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Lawrence A. Cunningham
George Washington University Law School, lacunningham@law.gwu.edu

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Abstract

This Article contributes a novel idea to the literature on capital market gatekeepers: positive incentive systems for gatekeepers to perform functions not required of them in exchange for rewards if they perform the functions successfully. Capital market gatekeeping theory relies upon the reputations that gatekeepers are assumed to command and protect backstopped by negative threats of legal liability for failure to perform legally mandated functions. The ineffectiveness of many gatekeepers during the late 1990s and early 2000s revealed practical limitations of the reputational constraint and the reforms that responded to the failures continue to emphasize the legal duties and legal liability that gatekeepers face. Adversely, that emphasis discourages gatekeepers from willingness to perform desired functions—such as to detect for fraud—whereas the positive approach induces performance of such functions. Without necessarily displacing existing reputation constraints and liability strategies, adding an incentive system as a public policy lever could promote gatekeeper effectiveness and poses little downside risk.

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CARROTS FOR VETOGATES: INCENTIVE SYSTEMS TO INCREASE CAPITAL MARKET GATEKEEPER EFFECTIVENESS

Lawrence A. Cunningham

INTRODUCTION

An abundant literature addresses how third-party intermediaries in securities transactions stake their reputations when attesting to the veracity of first-party, enterprise, assertions. The literature richly evaluates how such third-party "gatekeepers" are motivated to promote fair enterprise reporting based on the value of their respective reputations for doing so and backed by some risk of legal liability for failure. Yet, until recently, almost completely absent from this literature is any attention to how a regime can supply direct incentives into the gatekeeping function through positive inducements. Scholars are lately becoming more interested in this fresh approach.[1] This Article aims to enhance this emerging perspective.

Enterprises seeking access to capital entice investment by offering a compelling opportunity. A complex combination of forces shape the character of the reports they provide to potential investors. Pressures of morality and reputation incline managers to produce fair reporting while those of chicanery and short-sightedness sway them to provide misleading accounts. These forces operate at both the enterprise level and among individual agents. As an institution, the enterprise can design internal systems to shape the culture to lead individuals either towards fair or misleading reporting.

An enterprise can bolster an inclination towards fair reporting by hiring and paying third parties to examine and vouch for its reports. The common examples are using outside accountants to audit and attest to financial matters and outside lawyers to investigate, prepare and endorse narrative business information. While these third-parties can face competing pressures similar to those the enterprise faces, pressures toward misleading presentation are more attenuated when the third-party provides such services for a large numbers of enterprises. Third-parties with large client bases have less to gain and more to lose from complicity in misleading reporting with any given enterprise.

Law can contribute to shaping an enterprise's inclination toward fair or misleading reporting through a combination of positive reinforcement or negative threats. Law and legal scholarship focus nearly entirely on negative threats. Lawyers and scholars invariably struggle to design liability regimes to induce fair reporting. Law thus imposes duties on enterprises, individuals, outside accounting and law firms and their individual professional employees. These duties are backed by risk of legal liability, which can be criminal or civil and include money damages, prison terms, fines, license revocations and the like.

Complex layers of liability analysis result. The enterprise is potentially liable as a firm and some of its individual employees also face exposure. Despite such legal

[1] *See* Tamar Frankel, *Using the Sarbanes-Oxley Act to Reward Honest Corporations*, 62 BUS. LAW. 161 (2006) (offering "honest corporations" exemptions from certain provisions of the Sarbanes-Oxley Act); 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 (2004) (offering transactional immunity to securities lawyers who first report violations of law to authorities).

deterrence at the enterprise level, detection of mis-reporting is not assured and related enforcement may be ineffective or ultimate sanctions insufficient. To backstop these gaps that allow mis-reporting to persist, law imposes similar negative threats against outside third parties that an enterprise engages in its reporting exercises. These apply to the law and accounting firms that an enterprise retains as well as firm partners and other employees.

Yet law never supplies positive inducements (even lighter sanctions for conscientious enterprises or gatekeepers are weaker sticks, not carrots). True, 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. Examples include how the auditing profession has long resisted any undertaking to detect for fraud in financial audits and how the legal profession has long resisted any undertaking to conduct due diligence exercises in preparing public offerings of securities.

The following analysis examines the prevalent obsession with liability risk and reputation to develop new insights into the possible use of positive incentives to supplement these negative inducements. To simplify for illustration, consider a mix of sticks and carrots in a model. Suppose an enterprise is concerned about employee drinking on the job. The stick approach to regulation imposes fines when inebriation is discovered, which can be imposed on the individual employee or on supervisors (the functional equivalent of gatekeepers). The carrot approach would award merit points for sobriety, which can be given to employees and/or supervisors. A combination of sticks and carrots would likely increase the probability of optimal system design—minimizing drinking on the job.

The prevailing regime of securities gatekeepers is overwhelmingly a sticks-oriented system, based on reputation at risk and legal liability threats. That system failed during the late 1990s and early 2000s and 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.[2] Others point to factors that reduced auditor investment in reputation, such as industry concentration (and reformers prescribe breaking up large firms to reduce it), how partner incentives differ from firm-level incentives (and reformers prescribe realignment through various forms of vicarious liability), and the proliferation of non-audit services (and reformers prescribe restricting these). No reforms have considered, as this Article does, offering an additional but different set of inducements altogether.

[2] *E.g.*, John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid"*, 57 BUS. LAW. 1403, 1403-05, 1409-10 (2002); 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).

This Article's title, Carrots for Vetogates, refers to explicit compensation to gatekeepers who deny access to capital markets (either for an enterprise as a whole or as to individual transactions it seeks to pursue) unless corrections are made. The term vetogates is adapted from Professor Eskridge's coinage that designates the occasions when the passage of legislation is inhibited by legislative gatekeepers who hobble the process—activating levers called vetogates.[3] Political culture makes it difficult to get legislation passed; business culture is committed to getting the deal or audit done.

True, auditors increasingly severed clients during the mid-2000s, but only smaller companies where fees do not justify risks.[4] Yet the frauds of the late 1990s and early 2000s involved large companies. So despite changes, auditor vetogating may be too rare. Evidence as to law firm relationships with high-risk clients is more diffuse, but anecdotal inference at least plausibly justifies an inquiry into whether a carrot-based merit system may contribute greater willingness among lawyers to activate vetogates by denying access to capital markets unless corrections are made.

This Article uses a specific decision-making calculus that capital market gatekeepers are assumed to employ. A gatekeeper is invited, explicitly or implicitly, to acquiesce or participate in mis-reporting. It weighs the gains from doing so against the expected costs of inculpation. Gains are context-specific and may range from direct payments or indirect benefits such as continued revenue streams from providing additional services to the enterprise. The expected loss is a function of the probability of inculpation times the liability sanctions imposed plus the diminution of reputation value. The model that this Article discusses adds to the calculus new gains from preventing misleading reporting, adding carrots to offset gains arising from complicity.

Part I considers the theory of capital market gatekeeping. It presents the conceptual underpinnings of various components of this model of promoting capital market integrity, including discussing various forms that gatekeeping assumes and how a combination of reputation and liability risks sustains the existing system. Part II analyzes recent experience that shows limitations on the theory in practice, including limitations that continue despite various reforms. From this fairly extensive review offered to provide context, a carrot-based merit system emerges as a potential means of meeting some of these limitations and adding new useful features to the gatekeeping function.

Part III explores a carrot-based merit system. Its prescriptive discussion concentrates on auditors as the model gatekeeper and lawyers as an emerging gatekeeper, although some of the analysis leading up to it in Parts I and II also considers other

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[3] *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); *see infra* text accompanying notes ___-___.

[4] *See* John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 348, n. 148 ("In 2003, over 1460 public companies changed auditors, which was the highest number in at least five years.").

gatekeepers for illustrative purposes. Carrot systems for those gatekeepers can be tailored, as some examples of application to auditors and lawyers suggest. The Article emphasizes auditors because they are the quintessential gatekeeper. Indeed, auditors are the only professionals that public enterprises must engage before making a public offering and—even after recent reforms—the only professionals charged with speaking independently of an enterprise's management. The Article's supplemental emphasis on lawyers suggests that such merit systems can be generalized to other capital market gatekeepers too.

The analysis highlights how the heavy concentration placed on liability threats—by the existing system, recent reforms and throughout the literature—has the perverse effect of discouraging gatekeepers from willingness to perform vital functions. That makes a strong independent argument to inquire into how an additional but entirely different public policy lever could be activated, an inquiry that points directly to offering positive inducements to encourage gatekeepers to perform those vital functions. 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 illustrative descriptions to lead in that direction.

I. THEORY

A gatekeeping monitoring model can promote fair disclosure in securities transactions. If those primarily responsible fail, a regulatory authority steps in. In systems that interpose a secondary group of responsible parties between the primary party and the regulatory authority, misleading reporting can be prevented, not just punished.[5] True, secondary group failure will lead to punishing both primary and secondary actors. But fewer occasions requiring such punishment should arise. As a result, it is customary in the literature to define as gatekeepers only the group of secondary private professional firms and to treat the regulatory apparatus as a further backstop rather than as a gatekeeper.[6]

A. *Conceptions*

Several varieties of third-party assistance in accessing capital markets exist. The term "gatekeepers" designates professionals who enjoy some reputation for performing services that promote fair reporting and can deny capital market access to those not providing it. Gatekeepers offer this service in exchange for contractual fees. Their services are accompanied by legal duties that require them to act in certain ways or to

[5] *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.").

[6] *See* Peter Oh, *Gatekeeping*, 29 IOWA J. CORP. L. 735 (2004) (observing and reviewing the common focus on private gatekeepers and then taking up the case of the SEC as a public gatekeeper).

provide certain forms of attestation. Failure to do so puts at risk their reputations and exposes them to legal sanctions.

Whistleblowers, on the other hand, designate these and other participants who may identify mis-reporting, and contribute to correcting it, by reporting it internally within the enterprise or to official authorities. Whistleblowers may or may not have duties to do so and may be paid fees or bounties for doing so or simply win protection against retaliation. In addition to this customary distinction between gatekeepers and whistleblowers, it is increasingly necessary to consider various hybrids that blend features of both traditional categories. The following summarizes the main attributes of the alternative conceptions.

1. Gatekeepers — Gatekeepers work within the enterprise to correct mis-reporting before it occurs. They are able to do so by threatening to withhold support that is necessary to complete a report or consummate a transaction. Gatekeepers can deny access to capital markets.[7] So gatekeepers are "intermediaries who provide verification and certification services to investors" by pledging their professional reputations[8]—and, by withholding such support, block admission through the gate.[9]

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.[10] 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 thus 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; lawyers advise on transaction design and disclosure, including whether senior executives can sign disclosure documents, and often provide written legal opinions or memoranda concerning legality and compliance. Duties of both auditors and lawyers arise initially from contract but include a regulatory overlay of professional standards.

