FORDHAM L. REV.* 1105, 1117 (2005) (noting the increasing mobility of attorneys).

19. Pp. 227–39. To some extent, these forces may reflect a coarsening trend toward placing "self-regarding" values over "other regarding" ones. They reflect as well, however, technological and social changes that on the whole enhance society's welfare. If on balance these forces enhance well-being, the consequent weakening of the two agent self-policing mechanisms discussed above is simply a casualty of progress. Wishing for their return, therefore, would be mere nostalgia.

firm's reputational capital.²⁰ A second way is to engage in ex ante monitoring of firm verifications to prevent agents from providing faulty gatekeeper verifications. This may include a centralized standards group consisting of highly experienced agents without close client contacts who would review proposed verifications—especially ones involving close issues.²¹ It may also include rules requiring the periodic rotation of agents working closely with clients, thereby preventing agents from developing too strong an identification with clients.²² A group with forensic accounting skills that works to find the situations where clients are most likely to try to deceive the gatekeeper is also valuable.²³ A third way to control agency problems is to have a system of ex post investigation followed by sanctions—loss of job, promotions, or compensation—against agents who do not make verification decisions in the best interests of the firm.²⁴

4. Implications

Despite the increases in firm size and the weakening of the two agent self-policing mechanisms, the increase in gatekeeper failures that permitted the financial scandals in the early 2000s was probably not inevitable. Firms could have retained the higher quality characterizing their earlier years by devoting more resources to the task and more intensively utilizing each of these three alternatives to control agency problems.

20. The firm, for example, can self-consciously involve a number of partners in the work of an associate with potential for promotion in order to know better the associate's approach to work, even if the partner time involved goes beyond what is cost effective to assure that the associate's work is of acceptable quality to deliver to the client.

21. A group of this kind existed at Arthur Andersen, but in the last years of the firm's life, the group's influence was reduced. Moreover, the accountants working on Enron appeared to be exempt from needing to gain clearance from the group in the case of close judgments. Pp. 28–29.

22. Such rotation is now required following enactment of section 203 of the Sarbanes-Oxley Act of 2002, which prohibits an auditing firm from providing services to a client if the lead, reviewing, or coordinating audit partner has performed audit services for the client for the past five fiscal years. Pub. L. No. 107-204, § 203, 116 Stat. 745, 773 (codified at 15 U.S.C. § 78j-1(j) (Supp. V 2005)). The SEC has implemented this section in Regulation S-X, 17 C.F.R. § 210.2-06 (2007), though the stated period is seven years rather than five.

23. Ironically, the Arthur Andersen audit team at WorldCom in fact concluded in a brainstorming session that improper capitalization of expenses would be the most likely way that management could exaggerate income. As it turns out, an application of this tactic, capitalizing "line costs," was at the heart of the WorldCom fraud. Unfortunately, in order to ingratiate themselves with the WorldCom management in the hope of earning more consulting fees, the team did not test to see if this was actually going on. Pp. 41–42.

24. The effectiveness of ex post monitoring is limited by a firm's inherent reluctance to determine that an agent erred in his verification of an issuer statement. Since the agent acts on the firm's behalf, such a determination is an admission that the firm itself made an inappropriate verification. Thus, making such a determination can have unfortunate legal and reputational consequences for the firm. The effectiveness of ex post monitoring would not be similarly hobbled, however, to the extent that it is aimed at identifying instances of inadequate diligence by the agent where, as it turns out, the gatekeeper firm is lucky and the client's statement turns out not to be false or misleading. Since no harm resulted, a determination of agent error would gather little outside attention. In accounting, at least, periodic rotation of the agents in charge of verifying a client's disclosures would have an ex post as well as ex ante monitoring aspect because the new agent would wish to report anything amiss in the work of his predecessor so that the successor is not later found responsible.

We would normally expect that firms would want to minimize the number of gatekeeper failures if doing so were in their best interests. The interesting question is why did the rash of gatekeeping failures nevertheless occur. There are a variety of possible explanations, some combination of which probably provides the answer.