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

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

[9] 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); Oh, *supra* note ___, at 737 (noting conflation of reputational intermediary and professional capable of disrupting entry and exploring the distinction).

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

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. While auditors and lawyers essentially vouch for statements that the enterprise makes about itself subject to accompanying legal duties—financial statement assertions and narrative disclosure—the others generally offer separate statements of their own (a rating, a buy-sell recommendation and the like) without any equivalent duty.

Professionals within this broad conception of gatekeepers thus differ significantly.[11] Roles vary with product or service type and the information its buyers and users receive. In addition to the source of retention and inside or outside status and related duties, 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.

Accordingly, also varying are all other public policy aspects of their respective performance, including requirements, expectations, capacities, incentives and appropriate legal liability for failure. 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.[12] Despite these differences, the term gatekeeper has assumed customary usage, not only in the academic literature but in official regulatory pronouncements.[13]

2. Whistleblowers — Whistleblowers differ from gatekeepers, at least conceptually. While gatekeepers generally work internally within enterprises to negotiate access to capital markets or deny it without further ado (keeping information confidential), whistleblowers report violations at the gate to the public or to authorities. When gatekeepers determine that they cannot exercise internal influence to correct statements that they believe require correcting, they may resign or otherwise withhold their services, but this does not also involve blowing any kind of whistle to any enforcement authority or to the public generally.[14] The distinctive feature of the

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[11] *See* Coffee, *Gatekeeper Failure and Reform*, *supra* note ___, at 306 & 346-64 ("all gatekeepers are not alike," and developing proposals with entirely different content for auditors and for securities lawyers).

[12] Coffee, *What Caused Enron*, *supra* note ___, at 279-80.

[13] *See* Coffee, *What Caused Enron*, *supra* note ___, 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")).

[14] *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.").

whistleblower approach, then, is that the third party discloses wrongdoing to authorities or third parties.[15]

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. The classic example is the enterprise employee who comes forward with evidence of wrongdoing and 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, denying the enterprise's temptations toward retaliatory discharge.

The second is the volunteer who shares in a bounty arising from blowing the whistle. The classic general example outside the securities context are qui tam actions. In these, private parties are vested with authority to prosecute claims of violations of federal laws. They share in the recovery on behalf of government. The most prominent example is the False Claims Act.[16] Analogous bounty schemes appear, including, in the securities law context, the Securities and Exchange Commission's insider trading bounty program[17] and, in the tax context, the Internal Revenue Service's informant rewards system.[18]

The third form of whistleblower is the non-volunteer, one with duties to come forward with public disclosure of discovered wrongdoing. This type of whistleblower is also primarily a gatekeeper but has specific additional whistle blowing duties. Consider auditors. The Private Securities Litigation Reform Act (PSLRA)[19] expanded auditor whistle-blowing obligations, requiring the reporting of illegal acts within an enterprise and to the SEC if satisfactory responses are not forthcoming.[20] Notably, few reports have been made under this provision.[21]

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[15] *See Developments in the Law*, *supra* note ___, at 2245.

[16] 18 U.S.C. § 287 (2006).

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

[18] *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.

[19] 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.

[20] *See* Kostant, *Breeding Better Watchdogs*, *supra* note ___, at 1246, n. 150.

[21] 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.

3. Hybrids — Despite conceptual distinctions, the categories of gatekeeper and whistleblower do not exhaust the universe of possible designations. Hybrids arise. They can appeal for structural reasons. For example, auditors who are discharged must provide disclosure about why.[22] Auditor discharge invariably occurs because auditors believe that an enterprise is mis-reporting and they must blow the whistle publicly about that. The discharge is simultaneously an exercise of the gatekeeping function by refusing support and an exercise of whistle-blowing by reporting the reasons to the authorities.

Hybrids also can arise because of peculiar characteristics of particular professionals. Consider lawyers. Lawyers differ from auditors by having roles as advocate, deal designer and disclosure manager. They also enjoy the attorney-client privilege designed to promote frank communications, although also bear duties to refrain from advancing fraud or criminality. These special traits need not prevent performing gatekeeping or whistle-blowing functions, but they do lead to hybrid qualities.

Consider the rule addressing when lawyers report violations to the authorities (called "reporting out"). Rules permit but do not require disclosing confidential information to prevent crime or fraud.[23] Yet "true whistle-blowing strategies" require monitoring *and* reporting.[24] The SEC separately proposed, but has not adopted, the so-called "noisy withdrawal" alternative, which contemplates a lawyer announcing publicly its resignation based on perceived client violations. This might increase lawyer incentives to serve as whistleblowers "by imposing a mandatory reporting duty in certain circumstances."[25] But even noisy withdrawal is not quite whistle-blowing, largely due to limitations arising from the attorney-client privilege. That is, while it signals a red flag, it does not require that lawyers provide details.

Nor do the SEC's 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. 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.

So lawyers do not enforce, but bear witness. Enforcement is left to managers or directors in the reporting chain. Again, the noisy withdrawal proposal would improve

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[22] Sec. & Exch. Comm., Reg. S-K, 17 C.F.R. § 229.304 (Item 304); *see* Kostant, *Breeding Better Watchdogs, supra* note ___, at 1245-46.

[23] *Developments in the Law*, *supra* note ___, at 2245 (citing 17 C.F.R. 205.3(d)(2) (2003); Model Rules of Prof'l Conduct R. 1.6(b) (2004); Model Rules of Prof'l Conduct R. 1.13(c)).

[24] *Developments in the Law*, *supra* note ___, at 2245-46.

[25] *Id*. at 2246.

this by requiring a lawyer, when internal reporting does not cure a violation, to end the retention and thus deny access through the gate.[26] On the other hand, both existing and proposed rules impose liability for non-reporting, but not for the client's primary violation as under the gatekeeping model.[27]

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 attributes 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. Thus 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, which an enterprise must traverse, 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 imagery is intended to capture both enterprises seeking access to the public capital markets as an initial matter as well as existing public enterprises which effectively access those markets daily through obligations to provide disclosure on a periodic or transactional basis.

More fundamentally, the keeper must be able to influence the petitioner, to groom it for admission. That is, the third party must be able to promote fair reporting. That condition implies a universe of participants connected to initial, periodic or transactional reporting exercises. Section 11 of the 1933 Act and Section 10 of the 1934 Act have long imposed duties and associated liability risks on such persons and private and SEC enforcement actions make the risk real.[28] This approach can be justified by how these third parties enjoy low-cost access to information and thus can provide a "private monitoring service on behalf of the capital markets."[29]

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[26] *Developments in the Law*, *supra* note ___, at 2247.

[27] *See Developments in the Law*, *supra* note ___, at n. 133 (citations omitted); *see also* Peter C. Kostant, *Sarbanes-Oxley and Changing the Norms of Corporate Lawyering*, 2004 MICH. ST. L. REV. 541 (Section 307 and the Part 205 Rules have flaws but bode well to improve normative self-conception of securities lawyers to assume gatekeeper function); Stephen M. Bainbridge & Christina J. Johnson, *Managerialism, Legal Ethics, and Sarbanes-Oxley Section 307*, 2004 MICH. ST. L. REV. 299 (Section 307 and the Part 205 Rules give lawyers many ways to avoid reporting, so incentives have not changed much); 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 (failure to distinguish and give special dispensation to low level in-house counsel is major defect in Part 205 Rules).

[28] 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).

[29] *See* Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 891 (1984) [hereinafter, Kraakman, *Corporate Liability*]; *see also* Reinier H. Kraakman, *Gatekeepers:*

Finally, the keepers must be independent and possess sufficient stakes in their reputations as keepers so that petitioner bribes cannot weaken their resolve at the gate. Legal theorists invariably 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.[30] 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."[31]

Thus the third party must be an "outsider" in the sense that it commands assets apart from the enterprise and its individual members pursue careers apart from the enterprise.[32] This creates an incentive structure that differs from the enterprise and its employees. 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."[33] 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 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 admission, initially or as an ongoing matter, develop or have their own reputations for the quality of their disclosure, on the range from fair to misleading reporting. Candid enterprises enjoy more investor trust.[34] The more valuable a reputation is, the greater is the cost of jeopardizing it through opportunistic abuse of that trust.[35]

Third-parties can be hired to the same ends. The enterprise can hire attorneys, auditors, underwriters, and rating agencies to provide reports backed by their own reputations for thoroughness and veracity. Thorough and honest gatekeepers enjoy more

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The Anatomy of a Third-Party Enforcement Strategy, 2 J.L. ECON. & ORG. 53 (1986). These two articles by Professor Kraakman are generally recognized as the seminal contributions to the theory of capital market gatekeeping.

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

[31] Coffee, *The Attorney as Gatekeeper, supra* note ___, at 1269.

[32] Kraakman, *Corporate Liability, supra* note ___, at 891.

[33] *Id.*, at 891.

[34] 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.

[35] *See id.*

credibility, a valuable trait. The more valuable it is, the greater is the risk of loss to their reputations so that, at some point, no additional incentives are even necessary.[36]

The more frequently firms are employed to serve as gatekeepers, and the larger the number of repeat occasions in which they expect to play it, the greater the value.[37] Enterprises pay fees for this credence. Investors and other market participants appreciate these as valuable signals.[38] When operating effectively, they contribute to a market in which securities prices tend to converge accurately towards the fundamental value of the related enterprise.[39]

Gatekeepers are by definition part of a profession, which boasts its own reputation. This creates an externality—each firm exploits the profession's reputation.[40] Investment in reputation benefits each firm but also the profession at large, so investment creates external benefits. Others can free ride. Both points reduce reputation investment incentives. This problem is most severe in securities bucket shops but can also creep into the practices of both law and public accounting. It operates at the macro (firm) level and micro (individual partner) level too.

Two strategies address this externality problem which, in turn, promote both the profession's and each gatekeepers' reputations. First, professional membership associations articulate professional codes of gatekeeper ethics or conduct. These codes make clear, essentially, that admitting the inadmissible is simply wrong. This is especially so for lawyers and accountants, whose professional identities are based upon such codes. Lawyers thus serve gatekeeping functions in sifting out frivolous litigation claims and auditors do so when insisting that enterprises reclassify transactions or recalculate amounts.[41]

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[36] *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).

[37] *See* David Charney, *Nonlegal Sanctions in Commercial Relationships*, 104 HARV. L. REV. 375, 408-25 (1990).

[38] Coffee, *What Caused Enron*, *supra* note ___, 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.").

[39] *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).

[40] 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*].