The first explanation arises from the disproportionate number of accounting gatekeeper failures in one firm: Arthur Andersen (p. 29). Assume for a moment that a rational, value-maximizing gatekeeping firm would want to minimize its number of gatekeeper failures. Standard economic theory tells us that in equilibrium, only rational maximizing firms can survive. In that case, how could the Andersen fiasco have occurred? Industries are not always in equilibrium; so the result predicted in theory is not inconsistent with the existence, for a period of time, of a firm that has become dysfunctional. Market forces will ultimately force such a firm out of the industry, but these forces take time to work. Thus, even if it is necessary to minimize gatekeeper failures to maximize firm value, and even if most firms in the gatekeeper industry use agency-problem-control mechanisms at a level sufficient to accomplish this aim, a dysfunctional firm can exist for a period of time and generate a substantial portion of the industry's failures. Coffee believes that Andersen, even without the government indictment, would ultimately have been forced out of business, but not before the large number of Andersen gatekeeper failures had the time to come to light and clients the time to react (p. 4).

A second explanation is that in accounting, and perhaps in law, there may have been an industry-wide mistaken perception of optimal behavior. Such a mistake can only be corrected by bitter experience. Without resolving whether or not any of the following perceptions were in fact mistaken, let me suggest several possible candidates: There may have been an exaggerated sense of the optimal gatekeeper firm size because of inadequate appreciation of the increased agency problems inherent in larger firms.²⁵ Firms may have believed in the efficacy of billing-based agent compensation formulas without adequately appreciating the risks to firm reputational capital that such formulas generate. Alternatively, the increase in firm size and billing-based agent compensation schemes may in fact have made sense, but firms may not have appreciated how, to be worthwhile, these changes required substantially more resources be devoted to agency-problem-control mechanisms, especially given the decline in agent self-policing.

25. The economic theory of contracts and organization suggests that for any particular business, there is an optimal firm size that involves a tradeoff between scale economies (in a gatekeeper business, these might include marketing and the capacity to provide new employees training by working with the most highly skilled practitioners in the profession) and the managerial incentive problems that tend to grow with firm size (in the gatekeeper business, an example being the difficulties in providing incentives to work hard to generate fees while at the same time acting in a way that protects the firm's reputation). See OLIVER HART, *FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE* 51 (1995).

A third explanation is that top persons in each of the firms—the ones who set the structure of incentives for the agents actually verifying client statements—may have had a short-term bias, putting too much emphasis on current income and too little on maintaining firm reputation. This bias could arise because these top decision makers were near retirement. The partnership structure of the firm and their compensation plans may have given them little or no stake in future income. In essence, there may have been a top-level agency problem in gatekeeping firms, not just an agency problem with those making the day-to-day verification decisions.

The final explanation, contrary to the assumptions so far, is that it may not in fact have been in the best interests of the gatekeeping firms to minimize gatekeeper failures. Rather, given changes in the environment in which these firms operated, it was in their best interests, even in the longer run, to please client managers by verifying questionable statements or by not subjecting client statements to adequate due diligence, even though it was predictable that a significant number of these statements would ultimately prove to be false or misleading. In other words, the rash of gatekeeper failures may have been due, at least in part, to one or more of the other three problems identified by Coffee: imperfect competition, a decline in the value of reputational capital for generating future earnings, and reduced exposure to litigation.

Market forces tend to push firms to act in firm-value-maximizing ways and hence to minimize agency costs.²⁶ This point should lead to a healthy skepticism that gatekeeper agency problems were wholly responsible for the gatekeeper failures that permitted the early 2000s' rash of financial scandals. After all, if minimizing gatekeeper failures really maximized firm value, the gains for those who wanted to eliminate them would have been greater than for those who profit from permitting them. On the other hand, it is important to identify the extent to which agency problems contribute to gatekeeper failure compared to the other problems. Agency problems tend to be self-correcting through the work of market forces, and so regulatory intervention to correct them is less likely to be desirable.²⁷ Dysfunctional firms will be pushed out of the market. If gatekeeper firms have grown inefficiently large, firms will shrink. If compensation formulas emphasize billing too much, the formulas will change. If too few firm resources were invested in the non-self-policing agency cost control devices, more will be invested. If decision-making structures within firms are too focused on the near future, they will be changed.

26. Jensen & Meckling, *supra* note 5.

27. This statement is not meant to suggest that regulatory intervention is never appropriate in situations where market forces would otherwise eventually solve the problem. The market solution has the advantage of being assured of being efficient as long as there is adequate competition and no externalities. The regulatory solution has the advantage of being faster-acting. Thus two factors need to be considered in determining the desirability of regulatory intervention: how long will the market forces take to work, and how likely is it that regulators will come close to adopting efficient rules the market itself would eventually reach.