[41] Gilson, *The Devolution of the Legal Profession*, *supra* note ___; *see also* Pamela S. Karlan, *Contingent Fees and Criminal Cases*, 93 COLUM. L. REV. 595 (1993) (lawyers as gatekeepers in respect to contingent fees in criminal cases); David B. Wilkins, *Who Should Regulate Lawyers?*, 105 HARV. L. REV. 801 (1992).

Second, such associations or kindred organizations may provide specific licensing schemes that implicitly vouch for each gatekeeper.[42] Examples are the American Institute of Certified Public Accountants (AICPA) for auditors and the National Association of Securities Dealers (NASD) for securities firms, including underwriters. In theory, these organizations police reputations of members and deny admission to unqualified applicants or expel non-compliant members. Such threats may improve a profession's return on investment in reputation by individuals and their firms. They may be rooted in ethical or moral principles and they also perform an instrumental role in promoting a profession's reputation.

While profession-driven reputation protection can be vital, in practice, the professions have not proven particularly good at this quest.[43] 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,[44] but the threat of revocation is more nearly a stick. Enforcement steps lead to suspensions or expulsions.

Even so, the professional aspirations suggest the importance of culture in any analysis of reputation as a constraint on gatekeeper performance. This entails an enormously complex set of factors that it is exceedingly difficult for law to micro-manage (but not impossible for it to influence). Law can tinker with procedures and policies but these must be tailored to the peculiar attributes of a profession and in tune with idiosyncrasies of given firms and individuals.[45]

To reflect briefly some of these complexities, there is some debate about exactly what kind of reputation various gatekeepers seek to maintain. For auditors, it commonly is said that their reputation for honesty is their most valuable asset.[46] But as a matter of practice for effective auditing, far more important is a reputation with management for toughness.[47] For lawyers, there is some disagreement as to whether they seek to develop reputations with managers for complicity and empathy rather than with external investors for performing any kind of gatekeeping function.[48] These complexities pose difficulties

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[42] Black, *Preconditions for Strong Securities Markets*, *supra* note ___, at 788-89.

[43] *See* Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 CORNELL L. REV. 775 (2006) (as to NASD and New York Stock Exchange).

[44] Black, *Preconditions for Strong Securities Markets*, *supra* note ___, at 788-89.

[45] *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?*].

[46] *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).

[47] *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).

[48] *See* Langevoort, *Where Were the Lawyers?*, *supra* note ___ at 101-11; McGowan, *Why Not Try the Carrot?*, *supra* note ___, at 1833-34.

for both the general theory of gatekeeping and the model of a carrot-based merit system discussed in Part III.

2. Liability — An extensive literature dissects the varying 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. Third-party liability supplements this device to address residual risks that the former fails to deter or so internalize. It is justified 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 and a panoply of SEC administrative sanctions as well as criminal law.[49] In significant part, these doctrines are based on a theory of deterrence, a negative injunction to discourage misbehavior.[50] Scholars endlessly debate and policy analysts endlessly tinker with the numerous intricacies of this framework to seek its optimal structure. The following briefly highlights several examples.

At a general level, some believe that the liability risk need not be great and certainly nothing along the traditional US lines—a few high-damage lawsuits a decade is enough.[51] For others, 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.[52] Yet others announce the benefits of increasing liability as if this is inevitable. Thus: "Raising the penalties for both primary and third parties can be an effective way to make gatekeeping regimes work."[53] 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."[54]

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[49] See Puri, *supra* note ___, at 148-49 (reviewing all these liability risks).

[50] *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 (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).

[51] Black, *Preconditions for Strong Securities Markets*, *supra* note ___, at 794 (accountants) & 795 (bankers).

[52] *Id*. at 795 & 800.

[53] Kostant, *Breeding Better Watchdogs*, *supra* note ___, at 1248, n. 159.

[54] Coffee, *The Attorney as Gatekeeper*, *supra* note ___, at 1306.

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.[55] 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).[56]

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, associated punishment for violations can be relaxed accordingly.[57] 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.[58]

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.[59] In this quest, also relevant is the relative ability of enforcement authorities to learn of violations that warrant enforcement activity.[60] Damages caps and safe harbors are likewise debated, along with the role of insurance.[61] To conclude this non-exhaustive highlight of the many contestable parameters of system design, scholars debate the merits of enterprise versus individual liability.[62]

Finally, some believe that the corollary of liability regulation works too. Consider the Federal Sentencing Guidelines addressing corporate criminality. While increasing

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[55] Langevoort, *Where Were the Lawyers?*, *supra* note ___, at 115.

[56] *Compare* Frank Partnoy, *Barbarians at the Gatekeepers*, 79 WASH. U. L. Q. 491 (2001) *with* John C. Coffee, Jr., *Gatekeeper Failure and Reform*, *supra* note ___.

[57] *E.g.*, Kostant, *Breeding Better Watchdogs*, *supra* note ___, at 1248.

[58] *See* Stephen Choi, *Market Lessons for Gatekeepers*, 92 NW. L. REV. 916 (1998).

[59] *Compare* Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 HARV. L. REV. 963 (1994) and Joseph A. Grundfest, *Why Disimply?*, 108 HARV. L. REV. 727 (1995) *with* 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).

[60] Assaf Hamdani, *Gatekeeper Liability*, 77 S. CAL. L. REV. 53 (2003) (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).

[61] *Compare* Donald C. Langevoort, *Capping Damages for Open Market Securities Frauds*, 38 ARIZ. L. REV. 641 (1996) *with* Harvey J. Goldschmid, *Capping Securities Fraud Damages: An Unwise Proposal in an Imperfect World*, 38 ARIZ. L. REV. 665 (1996).

[62] *See*, *e.g.*, Kraakman, *Corporate Liability*, *supra* note ___.

sanctions on the guilty, they also reduce sanctions for those who actively seek to deter, detect and disrupt.[63] 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 'legal bribe' to encourage gatekeeping."[64] These examples represent progress compared to the *in terrorum* approach of liability threats. But they do not quite exhibit the attributes of a carrot-based merit system.

3. Assessment — A regime of third-party liability provides some benefits as well as costs. Benefits are the decreased incidence of mis-reporting by those otherwise inclined to mischief. Mis-reporting is reduced either because (a) third parties arrest it on site, (b) insiders calculate the price of mis-reporting as higher than the benefits or (c) the fear of third parties catching them nips the inclination in the bud.[65] Achieving these benefits requires a surgical attention to the perplexing challenges highlighted in the preceding section. Costs are summarized in this one.

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. These costs include the costs associated with defending against non-meritorious claims.

Second, liability risk can overshoot the mark, at least in some contexts, and this may create excessive risk-aversion, which can mean too many vetogates. It is a broad crude brush.[66] Costs of a gatekeeper liability regime are the increased (and otherwise unnecessary) compliance burdens on those predisposed to report fairly. A related cost of the regime is how third-parties, reflecting their own liability risk, will charge an associated premium or require over-investment in enterprise compliance and control infrastructure. Related costs can be passed on to enterprises, which ultimately increases their cost of capital. Smaller businesses are invariably hurt disproportionately.

Third, and given scant attention in the literature, liability risk may deter, but also can make gatekeepers unwilling to undertake functions that it would otherwise be desirable for them to perform. For example, auditors always have resisted accepting any

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[63] Kostant, *Breeding Better Watchdogs*, *supra* note ___, at 1245, n. 146.

[64] *Id*. at n. 164 (citing Kraakman, *Corporate Liability*, *supra* note ___, at 70-71) (on using legal bribes to promote effective gatekeeping).

[65] However these benefits are achieved, 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." Kraakman, *Corporate Liability*, *supra* note ___, at 891.

[66] *See* Choi, *supra* note ___.

undertaking to detect for fraud or opine on the reasonableness of management's accounting choices.[67] Lawyers likewise resist imposition of any obligations that even remotely threaten the jealously guarded attorney-client privilege and doctrines of confidentiality.[68]

In any event, the calculus in a gatekeeper liability regime is never perfect. It can be upset by contending business objectives over the short term. This occurs especially when individual decision makers face a different reputation calculus compared to their employers. It also occurs when enterprise personnel are able to pressure gatekeeping personnel into complacency or cooperation. Behavioral biases in each context can distort further the individual applications of the calculus. The fact that enterprises pay the gatekeeper's fee exacerbates these limitations.

II. FAILURE

Reputation and liability risk can be strong constraints in theory, but empirical evidence shows limitations on their success in practice. Lawyers and auditors sometimes bend to client preferences despite their contrary better judgment.[69] The recent era offered a laboratory of experience with the theoretical model which helps to illuminate its strengths, weaknesses, and how parts of the puzzle have been overlooked. Numerous non-exclusive explanations appear for the observed limitations on the theory, most of which constitute particularized absences of the theory's general requirements. Some of these explanations apply equally to all gatekeepers, including lawyers and auditors, although others are specific to given professions.

A. *Diminished Reputation Constraints*

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

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.[70] This occurs when individual partners have only one client, making their career depend on pleasing its management.

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[67] *See* Coffee, Gatekeepers, *supra* note ___; *infra* text accompanying notes ___-___.

[68] *See* McGowan, *Why Not Try the Carrot?*, *supra* note ___.

[69] Prentice, *The Inevitability of a Strong SEC*, *supra* note ___, at 776.

[70] *See* 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); Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure,*

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."[71] This diagnosis underscores the value of rewarding those who report negative information, which would be a prominent attribute of a carrot-based merit system but is essentially non-existent in the current regime.

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 destroys the condition of independence necessary for effective gatekeeping. Yet it occurred at Enron and perhaps on other engagements too.[72] At minimum, superior methods of internal assignment allocation are indicated. The same or superior results could be achieved, moreover, by a carrot-based merit system.

In the case of lawyers, the one-client problem was less obvious, as most law firm partners specialize by subject matter not client, and provide the specialized service to a broad range of clients.[73] 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.[74] This 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 a long time, the reputational constraint, backstopped by a modest threat of legal liability, satisfied the gatekeeper model's requirements.[75] But during the 1990s, a major factor contributing to the reputational constraint changed, especially for audit firms. Non-audit revenues soared in relation to audit revenue.[76] By cross-selling

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and Enron, 89 CORNELL L. REV. 394, 407-08 (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).

[71] Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron, supra* note ___, at 407-08.

[72] *Id*. at 410.

[73] *See* Coffee, *The Attorney as Gatekeeper, supra* note ___, 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).

[74] *See* Puri, *supra* note ___; *see also* John S. Dzienkowski & Robert J. Peroni, *The Decline in Lawyer Independence: Lawyer Equity Investments in Clients*, 81 TEX. L. REV. 405, 481-85 (2002) (discussing traditional gatekeeper liability theory and noting 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 (2005); Lisa H. Nicholson, *A Hobson's Choice for Securities Lawyers in the Post-Enron Environment: Striking a Balance Between the Obligation of Client Loyalty and Market Gatekeeper*, 16 GEO. J. LEG. ETHICS 91 (2002).

[75] *See* Bratton, *Enron and the Dark Side of Shareholder Value, supra* note ___, at 1350.

consulting services to audit clients, auditors had much to lose from severing clients or blowing the whistle on them.[77]

Apart from reducing incentives, this cross-selling essentially eliminated one of the most vital guarantors of auditor independence: the strong signal emitted when an auditor severs a client relationship.[78] The signaling power of auditor firing of clients arises from how the enterprise must have an auditor while the auditor need not retain any given client. Enterprises that are fired by their auditors thus lose much more than the auditor loses. Indeed, they may be unable to find any auditor at all after being fired. The auditor may even gain reputation value from this sternness, attracting new clients.[79]

Yet, during the 1990s, the incidence of auditor vetogating declined due to shifts in power from auditors to clients.[80] According to this diagnosis, the existing auditing structure "will not function properly until a lead audit partner can confidently fire a dishonest client without jeopardizing his career."[81] In the period after the Sarbanes-Oxley Act became law, the number of audit firms firing clients increased dramatically.[82]

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[76] Prentice, *Inevitability of a Strong SEC, supra* note ___, at 786 ("consulting 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 ___, at 1350 (fees from audit clients for non-audit services rose from 13% of revenues in the 1970s to 50% of revenues in the 1990s).

[77] 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 ___, at 786-98.

[78] *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).

[79] The danger in this structure—also true of a merit system—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 ___, at 1176. The effect, in any event, is a kind of balance of power between enterprises and auditors, one of "mutual reputation enhancement." *Id*.

[80] Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron, supra* note ___, at 409.

[81] *Id*.

[82] *See* Coffee, *Gatekeeper Failure and Reform, supra* note ___, 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.").

On the other hand, auditors severed only smaller enterprises, even though all the frauds leading to the Sarbanes-Oxley Act involved large enterprises. Moreover, not all non-audit services are banned, with a large exception for tax services to clients.[83] This is both extremely lucrative and a context in which acute risk of illegality and fraud appear.[84] Accordingly, while these reforms respond proportionately to a firm-level factor that reduced the reputational constraint's power, more policy levers likely need plying, warranting consideration of a carrot-based merit system.

3. Professions — Erosion of audit quality may have been due in part to auditing industry concentration. Mergers during the 1990s reduced the number of large audit firms from eight to five and the dissolution of Arthur Andersen reduced it further to the current four. 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. This concentration in the upper tier of the industry means that product differentiation is of little importance.[85] With a large number of firms, competition can concentrate on product differentiation, including investment in reputation; but with so few firms, reduced competition diminishes incentives to invest in reputation and thus diminishes the power of the reputational constraint.[86]

A final—and pervasive—limitation on gatekeeping efficacy is how the enterprise pays the gatekeeper.[87] That creates an inherent inclination for solicitude, simply to retain business. Numerous solutions to this limitation have been proposed, some applied to

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[83] *See* Matthew J. Barrett, *"Tax Services" as a Trojan Horse in the Auditor Independence Provisions of Sarbanes-Oxley*, 2004 MICH. ST. L. REV. 463 (noting continuing auditor dependence on clients to whom they render tax services which are still allowed).

[84] *See United States v. KPMG LLP*, 316 F. Supp. 2d 30 (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); *United States v. Stein*, 2006 U.S. Dist. LEXIS 42915 (S.D.N.Y. June 26, 2006); *see also* Sheldon D. Pollack & Jay A. Soled, *Tax Professionals Behaving Badly*, 105 TAX NOTES 201, 210 (2004).

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

[86] 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); Prentice, *Inevitability of a Strong SEC*, *supra* note ___, at ___.

[87] Coffee, *What Caused Enron?*, *supra* note ___, at 279-80 (noting that gatekeeper utility is limited because paid by party to be monitored).

auditors and some to other intermediaries. Examples include using insurance markets,[88] public funding,[89] funding through stock exchanges[90] or voucher financing programs.[91]

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 retention and dismissal).[92] 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.[93]

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, including gatekeepers. First, the Private Securities Litigation Reform Act (PSLRA) changed the liability regime from joint-and-several liability to proportionate.[94] Second, the Supreme Court held that the anti-fraud provisions of the federal securities laws did not reach those who aid or abet others in mis-reporting.[95] While this did not prevent SEC actions under that theory, it did significantly curtail those brought by private plaintiffs.[96] Such changes reduced the legal

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[88] Lawrence A. Cunningham, *Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability*, 52 UCLA L. REV. 413 (2004) (instead of having companies pay auditors, authorizing them to buy insurance and having insurers hire and pay auditors).

[89] 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).

[90] 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)).

[91] Stephen J. Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 YALE L.J. 269 (2003).

[92] Sarbanes-Oxley Act of 2002, § 301, codified in 15 U.S.C. § ___.

[93] COFFEE, GATEKEEPERS, *supra* note ___, at ___; *see infra* text accompanying notes ___-___ (one feature of the carrot-based merit system is the possibility of securities underwriters paying bonuses to auditors).

[94] 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.

[95] *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 177 (1994).

[96] *See* Talley, *Cataclysmic Liability Risk, supra* note ___ (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).

liability threat, and this could have been a factor in declining propensity to protect reputations for integrity as gatekeepers (or whistleblowers).[97] Certainly, when combined with the other factors noted above, incentives for quality gatekeeping declined.[98]

A related diagnostic concerning audit firms is based on changing forms of liability structures.[99] Audit firms shifted from partnerships to limited liability entities. This reduced incentives to maintain internal control. Litigation risk fell. So too did concern with steps that would reduce it. 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."[100]

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.[101] It is particularly perplexing to meet the specific objective of setting an optimal level of deterrence.[102] Nevertheless, that discussion also shows how fair it is to say that the role of liability risk is a dominant feature of the scholarly literature—nearly an obsession. Perhaps more litigation risk helps to reverse certain causes of gatekeeper failure. But further discussion of that strategy in this review of the law will not advance that cause. Indeed, the following discussion identifies systemic factors that contribute to reducing gatekeeper effectiveness, most of which are simply beyond the reach of any liability threats to control.

C. *Systemic Factors*

Cultural 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.

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97 Bratton, *Enron and the Dark Side of Shareholder Value*, *supra* note ___, 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).

98 *See* COFFEE, GATEKEEPERS, *supra* note ___, at 152-56; Bratton, *Shareholder Value and Auditor Independence*, *supra* note ___, 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).

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

100 *Id*. at 1181.

101 *See supra* text accompanying notes ___-___; *see also* John Siliciano, *Negligent Accounting and the Limits of Institutional Tort Reform*, 86 MICH. L. REV. 1929 (1988).

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

First, the era was characterized by financial euphoria. 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 whole new era had emerged, for which the traditional norms of business and standards of accounting were less suited.[103] It becomes easy in such periods to suspend critical judgment, including as to conventional matters of corporate governance and financial reporting. Any gatekeeping model will suffer serious stress in such periods.[104]

Second, a systemic emphasis on gatekeepers can backfire. That is, 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 they 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 assure permanent concealment.[105] Alas, during a euphoric period, even the effectiveness of a well-thatched mass of cross-checking gatekeepers can be impaired. 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.[106]

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. 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.[107]

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103 Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Might Just Work)*, 35 CONN. L. REV. 915 (2003).

104 *See* Gerding, *The Next Epidemic*, *supra* note ___, at 426-28; Bratton, *Shareholder Value and Auditor Independence*, *supra* note ___, at 470.

105 COFFEE, GATEKEEPERS, *supra* note ___.

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

107 *See* Gilson, *The Devolution of the Legal Profession*, *supra* note ___; *see also* Frederick W. Lambert, *Preliminary Inquiry into the Transcendence of Value Creation*, 74 OR. L. REV. 121 (1995).

Bonding also was impaired when clients began more frequently to use numerous different firms for different kinds of services, as where an enterprise that once used a single outside law firm for nearly all its legal needs increasingly uses numerous different firms.[108] 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—a significant phenomenon among law firms—reduces the value of bonding.[109]

Behavioral psychology contributes further partial but systemic 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.[110] Among numerous examples are the self-serving bias and the commitment bias, which can afflict auditors, lawyers and other gatekeepers.[111] 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 rather than update them in the face of new information.

Such biases can be addressed by structural devices. As to auditors, for example, self-serving bias can be neutralized by reposing auditor supervision in audit committees and commitment bias by rotating audit partners through different auditing engagements.[112] Harder to combat are more general behavioral biases known as

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[108] *See* Kraakman, *Corporate Liability*, *supra* note __ 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")).

[109] *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.).

[110] Prentice, *Inevitability of a Strong SEC*, *supra* note ___, 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)).

[111] 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 (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).

[112] 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).

"backward recursion" and the "time delay trap."[113] These incline people to discount the significance of future events or circumstances, even those posing high magnitude consequences, and to value instant gratification at higher levels than equal measures of deferred gratification.

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.[114] These systemic factors are taken to explain why reputation assumes lesser importance in certain market environments.[115] 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).[116] 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. CARROTS

Missing from the prevailing analysis in the literature on gatekeepers are values of awards that might be paid for activating vetogates—bonus payments to the gatekeeper who denies admission to the inadmissible. Professor Kraakman's original formulation 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.[117]

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[113] *See* Prentice *Inevitability of a Strong SEC*, *supra* note ___; *infra* text accompanying notes ___-___.

[114] *See*, *e.g.*, COFFEE, GATEKEEPERS, *supra* note ___, 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).

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[115] *See* COFFEE, GATEKEEPERS, *supra* note ___, at 67 & 318-324.

[116] 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, *The Thick Backstop for Auditor Liability: Analytical Skepticism about Damages Caps* (unpublished draft manuscript on file with the author) (March 2007); *supra* note ___ (citing debate between Professors Langevoort and Goldschmid on the merits of such efforts).

[117] Kraakman, *Corporate Liability*, *supra* note ___, at 891 (emphasis added).

What gatekeepers have to gain is the value of the bribe and what they have to lose are reputation (and its instrumental 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 equation should also emphasize "*more to gain*" from vetogating—bonuses in a carrot-based merit system of gatekeeping.

The following discusses carrots for vetogates from several perspectives. Discussion first provides an intuitive basis for the inquiry, followed by a formal and general model employing both rational and behavioral assumptions. Discussion then investigates how a system can be constructed from that model, first for lawyers and then for auditors. This investigation considers the services for which awards could be paid, potential sources of funds to pay them and contractual and other devices to implement the concept.