B. Imperfect Competition

Professor Coffee argues that another cause of gatekeeper failure is imperfectly competitive markets for gatekeeper services. Such markets, he suggests, allow gatekeepers, through collusion or consciously parallel behavior, to act differently than they would under competition (p. 6). He suggests that this is a problem primarily with accountants, where there were only five major firms prior to Arthur Andersen's demise, and credit rating agencies, where there are only two major firms.

Coffee argues that concentration into a handful of firms blurs the reputational effect of failure: "In a competitive industry with a dozen . . . firms available, any firm's involvement in a major financial scandal might inflict severe reputational damage But in a heavily consolidated industry, . . . all firms may have experienced a similar level of embarrassing episodes" (p. 159). While there may be something to the idea that in a less concentrated industry, one firm might find it easier to develop a niche market for quality and to point out the defects of the others, Coffee's story does not seem all that convincing. The real problem for the outside observer trying to figure out what to infer, if anything, from the number of failures associated with a given gatekeeper is whether these failures are the result of chance or responsibility. Concentration, by increasing each firm's opportunities to fail if their standards are low and to avoid failure if they are high, in essence increases the observer's sample size and hence makes it easier to separate out responsibility from chance. If one firm out of an industry of four has a higher failure rate than another, this tells the observer more than if one firm out of an industry of twelve has a comparably higher rate than another.²⁸

How then does market power affect quality? Consider the following model of gatekeeper behavior under imperfect competition. Assume for a moment that the principal seeking the gatekeeper services is strong and there are no agency problems internal to the gatekeeper firms. Investigating issuer statements is costly. The more cost that the gatekeeper incurs, the more reliable its verification. How would a gatekeeper with market power behave differently than one without market power?

Answering the question is complicated by the fact that there are potentially two dimensions to supply and demand for gatekeeper services: the number of verifications and the quality of each verification. It is not implausible to assume, however, that the number of verifications is fixed at least in the short run.²⁹ Thus, we can measure the amount of service demanded and supplied in terms of the quality of the verification. This is consistent with the billing of professional services on an hourly basis. Then the familiar

28. One firm, Arthur Andersen, did in fact have a higher failure rate and, although it took time, was ultimately perceived to be of lower quality. If its business had been split among three low-quality firms and each had one or two major scandals associated with it, compared to Arthur Andersen's five or six, it would probably have taken longer for the low quality of each of them to have been definitively established.

29. For example, every public issuer needs an audited financial statement and, in the short run, the cost of the audit is not going to affect the total number of public companies.

analysis of the effect of monopoly power can be applied: the amount supplied (in this case quality) will be lower than in a competitive market and the price will be higher.³⁰ The only question is the principal's price sensitivity to the quality of services demanded. If demand is inelastic (i.e., the quality demanded is relatively insensitive to price), then the impact of oligopoly on the quality of verifications would be minor. Most of the effect of the oligopoly will be on price. If the demand for quality is relatively elastic, the opposite would be true. If the assumed strong principal were the investor community, one would suspect that the elasticity of the demand for quality would be low since the extra cost that an oligopolist could extract for high quality would be small compared to what is at stake. In that event, at least according to this static microeconomic line of analysis, lack of competition would not explain much gatekeeper failure in accounting. In fact, managers are the real principal and they may on balance not want quality, but that is an alternative explanation for gatekeeper failure that does not depend on lack of competition.

Coffee, however, also argues that lack of competition permits gatekeeping firms (at least the credit rating agencies) "to shirk, engaging in less effort and research than if there were true active competition" (p. 285). Another mode of economic analysis, focusing on the relationship between competition and innovation, resonates with this second argument. Although not free from controversy, many economists believe that, while perfect competition is not ideal for innovation, industries with very few firms may also not be very innovative because there are too few independent centers of initiative.³¹ Issuers are changing all the time and some, like Enron, are constantly inventing new ways to create misimpressions with investors. Unless gatekeepers can respond innovatively, the failure rate will be higher.