A. *A General Model*

This section outlines a general model of a carrot-based merit system. It begins with an account of the intuition, followed by a rational economic actor model and some perspectives from behavioral economics.

1. Intuition — Popular corporate governance strategies include incentives designed to align principal-agent interests. These are intended to supplement primary tools such as shareholder election and removal of directors and shareholder voting on extraordinary transactions. The most conspicuous of these popular strategies are the executive compensation packages that are tied to corporate performance. Stock options are the commonest form of these incentive systems. They epitomize the intuition behind any merit system: stock options give managers incentives to increase stock price. How effective these devices are is debated, however, with some critics asserting that they overreach by tempting managers to provide misleading reporting to inflate stock price artificially.[118]

Yet the intuition remains strong. It is an exquisite instance of giving agents (managers) incentives to promote an alignment of their interests with principals (shareholders). The insight can be adapted correspondingly for gatekeepers. They can be

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[118] *See, e.g.*, LUCIAN BEBCHUK & JESSE M. FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004); 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); *but see* William W. Bratton, Jr., *The Academic Tournament over Executive Compensation*, 93 CAL. L. REV. 1557 (2005); Stephen Bainbridge, *Executive Compensation: Who Decides*, 83 TEX. L. REV. 615 (2005).

given incentive compensation that is contingent upon achieving designated results, namely, discovering and correcting mis-reporting. Indeed, if the benefits of stock options are real, as devotees contend, similar benefits should accrue from awarding analogous options to gatekeepers. Moreover, 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. That is, to the extent that 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. In a symposium panel discussing how boards of directors assess mergers, Mr. Buffett considered the role that board advisors play in pursuing mergers, especially the role of investment bankers. Many investment bankers charge contingent fees for merger transactions, giving them strong incentives to close a transaction even if not in the client's best interest.

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 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."[119] Similarly, if shareholders pay senior executives incentive compensation to achieve designated corporate performance measures, then 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 retaining law firms in merger transactions.[120] They too have been known to 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). The price Time-Warner paid for AOL in that merger was exorbitant and wound up costing its shareholders some $200 billion in investment value.[121] As with Mr. Buffett's quip about investment 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 for a carrot-based merit system for gatekeepers, including lawyers. That is, it may promote effective gatekeeping

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

[120] Painter, *Convergence and Competition*, *supra* note ___, at 412.

[121] *See* Matthew T. Bodie, *AOL Time Warner and the False God of Shareholder Primacy*, 31 IOWA J. CORP. L. 975 (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).

for enterprises to employ or otherwise take advantage of two teams of lawyers rather than rely upon one. Moreover, to correct this problem, Professor Painter advocated banning lawyer contingent fees in corporate transactions. This sensible proposal is akin to existing bans against auditors from charging clients contingent fees.[122] The rationale, of course, is to impair managerial power to bribe gatekeepers into complicity.

A further step appears, however, that could strengthen gatekeeper effectiveness. It would provide for contingent fees for auditors (or lawyers) who discover and correct mis-reporting under circumstances when they otherwise had no legal obligation to do so. This would not require amending the current ban on auditors charging contingent fees or interfere with imposing one on transactional lawyers.[123] Fees still would be charged. Additional fees would be payable upon discovery of errors or irregularities not otherwise within the existing responsibilities of gatekeepers to uncover or report upon.[124]

A merit system's intuitive appeal also shows in how it can respond to some of the diagnoses of gatekeeper failure noted earlier in this Article. First, it generally is agreed that the scale of consulting services enabled managers to pressure auditors into acquiescence.[125] Firing an auditor for being a tough auditor is a red flag to the market but firing an auditor from its non-audit services is not. Managers thus offered a carrot while holding out a stick as well: a favorable audit in exchange for lucrative consulting assignments. Auditors in the consulting business may have offered favorably lax audits

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[122] Painter, *Convergence and Competition*, *supra* note ___, at 410 (citing AICPA, Code of Prof'l Ethics, 302, R. 302.01).

[123] *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."

[124] 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 ___, 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).").

[125] *See supra* text accompanying notes ___-___; COFFEE, GATEKEEPERS, *supra* note ___, 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 (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 (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).

to generate more assignments.[126] As Professor Coffee says, "the carrot works better than the stick, precisely because the threat to take the carrot away [can be] more credible."[127]

This insight suggests inverting the policy experience. If auditors paid bonuses to do consulting work became more lax on audits, then paying them bonuses for fraud detection and discovery should improve audit effectiveness. That is, during the 1990s, firms adopted the business model that rewarded audit partners for generating consulting work. It should now 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 (whether the compensation is called "bribes," "carrots," or "contingent fees") in addition to the existing regime that imposes liability risks (whether those risks are called "threats," "sticks" or "deterrence penalties").

Second, a common diagnosis of the reputational constraint failure is how a firm's and a partner's incentives may differ.[128] 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.[129] This response, which seems correct, also contributes to the intuitive case for a carrot-based merit system. 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.[130] So viewed, carrots play no obvious role—integrity reflects a "disclose if detected" approach. But if one emphasizes an auditor's or other gatekeeper's reputation with management for toughness, carrots become more obvious tools. Given the inherent limits that auditors and other gatekeepers face in testing the veracity of managerial assertions, reducing mis-reporting requires *managers* to *believe* that auditors and other gatekeepers are ruthless. *That* reputation can be enhanced by rewarding auditors and others for successful detection and correction of mis-reporting.

Finally, some believe that lawyers who were paid in equity securities of clients may have suffered impaired judgment as a result.[131] This can be akin to the downside of

[126] *See* COFFEE, GATEKEEPERS, *supra* note ___, at 64-65.

[127] *Id*. at 159; *see also id*. at 65 ("Bribes work better than threats for a variety of reasons . . .").

[128] *See supra* text accompanying notes ___-___.

[129] COFFEE, GATEKEEPERS, *supra* note ___, at 318.

[130] *See supra* note ___ (quoting Judge Easterbrook's opinion in *DeLio*).

[131] *See supra* text accompanying notes ___-___.

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 both gatekeepers and agents to acquiesce in or promote mis-reporting. This likewise suggests inverting the experience. Instead of compensating lawyers in client equity securities, a carrot-based merit system would compensate them, in part, with contingent bonuses for discovering mis-reporting.

2. Rational Economics — A basic formal model of gatekeeper decision-making compares the gains from acquiescence to the expected costs of inculpation. The carrot system adds gains from vetogating to the calculus, which must be sufficient to tip the balance for both firms and individuals. The following discussion presents a general model of this calculus. Its deliberate generality is intended to enable the model to be tailored to address specific attributes of differing situations. For example, specifications of the model would address variations arising from the kind of professional involved (*e.g.*, auditor or lawyer), the characteristics of its role (as gatekeeper, whistleblower or hybrid) and the bearing that reputational constraints have on discharging those functions.

A similarly generalized fact pattern offers a good starting point for introducing the general model. In connection with a pending transaction, a corporate employee (worker, manager or director) commits fraud (say booking false revenues or wrongly classifying an expense as an asset). Gatekeepers participate in generating the related documentation (which 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 inculpation. 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.[132] Setting those latter cases aside for the moment, the following formulation captures the decision's principal elements:[133]

[132] It is possible for reputation effects of effective gatekeeping to be a negative. *See* McGowan, *Why Not Try the Carrot?*, *supra* note 1, 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-

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

where:

B = benefits from mis-reporting
P[d] = probability of detection
P[e] = probability of enforcement
L[1] = legal liability
L[r] = reputation damage.

This formulation expresses the relationship between the benefits of complicity on the left hand and the costs of inculpation on the right. It captures how rational actors will facilitate mis-reporting when the benefits, *B*, exceed expected total costs. In turn, 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 the laws being successfully enforced, *P[e]*, and associated legal liability if so, *L[1]*. Expected total costs add reputation damage, *L[r]*, to that result.

Recall how assessments in the scholarly literature, including diagnoses of the Enron era, highlight mis-aligned incentives and under-deterrence from inadequate liability risk.[134] The foregoing model captures these, respectively, in the magnitude of the benefits, *B*, and the magnitude of legal liability, *L[1]*. The mis-aligned incentives thesis as applied to gatekeepers supposes that *B* was too high compared to *L[r]* and the legal liability thesis supposes that *L[1]* was too low compared to the optimal level.

Recall also how, in the scholarly literature, little or nothing is said about carrots—that is, incentive compensation from activating a vetogate. 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 gains that she would earn from vetogating. In the formula, this would mean adding a new variable to the right side of the equation, as follows:

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

where

G = gains from payments received under a carrot-based merit system for disrupting mis-reporting (vetogating).

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blowing that high levels of effective gatekeeping exist. *Compare supr*a note ___ (mentioning the chaperon thesis of gatekeeping in relation to whistle-blowing).

[133] Gerding, *The Next Epidemic*, *supra* note ___, at 426-28.

[134] *See supra* text accompanying notes ___-___.

For convenience, in the ensuing discussion, the components of this expanded equation will be referred to as follows: *G* for these newly-added gains, *B* for the benefits of complicity and *C* for the total expected costs of inculpation [*P[d]* * {(*P[e]* * *L[l]*) + *L[r]*}].

In pursuing the optimal level of *G*, it must be sufficient so that $B < C + G$. In other terms, *G* must equal or exceed $B - C$. The necessary amount of *G* will vary with particular attributes of different professions, functions, environments and so on. But to offer a sense of the likely parameters, it should be possible to hazard reasonable theoretical approximations of both a minimum level and a maximum level. While these approximations may be made using a number of different tools, consider one example of each. The minimum required level of *G* might be approximated by reference to a deciding agent's opportunity cost—a portion of *B*. A maximum level can be approximated by reference to the next best deterrence strategy. Consider each in turn, appreciating that these are analytical and illustrative rather than scientific or definitive.

As to approximating the minimum *G*, firms should compensate members to motivate them to build the firm's long-term reputation but, for firms, retention requires meeting employee opportunity costs.[135] A professional's opportunity costs—gains available from the next best option—are determined in large measure 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 subsequently apply for new employment). This can put her allegiances with those persons, not with her firm. This increases the difficulties that the firm has in monitoring its clients. To neutralize this difficulty, a minimum *G* would be that amount necessary to bond the professional's interests to that of the firm's long-term reputation. In this approximation, that is the amount of those opportunity costs.

As to approximating the maximum *G*, 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 would be held liable for violations committed by Partner Y. This would increase the 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."[136] Thus, such a system of negative threats may create excessive incentives for internal monitoring and yet remain ineffective.

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[135] Larry E. Ribstein, *SarbOx: The Road to Nirvana*, 2004 MICH. ST. L. REV. 279, 288-289.