At first glance, this innovation–market power explanation of gatekeeper failure does not seem very convincing either, at least in accounting. There were five leading accounting firms in the period immediately preceding the financial scandals of the early 2000s. In many industries, the presence of five major firms is enough to promote vigorous, innovative competition.³² But there is another factor at work that makes the explanation more plausible: the "lock in" once one gatekeeping firm has been chosen. An issuer will be reluctant to switch accounting firms because it is expensive for a new accounting firm to get to know the company and because investors will wonder whether the switch suggests a problem that the first accounting firm had with the issuer's financials. Thus once an issuer has chosen an accountant,

30. RICHARD G. LIPSEY ET AL., *ECONOMICS* 292 (10th ed. 1993).

31. See F.M. SCHERER & DAVID ROSS, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* 646–48, 651 (3d ed. 1990).

32. In contrast, the explanation works straightforwardly with credit rating, where there are only two firms, and most bond issuers feel they need to get rated by both.

the effective level of competition is much lower than the number of firms in the industry—whether twelve or five—would normally imply.³³

C. *Reduced Value of Reputational Capital*

Coffee also suggests reputational capital may have become less valuable to gatekeeper firms relative to current earnings than before. Certainly reliable information was no less valuable to investors than it had been in the past.³⁴ To issuer managers, who actually choose the accountant and lawyer, everything else being equal, hiring a gatekeeper with a good reputation is a positive thing to do because it signals that the firm has nothing to fear from a thorough examination and that the firm will be subject to benefits of better corporate governance.³⁵

Everything else is not equal, however, and the forces favoring a more lenient gatekeeper being chosen are strengthening. As discussed earlier,³⁶ the much greater use of share-price-based compensation increased management desire for gatekeepers willing to verify exaggerated earnings and thus their willingness to pay more for lenient gatekeepers. At the same time, changes in the range of services these firms offer increased the additional income that the gatekeeper could earn by going along and verifying such earnings. Accounting firms were more inclined to be lenient in their verifications when a happy customer could provide consulting fees as well as auditing fees. Analysts were more inclined to be lenient in their recommendations when a happy issuer could avail itself of other services offered by the investment bank.

Thus a good gatekeeper reputation has not become less valuable in terms of the benefits a manager receives when it chooses a gatekeeper that investors appreciate. For the manager, however, his opportunity cost for enjoying this benefit—the risk of foregoing substantial amounts of compensation—has increased with the increased use of share-price-based compensation. So

33. Five major firms is a small enough number by itself to have another quality-depressing effect. Compared to an industry with more firms, five firms would have an easier time coordinating, in the guise of self-regulation, to adopt self-serving rules and to lobby Congress and the SEC effectively.

34. Contrary to my assertion here, Coffee suggests that in the bubble market of the late 1990s, investors, just like managers, might have valued verification of issuer statements that were more optimistic than the gatekeeper reasonably believed were accurate. Pp. 329–30. Normally we would assume that while one group of investors, sellers, would have no problem with such behavior, an equally important group of investors, buyers, would feel ill-served by such gatekeeper behavior because it would lead them to pay what would turn out to be an unsustainably inflated price for their shares. Coffee's idea may be that in a bubble, a buyer would also be glad to have such a gatekeeper because she would hope that the gatekeeper would be verifying even more optimistic issuer statements by the time the buyer sells. This seems a bit of a stretch, at least for auditors, because probably most buyers in a bubble market genuinely believe that issuers will have earnings growth beyond what is realistic, not that they are buying into a bubble but expect to be smart enough to get out ahead of the crowd before the bubble bursts. There may be more truth to Coffee's idea when it comes to analysts, since investing, especially in a bubble market, has a consumption good aspect to it and an optimistic analyst is appreciated for adding to the party atmosphere.

35. See *supra* Part I.

36. See *supra* Section I.C.3.

the interests of the manager when he makes the choice of a gatekeeper diverge more widely than in the past from the interests of investors. For the gatekeeper, the opportunity cost of preserving its reputation—foregoing the profitable consulting or underwriting business that a happy management might elect to procure—has gone up as well. Thus it is more likely than in the past that the implicit deal struck between the manager and the gatekeeper will be for more lenient verification standards.

D. Reduced Risk of Liability

Imposing liability on gatekeepers for the damages to investors caused by gatekeeper failures is a substitute for the impractical ideal of investors acting as a strong principal themselves. Liability is an antidote for the fact that the manager, the person who actually chooses and deals with the gatekeepers, does not have the same interests as the shareholders. The threat of such liability will create an incentive for the gatekeeper to approach its verifications in a way that minimizes failures even where, in the absence of the threat, the gatekeeper and the managers would implicitly agree on a more lenient approach.

Professor Coffee makes an incontrovertible case that the risk of liability for gatekeepers declined significantly in the 1990s, particularly for accountants (p. 152–56). Thus, at the same time that the divergence between the interests of managers and investors was widening, the antidote was weakening.

This coincidence of events probably goes a long way toward explaining the gatekeeper failures that led to the rash of financial scandals in the early 2000s. The implicit deal that managers and value maximizing gatekeepers were making was moving toward increasingly lenient standards of gatekeeper verification. That would seem to have called for an increase in the liability threat, but the opposite happened.

Why did the risk of accountant liability decrease? At the level of practical politics, the decline in the risk of accountant liability is probably substantially due to the profession's organized clout in Congress³⁷ and its determined and capable effort to help shape the climate of opinion in which judicial decisions have been made. That does not mean, however, that the reductions in litigation risk should necessarily be rolled back wholesale. The profession correctly identified the fact that litigation can be a very expensive way to change behavior. With a rules-based system of accounting such as we have in the United States, litigation also may not be totally effective, since clever managers and accountants, if so inclined, can figure out how to make issuer statements comply with the rules while still creating an impression that the issuer is doing better than it is. Increasingly in the 1990s, they did.

37. See *Arthur Levitt's Crusade*, *BUS. WK.*, Sept. 30, 2002, at 74 (describing how the accounting industry's campaign contributions allowed it to wield considerable influence in Congress and the SEC).

Instead of a wholesale rollback of the liability reforms of the 1990s, what is needed is a new kind of prophylactic gatekeeping institution. This would involve a gatekeeper in a questioning and challenging role to improve the overall quality of issuer disclosure. While it may be necessary to motivate this new gatekeeper by the fear of liability, if the arrangement is properly designed so that the quality of disclosure improves, the occasion for litigation, and its accompanying costs, will be reduced.

III. THE NEED FOR A NEW GATEKEEPER INSTITUTION

In Professor Coffee's view, there are some changes to the rules by which gatekeepers operate, and to the liabilities applicable when they are violated, that would combat the trends that led to the increased gatekeeper failure of recent decades (pp. 340–47). Yet he is skeptical such reforms by themselves would be sufficient to cure the problem, at least cost effectively (pp. 333–36). The review of the origins of gatekeeper failure in Part II above tends to confirm his conclusion. Coffee proposes to improve the quality of ongoing periodic disclosure filed with the SEC by the creation of a new gatekeeping institution: the certifying disclosure counsel (p. 347–52). Each issuer would need to appoint an outside counsel that would monitor all such disclosures and would sign the filings. Counsel who fail in their gatekeeping role would be disciplined by the SEC.

Coffee is correct that improving the quality of periodic disclosure filings is key to reducing the rate of corporate governance malfunctions. And, for this to happen, a new gatekeeping institution needs to be created. In my view, though, Coffee has chosen the wrong institution.

My proposal would require periodic filings to be certified by an adequately capitalized investment bank that faces measured liability in the event that it fails to engage in adequate due diligence. An investment bank is uniquely situated to play this gatekeeping role. Unlike a law firm, an investment bank already has experience being responsible, under the threat of liability, for the full range of required issuer disclosures. Every time it underwrites an IPO, it must play this due diligence investigatory role. Additionally, before the advent of short-form and shelf registration, investment banks played this role for every public offering.

It is true that, in public offerings, the investment bank delegates much of this due diligence work to its lawyers. But it is the investment bank that maintains overall responsibility and faces the liability for failure.³⁸ It is also the bank that is expert at projecting future cash flows, which is at the heart of determining share value. Under my proposal, just as with public offerings, the investment bank, in its rational self interest, would delegate responsibility for the work that lawyers or accountants could do better where that is the least-cost way of minimizing the bank's risk of liability. My proposal would raise the quality of established issuers' periodic disclo-

38. *Escott v. Barchris Constr. Corp.*, 283 F. Supp. 643, 687, 696 (S.D.N.Y. 1968).

sure to the high level traditionally associated with public offerings by such issuers, prior to the advent of shelf and short-form registration.³⁹