[136] Larry E. Ribstein, *Limited Liability of Professional Firms After Enron*, 29 IOWA J. CORP. L. 427, 447 (2004).

As a next-best strategy, however, the alternative can be used to approximate a maximum level of *G* necessary to support a merit system. With a merit system, 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, a merit system awards Partner Y bonuses for "rights" that reduce Partner X's need to monitor Partner Y. The maximum *G*, then, would be the cost to Partner X of engaging in such oversight (if *G* were more than that, the vicarious deterrence alternative would be superior).[137]

Obviously, other avenues for estimating the parameters or ranges of *G* are possible and I provide these to suggest the model's feasibility rather than to delineate it completely. In the same vein, it may be useful to consider additional alternatives to the existing gatekeeper regime with its emphasis on sticks. Consider, for example, the extreme alternative of eliminating using private gatekeeping altogether. 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.[138] Even so, some critics lament that limitations on the reputational constraint—manifested by the discrete and cumulative failures of private gatekeeping—warrant displacing it altogether in favor of an emboldened public enforcement program through a strengthened SEC.[139]

In this critique, reputation is insufficient when partners (even rational ones) focus on short-term personal gain rather than long-term firm reputation.[140] Apart from whether the limitations justify such a revolutionary move, a more incremental step yet untried would look to carrots to increase gatekeeper effectiveness. Under this view, the misaligned incentives critique of the reputation constraint can best be met by using carrots to counterbalance this effect by offering short-term personal gain *not* to be in on the fraud. That is, adding *G* to the model is superior to increasing *C* through regulatory empowerment.

Another alternative would manipulate the costs of inculpation (the level of *C*) using devices other than cash. For example, Professor McGowan proposed that securities lawyers who are first to exercise a vetogate against a mis-reporting enterprise be rewarded with transactional immunity from any related prosecution.[141] This is a valuable contribution to the literature, exploring as it does the potential utility of adding carrots to the existing regime. Possibly due its novelty, however, it is a narrow and modest change: it applies only to lawyers for a limited whistle-blowing function and provides the carrot

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

[138] *Cf. supra* note ___ (noting how regulators are not generally seen as gatekeepers).

[139] *See* Prentice, *The Inevitability of a Strong SEC*, *supra* note ___, at ___.

[140] *Id*. at 798.

[141] McGowan, *Why Not Try the Carrot?*, *supra* note 1, at ___ (proposing transactional immunity to the first securities lawyer to blow the whistle on an unlawful transaction).

of lenity (which may be more accurately perceived as a lighter stick than a carrot). This Article is offering 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 Article accordingly operates at a higher level of generality and, as noted, this means that the foregoing general 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. The leading example would be how to interpret the reputational constraint. For auditors, all seem agreed, that reputation value is increased by enforcement and compelling disclosure whereas, for lawyers, scholars debate whether a reputation for complicity is more valuable than one for probity.[142] In the foregoing model, this difference between auditors and lawyers concerns whether to locate reputation, *[r]*, on the left or right side of the equation. While *[r]*'s location influences *G*'s requisite level, *G* remains a useful addition to the decision calculus under either assumption.

Second, the model requires specification for variations among gatekeepers, whistleblowers and hybrid species. As traditionally defined, gatekeepers are present to prevent access to capital markets or to correct a problem before a party is granted access. 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 (has accessed the capital markets). Setting hybrid models aside, whistle-blowers often do not have duties to report and those engaged in mis-reporting may be less conscious of the value of offering bribes to them. Accordingly, this means that the comparative benefits of complicity and costs of inculpation vary as between gatekeepers and whistleblowers (or hybrids). Again, these differences do not alter the basic relationships between benefits and costs in the general model but would require specification for particular applications.

3. Behaviorism — Carrots can supplement not only the foregoing rational economic actor model but also address criticisms of gatekeeping that arise from behavioral economics. Professor Prentice identifies two major behavioral limitations on the reputational constraint, both of which can be neutralized using a carrot-based merit system.[143] First, consider backward recursion.[144] This means future benefits of honesty are dwarfed by short-term returns from dishonesty. This problem can be especially 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

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[142] *See supra* note ___; *see also supra* text accompanying notes ___-___.

[143] *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). I cannot address all the behavioral factors, of which there are potentially hundreds or thousands. *See* Lawrence A. Cunningham, *Behavioral Finance and Investor Governance*, 59 WASH. & LEE L. REV. 767 (2002).

[144] Prentice, *The Inevitability of a Strong SEC*, *supra* note ___, at 798, n. 142.

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.

Again, while a carrot-based merit system may not eliminate these biases—especially the risk of mis-estimation—it would contribute to counteracting them.[145] It does so by increasing the short-term returns from honesty. It can surgically respond to the settings in which risk of backward recursion is particularly acute. For end-game settings, it increases retirement resources and firm solvency; it also closes the reputation gap that arises from mis-aligned incentives. If *G* is sufficiently large relative to the difference between *B* and *C*, it can even reduce the risk of mis-estimation.

Second, gatekeepers may suffer from a time delay trap.[146] This refers to how reputations take years to build, delaying gratification, but people often over-value instant gratification[147] and under-appreciate long-term effects.[148] This condition manifests in improper activities promising immediate payoffs if they are either unlikely to be detected in the long-term or if 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, including, in fraud-tempting contexts, rationalizing schemes. Liability risks are long-term and can be discounted; overlooking evidence of bad news enables being in on the scheme. A carrot system likewise counteracts all these biases: dollars paid today both offset the discounting effect and compensate gatekeepers for *not* being in on the scheme.

Professor Painter notes that regulations have done little to address cognitive biases.[149] 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.[150] The resulting biased judgments can infect related disclosure. Among possible regulatory 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

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[145] True, the biases may complicate estimating the optimal *G*, but that is likewise true of estimating the other components of the rational economic actor model.

[146] Prentice, *The Inevitability of a Strong SEC*, *supra* note ___, 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).

[147] Prentice, *The Inevitability of a Strong SEC*, *supra* note ___, at 798, n. 149.

[148] *Id*. at 798, n. 148.

[149] Painter, *Convergence and Competition*, *supra* note ___, at 415.

[150] *Id*. at 414.

regulatory requirement). Neither solution is perfect or complete—adding a carrot-based merit system can reduce the imperfections, if not complete the policy puzzle.[151]

B. *Private Arrangements*

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

1. Services — A carrot-based merit system concentrates on functions that gatekeepers are not otherwise required by law to perform but that, in certain circumstances, it would be productive to have them perform. This category can be large and exists, in part, because of gatekeepers' reluctance to accept categorical exposure to liability for undertaking the associated functions. Contract is a better approach since it is more clearly voluntary and enables tailoring to particular circumstances. The following illustrates some of the kinds of services that could be encompassed within a carrot-based merit system. It classifies them for convenience into two categories, called investigation and certification. Examples of each are provided for both lawyers and auditors.

For lawyers, a good illustration of the investigation category concerns due diligence exercises. Lawyers are permitted but not required to perform due diligence in respect of parties in numerous capital market transactions, from underwritten public offerings to change of control arrangements (when the party is their client or an opposing side). Lawyers generally perform due diligence but performance creates a defense against securities law liability. The failure to perform, or the failure to discover problems and block the gate, does not, ipso facto, expose lawyers to liability. However, lawyers are component to do so, of course, as they undertake such functions when retained for special purposes, as where an enterprise detects for specific misconduct that has come to its board of director's attention.[152]

For auditors, a good illustration of the investigation category concerns the context of fraud detection. Auditors conduct full-scale audits of clients but are not strictly

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[151] 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 ___-___. Given how episodes of financial euphoria recur in history, it seems doubtful that any system design feature can mediate them (yet regulatory change in response to fallouts from financial euphoria likewise recurs). *See* Larry E. Ribstein, *Bubble Laws*, 40 HOUS. L. REV. 77 (2003).

[152] *See, e.g.*, *Auerbach v. Bennett.*, 393 N.E. 994 (N.Y. 1979) (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).

obligated in doing so to detect for fraud. This means that their failure to discover fraud does not, in itself, expose them to legal liability. Professional auditing standards do articulate a modest measure of obligation to detect for fraud but its exact scope as a matter of law is contested and uncertain.[153] As a result, its execution in practice is limited rather than expansive. Auditors prefer to deny having any duties that would flow from a broad interpretation of the standard.[154]

Nevertheless, auditors sometimes do assume express contractual duties to undertake such an investigation, such as when they are engaged to conduct forensic audits. As with lawyers who undertake contractual duties to conduct due diligence, this signals that auditors command the requisite professional skills and ingenuity to perform this service.

In the certification category, for lawyers an example concerns written legal opinions. They often provide these to clients for various securities-related matters and sometimes prepare them for others at their client's request. A good example of the latter arises when an underwriting agreement contains a condition to the underwriter's duty that it shall first have obtained an opinion from issuer's counsel concerning the legality of the transaction and compliance, as to form, with federal securities regulations.

Even so, these lawyers' opinions are narrowly drawn and addressed. The scope is limited in several ways, including by providing so-called "negative assurance." This means that the opinion states that the law firm conducted such investigations as it deemed necessary and that, in the course of those investigations, nothing came to the firm's attention that would prevent it from opining that the transaction is lawful and disclosure in conformity with regulations. Any right of 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, failure to provide an opinion does not expose a lawyer to legal liability or even reputational damage. Nor, in most cases, does the rendering of such opinions expose lawyers to any significant liability due to the narrow manner of drafting and addressing them.

For auditors, the certification category concerns written comfort letters. These are generated and assume a form that is functionally equivalent to the lawyers' opinions. In underwriting contexts, for example, an underwriter's obligations are conditioned on

[153] 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 (1997).

[154] *See* COFFEE, GATEKEEPERS, *supra* note ___ 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.").

receipt of a designated comfort letter from the issuer's auditors. As to form, these likewise do not require the auditor to conduct any particular investigation and are written as negative assurance (stating that the auditor performed such procedures as it deemed necessary and that nothing came to its attention which would contradict the statements it attests to). In present practice, evidence suggests that auditors have taken additional pains to disclaim any specific responsibility for detecting fraud or illegal acts, echoing the profession's more general aversion to accepting related investigation duties.[155]

Law could *require* all of the foregoing services. It could mandate that lawyers perform due diligence in securities transactions and provide formal written certifications to designated transaction participants, including shareholders.[156] It could require that those certifications state affirmatively that disclosure is fair and accurate in all material respects. Law could clarify that auditors are responsible for detecting fraud and insist 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 and categorical requirements may demand more than is necessary. Not all enterprises require such comprehensive gatekeeper vetting. 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. The risks of error are so high that the expected costs to these professionals vastly exceed the price that they could charge for backstopping their opinions. As a result, the professions resist accepting any such duties as a political matter.[157] This implies, however, that the threat of legal liability can backfire. After all, it is likely that auditors and lawyers have a comparative advantage versus underwriters or others to investigate and certify yet, under the existing regime, these services may be rendered on sub-optimal terms.[158] Designing a system in which auditors and lawyers would readily agree to perform these functions—without fear of legal liability hanging over their performance—is thus appealing.

Finally, an additional reason why gatekeepers may be reluctant to undertake services of the kind described in the preceding section, even as a matter of contract, is the risk of expansive judicial interpretation of any governing agreement. That is, a law firm or auditing firm that expressly agrees to examine an enterprise to uncover mis-reporting but fails to do so may expose itself to liability even if the expressly-limited terms of the

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

[156] Coffee, *The Attorney as Gatekeeper*, *supra* note ___, at 1311 & 1313-15, n. 57.

[157] COFFEE, GATEKEEPERS, *supra* note ___ at 166 & 168.

[158] The greater the professional resistance to a broad mandate, the more likely it is suited to a carrot-based merit system. 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. Furthermore, to the extent that experience with a carrot-based merit system is favorable, it could be possible to increasingly substitute it for other existing mandatory duties backed by liability imposition.

contract do not carry any such guarantee of performance. This litigation risk can be sufficiently high that the expected liability costs of undertaking these functions exceed the fair market contract price obtainable for undertaking them. Given that the services could be desirable in many cases, a merit system can fulfill the desire. This should be possible by only slight tinkering with the approach currently taken in such contracts as underwriting agreements.

2. Contracts — Before turning to examples of contractual arrangements fit for adapting to facilitate the carrot-based merit system, consider two threshold attributes of the system that will influence its effectiveness. First, the system's strength depends on generating and channeling sufficient funds to designated gatekeepers to make the system cost-effective.[159] Compensation must be sufficient to fund an optimal level of *G*. Generating requisite funding to provide the carrots generally can be obtained through existing channels. Transaction-based gatekeeper information-sharing is a fruitful context for modification. The goal would be to develop a mutually rewarding and systematic process of information-sharing that draws on resources that already exist in the capital formation process. The major difference would concern the form of contracts compared to the existing pattern, especially those prevailing arrangements that generate negative assurance.

Second, all exercises that gatekeepers undertake in the system would be optional. They are services that gatekeepers are not otherwise required by law to perform, either before or after executing any contractual option to undertake to perform them. As such, the system's strength depends, in part, on dissemination of information concerning the system to all capital market participants. True, confidential incentive contracts could result in more effective gatekeeping (through discovery of mis-reporting and correcting it) but the value would be amplified in proportion to how widely-known the practice becomes.[160] Participants obtain the signaling value that adopting the system would carry. So market investors should understand which clients prefer engaging gatekeepers who use the devices and why and which gatekeepers use them and build a reputation for doing so. Enterprises and gatekeepers should understand the extent to which investors value the retention of gatekeepers using merit systems.[161]

Turning to contractual illustrations, consider the examples given in the previous section concerning lawyers' opinion letters and auditors' comfort letters. Both are products of underwriting agreements and reflect that those professionals conducted such

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[159] COFFEE, GATEKEEPERS, *supra* note ___, 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).

[160] *Cf.* Joseph V. Carcello, *et al.*, *Board Characteristics and Audit Fees*, 19 CONTEMP. ACCT. RES. 365 (2002) (empirical showing of positive relationship between auditor fees and various desirable characteristics of boards of directors, especially diligence and expertise).

[161] *Cf.* Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, *supra* note ___, 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).

investigations as they deemed necessary and that nothing came to their attention that prevents providing the certification given. The professionals earn their fee as a result, in accordance with their retention or engagement agreements with issuers.

Under a carrot-driven contract, in contrast, the professionals would agree with issuers, if they elect to do so, 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. 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 those cases in which their discoveries led to denying that access (vetogating).

Developing contracts to implement these arrangements require support from the issuer and underwriter as well as from auditors and lawyers. The latter professionals have every incentive to agree to accept the option. While the exact parameters of the option would be specified in a contract between the issuer and underwriter (the underwriting agreement), auditors and lawyers would necessarily need to negotiate with issuers for specifications to be set forth in their respective retainer and engagement letters. As discussed further below, the main examples of negotiated provisions would be the related compensation and the delineation of what kinds of activities or discoveries generate them and how verification of discovery is made.

Underwriters have incentives to modify existing arrangements too. First, the merit system component need not replace the existing conditions set forth in underwriting agreements that generate negative assurance. Second, underwriters are gatekeepers too and they face the general reputation and liability constraints elaborated in the traditional theoretical gatekeeping model. They can protect reputation and reduce liability risk by increasing the effectiveness of their fellow gatekeepers. Indeed, current evidence indicates that underwriters are seeking to have auditors perform such functions but auditors are unwilling to do so.[162] A carrot-based merit system 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.

Underwriters can thus apply pressure on issuers to move in the merit-system direction. For many issuers, moreover, such a strategy should be attractive. True, those enterprises that are institutionally dedicated to mis-reporting would find the proposal repellant. But the resulting differentiation between issuers in favor of and opposed to the system creates the desired signaling device on which the system's strength depends. For investors, this would separate enterprises according to the relative probability that their reporting is fair compared to misleading.

Furthermore, it is rare for entire enterprises to be institutionally dedicated to mis-reporting. Most commonly, individual agents within an enterprise wish to mis-report. In

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[162] *See supra* note ___.

either case, however, the reforms made in the Sarbanes-Oxley Act create internal governance structures that can be useful to developing the merit system. True, 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 many senior executives would find it attractive too. Board audit committees are a particularly likely source of support (and other board committees could be too, such as a legal compliance committees respecting services to be rendered by lawyers).

The audit committee is particularly promising because it wields considerable power. Indeed, many believe that the most important of the changes in the Sarbanes-Oxley Act is audit committee power over auditors.[163] This empowerment is designed to reduce agency costs that arise from the separation of ownership from control. To the extent that investors would find it desirable for an issuer's lawyers and auditors to provide more assurance to underwriters or others concerning reporting integrity, it would be prudent for audit committees to do the same. Adopting a merit system for gatekeepers is propitious.

Audit committees certainly possess the internal power necessary to generate this kind of change. Indeed, for audit committees who believe that the carrot approach is conceptually appealing in principle, this aspiration can be stated expressly as part of the audit committee's own charter. To the extent that the issuer assumes responsibility to fund any 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. 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. Rather, award funding would be subject to negotiation between the issuer and underwriter. The issuer could agree to pay all of the compensation or the issuer and the underwriter could agree to share designated portions. Funding a portion of the payout will be appealing to the underwriter according to its calculations, under the traditional theory of the gatekeeping model, of reputation and liability costs that result from later-discovered mis-reporting.

Triggers for the awards would likewise be subject to negotiation, with certain threshold levels necessary to earn compensation and certain kinds of error or irregularity specifically included and excluded. The parameters would reflect the difference between activities that the related gatekeeper has or does not have an independent legal duty to discover or correct. In delineating these boundaries in the underwriting agreement, all participants would contribute—not only issuers and underwriters, but also auditors and lawyers.

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[163] COFFEE, GATEKEEPERS, *supra* note ___, at 367; *see also* Erica Beecher-Monas, *Corporate Governance in the Wake of Enron: An Examination of the Audit Committee Solution to Corporate Fraud*, 55 ADMIN. L. REV. 357 (2003).

As noted, resulting incentives should make this system enticing to the professional service firms of auditors and lawyers. Even so, those 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.[164]

The philosophical aspects of the carrot-based merit system could be reflected more broadly within such firms as well. For example, among auditing firms, partner compensation is generally tied to generating revenues from consulting practices, attracting audit work and, since the Sarbanes-Oxley Act was passed, on designing and testing systems of internal control. Since the Public Company Accounting Oversight Board (PCAOB) was created, moreover, it has encouraged auditing firms to allocate resources, and compensation, to functions designed to improve auditors' technical competence.[165] Without diminishing the importance of any of these ways of allocating resources, sufficient flexibility appears that would make an incremental reallocation to carrot-based investigation and certification prudential.

All contracts governing a carrot-based merit system, and their interpretation, require attention to the (ironic) risk that gatekeepers will fabricate mis-reporting to obtain additional compensation. As a theoretical matter, of course, this risk also exists in the current reputation-and-liability model of gatekeeping. For example, 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 a carrot-based merit system. 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 by issuers to gatekeepers, this verification can be performed by audit committees; in the case of gatekeeper firm payments to its own personnel, special verification committees should be established. In general, however, it should be easier to detect *fraud about fraud* than fraud itself.

3. Teams — Beyond the foregoing examples of altering underwriting agreements to expand the probable scope of lawyer and auditor undertakings, a wide range of contexts exist in which a carrot-based merit system could be deployed. These include any context in which one or more teams of lawyers or auditors or other professionals participate in reviewing, preparing or correcting matters that require public disclosure. Traditionally, enterprises retain one law firm and engage one auditing firm in these exercises and often, especially for law firms, they dispatch a single team of experts who

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[164] *See supra* text accompanying notes ___-___.

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

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).

In a carrot-based merit system, these traditional approaches may warrant further adjustment. For example, as Professor Coffee has explored heuristically, it might be possible to imagine an enterprise engaging two separate teams of lawyers for a matter or retaining a single law firm but having that firm dispatch two separate teams of lawyers.[166] This construct is designed to reflect the dual role that lawyers play in such contexts, serving as both advocate and advisor to the enterprise on the one hand while also serving 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 altogether.

First, consider how 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. The novelty that a carrot-based merit system could inject is a willingness of either team 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 many large corporate law firms. Many 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. These structures were famously implemented by the New York law firm of White & Case in its agreement settling charges arising from its role in the notorious National Student Marketing fraud of the 1970s.[167]

Second, among lawyers, there invariably are two teams on cooperative transactions—usually from different law firms. In securities offerings, both underwriters' and issuers' counsel participate in due diligence exercises that are designed to enable preparing fair disclosure in the prospectus for the offering. In the context of business combinations, each side, buyer and seller, retains lawyers to negotiate the governing agreement, along with voluminous disclosure schedules, on the basis of respective due diligence investigations. Likewise, opinions in those transactions often are prepared by both sides' lawyers. While both sides seek to protect their own client's position, they are

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[166] COFFEE, GATEKEEPERS, *supra* note ___, at ___.