Coffee suggests that “ideally” the SEC should require the attorney to aver that its certification was made “after making such inquiry that the attorney reasonably believed appropriate under the circumstances” (p. 351). This affirmative due diligence requirement, however, would likely increase the risk of attorney liability for damages and is not at the center of his proposal. Coffee’s tentativeness is probably because he knows there would be fierce professional resistance to taking on a liability-inducing responsibility so different from what has traditionally been the norm for lawyers. Law firms also are not capitalized in ways that would make them good bearers of the residual risk of a major securities litigation judgment. In contrast, an investment bank is a pure business, often publicly owned, that would gladly seek this new opportunity to sell its services. The fee level that would develop in a competitive market would include enough to cover the costs of an adequate investigation and any residual expected litigation costs, and most importantly, new rents for its special diligence skills that it has already developed in other contexts. Assuming that minimum capital requirements are imposed to avoid “fly-by-night” operators, an investment bank would also be sufficiently capitalized for their incentives not to be compromised by the possibility of being judgment proof.

Professor Coffee briefly considers requiring investment banks to certify disclosures. While he finds it “feasible” (p. 353), he has two critiques. First, he suggests that the requirement would be costly because underwriters would demand a high fee before they would accept the accompanying liability (p. 353). It is not clear why, in a competitive market, the cost would not equal the social cost of the proposal: the opportunity cost of the personnel necessary to conduct the due diligence plus the expected value of the residual costs of litigation judgments, settlements, and legal fees. This cost was traditionally deemed worthwhile to assure quality disclosure at the time of a public offering. The whole premise of Coffee’s book is that high quality ongoing periodic disclosure is socially very valuable as well, a position reaffirmed by Part I of this Review. Hence high quality periodic disclosure should also be worth this cost. Moreover, if, contrary to my predictions, lawyers really could perform due diligence equally well and faced similar liabilities when they failed, it is not clear why they would be less costly than investment banks.

Second, Coffee suggests that the idea has already been tried on the AIM market in London and that the arrangement tied issuers too closely to a single investment bank. The result, he says, is that there is little competition among bankers for the issuer’s business and the bank can therefore extract monopoly rents from its situation (pp. 353–54). It is not clear that this would be a serious problem under my proposal. Admittedly, there would be

39. Coffee discusses the decline in the quality of new issue disclosure. Pp. 206, 348–49; see also Merritt B. Fox, *Shelf Registration, Integrated Disclosure, and Underwriter Due Diligence: An Economic Analysis*, 70 VA. L. REV. 1005 (1984).

synergies in the certifying bank being a lead underwriter in a subsequent public offering. The bank has already done the research necessary to assure itself that it wished to associate its name and reputational capital with the issuer. This is the limit of the tie, however. I would propose that if the issuer's recent periodic disclosures have been certified, the underwriter should be able to rely on them at the time of the offering, shielding it from liability for issuer misstatements contained in those disclosures. Thus any rents extracted by a certifying bank cannot be greater than what can be extracted for the amount of due diligence that should properly be done by someone at some point near the time of an offering. Other underwriters competing with the certifying bank would therefore not be at a disadvantage relative to the certifying bank in terms of fear of legal liability.

CONCLUSION

Professor Coffee has provided by far the most comprehensive documentation to date of the changes in the gatekeeping professions that led to the failures permitting the financial scandals of the early 2000s. His explanations of why these changes occurred are both conceptually broad and institutionally nuanced. His recommendations for reform are provocative and realistic. In one sense, however, he is too modest. The gatekeeper failures he identifies undermine not just the effectiveness of independent directors, where he chooses to put his focus, but also the whole panoply of other institutional devices that we have for good corporate governance in the United States. Coffee's explanations of gatekeeper failure are fertile and original. Carrying them a step further, though, suggests that the primary long-term problems are probably not agency problems within the gatekeeper firms or lack of competition, but rather a change of circumstances that leads managers and gatekeepers to agree to lower verification standards combined with a reduced risk of gatekeeper liability. Coffee is correct that the most effective response would be a new gatekeeping institution designed to improve the overall quality of issuers' ongoing periodic disclosures. But his suggested institution, outside disclosure counsel, is not as well suited to the task as would be a certifying investment bank, subject to measured liability for failures in due diligence.