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

most effective when generating maximum gains from the transaction—creating value, not just claiming it.[168]

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 can be designated as the closing team whose mission is to accomplish the transaction and the other as the gatekeeper 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). Obviously, addressing the specific professional responsibilities would 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 how complicity risks are higher 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 activate vetogates. Creating incentives to activate vetogates weakens the capacity to conspire.[169] Of course, participants in transactions must be capable of cooperation to a large extent and 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 (b) using fair reporting. Each would have incentives that contribute to promoting that twin result.

Finally, the dual-team approach reflects the insights from Mr. Buffett's and Professor Painter's bilateral professional service retention models.[170] 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 and temptations to overzealousness among the gatekeeping team are constrained by contrary incentives of the closing team.[171] Using teams to facilitate a carrot-based merit system would be particularly powerful when issuers themselves fund the resulting compensation—an innovation that audit committees could pioneer for the sake of investor prosperity.

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[168] *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)).

[169] *See* McGowan, *Why Not Try the Carrot?*, *supra* note 1, at 1833-36.

[170] *See supra* text accompanying notes ___-___.

[171] Other professional 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.

The foregoing examples are not intended to be either complete or exhaustive. Instead, they suggest some ways that gatekeeping teams can be deployed, using merit-based compensation, to promote gatekeeper effectiveness. Together with the more explicit descriptions of contractual examples discussed in the preceding section and the predicate intuitions, they are offered to introduce the possibility of promoting capital market gatekeeper effectiveness using carrot-based merit systems. Before concluding, the following section explores additional possible attributes of such systems.

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-based merit system to supplement the traditional gatekeeping model. A proposal to provide public recognition raises and requires addressing several additional issues warranting analysis. These are cultural challenges to implementing the system, the relation of compensation to professional morality and the potential that the system could create excessive incentives among gatekeepers to activate vetogates.

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.[172] In contemporary culture, media, regulators and scholars concentrate on persons who failed to perform their functions. These persons or firms are lambasted 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. 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. That status, in turn, played a significant role in his subsequent election as Governor of that State. True, private whistleblowers such as Kathy Wilkens of Enron shared in some of the limelight. But that too occurred long after the scandal had incubated, and no similar national "heroes" appeared amid the numerous other scandals of the era. More to the point, no heroes were identified at other enterprises who may have avoided similar fates of fraud because of the effective presence of gatekeepers in their midst.

A more proactive strategy of public recognition could be pursued. Unlike with gatekeeping contracts or team structures used to implement a merit system, public

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[172] *Cf.* Macey, *A Pox*, *supra* note ___, 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).

recognition does not necessarily require cash (or at least not large amounts).[173] A good model of public recognition are the Malcom Baldridge 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.[174] For capital market gatekeeping, the SEC or the PCAOB could adapt this honor to recognize an Auditor of the Year or Lawyer of the Year for successful correction of mis-reporting or vetogating. After all, 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 any such formal mode of public recognition must be drawn carefully, however. This is necessary to appreciate a more general potential obstacle to adding a carrot-based merit system to the gatekeeping function: a traditional cultural aversion to ratting in the United States.[175] This aversion arises from how competing values such as loyalty are implicated. 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.[176]

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

In contrast, lawyers face conflicting values as a result of the traditional advocacy model of that profession and the resulting principles of confidentiality epitomized in the attorney-client privilege. Yet while lawyers have not historically assumed this identity, it

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[173] 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 ___, 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").

[174] *See* National Institute of Standards and Technology, *Baldridge National Quality Program*, http://www.quality.nist.gov/.

[175] *See supra* note ___ and accompanying text.

[176] *See supra* text accompanying notes ___-___.

should be possible, at least for securities lawyers, to adapt to it. For them, a carrot-based merit system can help with the transition.

Either way, however, the public recognition for such activities must be carefully drawn to be in tune with the public's propensity toward aversion to ratting. The "heroes" must be portrayed in much the way that Elliott Spitzer was presented. They must be seen as dedicated, public-minded professionals, perhaps seeking to advance their own careers—as Spitzer certainly did—but only in a way that is consistent with the public interest—likewise, as Spitzer did.[177]

2. Functions — The prevailing lack of public recognition for successful vetogating may also be due, in part, to the historical emphasis on gatekeeping functions as opposed to whistleblower functions. That is, gatekeeper models are designed to act internally within an enterprise and not shine the public spotlight on it. But the concept of a vetogate would alter that practice when an enterprise is denied access to capital markets.

A good example occurred in the 1970s when the auditing firm of Arthur Young blew the whistle on, and withheld support from, the Lockheed Corporation amid the foreign government bribery scandals of that era.[178] Lockheed and its top managers had much to gain from concealing the scheme. But Arthur Young activated a vetogate that temporarily denied 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. And Arthur Young received considerable recognition for its refusal in the contemporary press.[179]

In contrast, today's sensibilities shower less praise on vetogates and instead display a diagnostic tendency to examine pathological cases for lessons about what went wrong and then generalize from these for systemic reform. With that orientation, it is unsurprising that policymakers and scholars incline toward refashioning the duties and

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[177] *See* Kulbir Walha & Edward E. Filusch, *Eliot Spitzer: A Crusader Against Corporate Malfeasance or a Politically Ambitious Spotlight Hound?*, 18 GEO. J. LEGAL ETHICS 1111, 1131 (2005) (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.").

[178] *See* John Braithwaite, *On Speaking Softly and Carrying Big Sticks: Neglected Dimensions of a Republican Separation of Powers*, 47 U. TORONTO L.J. 305 (1997) (discussing how Arthur Young, auditors of Lockheed, "put their responsible corporate self forward by refusing to certify the Lockheed Annual Report" prompting managers to respond, deliberate and reform and, amid the resulting "domino-effect of public-regarding deliberation, Lockheed became 'a born again corporation'") (attributing this latter phrase to DAVID BOULTON, THE GREASE MACHINE 276 (1978) and noting that additional details appear in BRENT FISSE & JOHN BRAITHWAITE, THE IMPACT OF PUBLICITY ON CORPORATE OFFENDERS 144 (1983)).

[179] *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).

liability strategies in search of optimal deterrence. An alternative, less common, approach would examine how and why things go well. True, reputation and liability risks may influence a professional's decision-making, but more fundamental norms drive professional behavior too.[180] 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 (as in a supervisor's pat on the back or handwritten note)[181] to a more compelling public expression of appreciation. A carrot-based merit system would envision that kind of public recognition for vetogating (in addition to the form of cash discussed in the preceding section).

For some readers, this may raise an objection. It may appear that the system is designed to pay gatekeepers extra for doing what they ought to do—whether required by law or by professional or other non-legal commands such as moral principles.[182] As to legal requirements, the proposal preempts this objection to avoid problems of contract law's pre-existing duty rule.[183] That is, the proposal envisions a system that provides compensation or recognition for performing functions not otherwise required by law. As to professional or moral principles, 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 realizing those aspirations.

Perhaps paradoxically, cash and recognition may even be edifying vehicles to reinforce professional or moral principles. Consider how the structural and systemic forces catalogued earlier may have reduced gatekeeper incentives to invest in reputational capital.[184] Among audit firms, for example, the phenomenon of cross-selling (bundling consulting assignments to auditing engagements) changed auditing culture from professionalism to commercialism. Since reversing culture is difficult,[185] tools that work

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

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

[182] *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.").

[183] *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).

[184] COFFEE, GATEKEEPERS, *supra* note ___, at 330; *see supra* text accompanying notes ___-___.

[185] *See supra* text accompanying notes ___-___.

within existing culture are more promising than those alien to it. A carrot-based merit 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 — The rhetorical term vetogate used in this Article is taken from politics, but capital markets differ. The concept of vetogates in capital markets may be medicine too strong. 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.[186] Implicitly, these critics essentially argue that gatekeeping can be too effective. A carrot-based merit system, in this view, is the last thing these markets need. This critique warrants considering how the concept of vetogates works in legislative theory and how it relates to capital market theory.

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.[187] 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.[188] Numerous gatekeepers participate in activating these vetogates, including the President, as well as committee chairs, senior Senators and House members and, especially, lobbyists.[189] The result is that the vast majority of bills do not become law, a deliberate strategy designed

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[186] *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 the optimal combination of rules and principles in corporate regulation).

[187] *See* ESKIRIDGE, FRICKEY & GARRETT, *supra* note ___, at 2-3, 17.

[188] *Id*.

[189] *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 ___, 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").

to minimize the risk of sub-optimal lawmaking as well as to promote confidence that law is supported by consensus.[190]

Compared to the legislative process, the capital formation process is both modestly parallel and 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 achievement of consensus and the effectiveness of laws. For securities transactions, the cultural milieu is nearly exactly the opposite. Participants generally want to facilitate the deal, to enable the financing, to form or transfer capital.

Indeed, many 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.[191] 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.[192]

It is unlikely, moreover, that vetogating in capital markets would or should ever be more common than vetogating in legislative processes. Indeed, under the carrot-based merit system introduced in this Article, 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

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[190] The concept of vetogates has been adapted to other collective decision-making processes, most notably that of the judicial branch in 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).

[191] *See supra* note ___ (Paulson Committee Report and McKinsey Report).

[192] Of course, one more Capitol Hill vetogate in 2002 could have choked the Sarbanes-Oxley bill and thereby reduced capital market vetogating in the years since; as it happened, insufficient vetogates existed and the Sarbanes-Oxley Act passed and the result has been more frequent capital market vetogating.

face gatekeepers whose compensation is not tied to the accuracy of reporting, except through vague reputation constraints and liability risks. Tying gatekeeper compensation to discovering and correcting 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 has 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. Penalties may even be necessary to achieve the optimal level of deterrence. Promoting investment in reputations for integrity likewise produces a valuable contribution to capital market integrity.

Yet underappreciated in practice and theory is the possibility of rewarding gatekeepers for exercising vetogates—for denying access to public capital markets unless reporting corrections are made. This innovation should have considerable purchase when one considers how the reputational constraint and liability threats were insufficient to deter widespread ineffective gatekeeping during the late 1990s and early 2000s. While reformers and scholars are right to focus on how to improve the traditional mechanisms, the additional policy lever of carrots for vetogates at least warrants consideration it has not been given.

After all, the inventory of legal liability constraints on securities professionals is extensive, while no similar set of carrots exists. A carrot-based merit system may be complex and cumbersome and raise hosts of difficult challenges of design, implementation and risks of over- or under-inclusiveness. But while this may be so, a carrot-based merit system is less complex and less cumbersome than the existing legal system of duties and liability that has been in use for many decades.[193] A main difference is that lawyers and legal scholars are familiar with the intricacies of the current duty-and-liability system but must begin their encounters with a carrot-side complement without that cognitive benefit.

[193] *E.g.*, Black, *Preconditions for Strong Securities Markets*, *supra* note ___, at 793 (the existing system can work fairly well but is "scarcely simple").